HSBC HOLDINGS PLC
Form 20-F
February 28, 2014
Table of Contents

As filed with the Securities and Exchange Commission on February 28, 2014.

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

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

For the fiscal year ended December 31, 2013

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: 001-14930

HSBC Holdings plc

(Exact name of Registrant as specified in its charter)

N/A	**United Kingdom**
(Translation of Registrant s name into English)	(Jurisdiction of incorporation or organisation)

8 Canada Square

London E14 5HQ

United Kingdom

(Address of principal executive offices)

Russell C Picot

8 Canada Square

London E14 5HQ

United Kingdom

Tel +44 (0) 20 7991 8888

Fax +44 (0) 20 7992 4880

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

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

Title of each class	Name of each exchange on which registered
Ordinary Shares, nominal value US$0.50 each.	London Stock Exchange Hong Kong Stock Exchange Euronext Paris 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
6.20% Non-Cumulative Dollar Preference Shares, Series A	New York Stock Exchange*
American Depositary Shares evidenced by American Depositary receipts, each representing one-fortieth of a Share of 6.20% Non-Cumulative Dollar Preference Shares, Series A	New York Stock Exchange
5.10% Senior Unsecured Notes Due 2021	New York Stock Exchange
4.00% Senior Unsecured Notes Due 2022	New York Stock Exchange
4.875% Senior Unsecured Notes Due 2022	New York Stock Exchange
7.625% Subordinated Notes due 2032	New York Stock Exchange
7.35% Subordinated Notes due 2032	New York Stock Exchange
6.5% Subordinated Notes 2036	New York Stock Exchange

6.5% Subordinated Notes 2037	New York Stock Exchange
6.8% Subordinated Notes Due 2038	New York Stock Exchange
6.100% Senior Unsecured Notes due 2042	New York Stock Exchange
8.125% Perpetual Subordinated Capital Securities Exchangeable at the Issuer s Option into Non-Cumulative Dollar Preference Shares	New York Stock Exchange
8.00% Perpetual Subordinated Capital Securities Exchangeable at the Issuer s Option into Non-Cumulative Dollar Preference Shares, Series 2	New York Stock Exchange

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

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

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

Ordinary Shares, nominal value US$0.50 each 18,830,007,039

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

þ 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 þ 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.

þ Yes ¨ No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

¨ 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 þ	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 þ	Other ¨

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

¨ Item 17 ¨ Item 18

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

¨ Yes þ No

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

Table of Contents

HSBC HOLDINGS PLC

Annual Report and Accounts 2013

Certain defined terms

Unless the context requires otherwise, HSBC Holdings means HSBC Holdings plc and HSBC , the Group , we , us and our refer to HSBC Holdings together with its subsidiaries. Within this document the Hong Kong Special Administrative Region of the People s Republic of China is referred to as Hong Kong . When used in the terms shareholders equity and total shareholders equity , shareholders means holders of HSBC Holdings ordinary shares and those preference shares classified as equity. The abbreviations US$m and US$bn represent millions and billions (thousands of millions) of US dollars, respectively.

Financial statements

The consolidated financial statements of HSBC and the separate financial statements of HSBC Holdings have been prepared in accordance with International Financial Reporting Standards (IFRSs) as issued by the International Accounting Standards Board (IASB) and as endorsed by the European Union (EU). EU-endorsed IFRSs could differ from IFRSs as issued by the IASB if, at any point in time, new or amended IFRSs were not to be endorsed by the EU. At 31 December 2013, there were no unendorsed standards effective for the year ended 31 December 2013 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 2013 are prepared in accordance with IFRSs as issued by the IASB.

We use the US dollar as our presentation currency because the US dollar and currencies linked to it form the major currency bloc in which we transact and fund our business. Unless otherwise stated, the information presented in this document has been prepared in accordance with IFRSs.

When reference to underlying is made in tables or commentaries, the comparative information has been expressed at constant currency (see page 47), the impact of fair value movements in respect of credit spread changes on HSBC s own debt has been eliminated and the effects of acquisitions, disposals and dilutions have been adjusted as reconciled on page 50. Underlying return on risk-weighted assets (RoRWA) is defined and reconciled on page 71.

Contents

1 *Detailed contents are provided on the referenced pages.*

Table of Contents

HSBC HOLDINGS PLC

Strategic Report

Who we are

HSBC is one of the largest banking and financial services organisations in the world.

Customers:

54 million

Served by:

254,000 employees

Through four global businesses:

Retail Banking and Wealth Management

Commercial Banking

Global Banking and Markets

Global Private Banking

Located in:

75 countries and territories

Across six geographical regions:

Europe

Hong Kong

Rest of Asia-Pacific

Middle East and North Africa

North America

Latin America

Offices:

Over 6,300

Global headquarters:

London

Market capitalisation:

US$207 billion

Listed on stock exchanges in:

London

Hong Kong

New York

Paris

Bermuda

Shareholders:

216,000 in 131 countries and territories

Cover images: internationalisation of the renminbi

The images show the views from HSBC s head offices in Shanghai, Hong Kong and London the three cities that are key to the development of China s currency, the renminbi (RMB). The growth of the RMB is set to be a defining theme of the 21st century. HSBC has RMB capabilities in over 50 countries and territories worldwide, where our customers can count on an expert service.

Our purpose

Our purpose is to be where the growth is, connecting customers to opportunities, enabling businesses to thrive and economies to prosper, and ultimately helping people to fulfil their hopes and realise their ambitions.

Our strategic priorities

We aim to be the world s leading and most respected international bank. We will achieve this by focusing on the needs of our customers and the societies we serve, thereby delivering long-term sustainable value to all our stakeholders.

For 2011 to 2013, we defined strategic actions across three areas: capital deployment, organisation and cost efficiency, and growth. In May 2013, we announced a set of three interconnected and equally weighted priorities for 2014 to 2016 to help us deliver our strategy:

- grow the business and dividends;

- implement Global Standards; and

streamline processes and procedures.

These priorities form the basis for this *Strategic Report*. Each priority is interrelated, complementary and underpinned by initiatives within our day-to-day business. Together they create value for our customers and shareholders, and contribute to the long-term sustainability of HSBC.

A diagrammatic representation of the priorities and their related themes is provided on page 12.

How we measure performance

We track our progress in implementing our strategy with a range of financial and non-financial measures or key performance indicators. Specific targets have been set for the period 2014 to 2016 at both a Group level and for each of our global businesses and regions.

Rewarding performance

The remuneration of all staff within the Group, including executive Directors, is based on the achievement of financial and non-financial objectives. These objectives, which are aligned with the Group s strategy, are detailed in individuals annual scorecards. To be considered for a variable pay award, an individual must have fully complied with HSBC Values.

For further information on HSBC Values, see page 25.

Table of Contents

HSBC HOLDINGS PLC

Strategic Report (continued)

Highlights of 2013

- Profit before tax was up 9% to US$22.6bn on a reported basis. Underlying profit before tax was up 41% to US$21.6bn.
- Considerable progress in delivering on strategic priorities including the disposal or closure of a further 20 businesses and non-core investments announced in 2013, helping make HSBC easier to manage and control.
- Reinforced HSBC s position as one of the best-capitalised banks in the world. Based on our current understanding of capital rules, we remain well-placed to meet expected future capital requirements.
- Dividends to shareholders increased to US$9.2bn as capital strength creates capacity for organic growth and allows us to increase the dividends paid.

For a description of the difference between reported and underlying performance, see page 16.

For footnotes, see page 46.

Table of Contents

HSBC HOLDINGS PLC

Strategic Report (continued)

Cautionary statement regarding forward-looking statements

The *Annual Report and Accounts 2013* contains certain forward-looking statements with respect to HSBC s financial condition, results of operations, capital position and business.

Statements that are not historical facts, including statements about HSBC s beliefs and expectations, are forward-looking statements. Words such as expects , anticipates , intends , plans , believes , seeks , estimates , potential and reasonably possible , variations of these words and 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. HSBC makes no commitment to revise or update any forward-looking statements to reflect events or circumstances occurring or existing after the date of any forward-looking statements.

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

Forward-looking statements involve inherent risks and uncertainties. Readers are cautioned that a number of factors could cause actual results to differ, in some instances materially, from those anticipated or implied in any forward-looking statement. These include, but are not limited to:

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

- changes in government policy and regulation, including the monetary, interest rate and other policies of central banks and other regulatory authorities; initiatives to change the size, scope of activities and interconnectedness of financial institutions in connection with the implementation of stricter regulation of financial institutions in key markets worldwide; revised capital and liquidity benchmarks which could serve to deleverage bank balance sheets and lower returns available from the current business model and portfolio mix; imposition of levies or taxes designed to change business mix and risk appetite; the practices, pricing or responsibilities of financial institutions serving their consumer markets; expropriation, nationalisation, confiscation of assets and changes in legislation relating to foreign ownership; changes in bankruptcy legislation in the principal markets in which we operate and the consequences thereof; general changes in government policy that may significantly influence investor decisions; extraordinary government actions as a result of current market turmoil; other unfavourable political or diplomatic developments producing social instability or legal uncertainty which in turn may affect demand for our products and services; the costs, effects and outcomes of product regulatory reviews, actions or litigation, including any additional compliance requirements; and the effects of competition in the markets where we operate including increased competition from non-bank financial services companies, including securities firms; and factors specific to HSBC, including discretionary RWA growth and our success in adequately identifying the risks we face, such as the incidence of loan losses or delinquency, and managing those risks (through account management, hedging and other techniques). Effective risk management depends on, among other things, our ability through stress testing and other techniques to prepare for events that cannot be captured by the statistical models it uses; and our success in addressing operational, legal and regulatory, and litigation challenges, notably compliance with the DPA.

Strategic Report (continued)

Group Chairman s Statement

Against the welcome backdrop of generally improving economic conditions, we significantly progressed the reshaping of HSBC during 2013. The focus of these efforts was two-fold; alongside concentrating on capturing the high quality opportunities from and within our increasingly distinctive international network and diversified business model we strove to improve risk management and control through eliminating or restructuring businesses with higher inherent risk characteristics. The combination of our commitment to implementing Global Standards, addressing regulatory changes and managing increased capital discipline has driven a fundamental review of all aspects of our business. I have no doubt that a stronger HSBC is emerging from this process. The Group Chief Executive s Review gives greater detail of the progress made on this journey and draws out the key elements of HSBC s performance in 2013.

If there is one thing to highlight from all the work being done, it is the recognition of the benefits to our customers of the connectivity we can deliver across geographies and through our universal banking model. As we reshape HSBC we shall not lose sight of the importance of these network benefits or of the fact that this network has taken close to 150 years to build.

Nowhere is this more evident than in our businesses facilitating cross-border investment and trade activities. Our geographic presence, which straddles both the key developed Western economies and the most important markets in Asia, Latin America and the Middle East, adds both comparative advantage and resilience to our competitive positioning.

China finished the year with record trade figures, thereby becoming the largest trading nation in the world, and it is fitting that the cover of this year s Annual Report features the three cities where HSBC s trade credentials were established in 1865 and which are now playing key roles in the internationalisation of the renminbi, namely Shanghai, Hong Kong and London.

Performance in 2013

HSBC s performance in 2013 was reassuringly sound across our main business areas with good underlying momentum in areas of targeted investment.

Pre-tax profit on a reported basis was US$22.6 billion, 9% or US$1.9 billion higher than that reported in 2012. On an underlying basis, profit before tax was 41% (US$6.3 billion) ahead of last year, driven primarily by welcome reductions in loan impairment charges as well as in fines and penalties and customer redress costs.

These improvements flow in large part from the re-positioning of the Group and from enhanced risk controls given effect over the last three years.

Earnings per share of US$0.84 compared with US$0.74 in 2012. Shareholders equity stood at US$181.9 billion, some US$6.6 billion higher than at the start of the year. The Group s market capitalisation rose over the year by US$13 billion and at US$207 billion exceeded shareholders equity by US$25 billion or 14%.

Continuing strong capital generation from operating results, together with the favourable effect of the ongoing run-off of exit portfolios and non-core disposals, lifted our core tier 1 ratio to 13.6% compared with 12.3% at the start of the year.

Taking account of our strong capital position and earnings performance, the Board has approved a fourth interim dividend in respect of 2013 of US$0.19 per share, as against US$0.18 per share in 2012. The Board intends to maintain the first three quarterly interim dividends in respect of 2014 at US$0.10 per share. Total dividends in respect of 2013 of US$0.49 per share were 9% or US$0.04 higher than in 2012, amounting to US$9.2 billion in aggregate, an increase in pay-out of US$0.9 billion.

Once again in 2013, the British Government increased the rate of the bank levy imposed on the consolidated balance sheets of UK domiciled banks and expanded the scope of the levy. This increased the cost to HSBC in 2013 by US$321 million, taking the levy for the year to US$904 million, of which US$484 million related to non-UK banking activity. The impact of the levy represented US$0.05 per share

Strategic Report (continued)

which would otherwise have been available for distribution to shareholders or retained to strengthen the capital base or support incremental growth.

Global Standards and regulatory change

In the current public policy debates about how best to restore and expand economic growth, two themes critical to our industry stand out. First, how to prevent another financial crisis and what tools are needed to minimise the cost to society should one occur. Second, how to achieve a better balance between economic activity and a more equitable distribution of the economic growth that is generated in the future.

We are clear that through building the further resilience mandated by global regulatory changes and by implementing and adhering to global standards in all aspects of compliance, we can address both sets of objectives and build a more sustainable future for HSBC. Much has been done but there is much still to do.

The Group Chief Executive s Review highlights the priority we give to this agenda. It remains the key focus of the Board s governance of executive performance. In executing these responsibilities, the Board is also acutely aware of its commitments under the Deferred Prosecution Agreement and associated regulatory undertakings entered into in December 2012. As reported at our interim results, Michael Cherkasky, the Monitor appointed to evaluate and report upon the effectiveness of the Group s AML and sanctions compliance function and HSBC s progress in meeting its remedial obligations, commenced his work in July last year. The Board, both directly and through its Financial System Vulnerabilities Committee, has established a good working relationship with the Monitor in order to support him and his team in the execution of their assignment.

Responding to heightened standards

Sustainable success in banking is founded upon meeting the expectations of society. Fundamentally, this means delivering transparent and fair outcomes to our customers. It also means avoiding any perception of self-interest by ensuring there is a proper division of value between providers and consumers of financial products and services. While regulatory changes seek to address the framework supporting these outcomes, responsibility and accountability rest with the industry itself, and ultimately with the management and boards of individual institutions. We understand this and strive to be seen as proactively responsive to rising expectations. We made good progress in 2013 in this regard. In particular, we redesigned the compensation frameworks in Retail

Banking and Wealth Management around the customer, so that from the start of 2014 we have removed the link between financial reward opportunity and product sales for substantially all of our staff in our retail and wealth businesses. We have also stepped up the Board s governance oversight over conduct and behavioural issues, and I deal with this later.

Board changes

It is critical to all we do that we have the breadth and depth of experience on the Board necessary to provide effective governance and challenge. As we refresh the Board to take account of planned retirements, we seek to add skills and experience complementary to those already on the Board in order to strengthen the range of oversight competences within the Board. Through the Nomination Committee we look up to two years ahead to identify a pipeline of suitable candidates and I am hugely encouraged by the quality of individuals we are able to identify and attract.

We shall be saying goodbye to two long-serving Directors later this year. Both John Coombe and James Hughes-Hallett have given outstanding service and commitment over their nine years on the Board and its Committees. They will not seek re-election at the AGM in May.

In his time on the Board, in addition to his measured contributions to Board discussions, John has brought a wealth of business and financial experience and expertise to the Group Audit Committee, which latterly he chaired, and to the Group Risk and Remuneration Committees. In these roles he has taken on a considerable workload and critical responsibilities throughout periods of significant economic and market uncertainty and major regulatory change. Upon his retirement it is proposed that John will be succeeded in his role as Chair of the Group Audit Committee by Renato Fassbind.

With his deep experience of managing a broad range of international businesses, notably in the Far East, James has brought a businessman s perspective to the Board as well as detailed knowledge of both Hong Kong and mainland China. James has served with distinction on the Group Audit, Risk, Corporate Sustainability and Nomination Committees.

On behalf of the Board and shareholders, I want to take this opportunity to acknowledge their contribution to HSBC and record our appreciation and gratitude for their long and distinguished periods of service.

On 21 February we announced the appointment of a new Director to the Board.

Strategic Report (continued)

Kathleen Casey, a former Commissioner of the US Securities and Exchange Commission (SEC), will join the Board as an independent non-executive Director with effect from 1 March 2014. She will become a member of the Group Audit Committee and the Financial System Vulnerabilities Committee.

Kathleen served as an SEC Commissioner from 2006 to 2011, acting as the regulator s principal representative in multilateral and bilateral regulatory dialogues including with the G-20 Financial Stability Board and the International Organisation of Securities Commissions. Before being appointed Commissioner, Kathleen spent 13 years on Capitol Hill, holding various positions including Staff Director and Counsel of the United States Senate Committee on Banking, Housing and Urban Affairs (2003-2006).

Kathleen brings to the Board a wealth of experience of financial services regulation gained though public service at a key time in the regulatory evolution of the sector. Her skills will complement well the diverse background and experience of the Board.

Governance changes

Recognising the benefits to be had from reinforcing the links between our major subsidiary boards and HSBC Holdings, the Board invited Rona Fairhead to extend her term of service on the Board and take on the Chairmanship of HSBC North America Holdings Inc. The Board was delighted when she accepted this invitation, taking on her new role with effect from the start of this year.

Finally, the Board considered in depth the conclusions and recommendations of the Parliamentary Commission on Banking Standards on conduct and behaviour in banks and concluded that the Board should expand and enhance its oversight of these areas. Accordingly, the Board has established a new Committee, the Conduct and Values Committee, into which will be folded much of what was done historically in the Group Corporate Sustainability Committee. I am delighted to report that Rachel Lomax has agreed to chair this new committee. Further details of its terms of reference and membership are set out on page 362.

Looking forward

As well as addressing the regulatory and governance challenges we face, it is essential to keep a sense of perspective and be able to focus on the significant opportunities arising from successful execution of our strategy. Let me outline four by way of illustration.

First, trade. HSBC was founded on financing trade and investment flows. By 2050 trade and capital flows between Asia, the Middle East and Latin America, in which we are well represented, could increase tenfold. The internationalisation of the renminbi, where HSBC is already the leading international bank, will amplify these opportunities.

Second, the world s population is ageing, necessitating considerably greater privately funded retirement saving. HSBC s research shows that globally some 48% of people have never saved for retirement and that 56% admit they are not preparing adequately.

Third, as the world s population expands there is an urgent need to fund the technology and infrastructure investment that will deliver the energy, water and food needed to support the extra two billion people predicted to be living by 2050.

Fourth, we need to invest to bring to our customers the benefits available through smarter digital technology and richer data.

The above represent only some of the foreseeable changes to which banking needs to respond in order to enable our customers better to meet their financial needs and aspirations.

The opportunities are clear; HSBC s commitment to be a trusted partner in the delivery of these opportunities lies at the heart of our strategy. Our ability to succeed lies in the strength and range of our networks and our universal banking model. The rest of this *Strategic Report* covers the detail of that strategy.

Finally, what we have achieved in 2013 and what we plan to do rests upon the dedication and commitment of our employees, the continuing support of our customers, counterparties and shareholders, the trust of our regulators and public confidence more generally. On behalf of the Board, I want to take this opportunity to thank our staff for all their efforts and their continuing loyalty to HSBC, and to commit to those we serve and those who regulate us that we are focused on continuing to earn their trust and deserve their confidence in HSBC.

D J Flint, *Group Chairman*

24 February 2014

Strategic Report (continued)

Group Chief Executive s Review

2013 marked the end of the first stage of implementation of our strategy for HSBC. Throughout this three-year period we have worked constantly to reshape HSBC and improve returns. The Group today is leaner and simpler than in 2011 with strong potential for growth.

In 2011, I outlined a strategy to realise our purpose as a business and to establish HSBC as the world s leading international bank. It aims to capitalise on two major trends: the continuing growth of international trade and capital flows; and wealth creation, particularly in Asia, the Middle East and Latin America. Over the last three years we have put this into action, pursuing more effective capital deployment, greater organisational efficiency and improved growth.

We have simplified HSBC considerably since 2011, initiating the disposal or closure of 63 non -strategic businesses or non-core investments, including 20 in 2013. This represents a potential reduction in risk-weighted assets of around US$95bn, equivalent to about 9% of 2010 year-end risk-weighted assets. To date, about US$90bn in risk-weighted assets have been released with, potentially, some US$5bn still to come.

We have transformed the way that we run the business, exerting pressure on costs and making it easier to manage and control. We have installed consistent business models, reshaped global businesses and global functions, and removed layers of management to give staff greater responsibility, improve decision making and remove bureaucracy. The number of full-time equivalent employees has been reduced from 295,000 at the start of 2011 to

254,000 at the end of 2013, primarily through disposals and our cost-reduction programmes. We achieved an additional US$1.5bn of sustainable cost savings bringing our total annualised sustainable cost savings to US$4.9bn since 2011. This comfortably exceeded our target of US$2.5-3.5bn and provides good momentum into 2014. On a constant currency basis and excluding UK customer redress and restructuring costs, operating expenses in 2013 were broadly flat compared to 2010. This demonstrates the impact of our sustainable cost savings and business disposals in broadly offsetting cost increases, which came primarily from inflationary pressures, the UK bank levy and investment in risk and compliance, as well as business initiatives.

We have positioned HSBC to capture international trade and capital flows, 90% of which go through markets covered by our international network. We have also sought to capitalise on the advantages that our unique network provides.

We have focused on our product capabilities to broaden client coverage, grown revenue through greater collaboration between global businesses and strengthened them through investment and senior hires in strategic markets such as Hong Kong, mainland China and Germany. We have also combined our market-leading position in Asia and our global reach to cement our position as the number one international bank for renminbi (RMB) business in the world, as recognised by the 2013 *Asiamoney* Offshore RMB Services Survey. Our leadership in the Greater Chinese market continues to be reflected in our first place rankings in the *dim sum* bond issuance and Hong Kong M&A league tables for 2013, and the announcement that we are the first custodian bank to service London-based renminbi qualified foreign institutional investors.

Our presence in markets across all of the major global trade routes has enabled us to support clients with international growth ambitions. In 2013 alone, we launched funds in Canada, Egypt, France, Mexico, Turkey, the UAE, the UK and the US offering financing to help our internationally focused SME clients. We have continued to build our international network through investments in city clusters, notably in the US, mainland China and Germany. Our clients are also benefiting from the global network of China desks that we established to assist companies trading with and from mainland China.

We also helped many of our customers achieve their personal ambitions. For instance, in the UK we lent £3.8bn (US$6.0bn) to help more than 30,000 first-time buyers purchase their own home in 2013.

Table of Contents

HSBC HOLDINGS PLC

Strategic Report (continued)

We also provided greater convenience for our retail customers by rolling out new mobile applications across 25 key markets, with 2.5 million downloads in 2013.

Through actions like these we have already replaced approximately a third of the reduction in total revenue from disposals by growing our business since the start of 2011.

Although much progress has been made since 2011, we did not meet all of our targets by the end of 2013. Our reported cost efficiency ratio of 59.6% and return on equity of 9.2% in 2013 were both outside our target ranges, in part affected by continuing UK customer redress. In addition, there is further work required to grow our incremental wealth revenues to achieve our target of US$3bn in the medium term.

Performance

Our performance in 2013 was influenced by the strategic measures that we have taken since the start of 2011.

Reported profit before tax was US$22.6bn, US$1.9bn higher than 2012, and underlying profit before tax was US$21.6bn, US$6.3bn higher than last year. Underlying revenue grew 9% faster than costs in 2013.

Underlying profit before tax was higher in three out of our four global businesses and all of our regions, with the exception of Latin America where underlying profit before tax fell. Whilst our performance in Latin America was affected by slower economic growth and inflationary pressures, we made significant progress in repositioning our portfolios with a focus on our priority markets of Brazil, Mexico and Argentina.

In Commercial Banking, underlying profit before tax increased by 5%, driven by higher revenues and lower costs. Higher revenue reflected average balance sheet growth, partly offset by spread compression, together with higher lending fees and improved collaboration with our other global businesses. These factors were partially offset by higher loan impairment charges, notably in Latin America.

In Global Banking and Markets, underlying profit before tax increased by 15%. This was driven by higher revenue and significantly lower loan impairment charges and other credit risk provisions. The increase in revenue was, in part, underpinned by a resilient performance in the majority of our customer-facing businesses.

In Retail Banking & Wealth Management underlying profit before tax increased by US$2.4bn as we made further progress in running-off the Consumer Mortgage and Lending (CML) portfolio in North America, with the improvement in loan impairment charges more than offsetting the decline in revenue. Our Retail Banking & Wealth Management business excluding the US run-off portfolio benefited from lower UK customer redress charges and further sustainable cost savings, together with revenue growth, mainly in Hong Kong and Europe excluding the loss on sale of the HFC Bank secured lending portfolio.

We continued to address legacy issues and reposition our business model and client base in Global Private Banking, which in part resulted in a reduction in underlying profit before tax of US$0.7bn.

Our capital position strengthened over the year. Our core tier 1 ratio increased to 13.6% and our estimated CRD IV end point basis common equity tier 1 ratio increased to 10.9%. We remain well placed to meet expected future capital requirements, and will continue to review the evolution of the regulatory environment.

We continued to demonstrate our ability to generate capital to grow our business and to support our progressive dividend policy, cementing our status as one of the highest dividend payers in the FTSE.

Strategy next phase

2014 marks the beginning of the next phase of strategy implementation. This will be a continuation of the work that we began in 2011, albeit with new goals informed by our experience of the past three years.

At our investor update in May we reaffirmed our return on equity target at 12-15% and modified our cost-efficiency target for 2014-16 to mid-50s. We also announced three strategic priorities for 2014-16, each of equal importance.

First, our strategy is designed to further grow the business and dividends. We will continue to recycle risk-weighted assets from lower return to higher return parts of the Group. Our capital strategy aims to increase dividends progressively. If we are unable to deploy the remaining capital ourselves in such a way that it provides incremental value for our shareholders, we may seek to neutralise the effect of scrip dividends through share buy-backs, subject to regulatory capital requirements and shareholder approval. We shall also continue to wind down and

Strategic Report (continued)

thus reduce the impact of our portfolio of legacy businesses.

Second, we will continue to implement our Global Standards programme which we believe will increase the quality of the Group s earnings. Global Standards governs all of our activity and will drive consistently high standards through HSBC globally. We have made substantial investment in risk and compliance capabilities across all businesses and regions to strengthen our response to the ongoing threat of financial crime, and will continue to do so. This is the right thing to do, in line with our values, and we believe that it will also become a source of competitive advantage.

Third, we aim to deliver a further US$2-3bn of sustainable savings by streamlining our processes and procedures without in any way compromising our commitment to compliance and Global Standards. There remains considerable scope within the business to globalise and simplify many of our operations and practices.

These priorities are essential to realising our vision of establishing HSBC as the world s leading international bank.

Outlook

We remain of the view that the GDP of mainland China will grow by 7.4% this year, the UK by 2.6%, the USA by 2.5% and Western Europe by 1.2%.

Although there has been a sharp sell-off in some emerging markets, both when tapering was first talked of last June and more recently in January of this year, we see this as a reflection of specific circumstances rather than a generalised threat. The countries most affected have two common themes, large current account deficits and the uncertain outcomes arising from elections within a year. Other emerging markets such as Mexico have, by contrast, been upgraded by the rating agencies in the same period. Overall, we remain optimistic about the longer-term prospects of emerging markets and especially the opportunities for HSBC, which will arise from the anticipated material expansion in South-South trade and capital flows. In the short term, we stress the importance of differentiating within and between individual countries within the generic category of emerging markets. Nevertheless, we anticipate greater volatility in 2014 and choppy markets as adjustments are made to changing economic circumstances and sentiment.

S T Gulliver, *Group Chief Executive*

24 February 2014

Strategic Report (continued)

Value creation and long-term sustainability

Through our principal activities making payments, holding savings, providing finance and managing risks we play a central role in society and in the economic system. Our target is to build and maintain a business which is sustainable in the long term.

In May 2013, we reinforced our vision for the long-term direction of HSBC first outlined in 2011, together with a clear strategy that will help us achieve it. It guides where and how we seek to compete. We constantly assess our progress against this strategy and provide regular updates to stakeholders.

How we create value

Banks, and the individuals within them, play a crucial role in the economic and social system, creating value for many parties in different ways. We provide a facility for customers to securely and conveniently deposit their savings. We allow funds to flow from savers and investors to borrowers, either directly or through the capital markets. The borrowers then use these loans or other forms of credit to buy goods or invest in businesses. By these means, we help the economy to convert savings which may be individually short-term into financing which is, in aggregate, longer term. We bring together investors and people looking for investment funding and we develop new financial products. We also facilitate personal and commercial transactions by acting as payment agent both within countries and internationally. Through these activities, we take on risks which we then manage and reflect in our prices.

Our direct lending includes residential and commercial mortgages and overdrafts, and term loan facilities. We finance importers and exporters engaged in international trade and provide advances to companies secured on amounts owed to them by their customers.

We also offer additional financial products and services including broking, asset management, financial advisory, life insurance, corporate finance, securities services and alternative investments. We make markets in financial assets so that investors have confidence in efficient pricing and the availability of buyers and sellers. We provide these products for clients ranging from governments to large and mid-market corporates, small and medium-sized enterprises, high net worth individuals and retail customers. We help customers raise financing from external investors in debt and equity capital markets. We create liquidity and price transparency in these securities allowing investors to buy and sell them on the secondary market. We exchange national currencies, helping international trade.

Value creation

Our main products and services are described in more detail on page 79.

Our operating income is primarily derived from:

- *net interest income* interest income we earn on customer loans and advances and on our surplus funds, less interest expense we pay on interest-bearing customer accounts and debt securities in issue;
- *net fee income* fee income we earn from the provision of financial services and products to customers less fees we pay; and
- *net trading income* income from client driven trading activities primarily conducted in Markets, including Foreign Exchange, Credit, Rates and Equities trading.

Strategic Report (continued)

We offer products that help a wide range of customers to manage their risks and exposures through, for example, life insurance and pension products for retail customers and receivables finance or documentary trade instruments for companies. Corporate customers also ask us to help with managing the financial risks arising in their businesses by employing our expertise and market access.

An important way of managing risks arising from changes in asset and liability values and movements in rates is provided by derivative products such as forwards, futures, swaps and options. In this connection, we are an active market-maker and derivative counterparty. Customers use derivatives to manage their risks, for example, by:

- using forward foreign currency contracts to hedge their income from export sales or costs of imported materials;
- using an inflation swap to hedge future inflation-linked liabilities, for example, for pension payments;
- transforming variable payments of debt interest into fixed rate payments, or vice versa; or
- providing investors with hedges against movements in markets or particular stocks.

We charge customers a margin, representing the difference between the price charged to the customer and the theoretical cost of executing an offsetting hedge in the market. We retain that margin, which represents a profit to the Group, at maturity of the transaction if the risk management of the position has been effective.

We then use derivatives along with other financial instruments to constrain the risks arising from customer business within risk limits. Normally, we will have customers both buying and selling relevant instruments so our focus is then on managing any residual risks through transactions with other dealers or professional counterparties. Where we do not fully hedge the residual risks we may gain or lose money as market movements affect the net value of the portfolio.

Stress tests and other risk management techniques are also used to ensure that potential losses remain within our risk appetite under a wide range of potential market scenarios.

In addition, we manage risks within HSBC, including those which arise from the business we do with customers.

For further information on our risk measures, see page 38, and on how we manage our own risks, see page 39.

Long-term sustainability

At HSBC, we understand that the success of our business is closely connected to the economic, environmental and social landscape in which we operate. For us, long-term corporate sustainability means achieving a sustainable return on equity and profit growth so that we can continue to reward shareholders and employees, build long-lasting relationships with customers and suppliers, pay taxes and duties in the countries in which we operate, and invest in communities for future growth. The way we do business is as important as what we do: our responsibilities to our customers, employees and shareholders as well as to the countries and communities in which we operate go far beyond simply being profitable.

Continuing financial success depends, in part, on our ability to identify and address environmental, social and ethical developments which present risks or opportunities for the business. It also depends on the consistent implementation of the highest standards everywhere we operate to detect, deter and protect against financial crime. Our response to these factors shapes our reputation, drives employee engagement and affects the riskiness of the business, and can help reduce costs and secure new revenue streams.

Our international spread and the long-established position of many of our businesses in HSBC s home and priority growth markets, when combined with our wide-ranging portfolio of products and services, differentiate HSBC from our competitors and give our business and operating models an inherent resilience. This has enabled the Group to remain profitable and grow through the most turbulent of times for our industry, and we are confident that the models will continue to stand us in good stead in the future and will underpin the achievement of our strategic priorities.

Our business and operating models are described in more detail on page 13. For further information on our response to environmental and community issues, see page 34.

Table of Contents

HSBC HOLDINGS PLC

Strategic Report (continued)

Our strategy

Long-term trends

Our strategy is aligned to two long-term trends:

- The world economy is becoming ever more connected, with growth in world trade and cross-border capital flows continuing to outstrip growth in average gross domestic product. Over the next decade we expect 35 markets to generate 90% of world trade growth with a similar degree of concentration in cross-border capital flows.
- Of the world s top 30 economies, we expect those of Asia-Pacific, Latin America, the Middle East and Africa to have increased by around four-fold in size by 2050, benefiting from demographics and urbanisation. By this time they will be larger than those of Europe and North America combined. By 2050, we expect 18 of the 30 largest economies will be from Asia-Pacific, Latin America or the Middle East and Africa.

Competitive advantages

What matters in this environment are:

- having an international network and global product capabilities to capture international trade and movements in capital; and
- being able to take advantage of organic investment opportunities in the most attractive growth markets and maintaining the capacity to invest.

HSBC s competitive advantages come from:

- our meaningful presence in and long-term commitment to our key strategic markets;
- our strong ability to add to our capital base while also providing competitive rewards to our staff and good returns to our shareholders;
- our stable funding base, with about US$1.5 trillion of customer accounts of which 73% has been advanced to customers;
- our business network, which covers over 90% of global trade and capital flows; and

our local balance sheet strength and trading capabilities in the most relevant financial hubs.

A two-part strategy

Based on these long-term trends and our competitive advantages, we have developed a two-part strategy:

A network of businesses connecting the world. HSBC is well positioned to capture growing international trade and capital flows. Our global reach and range of services place us in a strong position to serve clients as they grow from small enterprises into large multi-nationals through our Commercial Banking and Global Banking & Markets businesses.

Wealth management and retail with local scale. We will capture opportunities arising from social mobility and wealth creation in our priority growth markets across Asia-Pacific, Latin America and the Middle East, through our Premier proposition and Global Private Banking business. We will invest in full scale retail businesses only in markets where we can achieve profitable scale, namely in our home markets of the United Kingdom and Hong Kong.

Table of Contents

HSBC HOLDINGS PLC

Strategic Report (continued)

Our strategic priorities

Our strategic priorities are designed to ensure we have a sustainable business for the long term.

Grow

Profit underpins long-term business sustainability and growing our profit is an integral part of our strategy. The conditions for creating value and generating profits are reflected in our business and operating models, which determine how our global businesses, geographical regions and functions interact. Delivering organic growth will support a progressive dividend.

Implement

A global bank needs global standards consistent operating principles that are fundamental to the way we do business and which help us to detect, deter and protect against financial crime. Implementing Global Standards affects how we govern the Group, the nature of our core business and the performance, recognition and behaviours of all our people in managing high quality customer relationships. It starts with embedding our HSBC Values in everything we do.

Streamline

This initiative is critical to the long-term sustainability of our business. Society s expectations of the financial services industry are evolving and becoming more demanding. At the same time, the digital revolution is reducing barriers to new entrants to the industry and markets are becoming increasingly competitive. In this environment, it is essential that we focus relentlessly on improving efficiency, ensuring that all parts of the Group streamline their processes and procedures and, as a consequence, reduce their costs. In doing so, we must remain cognisant of our wider obligations to the community, including human rights, and the environment.

Strategic Report (continued)

Strategic priority 1

Grow the business and dividends

Our success in meeting our targets is described on page 20.

Our targets are to:

1. grow risk-weighted assets (RWA s) in line with our organic investment criteria;

2. progressively grow dividends and introduce share buy-backs as appropriate; and

3. reduce the effect of legacy and non-strategic activities on our profit before tax and RWAs.

Business model

Our business model is based on an international network connecting and serving a cohesive portfolio of markets.

Our comprehensive range of banking and related financial services is provided by operating subsidiaries and associates. Services are primarily delivered by domestic banks, typically with local deposit bases.

The UK and Hong Kong are our home markets, and a further 20 countries form our priority growth markets (see table below). These 22 markets accounted for over 90% of our profit before tax in 2013, and are the primary focus of capital deployment. Network markets are markets with strong international relevance which serve to complement our international spread, operating mainly through Commercial Banking and Global Banking and Markets. Our combination of home, priority growth and network markets covers around 85-90% of all international trade and financial flows.

The final category, small markets, includes those where our operations are of sufficient scale to operate profitably, or markets where we maintain representative offices.

Our legal entities are regulated by their local regulators and on a Group-wide basis we are regulated from the UK by the Prudential Regulation Authority (PRA) for prudential matters (safety and soundness) and by the Financial Conduct Authority (FCA) for conduct (consumer and market protection).

HSBC s market

Strategic Report (continued)

Operating model

Our operating model is based on a matrix management structure comprising global businesses, geographical regions and global functions.

The matrix is overlaid on a legal entity structure headed by HSBC Holdings plc.

Holding company

HSBC Holdings, the holding company of the Group, is the primary source of equity capital for its subsidiaries and provides non-equity capital to them when necessary.

Under authority delegated by the Board of HSBC Holdings, the Group Management Board (GMB) is responsible for the management and day-to-day running of the Group, within the risk

appetite set by the Board. GMB works to ensure that there are sufficient cash resources to pay dividends to shareholders, interest to bondholders, expenses and taxes.

HSBC Holdings does not provide core funding to any banking subsidiary, nor is a lender of last resort and does not carry out any banking business in its own right. Subsidiaries operate as separately capitalised entities implementing the Group strategy.

Matrix management structure

The following table lists our four global businesses, six geographical regions and 11 global functions, and summarises their responsibilities under HSBC s matrix structure.

For details of our principal subsidiaries see Note 24 on the Financial Statements. A simplified Group structure chart is provided on page 570.

Matrix management structure

Table of Contents

HSBC HOLDINGS PLC

Strategic Report (continued)

Global businesses

Our four global businesses are Retail Banking and Wealth Management (RBWM), Commercial Banking (CMB), Global Banking and Markets (GB&M) and Global Private Banking (GPB). They are responsible for developing, implementing and managing their business propositions consistently across the Group, focusing on profitability and efficiency. They set their strategies

within the parameters of the Group strategy in liaison with the geographical regions, are responsible for issuing planning guidance regarding their businesses, are accountable for their profit and loss performance, and manage their headcount.

The main business activities of our global business are summarised below, and their products and services on page 79.

Main business activities by global business and reported revenue[5] in 2013

For footnotes, see page 46.

Investment criteria

Our investment criteria are governed by six filters. The first two filters international connectivity and economic development determine whether the business is strategically relevant. The next three filters profitability, efficiency and liquidity determine whether the financial position of the business is attractive. The sixth filter the risk of financial crime governs our activities in high risk jurisdictions, and is applied to protect us by restricting the scope of our business where appropriate.

Decisions over where to invest additional resources have three components:

Strategic we will only invest in businesses aligned to our strategy, mostly in our 22 home and priority growth markets and in target businesses and clients;

Financial the investment must be value accretive for the Group, and must meet minimum returns, revenue and cost hurdles; and
Risk the investment must be consistent with our risk appetite.

Using the six filters in decision-making

Table of Contents

HSBC HOLDINGS PLC

Strategic Report (continued)

Financial performance

Performance reflected underlying momentum in areas of targeted investment

Reported results

	2013 US$m	2012 US$m	2011 US$m
Net interest income	**35,539**	37,672	40,662
Net fee income	**16,434**	16,430	17,160
Other income	**12,672**	14,228	14,458
Net operating income[5]	**64,645**	68,330	72,280
LICs[12]	**(5,849)**	(8,311)	(12,127)
Net operating income	**58,796**	60,019	60,153
Total operating expenses	**(38,556)**	(42,927)	(41,545)
Operating profit	**20,240**	17,092	18,608
Income from associates[13]	**2,325**	3,557	3,264
Profit before tax	**22,565**	20,649	21,872

For footnotes, see page 46.

Reported profit before tax of US$22.6bn in 2013 was US$1.9bn or 9% higher than in 2012. This was primarily due to lower adverse fair value movements of US$4.0bn on own debt designated at fair value resulting from changes in credit spreads and decreases in both loan impairment charges and other credit risk provisions (LICs) of US$2.5bn and operating expenses of US$4.4bn. These factors were partially offset by lower gains (net of losses) from disposals and reclassifications of US$2.2bn, compared with US$7.8bn in 2012. Gains on disposals in 2013 included the gain of US$1.1bn on sale of our operations in Panama and US$1.1bn from the reclassification of Industrial Bank Co. Limited (Industrial Bank) as a financial investment following its issue of share capital to third parties.

The Board approved a 6% increase in the final dividend in respect of 2013 to US$0.19 per share, US$0.01 higher than the final dividend in respect of 2012. Total dividends in respect of 2013 were US$9.2bn (US$0.49 per share), US$0.9bn higher than in 2012. The core tier 1 capital ratio strengthened from 12.3% to 13.6%, and the estimated CRD IV end point basis common equity tier 1 ratio also improved from 9.5% to 10.9%. This was driven by a combination of capital generation and a reduction in risk-weighted assets from management actions. Uncertainty remains, however, around the precise amount of capital that banks will be required to hold under CRD IV as key technical standards and consultations from regulatory authorities are pending. These include the levels, timing and interaction of CRD IV capital buffers and a review of the Pillar 2 framework.

Underlying performance

For further information on non-GAAP financial measures, see page 47.

From reported results to underlying performance

To arrive at underlying performance,

- we adjust for the year-on-year effects of foreign currency translation;
- we eliminate the fair value movements on our long-term debt attributable to credit spread (own credit spread) where the net result of such movements will be zero upon maturity of the debt; and
- we adjust for acquisitions, disposals and changes of ownership levels of subsidiaries, associates and businesses, by eliminating the gain or loss on disposal in the year incurred and removing the operating profit or loss of the acquired and disposed of businesses from all years presented.

Reconciliations of our reported results to an underlying basis are provided in the Form 20-F filed with the Securities and Exchange Commission which is available on www.hsbc.com.

Underlying profit before tax

(US$bn)

Profit attributable to ordinary shareholders (US$m)

Earnings per share

(US$)

Strategic Report (continued)

On an underlying basis, profit before tax rose by 41% to US$21.6bn, primarily from higher net operating income before loan impairment charges and other credit risk provisions (revenue), lower LICs, notably in North America, Europe and Middle East and North Africa, and lower operating expenses, mainly from the non-recurrence of a charge in 2012 arising from US investigations and reduced charges relating to UK customer redress.

Underlying profit before tax in our global businesses rose with the exception of GPB which decreased by US$0.7bn to US$0.2bn as we continued to address legacy issues and reposition the customer base.

The following commentary is on an underlying basis.

Revenue across the Group was stable, underpinned by a resilient performance in GB&M and growth in CMB

Underlying revenue rose by US$1.7bn or 3% to US$63.3bn. This reflected a number of factors including net favourable fair value movements on non-qualifying hedges of US$0.8bn, a net gain recognised on completion of the disposal of our investment in Ping An of US$0.6bn offsetting the adverse fair value movements on the contingent forward sale contract recorded in 2012, and foreign exchange gains on sterling debt issued by HSBC Holdings of US$0.4bn.

Revenue increased in CMB following average balance sheet growth partly offset by spread compression together with higher lending fees and improved collaboration with other global businesses. In GB&M, revenue was higher, in part reflecting a resilient performance in a majority of our customer-facing businesses. These factors were partially offset by lower revenue in RBWM, primarily from the run-off of our US CML portfolio and, in GPB, from the loss on write-off of goodwill relating to our Monaco business and the repositioning of our client base.

LICs fell in the majority of our regions, notably in North America, Europe and in the Middle East and North Africa

Underlying LICs were US$1.9bn or 25% lower than in 2012, primarily in North America where the decline was, in part, due to improvements in housing market conditions, reduced lending balances from continued portfolio run-off and loan sales, and lower levels of new impaired loans and delinquency in the CML portfolio. LICs were also lower in

Europe, mainly in GB&M and CMB, and in the Middle East and North Africa, which benefited from an overall improvement in the loan portfolio. By contrast, LICs were higher in Latin America, particularly in Mexico from specific impairments in CMB relating to homebuilders due to a change in the public housing policy and higher collective impairments in RBWM. In Brazil, although credit quality improved following the modification of credit strategies in previous periods to mitigate rising delinquency rates, LICs increased, reflecting impairment model changes and assumption revisions for restructured loan account portfolios in RBWM and CMB, and higher specific impairments in CMB.

Operating expenses were lower, primarily driven by the non-recurrence of certain notable items in 2012 and further sustainable cost savings

Underlying operating expenses were US$2.6bn or 6% less than in 2012, primarily due to the non-recurrence of a 2012 charge following US anti-money laundering (AML), Bank Secrecy Act (BSA) and Office of Foreign Asset Control (OFAC) investigations, lower UK customer redress charges and reduced restructuring and related costs.

Excluding these items, operating expenses were higher, mainly due to a rise in the UK bank levy, increased litigation-related expenses, notably a provision in respect of regulatory investigations in GPB, a Madoff-related charge in GB&M and investment in strategic initiatives, risk management and compliance. Higher operational costs also contributed, in part driven by general inflationary pressures and rental costs. These factors were partially offset by sustainable cost savings in the year and an accounting gain relating to changes in delivering ill-health benefits to certain employees in the UK.

The additional US$1.5bn of sustainable cost savings across all regions, took our total annualised cost savings to US$4.9bn since 2011 as we continued with our organisational effectiveness programmes during 2013. Together with business disposals, these led to a fall in the number of full-time equivalent staff of more than 6,500 to 254,000.

Income from associates rose, mainly driven by strong results in mainland China

Underlying income from associates increased, primarily from Bank of Communications Co., Limited (BoCom), where balance sheet growth and increased fee income were partially offset by higher operating expenses and a rise in LICs.

Strategic Report (continued)

The effective tax rate was 21.1% compared with 25.7% in 2012

The effective tax rate was lower than in 2012, reflecting non-taxable gains on profits associated with the reclassification of Industrial Bank as a financial investment and the disposal of our operations in Panama and our investment in Ping An Insurance (Group) Company of China, Ltd (Ping An). In addition, the 2012 tax expense included the non-tax deductible effect of fines and penalties paid as part of the settlement of the US AML, BSA and OFAC investigations.

For more details of the Group s financial performance, see page 51.

Balance sheet strength

Total reported assets were US$2.7 trillion, 1% lower than at 31 December 2012 on both a reported and a constant currency basis. Our balance sheet remained strong with a ratio of customer advances to customer accounts of 72.9%. This is a consequence of our business model and of our conservative risk appetite, which is predominantly to fund the growth in commercial assets with growth in customer accounts.

Loans and advances grew by US$87.0bn and Customer accounts increased by US$148.6bn on a constant currency basis. These included a US$52.8bn increase in reverse repo agreements and a rise of US$92.3bn in repo agreements, reflecting the change in the way GB&M manages these activities (see page 68). Excluding these, loans and advances to customers grew by more than US$34.0bn in 2013, notably in term and trade-related lending to corporate and commercial customers in Hong Kong and Rest of Asia-Pacific as demand for financing continued and, to a lesser extent, commercial real estate and other property-related lending grew. Mortgage lending rose in Rest of Asia-Pacific, Hong Kong and also in the UK. This was broadly offset by the strategic reduction in the US run-off portfolio. Customer accounts increased by over US$56.0bn in 2013, driven by growth mainly in Europe, Hong Kong and Rest of Asia-Pacific reflecting customer sentiment.

For further information on the Balance Sheet, see page 65, and on the Group s liquidity and funding, see page 213.

Total assets

(US$bn)

Post-tax return on average total assets

(%)

Loans and advances to

customers[14] *(US$bn)*

Customer accounts[14]

(US$bn)

Ratio of customer advances to customer

deposits (%)

For footnote, see page 46.

Strategic Report (continued)

Capital strength

Our approach to managing Group capital is designed to ensure that we exceed current regulatory requirements, and are well placed to meet those expected in the future.

We monitor capital adequacy, inter alia, by use of capital ratios which measure capital relative to a regulatory assessment of risks taken and by the leverage ratio which measures capital relative to exposure.

In June 2013, the European Commission published the final Regulation and Directive, known collectively as CRD IV, to give effect to the Basel III framework in the EU. This came into effect on 1 January 2014.

Under the new regime, common equity tier 1 (CET1) represents the highest form of eligible regulatory capital against which the capital strength of banks is measured. In 2013 we managed our capital position to meet an internal target ratio of 9.5-10.5% on a CET1 end point basis, changing to greater than 10% from 1 January 2014. We continue to keep this under review.

Leverage ratio

The following table presents our estimated leverage ratio in accordance with PRA instructions. The numerator is calculated using the CRD IV end point tier 1 capital definition and the exposure measure is calculated using the December 2010 Basel III text.

Estimated leverage ratio

	At 31 December	
	2013	2012
	US$bn	US$bn
Tier 1 capital under CRD IV (end point)	**133**	116
Exposures after regulatory adjustments	**3,028**	2,760
Estimated leverage ratio (end point)	**4.4%**	4.2%

For further details of the leverage ratio, see page 312.

The above calculation excludes those tier 1 capital instruments which will be ineligible for inclusion in regulatory capital after the Basel III transitional period has fully elapsed. If we were to calculate the leverage ratio by adding back those instruments, the effect would be to increase estimated end point tier 1 capital by US$16bn and the leverage ratio by some 50 basis points at 31 December 2013.

For further information on the Group s capital and our risk-weighted assets, see page 298.

Core tier 1 ratio[1]

Total capital ratio

Common equity tier 1 ratio[15]

(%)	*(%)*	*(%)*

For footnotes, see page 46.

Strategic Report (continued)

Meeting our targets

Grow risk-weighted assets in line with our organic investment criteria

In 2013, the reduction in RWAs was mainly a result of the reclassification of Industrial Bank from an associate to a financial investment and the run-off of the US CML portfolio. We will continue to recycle RWAs from low to high performing opportunities within the Group s risk appetite in line with our organic investment criteria. Organic investment decisions are made by GMB under authority delegated by the Board.

On the basis of current assumptions regarding the regulatory and the business operating environment, discretionary RWA growth remains targeted towards Rest of Asia-Pacific, Hong Kong, Latin America and Middle East and North Africa. Discretionary RWA growth excludes the effect of legacy and run-off portfolios, transactions, associates and major regulatory changes.

Return on risk-weighted assets (RoRWA), as measured by pre-tax return on average risk-weighted assets, is one of the main operational measures by which we assess business performance and organic investment opportunities. RoRWA targets are set to ensure that business decisions remain aligned with our medium-to-longer term financial performance objectives.

Progressively grow dividends and introduce share buy-backs as appropriate

We remain one of the best-capitalised banks in the world, providing capacity for both organic growth and dividend return to shareholders. Over the past two years we have increased our dividend per ordinary share by 20%.

Although significant regulatory uncertainty remains, we continue to demonstrate our ability to generate capital and support a progressive dividend policy based on our three key strategic priorities of growing the business and dividends, implementing Global Standards and streamlining processes and procedures.

Our policy on share buy-backs will be strongly influenced by the emerging requirements for capital by regulators. In order to give ourselves the full range of options, we will seek to table a resolution at our 2014 Annual General Meeting for shareholders to enable share buybacks at a future date.

Uncertainty remains around the amount of capital that banks will be required to hold as key technical standards and consultations from regulatory authorities are pending. These include the levels, timing and interaction of CRD IV capital buffers and a review of the Pillar 2 framework. As more information becomes available, this will inform our capital target, planning and dividend policy.

Reduce the effect of legacy and non-strategic activities on our profit before tax and RWAs

We continue to make good progress reshaping our business, announcing 20 transactions disposing of or closing non-strategic businesses in 2013, bringing the total number since the start of 2011 to 63. These transactions have released around US$90bn in risk weighted-assets to date, with a further potential release of around US$5bn to come.

In 2013, in addition to the reclassification of Industrial Bank, we completed the sale of our Panama operations and, in the US CML portfolio, the sale of the non-real estate loan portfolio together with several tranches of real estate loans. We expect the ongoing recovery of the US housing market and increased investor appetite may provide further opportunities to accelerate the run-off of our CML portfolio in 2014, following significant RWA reductions in 2013.

Risk-weighted assets (US$bn) *Return on risk-weighted assets (%)* *Dividend payout ratio (%)*

Table of Contents

HSBC HOLDINGS PLC

Strategic Report (continued)

We continue to actively manage down legacy RWA positions in GB&M. In 2013, increased disposals and amortisations contributed to the reduction in legacy RWA positions in GB&M.

Run-off portfolios contribution to RWAs (US$bn)

Run-off portfolios consist of legacy credit in GB&M and the US CML and other portfolios.

Brand value

Maintenance of the HSBC brand and our overall reputation remains a priority for the Group.

We continue to use the Brand Finance valuation method as reported in *The Banker* magazine as our core metric. This is our third year of using this benchmark. The Brand Finance methodology provides a comprehensive measure of the strength of the brand and its impact across all business lines and customer segments. It is wholly independent and is publicly reported. Our target is a top three position in the banking peer group and we have achieved this target with an overall value of US$26.9bn (up 18% from 2013), placing us second. We are the only company to be given an AAA rating for our brand in this year s report.

Brand value (US$bn)

In addition to the Brand Finance measure, we have reviewed our performance in two other rating agency evaluations that receive substantial public

coverage. In the Brand Z Most Valuable Global Brand tables published in the *Financial Times* in May 2013, we achieved first place in the International Banks peer grouping with a valuation of US$24bn (up 24% from 2012). The *Interbrand* Annual Best Global Brands report, published in September 2013, showed HSBC as the top ranked banking brand with a valuation of US$12bn (up 7% from 2012) and in second place when all financial services brands are considered.

We believe this performance is driven by an underlying strong brand equity established in recent years and a consistent and active programme of activities in support of the brand throughout 2013.

Economic contribution

By running a sustainable business, HSBC is able to make a valuable contribution to the economy by paying dividends to our shareholders; salaries to our employees; payments to suppliers; and tax revenues to governments in the countries and territories where we operate. We also finance companies so that they, in turn, can create employment.

HSBC has adopted the UK Code of Practice for the Taxation of Banks and seeks to apply the spirit as well as the letter of the law in all the territories in which we operate. In January 2013, the Global Standards Steering Meeting of the GMB agreed terms of a new Global Standard on tax transparency to ensure that HSBC s banking services are not associated with any arrangements that are known or suspected to be designed to facilitate tax evasion by a customer.

This supplements anti-money laundering and know your customer (KYC) checks and is supported by an educational programme to train employees on how to identify possible tax evasion by customers and the procedures for reporting and escalating such situations.

HSBC s net tax paid

	2013	2012
	US$bn	US$bn
Tax on profits	**4.7**	5.6
Employer taxes	**1.6**	1.6
UK bank levy[16]	**0.7**	0.5
Irrecoverable value-added tax	**0.8**	0.8
Other duties and levies	**0.8**	0.8
	8.6	9.3

For footnote, see page 46.

Table of Contents

HSBC HOLDINGS PLC

Strategic Report (continued)

Distribution of economic benefits

	2013 US$bn	2012 US$bn	2011 US$bn
Net cash tax outflow	**8.6**	9.3	8.0
Distributions to shareholders and non-controlling interests	**10.2**	8.7	8.3
Employee compensation and benefits	**19.2**	20.5	21.2
General administrative expenses including premises and procurement	**17.1**	20.0	17.5

Pro-forma post-tax profit allocation[17]

	2013 %	2012 %
Retained earnings/capital	**53**	60
Dividends	**35**	29
Variable pay	**12**	11
	100	100

For footnote, see page 46.

Market capitalisation and total shareholder return

US$0.50 ordinary shares in issue	**Market capitalisation**	Closing market price: London	Closing market price: Hong Kong	Closing market price: American Depositary Share[18]
18,830m	US$207bn	£6.62	HK$84.15	US$55.13
		2012: £6.47	2012: HK$81.30	
2012: 18,476m	2012: US$194bn	2011: £4.91	2011: HK$59.00	2012: US$53.07

2011: 17,868m	2011: US$136bn	2011: US$38.10

	Total shareholder return[19]		
	Over 1 year	Over 3 years	Over 5 years
To 31 December 2013	107	118	144
Benchmarks:			
FTSE 100[20]	119	128	183
MSCI World[20]	127	141	207
MSCI Banks[20]	125	132	186

For footnotes, see page 46.

Strategic Report (continued)

Strategic priority 2

Implement Global Standards

Our target is to make significant progress in implementing Global Standards for the benefit of HSBC and the financial system as a whole.

Our Values, good governance and commitment to operating sustainably guide the way we manage our business and help us create value for our stakeholders.

We have committed to develop Global Standards shaped by the highest or most effective standards of financial crime compliance available in any jurisdiction where HSBC operates and to deploy them globally on a consistent basis.

By definition, the impact of Global Standards is organisation-wide, and the principal means by which we drive consistently high standards is through universal application of our HSBC Values, strong systems of governance and the behaviours, performance and recognition of all our people in managing high quality customer relationships.

In line with our ambition to be recognised as the world s leading international bank, we aspire to set the industry standard for knowing our customers and detecting, deterring and protecting against financial crime. As international markets become more interconnected and complex and as threats to the global financial system grow, we are strengthening further the policies and practices which govern how we do business and with whom.

We greatly value our reputation. Our success over the years is due in no small part to our reputation for trustworthiness and integrity. In areas where we have fallen short in recent years in the application of our standards and in our ability to identify and so prevent misuse and abuse of the financial system through our networks we have moved immediately to strengthen our governance processes and have committed to adopt and enforce the highest or most effective financial crime compliance standards across HSBC.

We continue to reinforce the status and significance of compliance and adherence to our Global Standards by building strong internal controls, developing world class capabilities through communication, training and assurance programmes to make sure employees understand and can meet their responsibilities, and redesigning core elements of how we assess and reward senior executives.

We see the implementation of Global Standards as a source of competitive advantage. Global Standards allow us to:

- strengthen our response to the ongoing threat of financial crime;
- make consistent   and therefore simplify   the ways by which we monitor and enforce high standards at HSBC;
- strengthen policies and processes that govern how we do business and with whom; and
- ensure that we consistently apply our HSBC Values.

Implementing Global Standards

We expect our Global Standards programme to underpin our business practices in the future. Initially, we are concentrating on transforming how we detect, deter and protect against financial crime. We are implementing a more consistent, comprehensive approach to assessing financial crime risk in order to help protect our customers, our employees and the financial system as a whole.

Governance framework

The Global Standards Execution Committee provides execution control based on direction and priorities set by the Global Standards Steering Meeting (a meeting of the GMB), details of which may be found in the Directors   Report on page 354. The Financial System Vulnerabilities Committee and the Board receive regular reports on the Global Standards programme.

Under this governance structure, a sequenced approach to global implementation was designed, tested and deployed during 2013 following detailed planning, to closely identify and manage execution risk, ensure that our Global Standards are delivered in a globally consistent and coherent way, and embed sustained ways of working.

The process of embedding Global Standards and the supporting controls and capabilities that allow the business to identify and mitigate financial crime

Strategic Report (continued)

risk is underway and will continue in 2014 and beyond. The implementation programme is focused on the following four areas:

data readiness: creating a complete, cleansed data set to improve our understanding of the customer base and facilitate our financial crime risk assessment. This will provide the basis for transaction monitoring and assist capacity planning to improve the quality and efficiency of our KYC activities.

customer due diligence: strengthening the rigour with which we research and evaluate our customers and affiliates to better understand them and their activities; improving KYC profiling through enhanced due diligence, customer identification, screening and financial crime risk scoring; tightening our controls around tax transparency and bearer shares and putting a global customer selection and exit policy in place.

financial crime compliance: building HSBC s Financial Crime Compliance organisation with the right people and capabilities to support the business; developing global policies for anti-money laundering (AML), sanctions and anti-bribery and corruption and enhancing the monitoring, screening and testing that will allow us to manage financial crime risk more effectively; and designing a new, annual HSBC-wide risk assessment to better understand the financial crime risk we carry in the business and determine the best approach to managing it.

financial intelligence: establishing a new global network of Financial Intelligence Units that use cutting edge technology to identify and investigate significant cases, trends and strategic issues related to financial crime risks.

Changes in day-to-day activities

Risk appetite

Our global Financial Crime Risk Appetite statement was approved by the Board in October 2013 on the recommendation of the Risk Management Meeting of the GMB, the Group Risk Committee and the Financial System Vulnerabilities Committee. It was incorporated into the Risk Management Meeting s process monitoring from November 2013. The statement sets the Global Standard for financial crime compliance across HSBC, and is expected to evolve and be refined over time.

Enterprise-wide risk assessment

We completed enterprise-wide assessments of our

risks relating to sanctions and AML compliance. The outcome of these assessments is the basis for risk management planning, prioritisation and resource allocation for 2014. In the future, we shall conduct such assessments annually.

Incentives

We adapted our remuneration strategy to balance short-term and sustainable performance. It rewards commercial success and compliance with our risk management framework.

Organisation

We continued to significantly reinforce our second line of defence (described on page 39) through an increase in Regulatory and Financial Crime Compliance headcount of more than 1,750 in 2013 (up by more than 50% since December 2012).

We are raising awareness and capabilities among our employees through a comprehensive global campaign to Ask the Right Questions .

The Monitor

Under the agreements entered into with the US Department of Justice (DoJ), the UK Financial Conduct Authority (the FCA , formerly the FSA) and the US Federal Reserve Board (FRB) in 2012, including the five-year Deferred Prosecution Agreement (US DPA), it was agreed that an independent compliance monitor (the Monitor) would be appointed to evaluate our progress in fully implementing our obligations and produce regular assessments of the effectiveness of our Compliance function.

Michael Cherkasky began his work as the Monitor on 22 July 2013, charged with evaluating and reporting upon the effectiveness of the Group s internal controls, policies and procedures as they relate to ongoing compliance with applicable AML, sanctions, terrorist financing and proliferation financing obligations, over a five-year period.

The Monitor s work is proceeding as anticipated, consistent with the timelines and requirements set forth in the relevant agreements.

HSBC is taking concerted action to remediate AML and sanctions compliance deficiencies and to implement Global Standards. We recognise we are only at the start of a long journey, being one year into our US DPA. We look forward to maintaining a strong, collaborative relationship with the Monitor and his team.

Table of Contents

HSBC HOLDINGS PLC

Strategic Report (continued)

HSBC Values

Embedding HSBC Values in every decision and every interaction with customers and with each other is a top priority for the Group and is shaping the way we do business.

The role of HSBC Values in daily operating practice is fundamental to our culture, and is particularly important in the light of developments in regulatory policy, investor confidence and society s expectations of banks. HSBC Values are integral to the selection, assessment, recognition, remuneration and training of our employees. We expect our executives and employees to act with courageous integrity in the execution of their duties in the following ways:

HSBC Values

Be dependable and do the right thing

stand firm for what is right, deliver on commitments, be resilient and trustworthy;

take personal accountability, be decisive, use judgement and common sense, empower others.

Be open to different ideas and cultures

communicate openly, honestly and transparently, value challenge, learn from mistakes;

listen, treat people fairly, be inclusive, value different perspectives.

Be connected with our customers, communities, regulators and each other

build connections, be externally focused, collaborate across boundaries;

care about individuals and their progress, show respect, be supportive and responsive.

For further details on the role of HSBC Values in the employee proposition, see page 27.

Business principles

HSBC Values describe how we should interact with each other, with customers, regulators and the wider community. Our business principles set the standard by which we derive our strategy and make commercial decisions. Together our values and business principles form our character and define who we are as an organisation and what makes us distinctive. They describe the enduring nature of how we do business. We aim to bring these values and business principles to life through our day-to-day actions.

The emphasis we place on adhering to high behavioural standards and doing the right thing has led us to establish a new Board committee, the Conduct & Values Committee, which will oversee design and application of HSBC s policies, procedures and standards to ensure that we conduct

business responsibly and consistently adhere to HSBC Values.

Business principles

Financial strength maintain capital strength and liquidity

Risk-management be enterprising and commercial, understand and be accountable for the impact of our actions, take prudent decisions

Speed be fast and responsive, make principles-led decisions

Performance-focus drive leading, competitive levels of performance, act with urgency and intensity, prioritise, simplify

Efficiency focus on cost discipline and process efficiency

Quality pursue excellence

Customer-focus provide outstanding customer experience

Integrated align the Group and break down silos

Sustainability take a long-term outlook, understand impact of actions on stakeholders, brand and reputation

Governance

The Board is committed to establishing and maintaining the highest standards of corporate governance wherever we operate. This is key to the Group s ability to capitalise on the opportunities arising from successful implementation of our strategic priorities.

We believe that a robust and transparent corporate governance framework is vital to the sustainable success of HSBC. Strengthening our corporate governance framework to support the successful implementation of our Global Standards programme is a continuing focus of the Board s agenda.

Role of the Board and Committees

The strategy and risk appetite for HSBC is set by the Board, which delegates the day-to-day running of the business to the GMB. Risk Management Meetings and Global Standards Steering Meetings of the GMB are held in addition to regular GMB meetings.

GMB executive committees

The key roles of the non-executive committees established by the Board are described in the chart below.

Strategic Report (continued)

The committee structure and governance framework of the HSBC Holdings Board

For footnotes, see page 46.

The terms of reference of the principal non-executive Board committees are available at www.hsbc.com/ boardcommittees.

For further details on Group corporate governance, see page 329.

Strategic Report (continued)

Employees

Successfully enhancing a values-led high performance culture in HSBC is critical to implementing Global Standards sustainably. We continue to focus on embedding HSBC Values in every decision and interaction between colleagues and with customers.

We aim to attract, retain and motivate the very best people, and our remuneration policy supports this endeavour.

We actively manage succession planning by defining the capabilities we need and complementing this by identifying talented individuals and ensuring they are provided with appropriate career and development opportunities to fulfil their potential in HSBC.

We provide training and development opportunities to enable employees to acquire the technical and leadership skills needed to enhance their careers.

We are committed to a diverse and inclusive culture reflective of our customer base.

We encourage employees to engage in the local communities in which they work.

At the end of 2013 we had a total workforce of 263,000 full-time and part-time employees compared with 270,000 at the end of 2012 and 298,000 at the end of 2011. Our main centres of employment were as follows (approximate numbers):

Profile of leadership

The executive management of HSBC consists of four Executive Directors, 13 Group Managing Directors, and 51 Group General Managers. This leadership team is based in ten different countries and comprises 14 nationalities. 70% have served with HSBC for more than ten years and the total average tenure is 19 years.

HSBC has 13 non-executive directors. Of the 17 Directors, four (23.5%) are female.

Employment proposition

HSBC Values

In 2013, education on HSBC Values continued for all levels of employees, through induction and training programmes that covered relevant technical, management and leadership skills. We require a high behavioural standard from all our employees, and our focus on values and courageous integrity is being instilled at every level of the Group. For example, the values of being open, connected and dependable are an important first part of every appraisal for employees, including the most senior managers. In 2013, nearly 135,000 employees received values training, in addition to the 103,000 employees in 2012. A number of employees left the Group for breaching our values.

Employee development

The development of employees is essential if our businesses and operations are to strengthen and prosper. We take a systematic approach to identifying, developing and deploying talented employees to ensure we have a robust supply of high calibre individuals with the values, skills and experience for current and future senior management positions.

We keep our approach to training current and under constant review in order to improve the quality of our curricula and ensure employees are equipped with the technical and leadership skills to operate in a global organisation. We are standardising our training to help employees provide a high quality and consistent experience for customers in all our markets.

Employee engagement

Strong employee engagement leads to positive commercial outcomes and underpins improved business performance, increased customer satisfaction, higher productivity, talent retention and reduced absenteeism.

We assess our employees engagement through our Global People Surveys, which were held annually from 2007 to 2011 and bi-annually thereafter. The latest Survey, in 2013, focused on supporting a values-led high performance culture by assessing if our employees were engaged in the Group s purpose and felt able to deliver on our ambition to become the world s leading international bank.

The overall engagement score in 2013 was 68%, which was four points ahead of the financial services industry norm and eight points behind the best-in-

Table of Contents

HSBC HOLDINGS PLC

Strategic Report (continued)

class benchmark. Strong scores were registered in risk awareness (81% and nine points above best-in-class), leadership capability (67%) and living the HSBC Values (77%). Employee development significantly improved from six points below best-in-class in 2011 to three points above in 2013. Aspects that require attention included pride and advocacy, which were 12 and 13 points, respectively, below best-in-class norms and had fallen from 2011 levels.

Succession planning

Our talent strategy aims to ensure that high-quality candidates are available to fill key positions and meet business needs across all areas of the Group. We closely align succession planning with talent management, individual development and career planning. The succession plan defines the number, distribution and types of roles and capabilities needed by HSBC, and talented individuals are then aligned to these roles. This approach in turn defines the individual s career path and development plan. In 2013, we assessed about 24,000 senior employees with the potential to become leaders and determined their career development needs. Potential successors must demonstrate an understanding of our Global Standards and exemplify HSBC Values.

Our talent strategy supports our aspirations in the emerging markets, where in 2013 we maintained 2012 s proportion of those defined as talent at 39%. 25% of CEOs in emerging markets were local nationals. We closely monitor local nationals identified as short-term and medium-term successors to key leadership roles and have established base lines by which we intend to improve the proportion of local nationals over the medium term.

Diversity and inclusion

HSBC is committed to a diverse and inclusive culture where employees can be confident their views are encouraged, their concerns are attended to and they work in an environment where bias, discrimination and harassment on any matter, including gender, age, ethnicity, religion, sexuality and disability, are not tolerated and where advancement is based on meritocracy. Our diversity helps us respond to our increasingly diverse customer base, and to develop and retain a secure supply of skilled, committed employees.

Oversight of our diversity and inclusion agenda resides with executives on the Group Diversity Committee, complemented by a number

of Group People/Diversity Committees. We have over 55 employee network groups representing gender, ethnicity, age, sexuality, disability, religion, culture, working parents, health and community volunteering. These groups are instrumental in driving an inclusive culture and maintaining effective dialogue between management and employees.

Gender balance

An area of continued focus is gender representation, particularly at senior levels of our organisation. We are addressing bias in hiring, promotions and talent identification, expanding mentoring and sponsorship, introducing better support for returning parents, and increasing flexible working opportunities.

The gender balance for HSBC Directors and employees at 31 December 2013 was as follows:

Gender balance

	Male	Female	Total

Executive Directors	**3**		**3**
Non-executive Directors	**9**	**4**	**13**
Directors	**12**	**4**	**16**
Senior employees	**6,339**	**1,867**	**8,206**
Other employees	**118,981**	**135,714**	**254,695**
Total	**125,331**	**137,585**	**262,916**

	Male %	**Female** %	**Total** %
Executive Directors	**100.0**		**100**
Non-executive Directors	**69.2**	**30.8**	**100**
Directors	**75.0**	**25.0**	**100**
Senior employees	**77.3**	**22.7**	**100**
Other employees	**46.7**	**53.3**	**100**
Total	**47.7**	**52.3**	**100**

Overall, global female representation was 52.3% at 31 December 2013, having been as high as 53.3% in 2009. Female representation at senior levels rose from 21.4% in 2010 to 22.7% in 2013, and our target is to improve this to 25% by 2014/15. The proportion of females in our talent pipeline improved from 25.8% in 2010 to 32.2% in 2013 and female representation on the GMB increased significantly from 10% (one out of 10) to 19% (three out of 16) in December 2013.

The average age of our employees is 36 years and average tenure is 8.9 years.

Strategic Report (continued)

Unconscious bias

It is recognised that social behaviour may be driven by stereotypes that operate automatically and therefore unconsciously. These stereotypes can lead to a less inclusive environment. We are addressing this through unconscious bias training which was delivered through e-learning to 8,300 managers and nearly 50,000 employees in 2013 (21,000 managers and 8,000 employees in 2012).

In 2014, our diversity and inclusion priorities will include continuing to address unconscious bias through targeted education, encouraging the career development of diverse talent with an emphasis on gender and local nationals, enhancing a bias-free approach to performance management and improving internal and external candidate lists, connecting and leveraging our Employee Resource Network Groups, and maintaining a consistent framework for governance and sponsorship.

Health, welfare and safety

We regard the physical and psychological health, welfare and safety of our people as being of the utmost importance. We recently introduced a global occupational health framework which requires the proactive management of employee welfare and encourages the sharing of best practice across the Group. Between August 2012 and the end of 2013, 94% of assigned HSBC employees carried out our bi-annual online health and safety training.

We run a number of employee assistance programmes tailored to local requirements. Skilled professional counsellors are available on free phone lines 24 hours a day and seven days a week to help employees manage personal or work-related problems that create stress and affect their work. Free face-to-face counselling is also provided, as is support for partners and dependents. Programmes are offered in the UK, Hong Kong, North America and India.

Whistleblowing

The HSBC Group operates a global Compliance Disclosure Line (telephone and email) which is available to allow employees to make disclosures when the normal channels for airing grievances or concerns are unavailable or inappropriate.

The Compliance Disclosure Line is available to capture employee concerns on a number of matters, including breaches of law or regulation, allegations of bribery and corruption, failure to comply with Group policies, suspicions of money laundering, breaches of internal controls and fraud or deliberate error in the financial records of any Group company. Global Regulatory Compliance is responsible for the operation of the Compliance Disclosure Line and the handling of disclosure cases. Each case is reviewed and referred for appropriate investigation. The disclosure is acknowledged (when contact details are provided) and the employee is advised when the investigation has been concluded. Global Regulatory Compliance may also be made aware of whistleblowing cases made directly to senior executives, line managers, Human Resources and Security and Fraud, and will investigate accordingly.

Additional local whistleblowing lines are in place in several countries, operated by Security and Fraud, Human Resources and Regulatory Compliance. When such lines are established, processes are put in place to escalate relevant disclosures made on the local whistleblowing lines to Global Regulatory Compliance or Financial Crime Compliance. Global Regulatory Compliance also monitor an external email address for complaints regarding accounting and internal financial controls or auditing matters (accountingdisclosures@hsbc.com highlighted under Investor Relations and Governance on www.hsbc.com). Cases received are escalated to the Group Chief Accounting Officer, Group Finance Director and Group Chief Executive as appropriate.

29

Strategic Report (continued)

Strategic priority 3

Streamline processes and procedures

		Our aim is to achieve a cost efficiency ratio in the mid 50 s.

We are redesigning key processes and procedures in order to manage risk, improve customer service, enhance quality and reduce expenses. Sustainable savings will release funds to invest in growing our business, Global Standards and increasing dividends.

Operational performance

We continue to refine our operational processes, develop our global functions, implement consistent business models and streamline IT.

Sustainable savings are the financial outputs from our organisational effectiveness and streamlining programmes. They arise from the reduction or elimination of complexity, inefficiencies or unnecessary activities, and release capital that can be reinvested in growing our business as well as increasing returns to shareholders.

We are transitioning from organisational effectiveness to streamlining, which is the next phase of our transformation. While organisational effectiveness was about how HSBC is managed, streamlining is about how we operate.

We committed to deliver US$2.5-3.5bn of sustainable savings at the outset of the organisational effectiveness programme. We have achieved US$4.5bn for the period from 2011 to the end of 2013, equivalent to US$4.9bn on an annualised (run rate) basis, as follows:

Sustainable savings 2011 to 2013

	US$bn

Re-engineering operational processes	**1.6**
Re-engineering global functions	**1.4**
Implementing consistent business models	**0.7**
Streamlining IT	**0.8**
	4.5

In implementing our operational effectiveness programme, we concentrated on a number of key elements:

people and structure we implemented an 8x8 reporting structure, moved to a global operating model, and defined and introduced target business models across all global businesses and functions;

software development we improved software development productivity and shifted the mix of employees towards lower-cost locations;

process optimisation we improved the efficiency of our operational activities such as contact centres (including offshoring), trade and payments services; and

corporate real estate we rationalised our property portfolio by leasing and launching facilities management initiatives.

In phase 2, from 2014 to 2016, we will concentrate on streamlining operations, focusing on reducing or eliminating complexity, inefficiencies, risks or unnecessary activities across the whole Group. This exercise will be applied to:

propositions, and sales channels;

processes and servicing channels, including production management, multi-channel servicing, operational processes and the locations of activities; and

infrastructure, including real estate, technology, supplier management and global functions.

Streamlining will be achieved through a combination of simplifying and globalising our processes, products, systems and operations. Simplifying involves identifying inefficiencies or excessive complexity and redesigning or rationalising processes to make them easier to understand and manage and more efficient. Globalising involves developing standard global processes and implementing them around the Group with minimal local variations.

Cost efficiency ratio

Our cost efficiency ratio for 2013 was 59.6%, down from 62.8% in 2012.

Strategic Report (continued)

Customers

Our purpose is to connect customers to opportunities, enabling businesses to thrive and economies to prosper, helping people to fulfil their hopes and realise their ambitions.

Our dealings with customers are conditioned by our understanding of their needs, the quality of the service we provide and the standards which govern how we operate. With over 54 million personal and business customers around the world, we know that only by putting customers at the centre of what we do can we achieve our purpose.

Customer service and satisfaction

Throughout 2013 we concentrated on enhancing the customer service we provide through our global businesses.

In RBWM, we measure customer satisfaction through an independent market research survey of retail banking customers in selected countries and calculate a Customer Recommendation Index (CRI) to score performance. This CRI score is benchmarked against average scores of a peer group of banks in each market and we set targets for our business relative to our competitive set of banks. The Group target is for 75% of all the markets (based on their weighted revenue) to meet their CRI targets. This year, RBWM met its target of 75% with a score of 85% through strong performances in our home markets of Hong Kong and the UK and significant improvements in other major markets such as Brazil and Turkey. Historically, our strongest performance markets have been in Asia and this continued in 2013 with excellent results recorded in Taiwan, Malaysia and mainland China.

In CMB, we continued to measure our client engagement through a survey of key customers, the Client Engagement Programme (CEP). This survey is conducted by an independent third party. We have gained valuable insights from this work which help us tailor solutions and service offerings to meet our customers individual needs.

The survey was conducted in the following markets: UK, Germany, France, Turkey, US, Canada, UAE, mainland China, Hong Kong, India, Australia, Singapore, Mexico, Argentina and Brazil, and provides aggregate scores for each of our Business Banking and Corporate Banking businesses.

We have conducted over 2,500 interviews with our Corporate Banking customers and over 6,000 interviews in our Business Banking customers. These interviews allow us to build an overall score

from a possible 100 by our customers rating us on seven key relationship criteria. We have seen consistent positive performance, and in 2012 our score for the Corporate Banking segment was 84, rising slightly to 85 in 2013 with strong performances in mainland China, the US, Brazil and Germany. In our Business Banking segment our score was 81 in 2012 and 82 in 2013, with strong performances in a number of priority markets notably our home markets of Hong Kong and UK. Given the complex and competitive environment we have seen in many of the markets surveyed, we believe this to be a very good, consistent, performance and shows a positive relationship for HSBC with these valuable customers.

Retail Banking and Wealth Management

Standardising our propositions to make it easier for customers to do business

We continue to make significant progress in executing our customer strategy in RBWM.

In HSBC Premier, we are focusing on meeting the wealth management needs of our customers in five respects: protection, education, retirement, managing and growing wealth, and legacy planning. We have improved the platforms used by both customers and relationship managers, helping us to enhance customer experience and raise the standards of our financial planning.

We intend to refresh HSBC Advance in all our priority markets in 2014, putting digital functionality at the heart of the updated proposition. We are focusing on the day-to-day banking needs of our customers and improving their access to personal lending.

In 2013, we deployed service enhancements for customers in all segments (Premier, Advance and personal banking) using mobile phones and saw 2.5m downloads of our global mobile banking app in 25 countries, with over 1.1m downloads in the fourth quarter of 2013 alone. We also selectively piloted Twitter and Facebook-based services for customers and were voted the top social media bank in the UK in 2013 by IMGroup, the digital management consultancy.

We have undertaken a full review of all our products in RBWM, and are standardising our offering across all categories. Products are assessed on grounds of fairness and transparency before being approved. For example, in the UK, we made money management easier by simplifying automated teller machine (ATM) withdrawals, we improved our branch infrastructure to enable customers to reset their telephone security at the branches and we

Strategic Report (continued)

updated our on-line avatar, Ask Olivia , so that customers can easily get online answers to questions about error codes on their secure key. In Vietnam, an SMS Alert message will now be sent to a customer s registered mobile phone number as soon as they complete a credit card transaction, preventing fraud and helping to protect our credit cardholders.

We are also continuing to develop new products. We have extended our range of renminbi offerings and improved our foreign exchange services, particularly online. Through our Asset Management Group, we have now launched Managed Solutions in eight of our priority markets.

Interacting with customers

In 2013, we took a major step to align our staff s remuneration with customer interests by introducing a new incentive programme for our Wealth Management relationship managers. The programme removed all formulaic links to sales volumes and focused on assessing how well we are meeting our customers needs. We developed a similar incentive programme covering the rest of the RBWM front line staff and all our retail products. This was partially implemented in the UK and France in 2013 and will be effective in most markets from the beginning of 2014.

We continue to invest in all the channels that customers use to enhance ease of use and improve the overall customer experience. Upgrades to our physical estate included increasing physical access for disabled customers to branches in the UK and Hong Kong. In Canada, the upgraded ATMs now feature paperless bill payments and voice guidance in English, French, Cantonese and Mandarin. On digital channels, we launched new mobile applications and increased the functionality of our internet banking platforms. In Brazil, we were recognised as best internet bank in the market for the second year running, and launched bill payment by digital picture on mobiles. We are working on improving our international account opening processes while also raising the standards we employ for combating financial crime risk.

Supporting home ownership

Mortgages are a key product for our customers in enabling home ownership, and we continue to improve our products and processes.

In the UK, we granted over 30,000 first time buyer loans, and started selectively offering 95% loan-to-value mortgages as part of the government s Help to Buy scheme. We won the *Moneyfacts*

award for Best Bank Mortgage Provider for the fifth year running.

In mainland China, where we have achieved double digit growth in balances in each of the last three years, we re-engineered our processes to accommodate increased volumes and to speed up the granting of loans. We have reduced overall turnaround times from 12 days to six days. Through our Decision in Principle service we can now give customers the results of their initial screening within one hour.

In the UAE, we launched a tracker rate mortgage linked to a public benchmark, along with other initiatives including assisting customers with the registry process. Customer feedback was very positive and RBWM continued to grow strongly even as the overall market fell slightly.

In the US, we continued to work with the Federal Home Loan Bank of New York in offering First Home Club , a savings and education programme that assists low income families generate the down payment required to buy their first home.

Supporting customers in financial difficulty

We recognise that some of our customers are facing challenging financial situations, and we have looked to support them during difficult times.

Across Europe, frontline specialists were trained to offer an income and expenditure review for customers who are likely to face difficulty in making repayments to HSBC in the near future. We also eliminated certain current account charges in the UK (unpaid transaction fees). We updated our restructure and payment programme suites in the Middle East and Mexico while collaborating with charities, associations and government loan relief programmes in the US, Canada and France. In the Philippines, we offer a General Restructuring Facility as a restructuring programme for both non-delinquent and delinquent customers, and responded to Typhoon Haiyan with targeted payment holidays to credit card customers affected by the catastrophe. In Australia, we offered hardship relief on mortgage repayments to customers affected by bushfires in New South Wales.

Commercial Banking

Supporting small and medium-sized entities

To help our customers find the right financial solutions to succeed in the global economy, we launched a series of funds to support SME s that trade or aspire to trade internationally. We launched SME funds in the UK, France and Mexico in the first

Strategic Report (continued)

half of 2013 and in the US and Canada in the second half of the year. The latter two were of US$1bn each. We also launched our fourth SME fund in the UAE of AED1bn (US$272m) for international trade customers.

Our International Exchange programme continued to be a cornerstone of our client retention activity. In 2013, we hosted four events, in Singapore, Guangzhou, Mexico City and Istanbul, and provided leadership content and networking opportunities for over 300 corporate clients from around the world. We work closely with local government, trade bodies and central banks to provide the best possible insights and information for these customers. The client feedback confirmed that customers derive huge value from connecting with like-minded businesses, and there are multiple examples of new business relationships formed as a result of these conferences.

Interacting with customers

- In 2013, our CEP undertook over 10,000 customer interviews in 15 of CMB s priority markets. The programme gives customers the opportunity to share their views, and demonstrates that HSBC is listening and actively working to improve our ability to support customers with global operations.

- We are enhancing our customers account opening experience, enabling it to take place anytime anywhere, provided we can fulfil regulatory and Group KYC requirements. At the end of 2013, we launched a multi-channel business account opening tool in the UK for customers who wish to open accounts using online channels or call centres without visiting a branch.

- In Hong Kong, in the fourth quarter of 2013, we made *iPads* available in Business Banking centres to enable customers to register for internet banking at the time of account opening.

- We are expanding the servicing and transaction options available on our international online platform, HSBCnet, to better cater for the requirements of businesses of different sizes and needs. In addition to our payments and cash management HSBCnet package, which is available in all markets, we launched domestic and international HSBCnet packages in our top 12 markets during 2013.

- Relationship managers now update and validate customer information through regular routine discussions.
- Significant training is being provided for staff, including around the use of tools to help them support customers in completing required customer due diligence information.

New renminbi products and services

The growing use of China s currency worldwide is creating new opportunities for our customers engaging in trade, capital transactions and financing business in or with mainland China. We continued to strengthen our ability to meet these customers needs by playing a major part in a number of innovative transactions for the currency, including being the first international bank to:

- offer an automated foreign currency cross-border sweeping structure in mainland China to help multinationals optimise the use of internal funding by consolidating their liquidity positions onshore and offshore;

pilot foreign currency cross-border netting in mainland China, enabling multinationals to offset foreign currency payables and receivables between Chinese subsidiaries and netting centres overseas. The product allows companies to reduce inter-company transactions while lowering processing costs and currency risk exposure; and

implement a tailor-made renminbi cross-border centralised payments and collections settlement product in mainland China. This eliminates foreign exchange exposure and optimises working capital management for companies.

For further information on the products and services we offer, see page 79.

Client selection

Client selection is core to our growth strategy as we seek to generate long-term relationships and sustainable revenue streams within acceptable risk parameters. In 2013, we initiated a comprehensive programme to reposition our portfolios and better manage our business. This involves reviewing our customer base and establishing robust client selection filters designed to ensure that our controls and information flows are such that we can be confident that we only do business with customers who meet our criteria.

We are also undertaking a review of business policies and controls as part of our implementation of Global Standards to further guard against money laundering and sanctions risks.

Our risk profile is described on page 134.

Table of Contents

HSBC HOLDINGS PLC

Strategic Report (continued)

Environmental, social and community obligations

We will create a robust, resilient and sustainable business in which our clients can have confidence, our employees can take pride and our communities can trust.

Our continuing success depends, in part, on our ability to identify and address environmental, social and ethical factors which present risks to our business or offer opportunities to support customers in a more sustainable way. These can affect our reputation, drive employee engagement, help manage the risks of lending, leverage savings through eco-efficiency and secure new revenue streams.

Human rights
We apply human rights considerations directly as they affect our employees and indirectly through our suppliers and customers, in the latter case in particular through our project finance lending. Human rights issues most directly relevant for HSBC are those relating to the right to just and favourable conditions of work and remuneration, the right to equal pay for equal work, the right to form and join trade unions, the right to rest and leisure and the prohibition of slavery and child labour. Alongside our own commitments, such as our HSBC Code of Conduct for Suppliers (in place since 2005), the HSBC Global Standards Manual, HSBC Values and our Business Principles, we have signed up to global commitments and standards, including the UN Global Compact, the Universal Declaration of Human Rights and the Global Sullivan Principles.

Our sustainability risk framework

We recognise that businesses can have an impact on the environment and communities around them. For over 10 years we have been developing, implementing and refining our approach to working with our business customers to understand and manage these issues. We assess and support customers in six sensitive sectors using our own policies and, in financing projects, using the Equator Principles as a starting point. By extending their application to all relevant corporate loans and providing independent assurance on their implementation, we go beyond the minimum requirements of the Equator Principles framework. Our sustainability risk framework is based on robust policies, formal processes and well-trained, empowered people.

We welcome constructive feedback from NGOs and campaign groups and regularly engage with a number of them on matters of shared interest. In 2013, HSBC was approached by non-governmental organisations (NGO s) raising concerns regarding the implementation of our forest land and forest products sector policy. If our clients do not comply fully with our policies, or cannot show that they are on a credible path to do so, we will exit our relationship with them.

Our approach to managing sustainability risk is described on page 297.

Climate business

We define climate business as seeking long-term commercial business opportunities to support transition to a low-carbon economy. Our climate business includes clients in the solar, wind, biomass, energy efficiency, low carbon transport and water sectors, and revenues are growing year on year. HSBC s Climate Change Centre of Excellence, part of our global research team focusing on business risks and opportunities created by climate change, was established in 2007 and its research estimates that the climate business sector could exceed US$2.2 trillion by 2020.

Our sustainable operations strategy

HSBC s carbon dioxide emissions are calculated on the basis of the energy used in our buildings and employee business travel from over 30 countries (covering about 93% of our operations by FTE). The data gathered on energy consumption and distance travelled are converted to carbon dioxide emissions using conversion factors from the following sources, if available, in order of preference:

1. factors provided by the data/service providers;

2. factors provided by the local public environmental authorities. For electricity, if specific factors cannot be obtained from the above two sources, we use the latest available carbon emission factors for national grid electricity from the International Energy Agency as recommended for use by the Greenhouse Gas Protocol; and

3. for other types of energy and travel, if no specific factors can be obtained from the first two sources, we use the latest available factors provided by the UK Department for Environment, Food and Rural Affairs and/or the Department of Energy and Climate Change in the UK.

To incorporate all of the operations over which we have financial (management) control, the

Table of Contents

HSBC HOLDINGS PLC

Strategic Report (continued)

calculated carbon dioxide emissions are scaled up on the basis of the FTE coverage rate to account for any missing data (typically less than 10% of FTEs). In addition, emission uplift rates are applied to allow for uncertainty on the quality and coverage of emission measurement and estimation. The rates are 4% for electricity, 10% for other energy and 6% for business travel, based on the Intergovernmental Panel on Climate Change Good Practice Guidance and Uncertainty Management in National Greenhouse Gas Inventories, and HSBC s internal analysis of data coverage and quality.

Carbon dioxide emissions in tonnes

	2013	2012
Total	**889,000**	963,000
From energy	**755,000**	825,000
From travel	**134,000**	138,000

Carbon dioxide emissions in tonnes per FTE

	2013	2012
Total	**3.43**	3.61
From energy	**2.91**	3.09
From travel	**0.52**	0.52

Our greenhouse gas reporting year runs from October to September. For the year from 1 October 2012 to 30 September 2013, carbon dioxide emissions from our global operations were 889,000 tonnes.

HSBC Technology and Services employs around a third of our workforce and runs our operations, including real estate, IT infrastructure and supply chain. One of its goals, known as REDUCE , is to cut annual carbon dioxide emissions per employee by a tonne between 2012 and 2020 to 2.5 tonnes. Our baseline year is 2011, in which emissions were 3.44 tonnes (rounded up to 3.5).

To tackle this challenge, we set a 10-point sustainable operations strategy at the start of 2012, listed below. This strategy covers issues from sustainability leadership and engagement to supply-chain collaboration, and includes ambitious targets to reduce our use of energy and reduce our waste. We made progress in 2013, but recognise that stretching goals like these will take time to achieve. We have capitalised on quick wins where possible, but have also spent time to analyse thoroughly and prepare for achieving these targets.

Our 10-point sustainable operations strategy

1. We are engaging all employees in delivering improved efficiency by 2020 with training and sustainability leadership programmes.
2. We will increase energy consumption from renewables from 24% to 40% and increase self-generated electricity capacity from zero to 5%.
3. We will collaborate with our supply chain to achieve sustainable savings through efficiency and innovation.
4. We will improve the energy efficiency of our Group data centres.
5. An annual US$5m investment in an HSBC Eco-efficiency Fund has been committed to trial sustainable innovation.
6. Our target is to increase the recycling of HSBC s waste from 60% to 100% of our office waste and electronic-waste.
7. Work on all new and redesigned buildings costing over US$10m in our portfolio of 7,500 buildings will be done to Leadership in Energy and Environmental Design (LEED) certification standards.
8. We aim to reduce annual energy consumption per employee by 1MWh.
9. We will reduce paper usage, ensure it comes from sustainable sources, and encourage paperless banking for all retail and commercial customers.
10. We continue to promote alternatives to travel, reducing travel carbon emissions per employee.

Further details on our progress with achieving our sustainability operations programme will be published in our Sustainability Report 2013 *on 23 May 2014.*

Community investment

In 2013, we donated a total of US$117m to community investment projects (2012: US$120m).

Youth education

Education is key to prosperity. We seek to help young people fulfil their potential through global and local investment in education programmes. Our programmes span various levels of need, including financial literacy training, scholarships, cultural awareness programmes and teaching life skills.

In 2013, we launched the three-year £30m (US$47m) Opportunity Partnership, to help transform the lives of 25,000 disadvantaged young people in the UK through education, training and work.

Staff volunteering

Thousands of HSBC employees globally are involved every year through volunteering for our Community Investment programmes. We report in detail on this in the HSBC *Sustainability Report 2013*.

HSBC Water Programme

2013 was the second year of our flagship environmental project, the HSBC Water Programme. This is a five-year, US$100m programme in partnership with Earthwatch, WaterAid and WWF to deliver water provision, protection, information and education across the world. In 2013, we developed the programme by connecting specific parts of our business with HSBC Water Programme activities.

Strategic Report (continued)

Risk overview

All our activities involve, to varying degrees, the measurement, evaluation, acceptance and management of risk or combinations of risks. Our risk management framework, employed at all levels of the organisation, ensures that our risk profile remains conservative and aligned to our risk appetite and strategy.

Risk and our strategic priorities

The Group s three strategic priorities are reflected in our management of risk.

Grow both business and dividends we ensure risk is maintained at appropriate levels while HSBC is positioned for growth and capital is deployed accordingly to maximise revenue opportunities.

Implement Global Standards our management of financial crime risk is strengthened by the implementation of Global Standards, which are enhancing the procedures, policies, capabilities and controls that govern how we do business and with whom.

Streamline processes and procedures during 2013, we initiated a comprehensive programme to reposition our portfolios in line with our updated risk appetite, and we made progress with programmes to make HSBC easier to manage and control. We also continued to simplify the Group structure through our disposal programme and to de-risk legacy portfolios. The steps we have taken to reshape HSBC have released around US$90bn in risk-weighted assets to date.

Our business and operating models are described on page 13. For further information on Global Standards, see page 23.

Risk in 2013

Financial markets were volatile during 2013, reflecting concerns over the US fiscal cliff and debt ceiling, the potential tapering of quantitative easing, the continuing political instability in the Middle East and its possible effect on global energy prices, and the widely held view that the global economic recovery remains fragile. We maintained a conservative risk profile by reducing exposure to the most likely areas of stress:

- we managed selectively our exposure to sovereign debt and bank counterparties to ensure that the overall quality of the portfolio remained strong;
- we regularly assessed higher risk countries and adjusted our risk appetite and exposures accordingly;
- we repositioned certain portfolios through our six filters process (see page 15) and our focus on certain products or customer segments;
- we made our client selection filters more robust in managing the risk of financial crime; and
- we mitigated risks, for example reputational and operational, when they were forecast to exceed our risk appetite.

The diversification of our lending portfolio across global businesses and regions, together with our broad range of products, ensured that we were not overly dependent on a limited number of countries or markets to generate income and growth.

We monitored a range of key risk metrics in 2013, including the following:

	2013 US$bn	2012 US$bn
Maximum exposure to credit risk	**3,112**	3,140
of which:		
loans and advances held at amortised cost[14]	**1,292**	1,150
Risk-weighted assets	**1,093**	1,124
of which:		
credit risk RWAs	**864**	898
market risk RWAs	**63**	55
operational risk RWAs	**119**	122
Proportion of RWAs on standardised approach	**30%**	34%
Trading value at risk (US$m)	**52**	79
Advances to deposits ratio[14]	**73%**	74%
Advances to core funding (year end)[14]:		
HSBC UK[23]	**100%**	106%
HBAP[24]	**72%**	73%
HSBC USA[25]	**85%**	78%

For footnotes, see page 46.

Strategic Report (continued)

Risks incurred in our business activities

Our principal banking risks are credit risk, liquidity and funding risks, market risk, operational risk, compliance risk, fiduciary risk, reputational risk pension risk and sustainability risk. We also incur insurance risk. The chart below provides a

high level guide to how our business activities are reflected in our risk measures and in the Group s balance sheet. The third-party assets and liabilities indicate the contribution each business makes to the balance sheet, while RWAs illustrate the relative size of the risks incurred in respect of each business.

For a description of our principal risks, see page 136.

Exposure to risks arising from the business activities of global businesses

For footnote, see page 46.

For further information on credit risk, see page 150; capital and risk-weighted assets, see page 298; market risk, including value at risk, see page 230; and operational risk see page 244.

Top and emerging risks

Identifying and monitoring top and emerging risks are integral to our approach to risk management. We define a top risk as being a current, emerged risk which has arisen across any of our risk categories, regions or global businesses and has the potential to have a material impact on our financial results or our reputation and the sustainability of our long-term business model, and which may form and crystallise within a year. We consider an emerging risk to be one with potentially significant but uncertain outcomes which may form and crystallise beyond a one-year time horizon, in the event of which it could have a material effect on our ability to achieve our long-term strategy.

The ongoing assessment of our top and emerging risks is informed by a comprehensive suite of risk factors (see page 135) which may result in our risk appetite being revised.

During 2013, senior management paid particular attention to a number of top and emerging risks. These risks, as at 31 December 2013, are tabulated below.

We made a number of changes to our top and emerging risks to reflect revised assessment of their effect on HSBC during 2013. Threats to the global economy from a disorderly exit from quantitative easing, which emerged as a risk during the first half of 2013 following announcements that monetary stimuli may be scaled back, receded during the second half of the year. This followed announcements by central banks on the likely pace and scale of tapering together with an acceleration of economic growth in the US and UK.

Strategic Report (continued)

Top and emerging risks /

Macroeconomic and geopolitical risks	Macro-prudential, regulatory and legal risks to our business model	Risks related to our business operation, governance and internal control systems
Emerging markets slowdown	Regulatory developments affecting our business model and Group profitability	Heightened execution risk
Growth decelerated in a number of emerging markets during 2013. Any contraction in trade and capital flows would affect both emerging and developed economies.	Governments and regulators in numerous jurisdictions continue to develop policy which may impose new requirements, including in the areas of capital and liquidity management and business structure.	Regulatory demands, a challenging external environment, the level of internal transformation and risks arising from business and portfolio disposals may affect our ability to execute our strategy.
Increased geopolitical risk	Regulatory investigations, fines, sanctions, commitments and consent orders and requirements relating to conduct of business and financial crime negatively affecting our results and brand	Internet crime and fraud and Information security risk
Our operations are exposed to risks arising from political instability and civil unrest in a number of countries, which may have a wider effect on regional stability and regional and global economies.	Financial service providers are at risk of regulatory sanctions or fines related to conduct of business and financial crime.	Our businesses face a range of operational risks, including those arising from internet crime and fraud and cyber attacks affecting the security of Group and customer information.
		Data management
	In December 2012, HSBC entered into agreements with US and UK authorities in relation to investigations regarding past inadequate compliance with AML and sanctions laws and we continue to be subject to other regulatory proceedings, the outcome of which is difficult to predict. There is a risk that we fail to meet agreed deadlines or are found to have material gaps in our plans or the implementation progress compared with that required by the DPAs and other orders.	New regulatory requirements necessitate more frequent and granular data submissions, which must be produced on a consistent, accurate and timely basis.

Dispute risk	Model risk
HSBC is party to legal proceedings arising out of its normal business operations which could give rise to potential financial loss and significant reputational damage.	Regulatory requirements relating to models and assumptions in areas such as capital calculations and stress testing could potentially result in an increased and more volatile capital requirement.

Heightened execution risk was also assessed as a top risk to reflect the external and internal challenges to delivering our strategy at the same time

as implementing the changes necessitated by regulatory change and the implementation of Global Standards.

Strategic Report (continued)

When the top and emerging risks listed above resulted in our risk appetite potentially being exceeded, we took steps to mitigate them, including reducing our exposure to areas of stress. Given the impact on the Group of breaching the US DPA, significant senior management attention was given to tracking and monitoring our compliance with its requirements and improving policies, processes and controls to minimise the risk of a breach.

For a detailed account of these risks see page 141 and for a summary of our risk factors, see page 135.

How we manage risk

Our risk culture is fundamental to the delivery of our strategic objectives. It may be characterised as conservative, control-based and collegiate. It is reinforced by our HSBC Values and our Global Standards, and forms the basis on which our risk appetite and risk management framework are established. These are instrumental in aligning the behaviour of individuals with the Group s attitude to assuming and managing risk.

We manage risk actively, with five main elements underpinning our risk culture.

Running risk like a business

Running risk like a business means ensuring that the Global Risk function is dynamic and responsive to the needs of its stakeholders. We continue to focus on:

- making systems compatible (for example, in Global Risk and Global Finance) so a complete picture of our risks is obtained;
- streamlining data production and re-engineering processes to create time to spend on risk management; and
- understanding the detail behind our risks and costs.

Organisation and structure

Robust risk governance and accountability are embedded throughout the Group, fostering a continuous monitoring of the risk environment and an integrated evaluation of risks and their interactions. Adherence to consistent standards and risk management policies is required across HSBC by our Global Standards and our Global Risk Operating Model.

Our risk governance framework, of which our risk appetite framework is a significant element, ensures the appropriate oversight of and accountability for the effective management of risk, including financial crime risk, at Group, regional and

global business levels. Similar arrangements are in place in our major operating subsidiaries.

The Group Risk Committee is responsible for advising the Board on high-level risk related matters and risk governance.

The risk governance framework was augmented by the establishment in January 2013 of the Financial System Vulnerabilities Committee, which reports to the Board on matters relating to financial crime and financial system abuse and provides a forward-looking perspective on financial crime risk.

A Conduct & Values Committee was established in January 2014, to oversee the design and application of HSBC s policies, procedures and standards, to ensure that we conduct business responsibly and consistently adhere to HSBC Values and to advise the Board accordingly.

For a description of the governance structure for managing risk at the Group level, see the report of the Group Risk Committee on page 352. The Report of the Financial System Vulnerabilities Committee is on page 358.

Three lines of defence

The Group has adopted a risk management and internal control structure referred to as the three lines of defence to ensure we achieve our commercial aims while meeting regulatory and legal requirements. It is a key part of our operational risk management framework.

First line every employee is responsible for the risks that are part of their day to day jobs. The first line of defence ensures that all key risks within their operations are identified, mitigated and monitored by appropriate internal controls within an overall control environment.

Second line global functions, such as Global Risk, Global Finance and Global Human Resources form the second line of defence. They have similar responsibilities to the first line of defence for the processes and activities they own. In addition, they are responsible for setting policy and for providing oversight and challenge of the activities conducted by the first line.

Third line Internal Audit forms the third line of defence, providing independent assurance to senior management and the Board over the design and operation of HSBC s risk management, governance and internal control processes.

For details of our operational risk management framework, see page 244.

Strategic Report (continued)

People

All employees are required to identify, assess and manage risk within the scope of their assigned responsibilities and, as such, they are critical to the effectiveness of the three lines of defence. Personal accountability for Global Standards is reinforced by HSBC Values.

Clear and consistent employee communication on risk conveys strategic messages and sets the tone from senior leadership. A suite of mandatory training on critical risk and compliance topics is deployed to embed skills and understanding and strengthen the risk culture within HSBC. It reinforces the attitude to risk in the behaviour expected of employees, as described in our risk policies. The training is updated regularly, describing technical aspects of the various risks assumed by the Group and how they should be managed effectively. Staff are supported in their roles by a disclosure line which enables them to raise concerns confidentially (see page 29).

Our risk culture is reinforced by our approach to remuneration. Individual awards are based on compliance with HSBC Values and the achievement of financial and non-financial objectives which are aligned to our risk appetite and global strategy.

For further information on risk and remuneration, see the Report of the Group Remuneration Committee on page 360.

Risk management processes and procedures

Risk management within HSBC is driven by the following four processes:

- risk identification;
- risk appetite;
- mapping our risk profile; and
- stress testing and scenario analysis.

Risk identification

We identify and monitor risks continuously. This process, which is informed by analysis of our risk factors and the results of our stress testing programme, gives rise to the classification of certain key risks as top or emerging. Changes in our assessment of top and emerging risks may result in adjustments to our business strategy and, potentially, our risk appetite.

Risk appetite

The Group s Risk Appetite Statement describes the types and levels of risk that we are prepared to accept in executing our strategy. The Risk Appetite Statement is approved by the Board on the advice of the Group Risk Committee. It is a key component of our risk management framework, informs our annual

operating plan and plays an important role in our six filters process.

Global businesses, geographical regions and global functions are required to align their risk appetite statements with the Group s.

Quantitative and qualitative metrics are assigned to nine key categories: earnings, capital, liquidity and funding, securitisations, cost of risk, intra-group lending, strategic investments, risk categories and risk diversification and concentration. Measurement against the metrics:

- guides underlying business activity, ensuring it is aligned to risk appetite statements;
- informs risk-adjusted remuneration;
- enables the key underlying assumptions to be monitored and, where necessary, adjusted through subsequent business planning cycles; and
- promptly identifies business decisions needed to mitigate risk.

Some of the core metrics that are measured and presented to the Board monthly are tabulated below:

Key risk appetite metrics

	2013	
	Target[27]	**Actual**
Core tier 1 ratio	9.5% to 10.5%	**13.6%**
Common equity tier 1 ratio	9.5% to 10.5%	**10.9%**
Return on equity	12% to 15%	**9.2%**
Return on RWAs	2.1% to 2.7%	**2.0%**
Cost efficiency ratio	48% to 52%	**59.6%**
Advances to customer accounts ratio[14]	Below 90%	**72.9%**
Cost of risk (loan impairment charges)	Below 15% of operating income	**7.7%**

For footnotes, see page 46.

In 2013, we changed the targets for two of these risk appetite metrics. Our return on risk-weighted assets target was raised from 1.8-2.6% to the current target of 2.1-2.7%, reflecting changes in our risk profile as we reshaped our portfolio of businesses in line with our strategy and our six filters framework. As our portfolios became less risky, we reduced the acceptable cost of risk from below 20% to below 15% of operating income.

Our core tier 1 ratio exceeded the target, although remained within our risk tolerance to ensure we were well placed to meet requirements on a Basel III basis (page 309).

Our six filters are described on page 15.

Strategic Report (continued)

Mapping our risk profile

Risks are assumed by our global businesses in accordance with their risk appetite and are managed at Group, global business and regional levels. All risks are recorded and monitored through our risk mapping process, which describes our risk profile by category in the different regions and global businesses.

In addition to our banking and insurance risks, the risk mapping process identifies and monitors risks such as model, financial management, capital, Islamic finance and strategic risks. These risks are regularly assessed through our risk appetite framework, stress tested and considered for classification as top and emerging risks.

For a summary of our banking and insurance risks, see page 136.

Stress testing and scenario analysis

We conduct stress-testing scenarios across the Group on both enterprise-wide and regional bases, reflecting our business strategy and resultant risk exposures. These scenarios include, but are not limited to, adverse macroeconomic events, failures at country, sector and counterparty levels and a variety of projected major operational risk events. The results of the stress tests are used to assess potential unplanned demand for regulatory capital under the various scenarios. We also participate in scenario analyses requested by regulatory bodies including the Bank of England concurrent stress test exercise and the US Federal Reserve Comprehensive Capital Analysis and Review (CCAR) and Dodd-Frank Stress Testing programmes.

We tested several scenarios in the course of 2013. The results of these stress tests demonstrated that HSBC would remain satisfactorily capitalised after taking account of assumed management actions to mitigate the effect of the scenarios in question.

For further information on our stress-testing and scenario analyses, see page 139.

How risk affects our performance

The management of risk is an integral part of all our activities. Risk measures our exposure to uncertainty and the consequent variability of return.

The execution of our strategy, including the exit from non-strategic markets, the sale of businesses and non-core investments, the repositioning of our portfolios and implementation of revised client selection filters, together with an improvement in market conditions, led to a modest improvement in

credit metrics in our retail portfolios during 2013, while our wholesale portfolios remained stable.

LICs fell in North America, Europe and the Middle East and North Africa following a general improvement in credit conditions but rose in Latin America for reasons outlined on page 17.

Operational losses declined significantly compared with 2012, although remained above historical trend. The decrease reflected the non-recurrence of fines and penalties paid in 2012 as part of the settlement of investigations into past inadequate compliance with AML and sanctions laws. Provisions related to UK customer redress, principally payment protection insurance and interest rate protection products, also declined. There are many factors which could affect these estimated liabilities and there remains a high degree of uncertainty as to the eventual cost of redress for these matters.

HSBC is party to legal proceedings, investigations and regulatory matters in a number of jurisdictions arising out of its normal business operations. We recognise a provision for a liability in relation to these matters when it is probable that an outflow of economic benefits will be required to settle an obligation which has arisen as a result of past events, and for which a reliable estimate can be made of the amount of the obligation. Our provisions for legal proceedings and regulatory matters and for customer remediation at 31 December 2013 totalled US$4.2bn. While the outcome of these matters is inherently uncertain, management believes that, based on the information available to it, appropriate provisions have been made.

The reported results of HSBC are sensitive to the accounting policies, assumptions and estimates that underlie the preparation of our consolidated financial statements and reflect our assessment of the financial impact of risks affecting the Group.

For a description of material legal proceedings and regulatory matters, see Note 43 on the Financial Statements on page 554.

Provisions for legal proceedings and regulatory matters and for customer remediation are disclosed in Note 31 on the Financial Statements on page 526.

For details of operational losses, see page 246.

For details of our critical accounting policies, see page 72.

Table of Contents

HSBC HOLDINGS PLC

Strategic Report (continued)

Rewarding performance

Our remuneration strategy rewards commercial success and compliance with our risk management framework.

The quality of our people and their long-term commitment to the Group are fundamental to our success. We therefore aim to attract, retain and motivate the very best people who are committed to maintaining a long-term career with HSBC, and who will perform their role in the long-term interests of shareholders.

Employee remuneration

HSBC s reward package comprises four key elements of remuneration:

- fixed pay;
- benefits;
- annual incentive; and
- the Group Performance Share Plan (GPSP).

These elements support the achievement of our objectives through balancing reward for both short-term and long-term sustainable performance. Our strategy is designed to reward only success, and aligns employees remuneration with our risk framework and risk outcomes. For our most senior employees the greater part of their reward is deferred and thereby subject to malus, that is, it can be cancelled if warranted by events.

In order to ensure alignment between what we pay our people and our business strategy, we assess individual performance against annual and long-term financial and non-financial objectives which are summarised in performance scorecards. This assessment also takes into account adherence to the HSBC Values of being open, connected and dependable and acting with courageous integrity . Altogether, performance is therefore judged not only on what is achieved over the short and long-term but also importantly on how it is achieved, as we believe the latter is essential to the long-term sustainability of the business.

Industry changes and key challenges

The main drivers of change in remuneration policy and practice within the financial services industry are the new regulations under CRD IV which apply globally to all employees of EU headquartered banks. The key change is the application of a cap on variable pay that can be paid to any material risk taker (being employees who have been identified as having a material impact on the institution s risk profile). This presents significant challenges for HSBC given the fact that as a worldwide business, a

significant number of our material risk takers are based outside the EU.

This situation has necessitated a review of our remuneration policy, especially the balance between fixed and variable pay, to ensure we can remain competitive on a total compensation basis and retain our key talent. Bearing in mind the interests of our shareholders, the Board believes it is necessary to increase the variable pay cap to the 200% of fixed pay for material risk takers that is permitted under CRD IV with shareholder approval. This will enable us to hold back a larger proportion of variable pay, subject to malus, than would be the case if we were not to take advantage of this provision. It will require shareholder approval at the AGM on 23 May 2014.

Overall, a representative number of our major institutional shareholders have been supportive of the proposed changes to our remuneration policy and recognise the importance of ensuring we can retain our key talent.

Variable pay pool determination

Determining the quantum of variable pay requires consideration of affordability, the equitable distribution between shareholders and employees and market-based judgements around peer comparisons and retention risk. The Group Remuneration Committee considers many factors in determining HSBC s variable pay pool funding. The total variable pay pool for 2013 was US$3.9bn, increased from US$3.7bn in 2012, as shown in the table below:

Variable pay pool

	Group	
	2013	2012
	US$m	US$m
Variable pay pool		
total	**3,920**	3,689
as a percentage of underlying profit	**15%**	17%
percentage of pool deferred[28]	**18%**	17%

For footnote, see page 46.

42

Strategic Report (continued)

Funding

The variable pay pool takes into account the performance of the Group which is considered within the context of our Risk Appetite Statement. This ensures that the variable pay pool is shaped by risk considerations, and is shaped by an integrated approach to business, risk and capital management which supports achievement of our strategic objectives.

Funding is calibrated with reference to Group profitability, capital strength, and shareholder returns. This approach ensures that performance-related awards for any global business, global function, geographical region or level of staff are considered in a holistic fashion.

The methodology also considers the relationship between capital, dividends and variable pay to ensure that the distribution of post-tax profits between these three elements is considered appropriate.

For the Directors Remuneration Report for the 2012, 2013 and target split, see page 394.

Relative importance of spend on pay

The following chart provides a breakdown of total staff pay relative to the amount paid out in dividends.

Directors remuneration

The single total figure for Directors remuneration required by Schedule 8 of the Large and Medium-Sized Companies (Accounts and Reports) Regulations 2008 is as follows:

Executive Directors

	Douglas Flint		Stuart Gulliver		Iain Mackay	
	2013	2012	**2013**	2012	**2013**	2012
	£000	£000	**£000**	£000	**£000**	£000
Fixed pay						
Base salary	**1,500**	1,500	**1,250**	1,250	**700**	700
Pension	**750**	750	**625**	625	**350**	350

	2,250	2,250	**1,875**	1,875	**1,050**	1,050
Benefits	**48**	64	**591**	642	**33**	36
Variable pay						
Annual incentive			**1,833**	780	**1,074**	539
GPSP			**3,667**	3,000	**2,148**	1,400
			5,500	3,780	**3,222**	1,939
Notional return on deferred cash	**27**	12			**7**	3
Non-taxable benefits	**102**	98	**67**	65	**53**	50
Total single figure of remuneration	**2,427**	2,424	**8,033**	6,362	**4,365**	3,078
Addendum						
Annual incentive with performance conditions[30]				1,170		809
Total single figure of remuneration and annual incentive with performance conditions	**2,427**	2,424	**8,033**	7,533	**4,365**	3,887

For footnote, see page 46.

43

Table of Contents

HSBC HOLDINGS PLC

Strategic Report (continued)

Douglas Flint, as Group Chairman, is not eligible for an annual incentive and did not receive a GPSP award in 2013.

Marc Moses was appointed an executive Director with effect from 1 January 2014, reflecting the criticality of the Risk function to HSBC and his leadership of the function, and recognises his personal contribution to the Group.

A full summary of the variable pay performance outcomes for the two eligible executive Directors receiving such awards in 2013 is tabulated below.

For full details of Directors remuneration, see page 389.

Variable pay performance for 2013

	Stuart Gulliver						Iain Mackay			
	Maximum multiple	Pre-discretion performance outcome	Multiple awarded	Pre-discretion value £000	Committee discretion[31] £000	Post-discretion value £000	Maximum multiple	Post-discretion performance outcome	Multiple awarded	Value £000
Salary	1.00	100%	1.00	1,250	n/a	1,250	1.00	100%	1.00	700
Annual incentive	3.00	60%	1.80	2,250	(417)	1,833	3.00	51%	1.53	1,074
GPSP	6.00	60%	3.60	4,500	(833)	3,667	5.10	60%	3.07	2,148
Total				8,000	(1,250)	6,750				3,922

For footnote, see page 46.

Remuneration policy going forward

In order to deal with the challenges of CRD IV we have introduced changes to our remuneration structure for executive Directors in 2014 as summarised in the table below, subject to shareholders approval at the 2014 AGM. If approved, the policy is intended to apply for three years to the conclusion of the AGM in 2017.

For full details of the remuneration policy for executive Directors, see page 381.

Changes in remuneration policy for 2014

Purpose and link to strategy	**Operation**	**Maximum opportunity**	**Performance metrics**
Salary	No change	No change	No change (none)
Fixed pay allowance[32]	Introduction of share allowance	Maximum fixed pay allowance for each executive Director will be the difference between (i) 50% of the target remuneration of the executive Director under this policy and (ii) the aggregate of the base salary and cash allowance in lieu of pension for that executive Director	None
Benefits	No change	No change	No change (none)
Total variable pay	No change	Maximum at 900% of salary reduced to 200% of fixed pay	No change
Annual incentive[32]	No change	Maximum incentive reduced from 300% of base salary to 67% of fixed pay	See page 382
GPSP[32]	No change	Maximum incentive reduced from 600% of base salary to 133% of fixed pay	See page 383
Pension	No change	No change	No change (none)

For footnote, see page 46.

The mix of fixed and variable pay granted to an employee is commensurate with the individual s role, experience and responsibility and the local market.

Fixed pay allowances will only be granted to certain material risk takers based on their role, function, experience and technical expertise. The Group Chairman will not be eligible for a fixed pay allowance.

Executive Directors, Group Managing Directors and Group General Managers will receive shares that vest immediately. The shares (net of shares sold to cover any income tax and social security) will be subject to a retention period. 20% of these shares will be released in March immediately following the end of the financial year in which the shares are granted. The remaining 80% will be subject to a retention period of at least five years.

Strategic Report (continued)

All other employees will receive the fixed pay allowance in cash when it is below a specified threshold. Where the fixed pay allowance is above the specified threshold, all of it will be received in shares that vest immediately. Any shares delivered (net of shares sold to cover any income tax and social security) as part of the fixed pay allowance would be subject to a retention period. 40% of the shares will be released in March following the end of the relevant financial year in which the shares were granted. The remaining 60% will be released in three equal annual tranches on each anniversary of the initial release.

Group Managing Directors participate in both the annual incentive and the GPSP. Group General Managers participate in the annual incentive and may receive other long-term awards. Other employees across the Group are eligible to participate in annual incentive arrangements.

External reporting

The required remuneration disclosures for Directors and highest paid employees in the Group are made in the Directors Remuneration Report on page 378. Remuneration disclosures for Code Staff can be found in the *Pillar 3 Disclosures 2013*.

On behalf of the Board 24 February 2014

D J Flint, *Group Chairman*

HSBC Holdings plc

Registered number 617987

Strategic Report (continued)

Footnotes to Strategic Report

1 *A Basel II measure, of core tier 1 capital expressed as percentage of total risk-weighted assets.*
2 *The cost efficiency ratio is defined as total operating expenses divided by net operating income before loan impairment charges and other credit risk provisions.*
3 *Dividends recorded in the financial statements are dividends per ordinary share declared in a year and are not dividends in respect of, or for, that year. The third interim dividend for 2012 of US$0.09 was paid on 12 December 2012. The fourth interim dividend for 2012 of US$0.18 was paid on 8 May 2013. First, second and third interim dividends for 2013, each of US$0.10 per ordinary share, were paid on 11 July 2013, 9 October 2013 and 11 December 2013, respectively. Note 10 on the Financial Statements provides more information on the dividends declared in 2013. On 24 February 2014 the Directors declared a fourth interim dividend for 2013 of US$0.19 per ordinary share in lieu of a final dividend, which will be payable to ordinary shareholders on 30 April 2014 in cash in US dollars, or in pounds sterling or Hong Kong dollars at exchange rates to be determined on 22 April 2014, with a scrip dividend alternative. The reserves available for distribution at 31 December 2013 were US$49,339m.*
Quarterly dividends of US$15.5 per 6.2% non-cumulative Series A US dollar preference share, equivalent to a dividend of US$0.3875 per Series A American Depositary Share, each of which represents one-fortieth of a Series A US dollar preference share, were paid on 16 September 2013, 17 June 2013, 15 March 2013 and 16 December 2013.
Quarterly coupons of US$0.508 per security were paid with respect to 8.125% capital securities on 15 January 2013, 15 April 2013, 15 July 2013 and 15 October 2013.
Quarterly coupons of US$0.5 per security were paid with respect to 8% capital securities on 15 March 2013, 17 June 2013, 16 September 2013 and 16 December 2013.
4 *The return on average ordinary shareholders equity is defined as profit attributable to ordinary shareholders of the parent company divided by average ordinary shareholders equity.*
5 *Net operating income before loan impairment charges and other credit risk provisions, also referred to as revenue.*
6 *Intermediation of securities, funds and insurance products, including Securities Services in GB&M.*
7 *Merger and acquisition, event and project financing, and co-investments in GPB.*
8 *Including Foreign Exchange, Rates, Credit and Equities.*
9 *Including portfolio management.*
10 *Including private trust and estate planning (for financial and non-financial assets).*
11 *Including hedge funds, real estate and private equity.*
12 *Loan impairment charges and other credit risk provisions.*
13 *Share of profit in associates and joint ventures.*
14 *In 2013, GB&M changed the way it manages repo and reverse repo activities in the Credit and Rates businesses as set out on page 68 of the Financial Review . This led to an increase in the amount of reverse repo and repo agreements classified as Loans and advances to customers at amortised cost and Customer accounts at amortised cost in the balance sheet, respectively.*
15 *A Basel III measure, of common equity tier 1 capital expressed as percentage of total risk exposure amount.*
16 *UK bank levy paid reflects the payments made to the tax authorities during the calendar year and may differ from the recognition of liabilities charged to the income statement.*
17 *Excludes movements in the fair value of own debt and before variable pay distributions. See Directors Remuneration Report page 378.*
18 *Each American Depositary Share represents five ordinary shares.*
19 *Total shareholder return is defined as the growth in share value and declared dividend income during the relevant period.*
20 *The Financial Times Stock Exchange 100 Index, The Morgan Stanley Capital International World Index and The Morgan Stanley Capital International World Bank Index.*
21 *Established on 17 January 2014.*
22 *Established on 22 November 2013.*
23 *The HSBC UK entity shown comprises five legal entities; HSBC Bank plc (including all overseas branches), and SPEs consolidated by HSBC Bank plc for Financial Statement purposes), Marks and Spencer Financial Services Limited, HSBC Private Bank (UK) Ltd, HFC Bank Ltd and HSBC Trust Company (UK) Limited, managed as a single operating entity, in line with the application of UK liquidity regulation as agreed with the UK PRA.*
24 *The Hongkong and Shanghai Banking Corporation represents the bank in Hong Kong including all overseas branches. Each branch is monitored and controlled for liquidity and funding risk purposes as a standalone operating entity.*
25 *The HSBC USA principal entity shown represents the HSBC USA Inc consolidated group; predominantly HSBC USA Inc and HSBC Bank USA, NA. The HSBC USA Inc consolidated group is managed as a single operating entity.*
26 *The sum of balances presented does not agree to consolidated amounts because inter-company eliminations are not presented here.*

27 *Targets for 2014 to 2016 were announced at our Investor Update on 15 May 2013.*
28 *The percentage of variable pay deferred for the Code Staff population was 64%.*
29 *Dividends per ordinary share in respect of that year. For 2013, this includes the first, second and third interim dividends paid in 2013 of US$5.6bn (gross of scrip) and a fourth interim dividend of US$3.6bn.*
30 *60% of the 2012 annual incentive for Stuart Gulliver and Iain Mackay disclosed in the 2012 Directors Remuneration Report was deferred for five years. The vesting of these awards is subject to a service condition and satisfactory completion of the DPA. The DPA condition ends on the fifth anniversary of the award date unless the DPA is extended or otherwise continues beyond that date, in which case the awards will vest on the date on which the DPA expires and otherwise ceases to operate.*
31 *In its meeting of 15 January 2014, the Group Remuneration Committee used its discretion to reduce overall variable pay by £1.25m (equivalent to 18.5% of the total annual incentive and GPSP). This adjustment was considered appropriate in the context of overall Group-wide year-over-year profitability and incentive pool funding, Group-wide risk and compliance, market remuneration benchmarks and the remuneration recommendations for the Group CEO s direct reports.*
32 *Maximum award potentials for fixed pay allowances and variable pay awards are based on obtaining shareholder approval to increase the maximum variable pay award as a percentage of fixed pay under CRD IV from 100% to 200% at the Annual General Meeting on 23 May 2014. If shareholder approval is not obtained the maximum fixed pay allowance payable for each executive Director under the policy will be the difference between (i) 50% of maximum total remuneration of the executive Director under this policy as shown in the Remuneration scenarios chart on page 389 and (ii) the aggregate of the base salary and cash allowance in lieu of pension for that executive Director. Maximum variable pay award levels will be revised to 100% of fixed pay and the maximum annual incentive and GPSP awards will accordingly be reduced to 1/3 and 2/3 of this amount (i.e. 33% and 67% of fixed pay, respectively). The requested increase in the cap to 200% would enable us to minimise the increase in fixed remuneration costs and so help to maintain greater flexibility on total pay.*

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review

Financial summary

The management commentary included in the Report of the Directors: Financial Review , together with the Employees and Corporate sustainability sections of Corporate Governance and the Directors Remuneration Report is presented in compliance with the IFRSs Practice Statement Management Commentary *issued by the IASB.*

Use of non-GAAP financial measures

Our reported results are prepared in accordance with IFRSs as detailed in the Financial Statements starting on page 416. In measuring our performance, the financial measures that we use include those which have been derived from our reported results in

order to eliminate factors which distort year-on-year comparisons. These are considered non-GAAP financial measures. Non-GAAP financial measures that we use throughout our Financial Review and are described below. Other non-GAAP financial measures are described and reconciled to the closest reported financial measure when used.

Constant currency

The constant currency measure adjusts for the year-on-year effects of foreign currency translation differences by comparing reported results for 2013 with reported results for 2012 retranslated at 2013 exchange rates. Except where stated otherwise, commentaries are on a constant currency basis, as reconciled in the table below.

The foreign currency translation differences reflect the movements of the US dollar against most major currencies during 2013.

We exclude the translation differences because we consider the like-for-like basis of constant currency financial measures more appropriately reflects changes due to operating performance.

Constant currency

Constant currency comparatives for 2012 referred to in the commentaries are computed by retranslating into US dollars for non-US dollar branches, subsidiaries, joint ventures and associates:

- the income statements for 2012 at the average rates of exchange for 2013; and

- the balance sheet at 31 December 2012 at the prevailing rates of exchange on 31 December 2013.

Constant currency comparatives for 2011 referred to in the 2012 commentaries are computed on the same basis, by applying average rates of exchange for 2012 to the 2011 income and rates of exchange on 31 December 2012 to the balance sheet at 31 December 2011.

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 year on the basis described above.

Underlying performance

To arrive at underlying performance:

- we adjust for the year-on-year effects of foreign currency translation;

- we eliminate the fair value movements on our long-term debt attributable to credit spread (own credit spread) where the net result of such movements will be zero upon maturity of the debt. This does not include fair value

Report of the Directors: Financial Review (continued)

changes due to own credit risk in respect of trading liabilities or derivative liabilities; and

we adjust for acquisitions, disposals and changes of ownership levels of subsidiaries, associates, joint ventures and businesses.

For acquisitions, disposals and changes of ownership levels of subsidiaries, associates, joint ventures and businesses, we eliminate the gain or loss on disposal or dilution and any associated gain or loss on reclassification or impairment recognised in the year incurred, and remove the operating profit or loss of the acquired, disposed of or diluted subsidiaries, associates, joint ventures and businesses from all the years presented so we can view results on a like-for-like basis. For example, if a disposal was made in the current year, any gain

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Reconciliation of reported and constant currency profit before tax

	2013 compared with 2012					
			2012			
		Currency translation adjustment[1]	at 2013 exchange rates	2013 as reported	Reported change[2]	Constant currency change[2]
HSBC	2012 as reported US$m	US$m	US$m	US$m	%	%
Net interest income	37,672	(682)	36,990	35,539	(6)	(4)
Net fee income	16,430	(203)	16,227	16,434		1
Net trading income	7,091	(164)	6,927	8,690	23	25
Own credit spread[3]	(5,215)	12	(5,203)	(1,246)	76	76
Other income/(expense) from financial instruments designated at fair value	2,989	(53)	2,936	2,014	(33)	(31)
Net income/(expense) from financial instruments designated at fair value	(2,226)	(41)	(2,267)	768		
Gains on disposal of US branch network, US cards business and Ping An	7,024		7,024		(100)	(100)
Gains less losses from financial investments	1,189	(17)	1,172	2,012	69	72
Net earned insurance premiums	13,044	(118)	12,926	11,940	(8)	(8)
Other operating income (including dividend income)	2,321	(200)	2,121	2,954	27	39
Total operating income	82,545	(1,425)	81,120	78,337	(5)	(3)
Net insurance claims incurred and movement in liabilities to policyholders	(14,215)	96	(14,119)	(13,692)	(4)	(3)
Net operating income[4]	68,330	(1,329)	67,001	64,645	(5)	(4)
Loan impairment charges and other credit risk provisions	(8,311)	201	(8,110)	(5,849)	30	28
Net operating income	60,019	(1,128)	58,891	58,796	(2)	
Operating expenses	(42,927)	683	(42,244)	(38,556)	10	9
Operating profit	17,092	(445)	16,647	20,240	18	22
Share of profit in associates and joint ventures	3,557	45	3,602	2,325	(35)	(35)
Profit before tax	20,649	(400)	20,249	22,565	9	11
By global business						
Retail Banking and Wealth Management	9,575	(26)	9,549	6,649	(31)	(30)
Commercial Banking	8,535	(96)	8,439	8,441	(1)	
Global Banking and Markets	8,520	(147)	8,373	9,441	11	13
Global Private Banking	1,009	(16)	993	193	(81)	(81)
Other	(6,990)	(115)	(7,105)	(2,159)	69	70
Profit before tax	20,649	(400)	20,249	22,565	9	11

By geographical region						
Europe	**(3,414)**	**65**	**(3,349)**	**1,825**		
Hong Kong	**7,582**	**(1)**	**7,581**	**8,089**	**7**	**7**
Rest of Asia-Pacific	**10,448**	**(227)**	**10,221**	**7,764**	**(26)**	**(24)**
Middle East and North Africa	**1,350**	**(36)**	**1,314**	**1,694**	**25**	**29**
North America	**2,299**	**(28)**	**2,271**	**1,221**	**(47)**	**(46)**
Latin America	**2,384**	**(173)**	**2,211**	**1,972**	**(17)**	**(11)**
Profit before tax	**20,649**	**(400)**	**20,249**	**22,565**	**9**	**11**

For footnotes, see page 132.

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

or loss on disposal, any associated gain or loss on reclassification or impairment recognised and the results of the disposed-of business would be removed from the results of the current year and the previous year as if the disposed-of business did not exist in those years. Disposal of investments other than those included in the above definition do not lead to underlying adjustments.

We use underlying performance to explain year-on-year changes when the effect of fair value movements on own debt, acquisitions, disposals or dilution is significant because we consider that this basis more appropriately reflects operating performance.

The following acquisitions, disposals and changes to ownership levels affected the underlying performance:

Disposal gains/(losses) affecting underlying performance

	Date	Disposal gain/(loss) US$m
HSBC Bank Canada s disposal of HSBC Securities (Canada) Inc s full service retail brokerage business[5]	Jan 2012	83
The Hongkong and Shanghai Banking Corporation Limited s disposal of RBWM operations in Thailand[5]	Mar 2012	108
HSBC Finance Corporation, HSBC USA Inc. and HSBC Technology and Services (USA) Inc. s disposal of US Card and Retail Services business[5]	May 2012	3,148
HSBC Bank USA, N.A. s disposal of 138 non-strategic branches[5]	May 2012	661
HSBC Argentina Holdings S.A. s disposal of its non-life insurance manufacturing subsidiary[5]	May 2012	102
The Hongkong and Shanghai Banking Corporation Limited s disposal of its private banking business in Japan[5]	Jun 2012	67
The Hongkong and Shanghai Banking Corporation Limited s disposal of its shareholding in a property company in the Philippines[6]	Jun 2012	130
Hang Seng Bank Limited s disposal of its non-life insurance manufacturing subsidiary[5]	Jul 2012	46
HSBC Bank USA, N.A. s disposal of 57 non-strategic branches[5]	Aug 2012	203
HSBC Asia Holdings B.V. s investment loss on a subsidiary[5]	Aug 2012	(85)
HSBC Bank plc s disposal of HSBC Securities SA[6]	Aug 2012	(11)
HSBC Europe (Netherlands) B.V. s disposal of HSBC Credit Zrt[6]	Aug 2012	(2)
HSBC Europe (Netherlands) B.V. s disposal of HSBC Insurance (Ireland) Limited[6]	Oct 2012	(12)
HSBC Europe (Netherlands) B.V. s disposal of HSBC Reinsurance Limited[6]	Oct 2012	7
HSBC Private Bank (UK) Limited s disposal of Property Vision Holdings Limited[6]	Oct 2012	(1)
HSBC Investment Bank Holdings Limited s disposal of its stake in Havas Havalimanlari Yer Hizmetleri Yatirim Holding Anonim Sirketi[6]	Oct 2012	18
HSBC Insurance (Asia) Limited s disposal of its non-life insurance portfolios[5]	Nov 2012	117
HSBC Bank plc s disposal of HSBC Shipping Services Limited[6]	Nov 2012	(2)
HSBC Bank (Panama) S.A. s disposal of its operations in Costa Rica, El Salvador and Honduras[5]	Dec 2012	(62)
HSBC Insurance Holdings Limited and The Hongkong and Shanghai Banking Corporation Limited s disposal of their shares in Ping An Insurance (Group) Company of China, Ltd (Ping An[5])	Dec 2012	3,012
The Hongkong and Shanghai Banking Corporation Limited s disposal of its shareholding in Global Payments Asia-Pacific Limited[5]	Dec 2012	212
Reclassification gain in respect of our holding in Industrial Bank Co., Limited following the issue of additional share capital to third parties[5]	Jan 2013	1,089
HSBC Insurance (Asia-Pacific) Holdings Limited s disposal of its shareholding in Bao Viet Holdings[5]	Mar 2013	104
Household Insurance Group Holding company s disposal of its insurance manufacturing business[5]	Mar 2013	(99)
HSBC Seguros, S.A. de C.V., Grupo Financiero HSBC s disposal of its property and Casualty Insurance business in Mexico[5]	Apr 2013	20

HSBC Bank plc s disposal of its shareholding in HSBC (Hellas) Mutual Funds Management SA[5]	Apr 2013	(7)
HSBC Insurance (Asia-Pacific) Holdings Limited disposal of its shareholding in Hana HSBC Life Insurance Company Limited[5]	May 2013	28
HSBC Bank plc s disposal of HSBC Assurances IARD[5]	May 2013	(4)
The Hongkong and Shanghai Banking Corporation Limited s disposal of HSBC Life (International) Limited s Taiwan branch operations[6]	June 2013	(36)
HSBC Markets (USA) Inc. s disposal of its subsidiary, Rutland Plastic Technologies[6]	Aug 2013	17
HSBC Insurance (Singapore) Pte Ltd s disposal of its Employee Benefits Insurance business in Singapore[6]	Aug 2013	(8)
HSBC Investment Bank Holdings plc s disposal of its investment in associate FIP Colorado[6]	Aug 2013	(5)
HSBC Investment Bank Holdings plc group s disposal of its investment in subsidiary, Viking Sea Tech[5]	Aug 2013	54
HSBC Latin America Holdings UK Limited s disposal of HSBC Bank (Panama) S.A[6]	Oct 2013	1,107
HSBC Latin America Holdings UK Limited s disposal of HSBC Bank (Peru) S.A[6]	Nov 2013	(18)
HSBC Latin America Holdings UK Limited s disposal of HSBC Bank (Paraguay) S.A[6]	Nov 2013	(21)
Reclassification loss in respect of our holding in Yantai Bank Co., Limited following an increase in its registered share capital[5]	Dec 2013	(38)

For footnotes, see page 132.

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Acquisition gains/(losses) affecting underlying performance[6]

	Date	Fair value gain on acquisition US$m
Gain on the merger of Oman International Bank S.A.O.G. and the Omani operations of HSBC Bank Middle East Limited	Jun 2012	3
Gain on the acquisition of the onshore retail and commercial banking business of Lloyds Banking Group in the UAE by HSBC Bank Middle East Limited	Oct 2012	18

For footnote, see page 132.

The following table reconciles selected items for 2013 and 2012 to an underlying basis. Equivalent tables are provided for each of our global businesses

and geographical segments in the Form 20-F filed with the Securities and Exchange Commission (SEC), which is available on www.hsbc.com.

Reconciliation of reported and underlying items

	2013 US$m	2012 US$m	Change[2] %
Net interest income			
Reported	**35,539**	37,672	(6)
Currency translation adjustment[1]		(682)	
Acquisitions, disposals and dilutions	**(273)**	(2,015)	
Underlying	**35,266**	34,975	1
Other operating income			
Reported	**2,632**	2,100	25
Currency translation adjustment[1]		(195)	
Acquisitions, disposals and dilutions	**(2,234)**	(811)	
Underlying	**398**	1,094	(64)
Revenue[4]			
Reported	**64,645**	68,330	(5)
Currency translation adjustment[1]		(1,341)	
Own credit spread[3]	**1,246**	5,215	
Acquisitions, disposals and dilutions	**(2,596)**	(10,607)	
Underlying	**63,295**	61,597	3
Loan impairment charges and other credit risk provisions			

Reported	**(5,849)**	(8,311)	30
Currency translation adjustment[1]		201	
Acquisitions, disposals and dilutions	**32**	376	
Underlying	**(5,817)**	(7,734)	25
Total operating expenses			
Reported	**(38,556)**	(42,927)	10
Currency translation adjustment[1]		683	
Acquisitions, disposals and dilutions	**353**	1,490	
Underlying	**(38,203)**	(40,754)	6
Underlying cost efficiency ratio	**60.4%**	66.2%	
Share of profit in associates and joint ventures			
Reported	**2,325**	3,557	(35)
Currency translation adjustment[1]		45	
Acquisitions, disposals and dilutions	**(14)**	(1,425)	
Underlying	**2,311**	2,177	6
Profit before tax			
Reported	**22,565**	20,649	9
Currency translation adjustment[1]		(412)	
Own credit spread[3]	**1,246**	5,215	
Acquisitions, disposals and dilutions	**(2,225)**	(10,166)	
Underlying	**21,586**	15,286	41

For footnotes, see page 132.

Report of the Directors: Financial Review (continued)

Consolidated income statement

Five-year summary consolidated income statement

	2013	2012	2011	2010	2009
	US$m	US$m	US$m	US$m	US$m
Net interest income	**35,539**	37,672	40,662	39,441	40,730
Net fee income	**16,434**	16,430	17,160	17,355	17,664
Net trading income	**8,690**	7,091	6,506	7,210	9,863
Net income/(expense) from financial instruments designated at fair value	**768**	(2,226)	3,439	1,220	(3,531)
Gains less losses from financial investments	**2,012**	1,189	907	968	520
Dividend income	**322**	221	149	112	126
Net earned insurance premiums	**11,940**	13,044	12,872	11,146	10,471
Gains on disposal of US branch network, US cards business and Ping An		7,024			
Other operating income	**2,632**	2,100	1,766	2,562	2,788
Total operating income	**78,337**	82,545	83,461	80,014	78,631
Net insurance claims incurred and movement in liabilities to policyholders	**(13,692)**	(14,215)	(11,181)	(11,767)	(12,450)
Net operating income before loan impairment charges and other credit risk provisions	**64,645**	68,330	72,280	68,247	66,181
Loan impairment charges and other credit risk provisions	**(5,849)**	(8,311)	(12,127)	(14,039)	(26,488)
Net operating income	**58,796**	60,019	60,153	54,208	39,693
Total operating expenses	**(38,556)**	(42,927)	(41,545)	(37,688)	(34,395)
Operating profit	**20,240**	17,092	18,608	16,520	5,298
Share of profit in associates and joint ventures	**2,325**	3,557	3,264	2,517	1,781
Profit before tax	**22,565**	20,649	21,872	19,037	7,079
Tax expense	**(4,765)**	(5,315)	(3,928)	(4,846)	(385)
Profit for the year	**17,800**	15,334	17,944	14,191	6,694
Profit attributable to shareholders of the parent company	**16,204**	14,027	16,797	13,159	5,834
Profit attributable to non-controlling interests	**1,596**	1,307	1,147	1,032	860

Five-year financial information

	US$	US$	US$	US$	US$
Basic earnings per share[8]	**0.84**	0.74	0.92	0.73	0.34
Diluted earnings per share[8]	**0.84**	0.74	0.91	0.72	0.34
Dividends per ordinary share[9]	**0.48**	0.41	0.39	0.34	0.34

	%	%	%	%	%
Dividend payout ratio[10]	**57.1**	55.4	42.4	46.6	100.0
Post-tax return on average total assets	**0.7**	0.6	0.6	0.6	0.3
Return on average ordinary shareholders equity	**9.2**	8.4	10.9	9.5	5.1
Average foreign exchange translation rates to US$:					
US$1: £	**0.639**	0.631	0.624	0.648	0.641
US$1:	**0.753**	0.778	0.719	0.755	0.719

For footnotes, see page 132.

Unless stated otherwise, all tables in the *Annual Report and Accounts 2013* are presented on a reported basis.

For a summary of our financial performance in 2013, see page 16.

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Notable revenue items by geographical region

	Europe US$m	Hong Kong US$m	Rest of Asia-Pacific US$m	MENA US$m	North America US$m	Latin America US$m	Total US$m
2013							
Net gain on completion of Ping An disposal[11]			**553**				**553**
2012							
Ping An contingent forward sale contract[11]			(553)				(553)

Notable revenue items by global business

	Retail Banking and Wealth Management US$m	Commercial Banking US$m	Global Banking and Markets US$m	Global Private Banking US$m	Other US$m	Total US$m
2013						
Net gain on completion of Ping An disposal[11]					**553**	**553**
2012						
Ping An contingent forward sale contract[11]					(553)	(553)

For footnote, see page 132.

Notable cost items by geographical region

	Europe US$m	Hong Kong US$m	Rest of Asia-Pacific US$m	MENA US$m	North America US$m	Latin America US$m	Total US$m
2013							
Restructuring and other related costs	**217**	**6**	**81**	**3**	**100**	**76**	**483**
UK customer redress programmes	**1,235**						**1,235**
2012							

Restructuring and other related costs	299	31	131	27	221	167	876
UK customer redress programmes	2,338						2,338
Fines and penalties for inadequate compliance with anti-money laundering and sanction laws	375				1,546		1,921
2011							
Restructuring and other related costs	404	68	45	31	236	338	1,122
UK customer redress programmes	898						898

Notable cost items by global business

	Retail Banking and Wealth Management US$m	**Commercial Banking US$m**	**Global Banking and Markets US$m**	**Global Private Banking US$m**	**Other US$m**	**Total US$m**
2013						
Restructuring and other related costs	**165**	**32**	**15**	**74**	**197**	**483**
UK customer redress programmes	**953**	**148**	**134**			**1,235**
2012						
Restructuring and other related costs	266	62	63	58	427	876
UK customer redress programmes	1,751	258	331	(2)		2,338
Fines and penalties for inadequate compliance with anti-money laundering and sanction laws					1,921	1,921
2011						
Restructuring and other related costs	405	122	158	38	399	1,122
UK customer redress programmes	875	23				898

52

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Group performance by income and expense item

Net interest income

	2013 US$m	2012 US$m	2011 US$m
Interest income	**51,192**	56,702	63,005
Interest expense	**(15,653)**	(19,030)	(22,343)
Net interest income[12]	**35,539**	37,672	40,662
Average interest-earning assets	**1,669,368**	1,625,068	1,622,658
Gross interest yield[13]	**3.07%**	3.49%	3.88%
Less: cost of funds	**(1.10%)**	(1.36%)	(1.56%)
Net interest spread[14]	**1.97%**	2.13%	2.32%
Net interest margin[15]	**2.13%**	2.32%	2.51%

Summary of interest income by type of asset

	2013 Average balance US$m	2013 Interest income US$m	2013 Yield %	2012 Average balance US$m	2012 Interest income US$m	2012 Yield %	2011 Average balance US$m	2011 Interest income US$m	2011 Yield %
Short-term funds and loans and advances to banks	**301,267**	**3,655**	**1.21**	275,979	4,307	1.56	261,749	5,860	2.24
Loans and advances to customers	**946,756**	**38,720**	**4.09**	934,656	41,043	4.39	945,288	45,250	4.79
Financial investments	**393,309**	**8,002**	**2.03**	387,329	9,078	2.34	384,059	10,229	2.66
Other interest-earning assets	**28,036**	**815**	**2.91**	27,104	2,274	8.39	31,562	1,666	5.28
Total interest-earning assets	**1,669,368**	**51,192**	**3.07**	1,625,068	56,702	3.49	1,622,658	63,005	3.88
Trading assets and financial assets designated at fair value[16,17]	**354,817**	**5,763**	**1.62**	368,406	6,931	1.88	410,038	8,671	2.11
Impairment provisions	**(15,954)**			(17,421)			(18,738)		
Non-interest-earning assets	**683,785**			730,901			752,965		
Total assets and interest income	**2,692,016**	**56,955**	**2.12**	2,706,954	63,633	2.35	2,766,923	71,676	2.59

Summary of interest expense by type of liability and equity

2013	2012	2011

	Average balance US$m	**Interest expense US$m**	**Cost %**	Average balance US$m	Interest expense US$m	Cost %	Average balance US$m	Interest expense US$m	Cost %
Deposits by banks[18]	**86,882**	**691**	**0.80**	92,803	1,160	1.25	106,099	1,591	1.50
Financial liabilities designated at fair value own debt issued[19]	**72,333**	**967**	**1.34**	75,016	1,325	1.77	73,635	1,313	1.78
Customer accounts[20]	**1,104,644**	**9,063**	**0.82**	1,052,812	10,878	1.03	1,058,326	13,456	1.27
Debt securities in issue	**150,976**	**4,182**	**2.77**	161,348	4,755	2.95	181,482	5,260	2.90
Other interest-bearing liabilities	**11,345**	**750**	**6.61**	19,275	912	4.73	14,024	723	5.16
Total interest-bearing liabilities	**1,426,180**	**15,653**	**1.10**	1,401,254	19,030	1.36	1,433,566	22,343	1.56
Trading liabilities and financial liabilities designated at fair value (excluding own debt issued)	**301,353**	**3,027**	**1.00**	318,883	3,445	1.08	355,345	4,564	1.28
Non-interest bearing current accounts	**184,370**			177,085			162,369		
Total equity and other non-interest bearing liabilities	**780,113**			809,732			815,643		
Total equity and liabilities	**2,692,016**	**18,680**	**0.69**	2,706,954	22,475	0.83	2,766,923	26,907	0.97

For footnotes, see page 132.

53

Report of the Directors: Financial Review (continued)

The commentary in the following sections is on a constant currency basis unless stated otherwise.

Reported net interest income of US$35.5bn decreased by 6% compared with 2012 and on a constant currency basis, net interest income fell by US$1.5bn. Both net interest spread and margin also fell, reflecting lower yields on customer lending following the disposal in 2012 of the CRS business in the US, which was higher yielding relative to the average yield of our portfolio, and lower yields on our surplus liquidity. These factors were partially offset by a lower cost of funds, principally on customer accounts and debt issued by the Group.

On an underlying basis, which excludes the net interest income earned by the businesses sold during 2013 (see page 50) from both years (2013: US$273m; 2012: US$2.0bn) and currency translation movements of US$682m, net interest income increased by 1%. This reflected balance sheet growth in Hong Kong and Europe, partly offset by lower net interest income earned in North America as a result of the run-off and disposal of CML portfolios in the US and the consumer finance business in Canada.

Interest income

On a constant currency basis, interest income fell. This was driven by lower interest income from customer lending, including loans classified within Assets held for sale , as a consequence of the disposal of the CRS business in the US in 2012 and the CML non-real estate loan portfolio and select tranches of CML first lien mortgages in the US in 2013. In addition, average yields on customer lending in Latin America fell, notably in Brazil, following lower average interest rates; re-pricing in line with local competition; a change in the composition of the lending portfolios as we focused on growing secured, lower yielding, lending balances for corporate and Premier customers. Interest income earned in Panama, where we disposed of the business, also fell. By contrast interest income on customer lending in Hong Kong and Rest of Asia-Pacific rose, driven by growth in residential mortgage balances in RBWM and term and trade-related and commercial real estate and other property-related lending in CMB. This increase in interest income was partially offset by compressed yields on trade lending and lower yields as interest rates declined in a number of countries across the region.

Interest income in Balance Sheet Management also decreased. Yields on financial investments and cash placed with banks and central banks declined as

the proceeds from maturities and sales of available-for-sale debt securities were invested at prevailing rates, which were lower. This was partly offset by growth in customer deposits leading to an overall increase in the size of the Balance Sheet Management portfolio.

Interest expense

Interest expense fell in the year, though to a lesser extent than interest income, driven by a lower cost of funds relating to customer accounts. The reduction in interest rates paid to customers in Europe, Hong Kong and Rest of Asia-Pacific more than offset the effect of the growth in the average balances of customer accounts. There was also a decline in the interest expense on customer accounts in Latin America, principally in Brazil, reflecting the managed reduction in term deposits as we continued to change the funding base, substituting wholesale customer deposits for medium-term loan notes, together with a lower average base interest rate. The disposal of the business in Panama also reduced interest expense.

Interest expense on debt issued by the Group decreased too. In North America, as a result of the business disposals and the run-off of the CML portfolio, our funding requirements declined and led to a fall in average outstanding balances. In Europe, average outstanding balances fell as a result of net redemptions. Additionally, the effective rate of interest declined as new issuances were at lower prevailing rates.

Repos and reverse repos

During the final quarter, GB&M changed the way it manages reverse repurchase (reverse repo) and repurchase (repo) activities. For full details, see page 68. This had the effect of reducing the net interest margin as average interest earning assets and interest bearing liabilities increased significantly. These reverse repo and repo agreements have a lower gross yield and cost of funds, respectively, when compared with the remainder of our portfolio.

Net interest income includes the expense of internally funded trading assets, while related revenue is reported in Net trading income . The internal cost of funding these assets declined, reflecting a decrease in the average trading asset balances in most regions and reductions in our average cost of funds in these regions. In reporting our global business results, this cost is included within Net trading income .

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Net fee income

	2013 US$m	2012 US$m	2011 US$m
Account services	**3,581**	3,563	3,670
Funds under management	**2,673**	2,561	2,753
Cards	**2,455**	3,030	3,955
Credit facilities	**1,907**	1,761	1,749
Broking income	**1,388**	1,350	1,711
Imports/exports	**1,157**	1,196	1,103
Unit trusts	**891**	739	657
Underwriting	**866**	739	578
Remittances	**849**	819	770
Global custody	**698**	737	751
Insurance	**551**	696	1,052
Other	**2,957**	2,958	2,748
Fee income	**19,973**	20,149	21,497
Less: fee expense	**(3,539)**	(3,719)	(4,337)
Net fee income	**16,434**	16,430	17,160

Net fee income was broadly unchanged on a reported basis and increased by US$207m on a constant currency basis.

Fees from unit trusts grew, primarily in Hong Kong, as we captured improved market sentiment and strong customer demand. Fees from funds under management increased, primarily in Europe and Hong Kong, reflecting improved market conditions. Fee income from credit facilities rose, mainly in Europe in CMB.

Underwriting fees rose, notably in Europe and Hong Kong, as client demand for equity and debt capital financing increased and the collaboration between CMB and GB&M strengthened.

These factors were partly offset by the sale of the CRS business in North America, which led to a reduction in cards and insurance fee income and fee expenses. Fee income related to the sale fell following the expiry of the majority of the transition service agreements entered into during 2012. This is reported in other fee income while associated costs are reported in Operating expenses .

Net trading income

	2013 US$m	2012 US$m	2011 US$m
Trading activities	**6,921**	5,249	4,873

Ping An contingent forward sale contract[11]	**(682)**	(553)	
Net interest income on trading activities	**2,047**	2,683	3,223
Loss on termination of hedges	**(194)**		
Other trading income hedge ineffectiveness:			
on cash flow hedges	**22**	35	26
on fair value hedges	**65**	(27)	(224)
Non-qualifying hedges[21]	**511**	(296)	(1,392)
Net trading income[22]	**8,690**	7,091	6,506

For footnotes, see page 132.

Reported net trading income of US$8.7bn was US$1.6bn higher than in 2012. On a constant currency basis, income increased by US$1.8bn, notably in Europe. Net income from trading activities primarily arose from our Markets business within GB&M, which recorded a resilient performance during 2013.

The rise in net income from trading activities was due in part to lower adverse foreign exchange movements on assets held as economic hedges

of foreign currency debt designated at fair value. These adverse movements offset favourable foreign exchange movements on the foreign currency debt which are reported in Net expense from financial instruments designated at fair value . In addition, we made foreign exchange gains of US$442m on sterling debt issued by HSBC Holdings. We also recorded a favourable debit valuation adjustment (DVA) of US$105m on derivative contracts, compared with a net reported charge of US$385m in

Report of the Directors: Financial Review (continued)

2012, as a result of a change in estimation methodology in respect of credit valuation adjustments (CVA s) of US$903m and a DVA of US$518m, to reflect evolving market practices.

Net income from trading activities in Markets also rose. Trading revenue in Credit grew driven by revaluation gains from price appreciation on assets in the legacy portfolio together with increased customer activity. Foreign Exchange revenue rose as a result of increased client demand for hedging solutions, in part from increased collaboration, although this was partly offset by margin compression and reduced market volatility in the second half of 2013. Equities revenue also grew, from higher client flows and increased revaluation gains in Europe, together with minimal fair value movements on own credit spreads on structured liabilities, compared with adverse fair value movements in 2012.

Rates trading income in 2012 included a charge following a change in the CVA methodology, as noted above. In 2013, we won new client mandates and reported smaller adverse fair value movements on our credit spreads on structured liabilities. These factors were broadly offset by reduced revenue as in 2012 we benefited from a significant tightening of spreads on eurozone bonds following the ECB s

liquidity intervention. Revenue in 2013 was also affected by uncertainty regarding the tapering of quantitative easing in the US.

During 2013, we reported adverse fair value movements of US$682m compared with US$553m in 2012 on the contingent forward sale contract relating to Ping An in Rest of Asia-Pacific (see Note 25 on the Financial Statements).

Net interest income from trading activities also declined. This was driven by lower yields on debt securities in part reflecting the downward movement in interest rates.

In addition, net trading income was adversely affected by losses of US$194m relating to the termination of qualifying accounting hedges, mainly in HSBC Finance Corporation (HSBC Finance) of US$199m, as a result of anticipated changes in funding.

In 2013, there were favourable movements on non-qualifying hedges compared with adverse movements in 2012. In North America, we reported favourable fair value movements on non-qualifying hedges as US long-term interest rates increased, compared with adverse fair value movements in 2012. There were also favourable fair value movements on non-qualifying hedges in Europe, compared with adverse movements in 2012.

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

	2013 US$m	2012 US$m	2011 US$m
Net income/(expense) arising from:			
financial assets held to meet liabilities under insurance and investment contracts	**3,170**	2,980	(933)
liabilities to customers under investment contracts	**(1,237)**	(996)	231
HSBC s long-term debt issued and related derivatives	**(1,228)**	(4,327)	4,161
Change in own credit spread on long-term debt	**(1,246)**	(5,215)	3,933
Other changes in fair value[23]	**18**	888	228
other instruments designated at fair value and related derivatives	**63**	117	(20)

Net income/(expense) from financial instruments designated at fair value	**768**	(2,226)	3,439

For footnote, see page 132.

Report of the Directors: Financial Review (continued)

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

	2013	2012	2011
	US$m	US$m	US$m
Financial assets designated at fair value at 31 December	**38,430**	33,582	30,856
Financial liabilities designated at fair value at 31 December	**89,084**	87,720	85,724
Including:			
Financial assets held to meet liabilities under:			
insurance contracts and investment contracts with DPF[24]	**10,717**	8,376	7,221
unit-linked insurance and other insurance and investment contracts	**25,423**	23,655	20,033
Long-term debt issues designated at fair value	**75,278**	74,768	73,808

For footnote, see page 132.

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

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

We reported net income from financial instruments designated at fair value of US$768m in 2013 compared with a net expense of US$2.2bn in 2012. This included credit spread-related movements in the fair value of our own long-term debt, on which we experienced adverse fair value movements of US$1.2bn in 2013 compared with US$5.2bn in 2012. Adverse fair value

movements were less extensive in 2013 than in 2012 as HSBC spreads tightened significantly in Europe and North America, having widened during 2011.

Net income arising from financial assets held to meet liabilities under insurance and investment contracts increased reflecting higher net investment returns in 2013 than in 2012. These returns reflected favourable equity market movements in the UK and France, partly offset by weaker equity market performance and falling bond prices in Hong Kong and lower net income on the bond portfolio in Brazil.

Investment gains or losses arising from equity markets result in a corresponding movement in liabilities to customers, reflecting the extent to which unit-linked policyholders, in particular, participate in the investment performance of the associated asset portfolio. Where these relate to assets held to back investment contracts, the corresponding movement in liabilities to customers is also recorded under Net income/(expense) from financial instruments designated at fair value . This is in contrast to gains or losses related to assets held to back insurance contracts or investment contracts with discretionary participation features (DPF), where the corresponding movement in liabilities to customers is recorded under Net insurance claims incurred and movement in liabilities to policyholders .

Other changes in fair value reflected lower favourable foreign exchange movements in 2013 than in 2012 on foreign currency debt designated at fair value and issued as part of our overall funding strategy (offset from assets held as economic hedges in Net trading income), and higher adverse movements due to hedging ineffectiveness in 2013.

Report of the Directors: Financial Review (continued)

Gains less losses from financial investments

	2013 US$m	2012 US$m	2011 US$m
Net gains/(losses) from disposal of:			
debt securities	**491**	781	712
Ping An equity securities classified as available-for-sale[1]	**1,235**		
other equity securities	**462**	823	360
other financial investments	**(1)**	5	12
	2,187	1,609	1,084
Impairment of available-for-sale equity securities	**(175)**	(420)	(177)
Gains less losses from financial investments	**2,012**	1,189	907

For footnote, see page 132.

Gains less losses from financial investments rose by US$823m on a reported basis and by US$840m on a constant currency basis.

This was driven by a significant increase in net gains from the disposal of available-for-sale equity securities in Rest of Asia-Pacific following the completion of the sale of our remaining shareholding in Ping An and an increase in disposal gains in Principal Investments. These increases were partly offset by the non-recurrence of gains in Hong Kong from the sale of our shares in four Indian banks in 2012.

The year on year decline in impairments on available-for-sale equity securities also contributed to the rise in gains less losses from financial investments. This was driven by a reduction in write downs in our Principal Investments business.

Net gains on the disposal of debt securities fell as 2012 included significant gains on the sale of available-for-sale government debt securities, notably in Europe, arising from structural interest rate risk management of the balance sheet.

Net earned insurance premiums

	2013 US$m	2012 US$m	2011 US$m
Gross insurance premium income	**12,398**	13,602	13,338
Reinsurance premiums	**(458)**	(558)	(466)
Net earned insurance premiums	**11,940**	13,044	12,872

Net earned insurance premiums decreased by US$1.1bn on a reported basis, and by US$1.0bn on constant currency basis.

The reduction was primarily due to lower net earned premiums in Europe, Latin America and North America, partly offset by an increase in Hong Kong.

In Europe, net earned premiums decreased, mainly as a result of lower sales of investment contracts with DPF in France. In addition, 2012 benefited from a number of large sales through independent financial adviser channels which are now in run off.

In Latin America, net earned premiums decreased in Brazil due to lower sales of unit-linked

pension products, primarily as a result of changes to the distribution channel. In addition, the sale of the non-life business in Argentina in 2012 contributed to the decrease.

The reduction in net earned premiums in North America was due to the sale of our insurance manufacturing business in the first half of 2013.

In Hong Kong, premium income increased as a result of higher renewal premiums for insurance contracts with DPF and unit-linked insurance contracts, partly offset by lower sales of new business in 2013 and the disposal of the non-life business during 2012.

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Gains on disposal of US branch network, US cards business and Ping An

	2013	2012	2011
	US$m	US$m	US$m
Gains on disposal of US branch network		864	
Gains on disposal of US cards business		3,148	
Gains on disposal of Ping An[11]		3,012	
		7,024	

For footnote, see page 132.

In 2012, we made significant progress in exiting non-strategic markets and disposing of businesses and investments not aligned with the Group s long-term strategy. These included three major disposals:

- In May 2012, HSBC USA Inc., HSBC Finance and HSBC Technology and Services (USA) Inc. sold their US Card and Retail Services business, realising a gain on sale of US$3.1bn.
- In May 2012, HSBC Bank USA, N.A. (HSBC Bank USA) sold 138 out of 195 branches, primarily in upstate New York, realising a gain of US$661m. In August 2012, it sold the remaining 57 branches to the same purchaser, realising a gain of US$203m.
- In December 2012, HSBC Insurance Holdings Limited and The Hongkong and Shanghai Banking Corporation agreed to sell their entire shareholdings in Ping An, representing 15.57% of the issued share capital of Ping An, in two tranches. The first tranche was completed on 7 December 2012, at which point we ceased to account for Ping An as an associate and recognised a gain on disposal of US$3.0bn. The remaining shareholding in respect of the second tranche was recognised as a financial investment.

The fixing of the sale price in respect of the second tranche gave rise to a contingent forward sale contract, for which there was an adverse fair value movement of US$553m recorded in Net trading income in 2012. The disposal of our investment in Ping An was completed in 2013. We realised a gain of US$1.2bn, which was recorded in Gains less losses from financial investments . This was partly offset by the adverse fair value movement of US$682m on the contingent forward sale contract recorded in Net trading income , leading to a net gain in the year of US$553m.

Other operating income

	2013	2012	2011
	US$m	US$m	US$m
Rent received	**155**	210	217
Gains/(losses) recognised on assets held for sale	**(729)**	485	55
Gains on investment properties	**113**	72	118
Gain on disposal of property, plant and equipment, intangible assets and non-financial investments	**178**	187	57
Gains arising from dilution of interest in Industrial Bank and other associates and joint ventures	**1,051**		208
Gain on disposal of HSBC Bank (Panama) S.A.	**1,107**		
Change in present value of in-force long-term insurance business	**525**	737	726
Other	**232**	409	385
Other operating income	**2,632**	2,100	1,766

Change in present value of in-force long-term insurance business

	2013	2012	2011
	US$m	US$m	US$m
Value of new business	**924**	1,027	943
Expected return	**(505)**	(420)	(428)
Assumption changes and experience variances	**88**	69	(30)
Other adjustments	**18**	61	241
Change in present value of in-force long-term insurance business	**525**	737	726

Report of the Directors: Financial Review (continued)

Other operating income of US$2.6bn increased by US$532m in 2013 on a reported basis and by US$727m on a constant currency basis.

Reported other operating income included net gains on the disposals and the reclassifications listed on page 49 of US$2.2bn in 2013, principally relating to an accounting gain arising from the reclassification of Industrial Bank as a financial investment following its issue of additional share capital to third parties and a gain on the disposal of our operations in Panama, compared with net gains of US$736m in 2012.

On an underlying basis, which excludes the net gains above, the results of disposed of operations and the effects of foreign currency translation, other operating income decreased. This was driven by losses totalling US$424m on the sales of our CML non-real estate personal loan portfolio and several tranches of real estate secured loans, and a loss of US$279m following the write-off of goodwill relating to our GPB business in Monaco. In addition,

we recognised a loss of US$146m on the sale of the HFC Bank UK secured loan portfolio in RBWM in Europe. These factors were partly offset by higher disposal and revaluation gains on investment properties in Hong Kong.

There were lower favourable movements on the present value of the in-force (PVIF) long-term insurance business asset compared with 2012. This was largely due to lower values of new business in Europe, Hong Kong and Rest of Asia-Pacific, reflecting lower sales. Additionally, expected returns increased due to the growth of the opening PVIF asset year on year, particularly in Hong Kong and Brazil.

These factors were partly offset by higher favourable assumption changes in Hong Kong, which exceeded the adverse experience and assumption changes in Latin America. The lower other PVIF movements in 2013 compared with 2012 were driven by Latin America, notably the favourable effect of the recognition of a PVIF asset in Brazil in 2012 which did not recur.

Net insurance claims incurred and movement in liabilities to policyholders

	2013	2012	2011
	US$m	US$m	US$m
Insurance claims incurred and movement in liabilities to policyholders:			
gross	**13,948**	14,529	11,631
reinsurers share	**(256)**	(314)	(450)
net[25]	**13,692**	14,215	11,181

For footnote, see page 132.

Net insurance claims incurred and movement in liabilities to policyholders decreased by 4% on a reported basis, and by 3% on a constant currency basis.

The reduction largely reflected the decrease in premiums, notably in Latin America, North America and France, and included the effect of business disposals described under Net earned insurance premiums .

This reduction was partly offset by increases in reserves attributable to increased renewal premiums in Hong Kong and higher investment returns on the

assets held to support policyholder contracts where the policyholder bears investment risk. These returns reflected favourable equity market movements in the UK and France, partly offset by weaker equity market performance and falling bond prices in Hong Kong and lower net income on the bond portfolio in Brazil.

The gains or losses recognised on the financial assets designated at fair value held to support these insurance and investment contract liabilities are reported in Net income from financial instruments designated at fair value .

60

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Loan impairment charges and other credit risk provisions

	2013	2012	2011
	US$m	US$m	US$m
Loan impairment charges			
New allowances net of allowance releases	**7,344**	9,306	12,931
Recoveries of amounts previously written off	**(1,296)**	(1,146)	(1,426)
	6,048	8,160	11,505
Individually assessed allowances	**2,320**	2,139	1,915
Collectively assessed allowances	**3,728**	6,021	9,590
Impairment/(releases of impairment allowances) on available-for-sale debt securities	**(211)**	99	631
Other credit risk provisions/(recoveries)	**12**	52	(9)
Loan impairment charges and other credit risk provisions	**5,849**	8,311	12,127
	%	%	%
Impairment charges on loans and advances to customers as a percentage of average gross loans and advances to customers	**0.6**	0.9	1.2

On a reported basis, loan impairment charges and other credit risk provisions (LICs) were US$2.5bn lower than in 2012, decreasing in the majority of regions, most notably in North America, Europe and the Middle East and North Africa. Underlying LICs declined by US$1.9bn to US$5.8bn.

The percentage of impairment charges to average gross loans and advances reduced to 0.6% at 31 December 2013 from 0.9% at 31 December 2012.

On a constant currency basis, LICs fell by US$2.3bn, a reduction of 28%. Collectively assessed charges decreased by US$2.1bn while individually assessed impairment charges increased by US$198m. Credit risk provisions on available-for-sale debt securities reflected net releases of US$211m in 2013 compared with charges in 2012.

The fall in collectively assessed charges largely arose in North America, in part due to improvements in housing market conditions. In addition, the decrease reflected lower lending balances, reduced new impaired loans and lower delinquency levels in the CML portfolio. This was partially offset by increases in Latin America, principally in Mexico due to higher collective impairments in RBWM. In Brazil, improvements in credit quality were broadly offset by higher charges from model changes and assumption revisions for restructured loan portfolios in RBWM and Business Banking in CMB.

The increase in individually assessed loan impairment charges reflected higher levels of impairment in Latin America, particularly on exposures to homebuilders in Mexico and across a number of corporate exposures in Brazil. These were partly offset by releases in the Middle East and North Africa, mainly in GB&M for a small number of customers as a result of an overall improvement in

the loan portfolio compared with charges in 2012. In Europe, higher provisions in GB&M were broadly offset by decreases in CMB, mainly in the UK and Greece.

The movement in credit risk provisions on available-for-sale debt securities was largely in GB&M as a result of net releases in Europe compared with charges in 2012, and a credit risk provision on an available-for-sale debt security in 2012 in Rest of Asia-Pacific.

In **North America**, LICs decreased by US$2.3bn to US$1.2bn, mainly in the US, in part due to improvements in housing market conditions. In addition, the decrease reflected lower lending balances from continued run-off and loan sales, and lower levels of new impaired loans and delinquency in the CML portfolio. US$322m of the decline in loan impairment charges was due to the sale of the CRS business in 2012. These factors were partly offset by an increase of US$130m relating to a rise in the estimated average period of time from a loss event occurring to writing off real estate loans to twelve months (previously a period of ten months was used). In CMB, loan impairment charges increased by US$77m, reflecting higher collectively assessed charges in the US as a result of increased lending balances in key growth markets and higher individually assessed impairments on a small number of exposures mainly in Canada.

In **Europe**, LICs decreased by 20% to US$1.5bn. In the UK, GB&M reported net releases of credit risk provisions on available-for-sale asset-backed securities (ABS s), compared with impairment charges in 2012, offset in part by higher individually assessed provisions. In addition, there were lower loan impairment charges in CMB due to lower collectively and individually assessed provisions, and in RBWM due to lower collectively assessed provisions reflecting recoveries from

61

Report of the Directors: Financial Review (continued)

debt sales. In other countries in Europe, lower individually assessed impairment provisions in Greece were partly offset by increases in Turkey, where there was growth in unsecured lending in RBWM and a rise in Spain, where the challenging economic conditions continued to affect the market.

In the **Middle East and North Africa**, LICs reflected a net release of US$42m compared with a charge of US$282m in 2012. We recorded provision releases, mainly in GB&M, for a small number of UAE-related exposures, reflecting an overall improvement in the loan portfolio compared with charges in 2012. In addition, loan impairment charges declined, due to lower individually assessed loan impairments in the UAE in CMB, and lower provisions in RBWM on residential mortgages following a repositioning of the book towards higher quality lending and improved property prices.

In **Rest of Asia-Pacific**, LICs decreased by US$63m as 2012 included a large individually assessed impairment of a corporate exposure in Australia and a credit risk provision on an available-for-sale debt security in GB&M. These factors were partly offset by an increase in individually assessed impairments in GB&M and CMB in a number of countries across the region.

In **Latin America**, LICs increased by US$693m, primarily in Mexico due to specific impairments in CMB relating to homebuilders from a change in the public housing policy, and higher collective impairments in RBWM as a result of increased volumes and higher delinquency in our unsecured lending portfolio. In Brazil, LICs increased due to changes to the impairment model and assumption revisions for restructured loan account portfolios in RBWM and CMB, following a realignment of local practices to Group standard policy. LICs were also adversely affected by higher specific impairments in CMB across a number of corporate exposures. These factors were partly offset by improvements in credit quality in Brazil following the modification of credit strategies in previous years to mitigate rising delinquency rates.

LICs in **Hong Kong** were US$63m higher due to a revision to the assumptions used in our collective assessment models in RBWM and a rise in individual impairment charges in CMB, although these remained low. This was partly offset by collective provision releases in CMB from lower historical loss rates and individual impairment releases in GB&M.

Operating expenses

	2013	2012	2011
	US$m	US$m	US$m
By expense category			
Employee compensation and benefits	**19,196**	20,491	21,166
Premises and equipment (excluding depreciation and impairment)	**4,183**	4,326	4,503
General and administrative expenses	**12,882**	15,657	12,956
Administrative expenses	**36,261**	40,474	38,625
Depreciation and impairment of property, plant and equipment	**1,364**	1,484	1,570
Amortisation and impairment of intangible assets	**931**	969	1,350
Operating expenses	**38,556**	42,927	41,545

Staff numbers (full-time equivalents)

	At 31 December		
	2013	2012	2011
Geographical regions			
Europe	**68,334**	70,061	74,892
Hong Kong	**28,367**	27,742	28,984
Rest of Asia-Pacific	**85,334**	85,024	91,051
Middle East and North Africa	**8,618**	8,765	8,373
North America	**20,871**	22,443	30,981
Latin America	**42,542**	46,556	54,035
	254,066	260,591	288,316

Reported operating expenses of US$38.6bn were US$4.4bn or 10% lower than 2012. On an underlying basis, costs fell by 6%.

On a constant currency basis, operating expenses in 2013 were US$3.7bn or 9% lower than in 2012, primarily due to the non-recurrence of a

charge for US AML, BSA, and OFAC investigations of US$1.9bn, and a reduction in restructuring and other related costs of US$369m. UK customer redress programmes were also lower than in 2012. These included:

Report of the Directors: Financial Review (continued)

- a charge for additional estimated redress for possible mis-selling in previous years of payment protection insurance (PPI) policies of US$756m (US$1.7bn in 2012);

- US$261m in respect of interest rate protection products (US$586m in 2012); and

- US$149m in respect of wealth management products.

- The provision for the UK customer redress programmes at 31 December 2013 is US$2.1bn

The business disposals, primarily the disposal of the CRS business and the non-strategic branches in the US in 2012, resulted in a lower cost base in 2013.

Excluding the above, expenses were US$808m higher than in 2012. The UK bank levy charge of US$904m in 2013 increased compared with US$571m in 2012, mainly due to an increase in its rate. In addition, operating expenses in both years included adjustments relating to the prior year charge for the UK bank levy (2013: US$12m adverse adjustment; 2012: US$99m favourable adjustment).

Litigation-related expenses increased primarily due to a provision in respect of regulatory investigations in GPB, Madoff related litigation costs in GB&M, and a customer remediation provision connected with our former CRS business.

During 2013:

- we increased our investment in digital and wealth management capabilities in RBWM;

- in CMB we continued our ongoing expansion into the large corporate market in the US; and

- increased investment spend on regulatory requirements particularly through the Global Standards programme.

In addition, other costs rose due to higher operational expenses in part driven by general inflationary pressures including wage inflation across the Group and rental costs in Hong Kong and Rest of Asia-Pacific. Cost growth in the Middle East and North Africa resulted from a customer redress programme in RBWM relating to fees charged on overseas credit card transactions, the acquisition of the Lloyds business in the UAE in 2012 and the merger with Oman International Bank S.A.O.G. (OIB). Operating expenses also increased in Hong Kong and North America as a result of changes to the recognition of pension costs.

These cost increases were in part offset by further sustainable cost savings of US$1.5bn from our ongoing organisational effectiveness programmes. In addition, we recorded an accounting gain of US$430m from changes in delivering ill-health benefits to certain employees in the UK (see Note 7 on the Financial Statements).

The number of employees expressed in full-time equivalent numbers (FTE s) at the end of 2013 was 3% lower than at the end of 2012 due to sustainable cost savings initiatives and business disposals. Average staff numbers fell by 6% compared with 2012.

Cost efficiency ratios[26]

	2013	2012	2011
	%	%	%
HSBC	**59.6**	62.8	57.5
Geographical regions			
Europe	**84.0**	108.4	70.4
Hong Kong	**38.2**	39.0	44.5
Rest of Asia-Pacific	**47.1**	42.7	54.2
Middle East and North Africa	**51.5**	48.0	44.5
North America	**72.9**	60.8	55.7
Latin America	**56.1**	58.7	63.3
Global businesses			
Retail Banking and Wealth Management	**64.5**	58.4	63.2
Commercial Banking	**43.1**	45.9	46.3
Global Banking and Markets	**51.9**	54.2	57.0
Global Private Banking	**91.4**	67.6	68.8

For footnote, see page 132.

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Share of profit in associates and joint ventures

	2013 US$m	2012 US$m	2011 US$m
Associates			
Bank of Communications Co., Limited	**1,878**	1,670	1,370
Ping An Insurance (Group) Company of China, Ltd		763	946
Industrial Bank Co., Limited		670	471
The Saudi British Bank	**403**	346	308
Other	**5**	72	126
Share of profit in associates	**2,286**	3,521	3,221
Share of profit in joint ventures	**39**	36	43
Share of profit in associates and joint ventures	**2,325**	3,557	3,264

The share of profit in associates and joint ventures was US$2.3bn, a decrease of 35% compared with 2012 on both a reported and constant currency basis. This was driven by the disposal of Ping An in 2012 and the reclassification in 2013 of Industrial Bank as a financial investment.

The recognition of profits ceased from Ping An following the agreement to sell our shareholding in December 2012, and from Industrial Bank following the issuance of additional share capital to third parties in January 2013, which resulted in our diluted shareholding being classified as a financial investment. In addition, in 2013, we recorded an impairment charge of US$106m on our banking associate in Vietnam.

Our share of profit from BoCom rose as a result of balance sheet growth and increased fee income, partly offset by higher operating expenses and a rise in loan impairment charges.

At 31 December 2013, we performed an impairment review of our investment in BoCom and concluded that it was not impaired at the year end, based on our value in use calculation (see Note 21 on the Financial Statements for further details). In future years, the value in use will remain relatively stable if the current calculation assumptions remain broadly the same. However, it is expected that the carrying amount will increase in 2014 due to retained profits earned by BoCom. At the point where the carrying amount exceeds the value in use, the carrying amount would be reduced to equal value in use, with a corresponding reduction in income, unless the market value has increased to a level above the carrying amount.

Profits from The Saudi British Bank rose, reflecting strong lending growth and effective cost management.

Tax expense

	2013	2012	2011

	US$m	US$m	US$m
Profit before tax	**22,565**	20,649	21,872
Tax expense	**(4,765)**	(5,315)	(3,928)
Profit after tax	**17,800**	15,334	17,944
Effective tax rate	**21.1%**	25.7%	18.0%

The effective tax rate for 2013 of 21.1% was lower than the UK corporation tax rate of 23.25%.

The lower effective tax rate reflected the geographical distribution of our profit, the non-taxable gain on profits resulting from the reclassification of our holding in Industrial Bank as a financial investment and the disposal of our operations in Panama and our investment in Ping An.

The tax expense decreased by US$0.6bn to US$4.8bn despite a US$2.0bn increase in accounting profit before tax, due to the combination of benefits noted above and because the 2012 tax expense included the non-tax deductible effect of fines and penalties paid as part of the settlement of

investigations into past inadequate compliance with anti-money laundering and sanction laws.

In 2013, the tax borne and paid by the Group to the relevant tax authorities, including tax on profits, bank levy and employer-related taxes, was US$8.6bn (2012: US$9.3bn). The amount differs from the tax charge reported in the income statement due to indirect taxes such as VAT and the bank levy included in pre-tax profit, and the timing of payments.

We also play a major role as tax collector for governments in the jurisdictions in which we operate. Such taxes include employee-related taxes and taxes withheld from payments to deposit holders. In 2013, we collected US$8.8bn (2012: US$8.5bn).

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

2012 compared with 2011

Reconciliation of reported and constant currency profit before tax

	2012 compared with 2011					
			2011			
		Currency	at 2012			Constant
		translation	exchange	2012 as	Reported	currency
	2011 as reported	adjustment[1]	rates	reported	change[2]	change[2]
HSBC	US$m	US$m	US$m	US$m	%	%
Net interest income	40,662	(1,151)	39,511	37,672	(7)	(5)
Net fee income	17,160	(436)	16,724	16,430	(4)	(2)
Own credit spread[3]	3,933	(35)	3,898	(5,215)		
Gains on disposal of US branch network, US cards business and Ping An				7,024		
Other income[7]	10,525	(446)	10,079	12,419	18	23
Net operating income[4]	72,280	(2,068)	70,212	68,330	(5)	(3)
Loan impairment charges and other credit risk provisions	(12,127)	277	(11,850)	(8,311)	31	30
Net operating income	60,153	(1,791)	58,362	60,019		3
Operating expenses	(41,545)	1,273	(40,272)	(42,927)	(3)	(7)
Operating profit	18,608	(518)	18,090	17,092	(8)	(6)
Share of profit in associates and joint ventures	3,264	55	3,319	3,557	9	7
Profit before tax	21,872	(463)	21,409	20,649	(6)	(4)
By global business						
Retail Banking and Wealth Management	4,270	(71)	4,199	9,575	124	128
Commercial Banking	7,947	(180)	7,767	8,535	7	10
Global Banking and Markets	7,049	(200)	6,849	8,520	21	24
Global Private Banking	944	(8)	936	1,009	7	8
Other	1,662	(4)	1,658	(6,990)		
Profit before tax	21,872	(463)	21,409	20,649	(6)	(4)
By geographical region						
Europe	4,671	(130)	4,541	(3,414)		
Hong Kong	5,823	20	5,843	7,582	30	30
Rest of Asia-Pacific	7,471	(79)	7,392	10,448	40	41
Middle East and North Africa	1,492	(7)	1,485	1,350	(10)	(9)
North America	100	(14)	86	2,299	2,199	2,573
Latin America	2,315	(253)	2,062	2,384	3	16
Profit before tax	21,872	(463)	21,409	20,649	(6)	(4)

For footnotes, see page 132.

64a

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Reconciliation of reported and underlying items

	2012	2011	Change[2]
	US$m	US$m	%
Revenue[4]			
Reported	68,330	72,280	(5)
Currency translation adjustment[1]		(2,033)	
Own credit spread[3]	5,215	(3,933)	
Acquisitions, disposals and dilutions	(10,048)	(6,976)	
Underlying	63,497	59,338	7
Loan impairment charges and other credit risk provisions			
Reported	(8,311)	(12,127)	31
Currency translation adjustment[1]		277	
Acquisitions, disposals and dilutions	338	1,619	
Underlying	(7,973)	(10,231)	22
Operating expenses			
Reported	(42,927)	(41,545)	(3)
Currency translation adjustment[1]		1,273	
Acquisitions, disposals and dilutions	1,004	2,666	
Underlying	(41,923)	(37,606)	(11)
Underlying cost efficiency ratio	66.0%	63.4%	
Profit before tax			
Reported	20,649	21,872	(6)
Currency translation adjustment[1]		(428)	
Own credit spread[3]	5,215	(3,933)	
Acquisitions, disposals and dilutions	(9,479)	(3,650)	
Underlying	16,385	13,861	18
By global business			
Retail Banking and Wealth Management	4,001	871	359
Commercial Banking	7,941	7,691	3
Global Banking and Markets	8,371	6,735	24
Global Private Banking	954	945	1
Other	(4,882)	(2,381)	(105)
Underlying profit before tax	16,385	13,861	18
By geographical region			
Europe	699	1,629	(57)
Hong Kong	7,162	5,761	24
Rest of Asia-Pacific	6,403	6,249	2
Middle East and North Africa	1,380	1,417	(3)
North America	(1,499)	(3,076)	51
Latin America	2,240	1,881	19
Underlying profit before tax	16,385	13,861	18

For footnotes, see page 132.

Consolidated income statement

Reported profit before tax of US$20.6bn in 2012 was US$1.2bn, or 6%, lower than in 2011. This was primarily due to adverse fair value movements on own debt attributable to credit spreads of US$5.2bn, compared with favourable movements of US$3.9bn in 2011. The variance was partially offset by US$7.5bn of gains (net of losses) on disposals, in particular in respect of the US Card and Retail Services business and our associate, Ping An. Our remaining shareholding in Ping An has been

reclassified as a financial investment, the sale of which was completed on 6 February 2013.

We expect disposal of the Card and Retail Services business in North America and of our associate shares in Ping An in Rest of Asia-Pacific to have a significant impact on our profits in each of these regions for the foreseeable future. In addition, future profits in Rest of Asia-Pacific are expected to be affected by the dilution of our shareholding in Industrial Bank Co. Limited (Industrial Bank), following its issue of additional share capital to third parties on 7 January 2013. Our shareholding in

64b

Report of the Directors: Financial Review (continued)

Industrial Bank has now been classified as a financial investment.

On an underlying basis, profit before tax rose by 18%, primarily due to higher net operating income before loan impairment charges and other credit risk provisions (revenue) and lower loan impairment charges and other credit risk provisions, which were partially offset by an increase in operating expenses. The latter was primarily driven by fines and penalties paid as part of the settlement of investigations into past inadequate compliance with anti-money laundering and sanctions laws of US$1.9bn, and a higher provision for UK customer redress programmes of US$1.4bn.

The following commentary is on an underlying basis, except where otherwise stated.

Revenue of US$63.5bn was US$4.2bn, or 7%, higher than in 2011, primarily due to lower adverse movements on non-qualifying hedges which accounted for US$1.1bn of the increase, and revenue growth in GB&M and CMB.

Revenue growth in GB&M mainly reflected higher Rates and Credit income, notably in Europe, as spreads tightened and investor sentiment improved following stimuli by central banks globally.

In CMB, revenue growth primarily reflected increased net interest income as a result of average balance sheet growth. Customer loans and advances grew in all regions, with over half this growth coming from our faster-growing regions of Hong Kong, Rest of Asia-Pacific and Latin America, driven by trade-related lending. In Europe, lending balances increased, notably in the UK, despite muted demand for credit. Customer deposits also rose as we continued to attract deposits through our Payments and Cash Management products.

Revenue growth in RBWM reflected increased insurance income, mainly in Hong Kong and Latin America, which benefited from higher investment returns and increased sales of life insurance products. In addition, net interest income grew, mainly in Hong Kong and Latin America, reflecting higher average lending and deposit balances. These factors were partially offset by the continued run-off of our Consumer and Mortgage Lending (CML) portfolio in the US.

Loan impairment charges and other credit risk provisions were US$2.3bn lower than in 2011. This primarily reflected a decrease in North America, mainly due to the continued decline in lending balances and lower delinquency rates in the CML portfolio. In addition, in Europe there were lower credit risk provisions on available-for-sale asset-

backed securities (ABS s) driven by an improvement in underlying asset prices, and lower loan impairment charges in RBWM, most notably in the UK, as delinquency rates improved across both unsecured and secured lending portfolios. These factors were partially offset by increased loan impairment charges and other credit risk provisions in Latin America, particularly in Brazil, which were primarily due to higher delinquency rates in RBWM and in Business Banking in CMB. In Rest of Asia-Pacific, there were also higher individually assessed loan impairments on a small number of customers in CMB.

Operating expenses were higher than in 2011, primarily from fines and penalties paid as part of the settlement of investigations into past inadequate compliance with anti-money laundering and sanctions laws of US$1.9bn, as well as an increase in provisions relating to UK customer redress programmes of US$1.4bn. In addition, in 2011 operating expenses included a credit of US$570m relating to defined benefit pension obligations in the UK, which did not recur.

The charges for UK customer redress programmes include estimates in respect of possible mis-selling in previous years of payment protection insurance (PPI) policies of US$1.7bn and interest rate protection products of US$598m. The additional provision relating to PPI reflects our recent claims experience. The provision in relation to interest rate protection products reflects an estimate of possible customer redress requirements following an independent review carried out at the request of the Financial Services Authority (FSA). There are many factors which affect these estimated liabilities and there remains a high degree of uncertainty as to the eventual cost of redress for these matters.

Operating expenses also increased due to inflationary pressures, for example, on wages and salaries, in certain of our Latin American and Asian markets. Other increases arose from investment in strategic initiatives including certain business expansion projects, enhanced processes and technology capabilities, and increased investment in regulatory and compliance infrastructure, primarily in the US. These factors were partly offset by US$2.0bn of sustainable cost savings achieved across all regions, as we continued with our organisational effectiveness programmes during 2012. The number of full time equivalent staff numbers (FTEs) fell by more than 27,700, reflecting the planned net reduction of staff numbers across the Group from organisational effectiveness initiatives and business disposals.

Report of the Directors: Financial Review (continued)

On a constant currency basis, *income from associates* increased, mainly driven by strong results in our mainland China associates. The contribution from Bank of Communications Co., Limited (BoCom) and Industrial Bank rose due to loan growth and higher fee income. These factors were partially offset by a decline in income from Ping An due to market valuation losses on equity securities held by their insurance business, reflecting volatile domestic equity markets.

The reported profit after tax was US$2.6bn or 15% lower than in 2011, reflecting a decrease in taxable profits, and a higher tax charge in 2012. The increased tax charge included the effect of the non-tax deductible charge for fines and penalties paid as part of the settlement of investigations into past inadequate compliance with anti-money laundering and sanctions laws, together with the non-recognition of the tax benefit in respect of the accounting charge associated with negative fair value movements on own debt. The lower tax charge in 2011 included the benefit of US foreign tax credits. The effective tax rate in 2012 was 26% compared with 18% in 2011.

Group performance by income and expense item

Net interest income

The commentary in the following sections is on a constant currency basis unless otherwise stated.

Reported net interest income decreased by 7%. On a constant currency basis, it declined by 5%.

On an underlying basis, excluding net interest income earned by the businesses sold during 2012 from all periods presented (2012: US$1.6bn; 2011: US$4.8bn) and currency translation movements of US$1.2bn, net interest income rose by 4%. This reflected strong balance sheet growth in Hong Kong and Rest of Asia-Pacific, together with a lower cost of funds in Latin America driven by a decline in interest rates in Brazil.

The decrease in both net interest spread and net interest margin compared with 2011 was attributable to significantly lower yields on customer lending and on our surplus liquidity, partly offset by a reduction in our cost of funds, notably on customer accounts.

Interest income was lower than in 2011. This was driven by lower interest income on customer lending, including loans classified within Assets held for sale , due in part to the loss of interest income from disposals during 2012, principally in the US. These disposals also led to a change in the composition of our lending book as the decline in higher yielding card balances was replaced by volume growth in relatively lower yielding products,

mainly residential mortgages and term lending, in Hong Kong, Rest of Asia-Pacific and Europe. Growth in average residential mortgage balances reflected the success of marketing campaigns and competitive pricing in the UK, the continued strength in the property market in Hong Kong and the expansion of our distribution network in Rest of Asia-Pacific. Average term lending balances increased in Hong Kong and Rest of Asia-Pacific as we capitalised on trade and capital flows, while the rise in Europe was in spite of muted demand for credit. As a result of the change in composition of the lending book, the gross yield on customer lending fell.

Revenue in Balance Sheet Management also decreased, principally in Europe as yield curves continued to flatten and liquidity arising from maturities and sales of available-for-sale debt securities was re-invested at lower prevailing rates. In addition, we placed a greater portion of our liquidity with central banks. This was partly offset by higher revenue in Rest of Asia-Pacific, notably mainland China, as strong customer deposit growth led to a rise in the size of the available-for-sale debt securities portfolio.

The decline in interest income was partly offset by lower interest expense, notably on customer accounts. This was driven by a reduction in the cost of funds on customer accounts in Latin America, notably in Brazil, and in Europe due to the downward movement in interest rates during the year, together with deposit repricing initiatives in the US and Europe. The reduction in average customer account balances due to the disposal of non-strategic branches in the US was largely offset by significant volume growth in other parts of the business, notably in Hong

Kong, reflecting more conservative customer behaviour during the year in RBWM, and in Rest of Asia-Pacific, as a result of new mandates and deposit acquisition in Payments and Cash Management in CMB and GB&M.

Interest expense on deposits by banks decreased, mainly in Europe. This was due to lower placements by other financial institutions with HSBC, in part due to lower interest rates offered, together with a reduction in the cost of sale and repurchase (repo) funding as market rates fell. Lower average balances and interest rates in Brazil also contributed to the decline.

There was also a decrease in interest expense on debt securities issued by the Group, driven by a net reduction in average balances outstanding, mainly in North America and, to a lesser extent, in Europe. Funding requirements in the US fell as a result of the

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

business disposals and continued reduction of the CML portfolio in run-off and, as a consequence, maturing debt was not replaced and some of the outstanding debt was repaid with the proceeds from the sales. In addition, maturing debt was not replaced in Europe. These decreases were partly offset by higher interest expense in Latin America, as a result of new debt issued, principally in 2011. The Group s cost of funds on debt securities rose as the new issuances in Latin America were at a higher effective interest rate than that paid in other parts of the Group. The replacement of short-term debt by the issuance of medium-term notes in Europe also contributed to the rise in the cost of funds of debt securities in issue.

Net interest income includes the expense of internally funding trading assets, while related revenue is reported in Net trading income . The internal cost of funding of these assets declined, reflecting the reduction in average trading assets during the year. In reporting our global business results, this cost is included within Net trading income .

Net fee income

Net fee income decreased by US$730m on a reported basis, and by US$294m on a constant currency basis.

On an underlying basis, which excludes the net fee income relating to the business disposals (2012: US$401m and 2011:US$1.41bn) and currency translation movements of US$436m, net fee income rose by US$726m, or 5%.

The reduction on a constant currency basis was primarily due to the sale of the Card and Retail Services business, which led to a reduction in cards and insurance fee income and fee expenses. As part of that transaction, we entered into a transition service agreement with the purchaser to support certain account servicing operations until they are integrated into the purchaser s infrastructure. We receive fees for providing these services, which are reported in Other fee income . The associated costs are reported in Operating expenses .

Broking income fell, most notably in Hong Kong and Europe, due to reduced transaction volumes reflecting investor sentiment. Income from funds under management (FuM) fell, mainly in Rest of Asia-Pacific, as customers invested in lower yielding products reflecting their lower risk appetite. Income from FuM was also lower in North America, due to the sale of the full service retail brokerage business in Canada. In Europe, the decline was mainly due to challenging market conditions in the latter half of 2011 which led to a fall in average

client assets in 2012 as well as net new money outflows and a fall in client numbers within GPB.

Partly offsetting these reductions was growth in underwriting fees as we actively captured increased client demand for debt capital financing in North America, Hong Kong and Europe in 2012, in part, reflecting the enhanced collaboration between CMB and GB&M. Trade-related income also increased, most notably in Europe and Hong Kong, reflecting increased transaction volumes as we capitalised on our global network to capture cross-border trade flows.

Fees from unit trusts also rose in Hong Kong, reflecting higher sales volumes.

Net trading income

Reported net trading income of US$7.1bn was US$585m higher than in 2011. On a constant currency basis, net trading income rose by US$849m, driven by lower adverse fair value movements on non-qualifying hedges. Net income from trading activities rose in GB&M, but this was more than offset by lower net interest income on trading activities and adverse fair value movements on the contingent forward sale contract relating to Ping An.

There were lower adverse fair value movements on non-qualifying hedges. These hedges are derivatives entered into as part of a documented interest rate management strategy for which hedge accounting was not, nor could be, applied. They are principally cross-currency and interest rate swaps used to economically hedge fixed rate debt issued by HSBC Holdings and floating rate debt issued by HSBC Finance Corporation (HSBC Finance). The size and direction of the changes in the fair value of non-qualifying hedges that are recognised in the income statement can be volatile from year-to-year, but do not alter the cash flows expected as part of the documented interest rate management strategy for both the instruments and the underlying economically hedged assets and liabilities if the derivative is held to maturity. In North America, there were lower adverse fair value movements on non-qualifying hedges as US long-term interest rates declined to a lesser extent than in 2011. There were also lower adverse fair value movements on non-qualifying hedges in Europe. This was driven by favourable fair value movements in HSBC Holdings, compared with adverse fair value movements in 2011, reflecting the less pronounced decline in long-term US interest rates relative to sterling and euro interest rates compared with 2011. This was partly offset by adverse movements in European operating entities as interest rates fell.

Report of the Directors: Financial Review (continued)

During 2012, HSBC Finance terminated approximately US$3.0bn of non-qualifying hedges. A further US$2.4bn of non-qualifying hedges were terminated in January 2013 to better align our hedges with the overall interest rate position in HSBC Finance. The losses on these economic hedges reported in previous years were therefore crystallised.

Net income from trading activities increased compared with 2011, driven by a strong performance in GB&M. This was after taking into account a net charge of US$385m in the fourth quarter of 2012 as a result of a change in estimation methodology in respect of credit valuation adjustments on derivative assets and debit valuation adjustments on derivative liabilities to reflect evolving market practices.

Rates revenue was significantly higher, notably in Europe, as spreads on government debt securities tightened and investor sentiment improved following stimuli by central banks. This was despite significant adverse fair value movements due to own credit spreads on structured liabilities as spreads tightened, compared with a gain reported in 2011, together with a credit valuation adjustment charge of US$837m. The improvement in market sentiment also led to tighter spreads on corporate debt securities, resulting in strong growth in Credit revenue. Foreign Exchange revenue was broadly in line with 2011, as higher income resulting from enhanced collaboration between GB&M and CMB, and increased volumes from improvements in our electronic pricing and distribution capabilities, offset the effect of less volatile markets in 2012. These favourable movements were partly offset by a reduction in Equities trading revenue, reflecting a decline in market volumes together with adverse fair value movements on structured liabilities as own credit spreads tightened in 2012, compared with favourable movements in 2011.

These factors were partly offset by unfavourable fair value movements on assets held as economic hedges of foreign currency debt at fair value compared with favourable movements in 2011, due to movements in the underlying currencies. These offset favourable foreign exchange movements on foreign currency debt which are reported in Net expense from financial instruments designated at fair value .

Net interest income on trading activities also declined. This was driven by a significant reduction in average trading assets, notably holdings of debt securities in Europe, in the latter part of 2011 and the first quarter of 2012 as eurozone sovereign debt concerns dominated the market. In addition, yields fell as a result of both price appreciation in a low

interest rate environment and an increase in the proportion of the portfolio invested in relatively lower-yielding treasury bills and government debt securities. This was partly offset by a reduction in funding costs, reflecting both the decline in the size of the portfolio and the low rate environment.

There were also adverse fair value movements of US$553m on the contingent forward sale contract relating to Ping An.

Net income from financial instruments designated at fair value

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

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

We reported net expense from financial instruments designated at fair value of US$2.2bn in 2012 compared with net income of US$3.4bn in 2011. This included the credit spread-related movements in the fair value of our own long-term debt, on which we reported adverse fair value movements of US$5.2bn in 2012 and favourable movements of US$3.9bn in 2011. The adverse fair value movements arose in 2012 as credit spreads tightened in Europe and North America, having widened during 2011.

Report of the Directors: Financial Review (continued)

Net income arising from financial assets held to meet liabilities under insurance and investment contracts reflected net investment gains in 2012 as global equity market conditions improved, compared with net investment losses in 2011. This predominantly affected the value of assets held to support unit-linked contracts in the UK and Hong Kong, insurance contracts with discretionary participation features (DPF) in Hong Kong, and investment contracts with DPF in France.

The investment gains or losses arising from equity markets result in a corresponding movement in liabilities to customers, reflecting the extent to which unit-linked policyholders, in particular, participate in the investment performance of the associated asset portfolio. Where these relate to assets held to back investment contracts, the corresponding movement in liabilities to customers is also recorded under Net income/(expense) from financial instruments designated at fair value . This is in contrast to gains or losses related to assets held to back insurance contracts or investment contracts with DPF, where the corresponding movement in liabilities to customers is recorded under Net insurance claims incurred and movement in liabilities to policyholders .

Within net income from financial instruments designated at fair value were favourable foreign exchange movements in 2012, compared with adverse movements in 2011, on foreign currency debt designated at fair value issued as part of our overall funding strategy. An offset from assets held as economic hedges was reported in Net trading income .

Gains less losses from financial investments

Gains less losses from financial investments increased by US$282m on a reported basis and US$310m on a constant currency basis.

The increase was driven by higher net gains from the disposal of available-for-sale equity securities, notably in Hong Kong as a result of the sale of our shares in four Indian banks. In addition, we reported a rise in disposal gains in Principal Investments in GB&M.

Higher gains were also reported on the disposal of available-for-sale government debt securities, principally in the UK as part of Balance Sheet

Management s structural interest rate risk management activities. This was partly offset by losses on the disposal of legacy assets in GB&M in the UK, together with the non-recurrence of gains in 2011 on the disposal of available-for-sale debt securities in our Insurance business in RBWM, also in Europe.

There were higher impairments of available-for-sale equity securities due to significant write-downs in 2012 on three holdings, two of which were in our direct investment business, which is in run-off.

Net earned insurance premiums

Net earned insurance premiums were broadly in line with 2011 on a reported basis. On a constant currency basis net earned premiums increased by 6%.

The rise in net earned premium income was driven by Hong Kong and Latin America. In Hong Kong, sales of insurance contracts increased, in particular deferred annuity products, as we widened our product offerings to fulfil customers long-term savings and retirement needs, supported by successful marketing campaigns. Renewal premiums from both unit-linked and insurance contracts with DPF also increased reflecting strong sales in previous years. The increase in net earned premiums in Latin America was due to higher sales of unit-linked and term life products in Brazil, reflecting customer appetite for life insurance products. It was partly offset by a decrease in net earned premiums following the sale of the general insurance business in Argentina in May 2012. In Europe, net earned premiums decreased, mainly on investment contracts with DPF in France, as a result of the uncertain economic and political environment in the election year and increased product competition. The non-renewal and transfer to third parties of certain contracts in our Irish business during 2011 also contributed to the decline. This was partly offset by a rise in net earned premiums in the UK due, in part, to the sale of a unit-linked insurance product through two new third party platforms.

Gains on disposal of US branch network, US cards business and Ping An

Significant progress was made in 2012 in exiting non-strategic markets and disposing of businesses and investments not aligned with the Group s long-term strategy. These included three major disposals:

In May 2012, HSBC USA Inc., HSBC Finance and HSBC Technology and Services (USA) Inc. sold their US Card and Retail Services business

64g

Report of the Directors: Financial Review (continued)

to Capital One Financial Corporation, realising a gain on sale of US$3.1bn.

In May 2012, HSBC Bank USA, N.A. (HSBC Bank USA) sold 138 out of 195 branches primarily in upstate New York to First Niagara Bank, realising a gain of US$661m. In August 2012, it sold the remaining 57 branches to the same purchaser, realising a gain of US$203m.
In December 2012, HSBC Insurance Holdings Limited and The Hongkong and Shanghai Banking Corporation agreed to sell to indirect wholly-owned subsidiaries of Charoen Pokphand Group Company Limited their entire shareholdings in Ping An, representing 15.57% of the issued share capital of Ping An, in two tranches. The first tranche was completed on 7 December 2012. The completion of the second tranche took place on 6 February 2013. The disposal of this associate resulted in a gain of US$3.0bn in 2012. Our remaining shareholding has been classified as a financial investment.

Other operating income

Reported other operating income of US$2.1bn increased by 19% in 2012. On a constant currency basis, it rose by 25% as a result of business disposals during the year.

We continued to rationalise our portfolio in non-strategic markets, resulting in a number of gains and losses on disposal which are excluded from our underlying results. These included gains of US$108m on the sale of our RBWM operations in Thailand, US$130m on the sale of our shareholding in a property company in the Philippines, US$163m on the sales of the HSBC and Hang Seng general insurance businesses in Hong Kong, US$102m following the completion of the sale of our general insurance manufacturing business in Argentina, and US$212m following the sale of our shares in Global Payments Asia-Pacific Ltd. The gains on disposal were partly offset by an investment loss on a subsidiary of US$85m in the Middle East and North Africa and a loss of US$62m on the sale of our operations in Costa Rica, Honduras and El Salvador.

Reported other operating income in 2011 included a gain of US$181m arising from a dilution of our holding in Ping An following its issue of share capital to a third party and a gain of US$83m from the sale of HSBC Afore S.A. de C.V. (HSBC Afore), our Mexican pension business.

On an underlying basis, excluding the gains and losses on disposal totalling US$747m in 2012 and US$354m in 2011, other operating income rose.

This was due to lower losses on foreclosed properties due to the reduction in foreclosure activity in the US, less deterioration in housing prices during 2012 and, in some markets, improvements in pricing compared with 2011 in the US.

The present value of in-force (PVIF) long-term insurance business asset was broadly in line with 2011. The value of new business from the sale of life insurance products, favourable investment returns, together with the recognition of a PVIF asset relating to the unit-linked pension products in Brazil contributed to a rise. In addition, there were lower adverse changes to non-economic assumptions, including mortality and lapse rates in Hong Kong and North America in 2012. These factors were substantially offset by adverse assumption changes in 2012, principally relating to the valuation of policyholder options and guarantees in Hong Kong, along with the non-recurrence of a gain of US$237m (US$243m as reported) recognised upon refinement of the PVIF asset in 2011.

The increase in other operating income was partly offset by losses recognised on the sale of syndicated loans in Europe and on the reclassification of certain businesses to held for sale in South America. In addition, a gain on sale and leaseback of branches in Mexico recognised in 2011 did not recur.

Net insurance claims incurred and movement in liabilities to policyholders

Net insurance claims incurred and movement in liabilities to policyholders increased by 27% on a reported basis, and by 33% on a constant currency basis.

The increase in liabilities to policyholders largely resulted from gains in the fair value of the assets where the policyholders bear the investment risk, particularly in relation to unit-linked insurance contracts and investment and insurance contracts with DPF.

The higher investment returns were largely the result of positive equity market movements in 2012 compared with losses experienced during 2011 notably in Hong Kong, France and the UK. The gains or losses on the financial assets designated at fair value held to support these insurance and investment contract liabilities are reported in Net income from financial instruments designated at fair value .

The increase in liabilities to policyholders also reflected the increase in new business written, notably in Hong Kong and Brazil as explained under Net earned insurance premiums . This was partly

Report of the Directors: Financial Review (continued)

offset by a lower increase in reserves in France attributable to the decline in net earned premiums, and a decrease in Argentina due to the sale of the general insurance business in May 2012.

Loan impairment charges and other credit risk provisions

Reported loan impairment charges and other credit risk provisions (LIC s) fell from US$12bn to US$8.3bn, a decrease of 31% compared with 2011. On an underlying basis they reduced from US$10bn to US$8.0bn.

On a constant currency basis, they declined by US$3.5bn or 30% compared with 2011. Collectively assessed allowances were down by US$3.3bn and credit risk provisions fell by US$456m, partly offset by higher individually assessed impairment charges of US$258m.

At 31 December 2012, the aggregate balance of customer loan impairment allowances was US$16bn. This represented 2% of gross loans and advances to customers (net of reverse repos and settlement accounts) in line with 31 December 2011.

The fall in collectively assessed impairment allowances was most significant in RBWM in North America due to the continued reduction in the CML portfolios in run-off, and the sale of the Card and Retail Services business. In addition, lower loan impairment charges in Europe in RBWM were due to improved credit quality as we continued to pro-actively identify and monitor customers facing financial hardship and focused our lending growth on higher quality assets, notably in the UK. These factors were partly offset by higher loan impairment charges and other credit risk provisions in Latin America which were driven by increased delinquency rates in RBWM and CMB, mainly in Brazil.

Impairment of available-for-sale debt securities reduced, mainly in Europe, due to lower charges on available-for-sale ABSs and on Greek sovereign debt, partly offset by an increase in Rest of Asia-Pacific due to a charge on an available-for-sale debt security in GB&M.

Individually assessed impairment allowances increased by 14%, primarily in Europe in CMB, reflecting challenging economic conditions in the UK, Greece, Spain and Turkey. In addition, higher individually assessed impairments in Latin America mainly related to a single exposure in Brazil.

LICs declined in North America, primarily in the CML portfolio, as well as in Europe, Hong Kong and the Middle East and North Africa. The decrease was

partly offset by an increase in Latin America and Rest of Asia-Pacific.

In North America, LICs fell by 51% to US$3.5bn. Within this, loan impairment charges fell by US$1.3bn following the sale of the Card and Retail Services business. Loan impairment charges in our CML business in the US fell by 48% to US$2.6bn, driven by lower lending balances, as we continued to run off the portfolio, and lower delinquency levels. Loan impairment charges continued to be adversely affected by delays in expected cash flows from mortgage loans due, in part, to delays in foreclosure processing, although the effects were less pronounced than in 2011. These decreases were partly offset by an adjustment made following a review completed in the fourth quarter of 2012 which concluded that the estimated average period of time from current status to write-off was ten months for real estate loans. In CMB and GB&M, loan impairment charges increased, mainly in Bermuda, due to individually assessed impairments on a small number of exposures.

In Europe, LICs decreased by 22% to US$1.9bn. This was mainly in GB&M due to lower credit risk provisions on available-for-sale ABSs as a result of an improvement in underlying asset prices, as well as lower charges on Greek sovereign debt. This was partly offset by increased impairment charges on the legacy credit loans and receivables portfolio. In RBWM, loan impairment charges continued to decline, primarily in the UK, as we focused our lending growth on higher quality assets and continued to pro-actively identify and monitor customers facing financial hardship. As a result, delinquency rates improved across both the secured and unsecured lending portfolios. This was partly offset by an increase in impairments in Turkey due to strong growth in previous years in our RBWM customer loans and advances. In addition, there were higher individually assessed provisions in CMB across a range of sectors, reflecting increased stress on the financial status of certain customers in the challenging economic conditions in certain eurozone countries.

In Hong Kong, LICs fell by 53% to US$74m, largely due to lower specific impairment charges in CMB and the non-recurrence of charges relating to available-for-sale Greek sovereign debt securities.

In the Middle East and North Africa, LICs decreased by US$6m to US$286m. Lower loan impairment charges in RBWM reflected repositioning of the book towards higher quality secured lending in previous years. This was largely

Report of the Directors: Financial Review (continued)

offset by higher LICs recorded for a small number of large exposures in GB&M.

LICs in Latin America and Rest of Asia-Pacific increased compared with 2011. In Latin America, they increased by 29% to US$2.1bn. This was mainly in Brazil, driven by increased delinquency rates in RBWM and CMB, particularly in the Business Banking portfolio reflecting lower economic growth in 2012. We took a number of steps to reposition the portfolios in RBWM and CMB including improving our collections capabilities, reducing third-party originations and lowering credit limits where appropriate. Loan impairment charges fell in Brazil during the second half of 2012, mainly due to lower collective portfolio provisions.

In Rest of Asia-Pacific, LICs increased by 64% to US$436m, notably in CMB as a result of the impairment of a corporate exposure in Australia and a small number of corporate exposures in India, as well as a credit risk provision on an available-for-sale debt security in GB&M.

Operating expenses

Reported operating expenses of US$42.9bn were US$1.4bn or 3% higher than in 2011. On an underlying basis, costs increased by 11%.

On a constant currency basis, operating expenses in 2012 were US$2.7bn or 7% higher than in 2011, primarily driven by fines and penalties paid as part of the settlement of investigations into past inadequate compliance with anti-money laundering and sanction laws of US$1.9bn, of which US$1.5bn was attributed to, and paid by, HNAH and its subsidiaries and US$375m was paid by HSBC Holdings. Further provisions for the UK customer redress programmes of US$2.3bn were raised during 2012 compared with a charge of US$890m in 2011 (US$898m as reported). This included a charge for additional estimated redress for possible mis-selling in previous years of PPI policies US$1.7bn (2011: US$713m) and interest rate protection products (US$598m), which took the balance sheet provision for the UK customer redress programmes at 31 December 2012 to US$2.2bn.

In 2011 we recorded a credit of US$570m (US$587m as reported) following a change in the inflation measure used to calculate the defined benefit obligation in the UK for deferred pensions which did not recur in 2012.

Costs also rose due to inflationary pressures in certain of our Latin American and Asian markets and increased investment costs in strategic initiatives,

including certain business expansion projects, and in enhanced processes and technology capabilities. We also increased investment in our regulatory and compliance infrastructure primarily in the US.

The above increases in costs were mitigated by strict cost control and the continued delivery of our organisational effectiveness programmes, which resulted in sustainable cost savings of US$2.0bn. The number of employees (expressed in FTEs) at the end of the 2012 was 10% lower than at the end of 2011. This reflected the planned net reduction of staff numbers across the Group from organisational effectiveness initiatives and business disposals. In 2012, average FTEs fell by 7%.

Business disposals in 2011 and 2012 resulted in a lower cost base, most significantly from the sale of the Card and Retail Services business and the 195 branches in the US.

Restructuring and other related costs were US$876m in 2012 compared with US$1.1bn in 2011 (US$1.1bn as reported).

Share of profit in associates and joint ventures

The reported share of profit in associates and joint ventures was US$3.6bn, an increase of 9% compared with 2011. On a constant currency basis, it increased by 7%, driven by higher contributions from our associates in mainland China.

Our share of profits from BoCom rose, as a result of loan growth and higher fee income from cards, management service and guarantees and commitments. This was partly offset by increased operating expenses reflecting investment in staff and technology, and higher loan impairment charges. Profits from Industrial Bank also increased, reflecting continued growth in lending balances and a rise in associated fee income, partly offset by higher operating expenses in line with business expansion, as well as increased loan impairment charges. On 7 January 2013, our holding in Industrial Bank was diluted following its issue of additional share capital to third parties. Our shareholding has now been classified as a financial investment.

Profits from The Saudi British Bank rose, driven by higher revenues reflecting strong balance sheet growth and lower costs resulting from effective control and monitoring.

Profits from Ping An were lower due to market valuation losses on equity securities held by their insurance business, reflecting volatile domestic equity markets, partly offset by increased income from the banking business reflecting the contribution of Ping An Bank (formerly Shenzhen Development

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Bank). On 5 December 2012, we agreed to sell our entire shareholding in Ping An and recognised a gain on the disposal of the associate. Our remaining shareholding has been classified as a financial investment.

Tax expense

The tax charge in 2012 was US$1.4bn or 35% higher than in 2011 on a reported basis.

The higher tax charge in 2012 reflected the non-tax deductible effect of fines and penalties paid as part of the settlement of investigations into past inadequate compliance with anti-money laundering and sanctions laws, together with the non-recognition of the tax benefit in respect of the accounting charge associated with negative fair value movements on own debt. The lower tax charge in 2011 included the

benefit of US deferred tax recognised in 2011 in respect of foreign tax credits.

As a result of these factors, the reported effective tax rate for 2012 was 25.7 % compared with 18.0% for 2011.

In 2012, the tax paid by the Group was US$9.3bn (2011: US$8.0bn). The amount differs from the tax charge reported in the income statement due to indirect taxes such as VAT and the bank levy included in the pre-tax profit and the timing of payments.

The Group also plays a major role as tax collector for governments in the jurisdictions in which we operate. In 2012, the Group collected US$8.5bn (2011: US$8.7bn).

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Consolidated balance sheet

Five-year summary consolidated balance sheet

	At 31 December				
	2013	2012	2011	2010	2009
	US$m	US$m	US$m	US$m	US$m
ASSETS					
Cash and balances at central banks	**166,599**	141,532	129,902	57,383	60,655
Trading assets	**303,192**	408,811	330,451	385,052	421,381
Financial assets designated at fair value	**38,430**	33,582	30,856	37,011	37,181
Derivatives	**282,265**	357,450	346,379	260,757	250,886
Loans and advances to banks	**211,521**	152,546	180,987	208,271	179,781
Loans and advances to customers[27]	**1,080,304**	997,623	940,429	958,366	896,231
Financial investments	**425,925**	421,101	400,044	400,755	369,158
Assets held for sale	**4,050**	19,269	39,558	1,991	3,118
Other assets	**159,032**	160,624	156,973	145,103	146,061
Total assets	**2,671,318**	2,692,538	2,555,579	2,454,689	2,364,452
LIABILITIES AND EQUITY					
Liabilities					
Deposits by banks	**129,212**	107,429	112,822	110,584	124,872
Customer accounts	**1,482,812**	1,340,014	1,253,925	1,227,725	1,159,034
Trading liabilities	**207,025**	304,563	265,192	300,703	268,130
Financial liabilities designated at fair value	**89,084**	87,720	85,724	88,133	80,092
Derivatives	**274,284**	358,886	345,380	258,665	247,646
Debt securities in issue	**104,080**	119,461	131,013	145,401	146,896
Liabilities under insurance contracts	**74,181**	68,195	61,259	58,609	53,707
Liabilities of disposal groups held for sale	**2,804**	5,018	22,200	86	3
Other liabilities	**117,377**	118,123	111,971	109,868	148,411
Total liabilities	**2,480,859**	2,509,409	2,389,486	2,299,774	2,228,791
Equity					
Total shareholders equity	**181,871**	175,242	158,725	147,667	128,299
Non-controlling interests	**8,588**	7,887	7,368	7,248	7,362
Total equity	**190,459**	183,129	166,093	154,915	135,661
Total equity and liabilities	**2,671,318**	2,692,538	2,555,579	2,454,689	2,364,452

Five-year selected financial information

Called up share capital	**9,415**	9,238	8,934	8,843	8,705
Capital resources[28,29]	**194,009**	180,806	170,334	167,555	155,729
Undated subordinated loan capital	**2,777**	2,778	2,779	2,781	2,785
Preferred securities and dated subordinated loan capital[30]	**48,114**	48,260	49,438	54,421	52,126

Risk-weighted assets and capital ratios[28]					
Risk-weighted assets	**1,092,653**	1,123,943	1,209,514	1,103,113	1,133,168
	%	%	%	%	%
Core tier 1 ratio	**13.6**	12.3	10.1	10.5	9.4
Total capital ratio	**17.8**	16.1	14.1	15.2	13.7
Financial statistics					
Loans and advances to customers as a percentage of customer accounts	**72.9**	74.4	75.0	78.1	77.3
Average total shareholders equity to average total assets	**6.55**	6.16	5.64	5.53	4.72
Net asset value per ordinary share at year-end[31] (US$)	**9.27**	9.09	8.48	7.94	7.17
Number of US$0.50 ordinary shares in issue (millions)	**18,830**	18,476	17,868	17,686	17,408
Closing foreign exchange translation rates to US$:					
US$1: £	**0.605**	0.619	0.646	0.644	0.616
US$1:	**0.726**	0.758	0.773	0.748	0.694

For footnotes, see page 132.

A more detailed consolidated balance sheet is contained in the Financial Statements on page 419.

Report of the Directors: Financial Review (continued)

Movement in 2013

Total reported assets were US$2.7 trillion, 1% lower than at 31 December 2012, on both a reported and constant currency basis. Our balance sheet remains strong, with a ratio of customer advances to customer accounts of 72.9%.

During 2013, GB&M changed the way it manages repo and reverse repo activities. This led to an increase in 2013 in reverse repo agreements classified as Loans and advances to customers and Loans and advances to banks , and a decline in those included in Trading assets . Similarly, there was an increase in repo agreements classified in Deposits by banks and Customer accounts , with a decline in Trading liabilities . For further details of this change, see page 68.

Loans and advances to customers grew by more than US$34.2bn in 2013, notably in term and trade-related lending to corporate and commercial customers. Customer accounts increased by over US$56.3bn in 2013. These movements exclude reverse repo and repo transactions and the effect of currency movements.

The following commentary is on a constant currency basis.

Assets

Cash and balances at central banks increased by 17%, mainly in Europe, driven by the placement of surplus funds reflecting growth in deposits in excess of lending growth and, to a lesser extent, in North America.

Trading assets decreased by US$110bn or 27%, driven by a fall in reverse repos, reflecting the change in the way GB&M manages these activities noted above. Excluding this, trading assets were broadly in line with December 2012 levels.

Financial assets designated at fair value increased by 16%, in part due to favourable market movements in our European insurance operations coupled with higher investments from premium income received during the year in our insurance businesses, notably in Europe and Hong Kong.

Derivative assets decreased by 22%. Upward movements in yield curves in major currencies led to a decline in the fair value of interest rate contracts, largely in Europe. In North America, declines in fair values of interest rate contracts reflected the increase in swap rates during the year and increased netting.

Loans and advances to banks rose by US$61.4bn or 41%, including a US$56.4bn increase in reverse repos reflecting the change in the way

GB&M manages these activities. Excluding this, there was a US$5.0bn increase driven by higher placements with financial institutions in Hong Kong and Rest of Asia-Pacific.

Loans and advances to customers increased by US$87.0bn or 9%, including a US$52.8bn rise in reverse repo balances reflecting the change in the way GB&M manages these activities, which mainly affected balances in North America and the UK. We reclassified over US$9.5bn of customer lending balances mainly relating to our operations in Panama and first lien mortgage portfolios in the US to Assets held for sale . These were subsequently disposed of in the second half of the year.

Excluding these factors, customer lending balances grew by US$44.0bn as continued demand for financing led to a rise in term and trade-related lending to CMB and GB&M customers in Hong Kong and, to a lesser extent, in Rest of Asia-Pacific. Commercial real estate and other property-related lending also grew in Hong Kong and Rest of Asia-Pacific. Residential mortgages remained broadly in line with 2012. There was growth in Rest of Asia-Pacific and, to a lesser extent, in Hong Kong, although the rate of growth in Hong Kong fell in the second half of the year. We also continued to grow our portfolio in the UK, which reflected our competitive offering. These factors were broadly offset by the continued reduction in the US run-off portfolio. In addition, in the UK there was an increase in corporate overdraft balances, mainly in GB&M that did not meet the criteria for netting, with a corresponding rise in related customer accounts.

Financial investments were broadly in line with 2012 levels. We recorded net sales and maturities of available-for-sale government debt securities in North America. This was broadly offset by an increase in Hong Kong due to net new purchases, together with the re-classification of our shareholding in Industrial Bank.

Assets held for sale decreased by 79%, driven by the completion of the sales of our investment in Ping An and of the non-real estate personal lending portfolio in the US.

Liabilities

Deposits by banks rose by US$21.4bn or 20% and included an increase of US$30.5bn relating to repo balances, reflecting the change in the way GB&M manages these activities. Excluding this, balances fell in Europe and North America.

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Customer accounts increased by US$148.6bn or 11%. This included a rise in repo funding of US$92.3bn reflecting the change in the way GB&M manages these activities, which mainly affected balances in North America and the UK. In addition, we reclassified over US$6.5bn of deposit balances, mainly relating to our operations in Panama, to Liabilities of disposal groups held for sale . These were subsequently disposed of in the second half of the year.

Excluding these factors, customer accounts increased by US$63.4bn, driven by a rise in the UK in RBWM reflecting customers continued preference for holding higher balances in readily-accessible current and savings accounts in the uncertain economic environment. This was coupled with higher balances in our Payments and Cash Management business in GB&M and CMB. Current accounts also grew in GB&M due to higher balances that did not meet the netting criteria and an increase in short-term deposits. In Hong Kong and Rest of Asia-Pacific, customer accounts rose, mainly in RBWM reflecting customer sentiment, but also in CMB reflecting deposit campaigns in the final quarter of the year. In North America, customer accounts grew, driven by higher balances in our CMB business although this was offset in part by a fall in RBWM, due to re-pricing.

Trading liabilities decreased by US$102.1bn or 33% and included a fall of US$114.3bn in repos reflecting the change in the way GB&M manages

these activities. Excluding this, trading liabilities increased by US$12.2bn driven by increases in Europe, reflecting client demand and volumes.

Financial liabilities designated at fair value remained broadly unchanged during 2013.

The reduction in the value of *Derivative liabilities* was in line with that of Derivative assets as the underlying risk is broadly matched.

Debt securities in issue fell by 12%. This was driven by a net redemption in debt securities in issue in Europe together with maturing debt that was not replaced in the US as funding requirements declined due to business disposals and the run-off of the CML portfolio. These factors were partly offset by an increase in Brazil as we substituted wholesale customer deposits for medium-term loan notes.

Liabilities under insurance contracts rose by 9% as a result of liabilities to policyholders established for new business, largely written in Hong Kong.

Liabilities of disposal groups held for sale decreased by US$1.9bn, driven by the disposal of non-strategic businesses in Latin America and North America.

Equity

Total shareholders equity rose by 4%, primarily driven by profits generated in the year, partly offset by dividends paid.

Report of the Directors: Financial Review (continued)

Reconciliation of reported and constant currency assets and liabilities

	31 December 2013 compared with 31 December 2012					
HSBC	31 Dec 12 as reported US$m	Currency translation adjustment[32] US$m	31 Dec 12 at 31 Dec 13 exchange rates US$m	31 Dec 13 as reported US$m	Reported change %	Constant currency change %
Cash and balances at central banks	141,532	565	142,097	166,599	18	17
Trading assets	408,811	4,379	413,190	303,192	(26)	(27)
Financial assets designated at fair value	33,582	(372)	33,210	38,430	14	16
Derivative assets	357,450	6,480	363,930	282,265	(21)	(22)
Loans and advances to banks	152,546	(2,420)	150,126	211,521	39	41
Loans and advances to customers	997,623	(4,367)	993,256	1,080,304	8	9
Financial investments	421,101	(3,132)	417,969	425,925	1	2
Assets held for sale	19,269	(303)	18,966	4,050	(79)	(79)
Other assets	160,624	3,215	163,839	159,032	(1)	(3)
Total assets	2,692,538	4,045	2,696,583	2,671,318	(1)	(1)
Deposits by banks	107,429	339	107,768	129,212	20	20
Customer accounts	1,340,014	(5,801)	1,334,213	1,482,812	11	11
Trading liabilities	304,563	4,605	309,168	207,025	(32)	(33)
Financial liabilities designated at fair value	87,720	1,155	88,875	89,084	2	-
Derivative liabilities	358,886	6,815	365,701	274,284	(24)	(25)
Debt securities in issue	119,461	(1,088)	118,373	104,080	(13)	(12)
Liabilities under insurance contracts	68,195	115	68,310	74,181	9	9
Liabilities of disposal groups held for sale	5,018	(280)	4,738	2,804	(44)	(41)
Other liabilities	118,123	(1,594)	116,529	117,377	-	1
Total liabilities	2,509,409	4,266	2,513,675	2,480,859	(1)	(1)
Total shareholders equity	175,242	(463)	174,779	181,871	4	4
Non-controlling interests	7,887	(43)	7,844	8,588	9	9
Total equity	183,129	(506)	182,623	190,459	4	4
Total equity and liabilities	2,692,538	3,760	2,696,298	2,671,318	(1)	(1)

For footnote, see page 132.

In 2013, GB&M changed the way it manages repo and reverse repo activities in the Credit and Rates businesses, which were previously being managed in a trading environment. During the year, the repo and reverse repo business activities were organised into trading and non-trading portfolios, with separate risk management procedures. This resulted in an increase in the amount of reverse repos classified as Loans and advances to customers and Loans and advances to banks , and a decline in the amount classified as Trading assets at 31 December 2013, compared with previous year-ends. Similarly, at 31 December 2013 there was an increase in the amount of repos classified as Customer accounts and Deposits by banks , with a

decline in the amount classified as Trading liabilities , compared with previous year-ends. The increase in amortised cost balances and the decrease in trading balances primarily occurred in Europe and North America, specifically the UK and the US.

The impact of repos and reverse repos on the balance sheet is set out in the table below. The table also provides a combined view of customer lending and customer deposits which, by taking into account loans and advances to customers and customer account balances reported as held for sale, more accurately reflects the overall size of our lending and deposit books.

Report of the Directors: Financial Review (continued)

Combined view of lending and deposits

	2013 US$m	2012 US$m	Change %
Customers amortised cost			
Loans and advances to customers	**1,080,304**	997,623	8
loans and other receivables	**992,089**	962,972	3
reverse repos	**88,215**	34,651	155
Loans and advances to customers reported in Assets held for sale[33]	**1,703**	6,124	(72)
Combined customer lending	**1,082,007**	1,003,747	8
Customer accounts	**1,482,812**	1,340,014	11
cash deposits and other accounts	**1,361,297**	1,311,396	4
repos	**121,515**	28,618	325
Customer accounts reported in Liabilities of disposal groups held for sale	**2,187**	2,990	(27)
Combined customer deposits	**1,484,999**	1,343,004	11
Banks amortised cost			
Loans and advances to banks	**211,521**	152,546	39
loans and other receivables	**120,046**	117,085	3
reverse repos	**91,475**	35,461	158
Deposits by banks	**129,212**	107,429	20
cash deposits and other accounts	**86,507**	95,480	(9)
repos	**42,705**	11,949	257
Customers and banks fair value			
Trading assets reverse repos	**10,120**	118,681	(91)
loans and advances to customers	**7,180**	73,666	(90)
loans and advances to banks	**2,940**	45,015	(93)
Trading liabilities repos	**17,421**	130,223	(87)
customer accounts	**9,611**	103,483	(91)
deposits by banks	**7,810**	26,740	(71)

For footnote, see page 132.

Financial investments

	At 31 December 2013			At 31 December 2012		
	Equity securities US$bn	**Debt securities US$bn**	**Total US$bn**	Equity securities US$bn	Debt securities US$bn	Total US$bn
Balance Sheet Management		**314.4**	**314.4**		293.4	293.4
Insurance entities		**46.4**	**46.4**		43.4	43.4
Structured entities	**0.1**	**22.6**	**22.7**		24.7	24.7
Principal investments	**2.7**		**2.7**	2.9		2.9

Other	**6.3**	**33.4**	**39.7**	2.9	53.8	56.7
	9.1	**416.8**	**425.9**	5.8	415.3	421.1

The table above analyses the Group s holdings of financial investments by business activity. Further information can be found in the following sections:

Balance Sheet Management (page 238) for a description of the activities and an analysis of third party assets in balance sheet management.

Risk management of insurance operations (page 249) includes an analysis of the financial investments within our insurance operations by the type of contractual liabilities that they back.

Structured entities (page 550) for further information about the nature of securities investment conduits in which the above financial investments are held.

Equity securities classified as available for sale (page 235) includes private equity holdings and other strategic investments.

Other represents financial investments held in certain locally managed treasury portfolios and other GB&M portfolios held for specific business activities.

Report of the Directors: Financial Review (continued)

Average balance sheet

Average balance sheet and net interest income

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

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

Balances and transactions with fellow subsidiaries are reported gross in the principal

commercial banking and consumer finance entities and the elimination entries are included within Other operations .

Net interest margin numbers are calculated by dividing net interest income as reported in the income statement by the average interest-earning assets from which interest income is reported within the Net interest income line of the income statement. Total interest-earning assets include loans where the carrying amount has been adjusted as a result of impairment allowances. In accordance with IFRSs, we recognise interest income on assets after the carrying amount has been adjusted as a result of impairment. Fee income which forms an integral part of the effective interest rate of a financial instrument is recognised as an adjustment to the effective interest rate and recorded in Interest income .

Assets

	2013			2012			2011		
	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									
Interest-earning assets measured at amortised cost (itemised below)	**1,669,368**	**51,192**	**3.07**	1,625,068	56,702	3.49	1,622,658	63,005	3.88
Trading assets and financial assets designated at fair value[55,56]	**354,817**	**5,763**	**1.62**	368,406	6,931	1.88	410,038	8,671	2.11
Impairment provisions	**(15,954)**			(17,421)			(18,738)		
Non-interest-earning assets	**683,785**			730,901			752,965		
Total assets and interest income	**2,692,016**	**56,955**	**2.12**	2,706,954	63,633	2.35	2,766,923	71,676	2.59
Average yield on all interest-earning assets			**2.81**			3.19			3.53

Short-term funds and loans and advances to banks										
Europe	HSBC Bank	**104,187**	**938**	**0.90**	86,496	1,040	1.20	62,489	1,186	1.90
	HSBC Private Banking Holdings (Suisse)	**15,400**	**10**	**0.06**	2,072	9	0.43	1,886	14	0.74
	HSBC France	**36,874**	**127**	**0.34**	33,199	176	0.53	36,023	477	1.32
Hong Kong	Hang Seng Bank	**16,496**	**251**	**1.52**	16,396	283	1.73	17,761	334	1.88
	The Hongkong and Shanghai Banking Corporation	**16,294**	**192**	**1.18**	18,379	224	1.22	22,033	233	1.06
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	**46,684**	**853**	**1.83**	42,814	805	1.88	41,692	920	2.21
	HSBC Bank Malaysia	**5,865**	**173**	**2.95**	5,375	157	2.92	6,049	174	2.88
MENA	HSBC Bank Middle East	**5,638**	**34**	**0.60**	5,922	41	0.69	4,467	42	0.94
North America	HSBC Bank USA	**25,105**	**87**	**0.35**	23,768	106	0.45	27,495	97	0.35
	HSBC Bank Canada	**3,174**	**30**	**0.95**	1,677	17	1.01	2,886	23	0.80
Latin America	HSBC Mexico	**2,979**	**114**	**3.83**	3,053	119	3.90	3,383	130	3.84
	Brazilian operations[57]	**11,076**	**788**	**7.11**	14,610	1,155	7.91	18,954	2,036	10.74
	HSBC Bank Argentina	**1,337**	**31**	**2.32**	396	45	11.36	341	33	9.68
Other operations		**10,158**	**27**	**0.27**	21,822	130	0.60	16,290	161	0.99
		301,267	**3,655**	**1.21**	275,979	4,307	1.56	261,749	5,860	2.24

69a

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

		2013 Average balance US$m	2013 Interest income US$m	2013 Yield %	2012 Average balance US$m	2012 Interest income US$m	2012 Yield %	2011 Average balance US$m	2011 Interest income US$m	2011 Yield %
Loans and advances to customers										
Europe	HSBC Bank	**306,065**	**10,686**	**3.49**	289,586	10,596	3.66	299,775	10,225	3.41
	HSBC Private Banking Holdings (Suisse)	**15,235**	**194**	**1.27**	12,591	199	1.58	14,631	255	1.74
	HSBC France	**67,062**	**1,670**	**2.49**	69,021	1,713	2.48	75,033	2,087	2.78
	HSBC Finance	**173**	**10**	**5.78**	886	42	4.74	1,486	98	6.59
Hong Kong	Hang Seng Bank	**72,537**	**2,179**	**3.00**	64,907	1,895	2.92	63,198	1,569	2.48
	The Hongkong and Shanghai Banking Corporation	**113,936**	**2,631**	**2.31**	100,203	2,410	2.41	91,209	1,975	2.17
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	**126,095**	**5,427**	**4.30**	109,298	5,231	4.79	99,683	4,863	4.88
	HSBC Bank Malaysia	**13,928**	**683**	**4.90**	13,456	707	5.25	12,118	657	5.42
MENA	HSBC Bank Middle East	**25,537**	**1,124**	**4.40**	24,012	1,214	5.06	22,494	1,296	5.76
North America	HSBC Bank USA	**58,177**	**1,786**	**3.07**	59,806	1,742	2.91	67,817	3,226	4.76
	HSBC Finance	**34,146**	**3,064**	**8.97**	43,887	3,904	8.90	59,857	5,842	9.76
	HSBC Bank Canada	**45,646**	**1,497**	**3.28**	44,673	1,588	3.55	44,512	1,683	3.78
Latin America	HSBC Mexico	**15,335**	**1,658**	**10.81**	14,411	1,613	11.19	14,290	1,630	11.41
	Brazilian operations[57]	**25,732**	**4,608**	**17.91**	27,621	5,468	19.80	30,212	6,584	21.79
	HSBC Bank Argentina	**3,615**	**799**	**22.10**	3,644	718	19.70	3,320	524	15.78
Other operations		**23,537**	**704**	**2.99**	56,654	2,003	3.54	45,653	2,736	5.99
		946,756	**38,720**	**4.09**	934,656	41,043	4.39	945,288	45,250	4.79
Financial investments										
Europe	HSBC Bank	**88,406**	**1,223**	**1.38**	80,475	1,275	1.58	95,522	1,631	1.71
	HSBC Private Banking Holdings (Suisse)	**13,509**	**183**	**1.35**	5,722	107	1.87	13,521	247	1.83
	HSBC France	**13,733**	**94**	**0.68**	11,208	130	1.16	4,662	133	2.85
Hong Kong	Hang Seng Bank	**31,502**	**601**	**1.91**	29,319	590	2.01	26,095	596	2.28
	The Hongkong and Shanghai Banking Corporation	**56,325**	**291**	**0.52**	48,695	320	0.66	52,357	399	0.76
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	**48,415**	**1,490**	**3.08**	46,095	1,501	3.26	40,033	1,422	3.55
	HSBC Bank Malaysia	**2,197**	**72**	**3.28**	1,798	59	3.28	1,013	33	3.26
MENA	HSBC Bank Middle East	**11,838**	**113**	**0.95**	10,266	113	1.10	10,944	150	1.37
North America	HSBC Bank USA	**56,302**	**884**	**1.57**	61,510	1,092	1.78	50,357	1,250	2.48
	HSBC Finance				941	67	7.12	2,956	104	3.52
	HSBC Bank Canada	**20,364**	**279**	**1.37**	21,179	297	1.40	17,821	307	1.72
Latin America	HSBC Mexico	**7,782**	**351**	**4.51**	8,021	379	4.73	9,767	473	4.84
	Brazilian operations[57]	**7,404**	**740**	**9.99**	9,527	1,019	10.70	10,072	1,206	11.97
	HSBC Bank Argentina	**451**	**71**	**15.74**	701	96	13.69	651	99	15.21
Other operations		**35,081**	**1,610**	**4.59**	51,872	2,033	3.92	48,288	2,179	4.51
		393,309	**8,002**	**2.03**	387,329	9,078	2.34	384,059	10,229	2.66

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Assets (continued)

		2013			2012			2011		
		Average balance US$m	**Interest income US$m**	**Yield %**	Average balance US$m	Interest income US$m	Yield %	Average balance US$m	Interest income US$m	Yield %
Other interest-earning assets										
Europe	HSBC Bank	**73,607**	**64**	**0.09**	119,175	153	0.13	53,394	101	0.19
	HSBC Private Banking Holdings (Suisse)	**7,441**	**69**	**0.93**	14,461	189	1.31	19,568	262	1.34
	HSBC France	**14,294**	**111**	**0.78**	13,107	121	0.92	10,037	160	1.59
Hong Kong	Hang Seng Bank	**2,088**	**14**	**0.67**	1,003	9	0.90	854	9	1.05
	The Hongkong and Shanghai Banking Corporation	**50,474**	**452**	**0.90**	43,871	441	1.01	32,917	383	1.16
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	**11,895**	**46**	**0.39**	15,320	40	0.26	15,414	53	0.34
	HSBC Bank Malaysia	**456**	**2**	**0.44**	553	4	0.72	578	8	1.38
MENA	HSBC Bank Middle East	**1,888**	**87**	**4.61**	1,914	72	3.76	698	22	3.15
North America	HSBC Bank USA	**6,386**	**103**	**1.61**	12,324	872	7.08	15,187	903	5.95
	HSBC Finance	**6,821**	**19**	**0.28**	7,723	656	8.49	6,014	671	11.16
	HSBC Bank Canada	**1,691**	**42**	**2.48**	2,340	69	2.95	3,109	59	1.90
Latin America	HSBC Mexico	**265**	**6**	**2.26**	614	39	6.35	383	27	7.05
	Brazilian operations[57]	**2,394**	**107**	**4.47**	1,338	100	7.47	2,031	54	2.66
	HSBC Bank Argentina	**93**			106	4	4	88		
Other operations		**(151,757)**	**(307)**		(206,745)	(495)		(128,710)	(1,046)	
		28,036	**815**	**2.91**	27,104	2,274	8.39	31,562	1,666	5.28
Total interest-earning assets										
Europe	HSBC Bank	**572,265**	**12,911**	**2.26**	575,732	13,064	2.27	511,180	13,143	2.57
	HSBC Private Banking Holdings (Suisse)	**51,585**	**456**	**0.88**	34,846	504	1.45	49,606	778	1.57
	HSBC France	**131,963**	**2,002**	**1.52**	126,535	2,140	1.69	125,755	2,857	2.27
	HSBC Finance	**173**	**10**	**5.78**	889	42	4.72	1,486	98	6.59
Hong Kong	Hang Seng Bank	**122,623**	**3,045**	**2.48**	111,625	2,777	2.49	107,908	2,508	2.32
	The Hongkong and Shanghai Banking Corporation	**237,029**	**3,566**	**1.50**	211,148	3,395	1.61	198,516	2,990	1.51
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	**233,089**	**7,816**	**3.35**	213,527	7,577	3.55	196,822	7,258	3.69
	HSBC Bank Malaysia	**22,446**	**930**	**4.14**	21,182	927	4.38	19,758	872	4.41
MENA	HSBC Bank Middle East	**44,901**	**1,358**	**3.02**	42,114	1,440	3.42	38,603	1,510	3.91
North America	HSBC Bank USA	**145,970**	**2,860**	**1.96**	157,408	3,812	2.42	160,856	5,476	3.40

	HSBC Finance	**40,967**	**3,083**	**7.53**	54,342	4,627	8.51	68,827	6,617	9.61
	HSBC Bank Canada	**70,875**	**1,848**	**2.61**	69,869	1,971	2.82	68,328	2,072	3.03
Latin America	HSBC Mexico	**26,361**	**2,129**	**8.08**	26,099	2,150	8.24	27,823	2,260	8.12
	Brazilian operations[57]	**46,606**	**6,243**	**13.40**	53,096	7,742	14.58	61,269	9,880	16.13
	HSBC Bank Argentina	**5,496**	**901**	**16.39**	4,847	863	17.80	4,400	656	14.91
Other operations		**(82,981)**	**2,034**		(78,191)	3,671		(18,479)	4,030	
		1,669,368	**51,192**	**3.07**	1,625,068	56,702	3.49	1,622,658	63,005	3.88

For footnotes, see page 133a.

69c

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Equity and liabilities

		2013 Average balance US$m	2013 Interest expense US$m	2013 Cost %	2012 Average balance US$m	2012 Interest expense US$m	2012 Cost %	2011 Average balance US$m	2011 Interest expense US$m	2011 Cost %
Summary										
Interest-bearing liabilities measured at amortised cost (itemised below)		**1,426,180**	**15,653**	**1.10**	1,401,254	19,030	1.36	1,433,566	22,343	1.56
Trading liabilities and financial liabilities designated at fair value (excluding own debt issued)		**301,353**	**3,027**	**1.00**	318,883	3,445	1.08	355,345	4,564	1.28
Non-interest bearing current accounts		**184,370**			177,085			162,369		
Total equity and other non-interest bearing liabilities		**780,113**			809,732			815,643		
Total equity and liabilities		**2,692,016**	**18,680**	**0.69**	2,706,954	22,475	0.83	2,766,923	26,907	0.97
Average cost on all interest-bearing liabilities				**1.08**			1.31			1.50
Deposits by banks[58]										
Europe	HSBC Bank	**29,394**	**209**	**0.71**	27,738	435	1.57	33,764	529	1.57
	HSBC Private Banking Holdings (Suisse)	**379**	**1**	**0.26**	657	2	0.30	874	2	0.23
	HSBC France	**20,081**	**85**	**0.42**	26,026	171	0.66	29,329	396	1.35
Hong Kong	Hang Seng Bank	**1,101**	**15**	**1.36**	1,305	15	1.15	1,903	7	0.37
	The Hongkong and Shanghai Banking Corporation	**6,638**	**13**	**0.20**	7,648	12	0.16	8,389	13	0.15
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	**9,701**	**103**	**1.06**	10,668	159	1.49	10,613	159	1.50
	HSBC Bank Malaysia	**865**	**20**	**2.31**	961	20	2.08	360	9	2.50
MENA	HSBC Bank Middle East	**1,488**	**4**	**0.27**	1,588	6	0.38	1,511	6	0.40
North America	HSBC Bank USA	**8,233**	**17**	**0.21**	7,587	19	0.25	7,730	18	0.23
	HSBC Bank Canada	**2,572**	**22**	**0.86**	1,613	9	0.56	760	15	1.97
Latin America	HSBC Mexico	**1,368**	**64**	**4.68**	1,103	52	4.71	1,167	62	5.31
	Brazilian operations[57]	**3,466**	**103**	**2.97**	4,323	194	4.49	6,433	331	5.15
	HSBC Bank Argentina	**20**	**2**	**10.00**	44	3	6.82	24	2	8.33
Other operations		**1,576**	**33**	**2.09**	1,542	63	4.09	3,242	42	1.30
		86,882	**691**	**0.80**	92,803	1,160	1.25	106,099	1,591	1.50
Financial liabilities designated at fair value own debt issued[59]										
Europe	HSBC Holdings	**19,719**	**366**	**1.86**	23,864	446	1.87	19,654	342	1.74
	HSBC Bank	**28,969**	**443**	**1.53**	28,046	556	1.98	26,504	462	1.74
	HSBC France	**9,173**	**67**	**0.73**	7,147	118	1.65	6,907	174	2.52
North America	HSBC Bank USA	**1,933**	**35**	**1.81**	1,853	38	2.05	1,642	38	2.31
	HSBC Finance	**8,878**	**80**	**0.90**	12,147	184	1.51	17,108	289	1.69

Other operations	**3,661**	**(24)**	**(0.66)**	1,959	(17)	(0.87)	1,820	8	0.44
	72,333	**967**	**1.34**	75,016	1,325	1.77	73,635	1,313	1.78

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Equity and liabilities (continued)

		2013 Average balance US$m	2013 Interest expense US$m	2013 Cost %	2012 Average balance US$m	2012 Interest expense US$m	2012 Cost %	2011 Average balance US$m	2011 Interest expense US$m	2011 Cost %
Customer accounts[60]										
Europe	HSBC Bank	**350,722**	**2,296**	**0.65**	309,808	2,445	0.79	306,060	2,387	0.78
	HSBC Private Banking Holdings (Suisse)	**16,453**	**70**	**0.43**	15,926	84	0.53	22,025	163	0.74
	HSBC France	**49,739**	**255**	**0.51**	47,974	403	0.84	49,363	650	1.32
Hong Kong	Hang Seng Bank	**91,778**	**360**	**0.39**	85,425	365	0.43	83,220	342	0.41
	The Hongkong and Shanghai Banking Corporation	**208,859**	**254**	**0.12**	190,654	250	0.13	177,336	231	0.13
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	**136,212**	**2,300**	**1.69**	129,419	2,381	1.84	121,237	2,277	1.88
	HSBC Bank Malaysia	**13,737**	**296**	**2.15**	13,624	311	2.28	13,326	299	2.24
MENA	HSBC Bank Middle East	**18,387**	**106**	**0.58**	17,477	163	0.93	17,484	237	1.36
North America	HSBC Bank USA	**65,578**	**115**	**0.18**	68,134	224	0.33	83,988	340	0.40
	HSBC Bank Canada	**42,936**	**340**	**0.79**	45,116	344	0.76	44,833	358	0.80
Latin America	HSBC Mexico	**16,808**	**455**	**2.71**	17,735	528	2.98	18,139	538	2.97
	Brazilian operations[57]	**21,596**	**1,545**	**7.15**	30,352	2,411	7.94	41,194	4,471	10.85
	HSBC Bank Argentina	**3,318**	**343**	**10.34**	3,594	268	7.46	3,149	200	6.35
Other operations		**68,521**	**328**	**0.48**	77,574	701	0.90	76,972	963	1.25
		1,104,644	**9,063**	**0.82**	1,052,812	10,878	1.03	1,058,326	13,456	1.27
Debt securities in issue										
Europe	HSBC Bank	**64,528**	**768**	**1.19**	69,294	989	1.43	79,670	982	1.23
	HSBC France	**13,365**	**54**	**0.40**	14,801	118	0.80	18,043	260	1.44
Hong Kong	Hang Seng Bank	**1,393**	**12**	**0.86**	1,606	15	0.93	1,424	13	0.91
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	**7,493**	**186**	**2.48**	7,732	241	3.12	7,918	263	3.32
	HSBC Bank Malaysia	**967**	**26**	**2.69**	1,016	25	2.46	568	18	3.17
MENA	HSBC Bank Middle East	**3,057**	**64**	**2.09**	3,769	83	2.20	3,870	77	1.99
North America	HSBC Bank USA	**14,012**	**415**	**2.96**	12,738	390	3.06	12,535	395	3.15
	HSBC Finance	**19,888**	**739**	**3.72**	29,198	1,059	3.63	40,629	1,413	3.48
	HSBC Bank Canada	**13,158**	**342**	**2.60**	12,675	390	3.08	12,061	392	3.25
Latin America	HSBC Mexico	**813**	**41**	**5.04**	897	51	5.69	1,074	57	5.31
	Brazilian operations[57]	**10,963**	**863**	**7.87**	9,114	732	8.03	6,825	708	10.37
	HSBC Bank Argentina	**52**	**10**	**19.23**	121	20	16.53	66	11	16.67

Other operations	**1,287**	**662**	**51.44**	(1,613)	642	(39.80)	(3,201)	671	(20.96)
	150,976	**4,182**	**2.77**	161,348	4,755	2.95	181,482	5,260	2.90

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

		2013 Average balance US$m	2013 Interest expense US$m	2013 Cost %	2012 Average balance US$m	2012 Interest expense US$m	2012 Cost %	2011 Average balance US$m	2011 Interest expense US$m	2011 Cost %
Other interest-bearing liabilities										
Europe	HSBC Bank	**96,464**	**659**	**0.68**	126,279	671	0.53	66,449	595	0.90
	HSBC Private Banking Holdings (Suisse)	**7,869**	**13**	**0.17**	4,195	4	0.10	3,006	8	0.27
	HSBC France	**26,159**	**77**	**0.29**	20,853	28	0.13	20,294	170	0.84
	HSBC Finance	**23**			303	2	0.66	828	6	0.72
Hong Kong	Hang Seng Bank	**2,021**	**48**	**2.38**	1,715	39	2.27	1,422	25	1.76
	The Hongkong and Shanghai Banking Corporation	**14,280**	**76**	**0.53**	11,213	71	0.63	12,759	72	0.56
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	**45,776**	**414**	**0.90**	40,827	406	0.99	35,562	361	1.02
	HSBC Bank Malaysia	**1,339**	**8**	**0.60**	1,069	16	1.50	1,121	17	1.52
MENA	HSBC Bank Middle East	**2,557**	**58**	**2.27**	1,681	76	4.52	1,506	50	3.32
North America	HSBC Bank USA	**17,793**	**176**	**0.99**	26,255	408	1.55	23,431	820	3.50
	HSBC Finance	**5,265**	**220**	**4.18**	3,196	162	5.07	4,345	29	0.67
	HSBC Bank Canada	**3,007**	**25**	**0.83**	772	4	0.52	360	2	0.56
	HSBC Markets Inc	**3,330**	**36**	**1.08**	1,202	36	3.00	2,193	40	1.82
Latin America	HSBC Mexico	**1,658**	**19**	**1.15**	1,305	19	1.46	1,379	22	1.60
	Brazilian operations[57]	**3,497**	**189**	**5.40**	4,705	362	7.69	4,223	335	7.93
	HSBC Bank Argentina	**29**	**3**	**10.34**	26	3	11.54	15	1	6.67
Other operations		**(219,722)**	**(1,271)**		(226,321)	(1,395)		(164,869)	(1,830)	
		11,345	**750**	**6.61**	19,275	912	4.73	14,024	723	5.16
Total interest-bearing liabilities										
Europe	HSBC Bank	**570,077**	**4,375**	**0.77**	561,165	5,096	0.91	512,447	4,955	0.97
	HSBC Private Banking Holdings (Suisse)	**24,701**	**84**	**0.34**	20,778	90	0.43	25,905	173	0.67
	HSBC France	**118,517**	**538**	**0.45**	116,801	838	0.72	123,936	1,650	1.33
	HSBC Finance	**23**			303	2	0.66	828	6	0.72
Hong Kong	Hang Seng Bank	**96,293**	**435**	**0.45**	90,051	434	0.48	87,969	387	0.44
	The Hongkong and Shanghai Banking Corporation	**229,777**	**343**	**0.15**	209,515	333	0.16	198,484	316	0.16
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	**199,182**	**3,003**	**1.51**	188,646	3,187	1.69	175,330	3,060	1.75
	HSBC Bank Malaysia	**16,908**	**350**	**2.07**	16,670	372	2.23	15,375	343	2.23
MENA	HSBC Bank Middle East	**25,489**	**232**	**0.91**	24,515	328	1.34	24,371	370	1.52
North America	HSBC Bank USA	**107,549**	**758**	**0.70**	116,567	1,079	0.93	129,326	1,611	1.25
	HSBC Finance	**34,031**	**1,039**	**3.05**	44,541	1,405	3.15	62,082	1,731	2.79
	HSBC Bank Canada	**61,673**	**729**	**1.18**	60,176	747	1.24	58,014	767	1.32
	HSBC Markets Inc	**3,330**	**36**	**1.08**	1,202	36	3.00	2,193	40	1.82

Latin America	HSBC Mexico	**20,647**	**579**	**2.80**	21,040	650	3.09	21,759	679	3.12
	Brazilian operations[57]	**39,522**	**2,700**	**6.83**	48,494	3,699	7.63	58,675	5,845	9.96
	HSBC Bank Argentina	**3,419**	**358**	**10.47**	3,785	294	7.77	3,254	217	6.67
Other operations		**(124,958)**	**94**		(122,995)	440		(66,382)	193	
		1,426,180	**15,653**	**1.10**	1,401,254	19,030	1.36	1,433,566	22,343	1.56

For footnotes, see page 133a.

Report of the Directors: Financial Review (continued)

Net interest margin[61]

		2013	2012	2011
		%	%	%
Total		**2.13**	2.32	2.51
Europe	HSBC Bank	**1.49**	1.38	1.60
	HSBC Private Banking Holdings (Suisse)	**0.72**	1.19	1.22
	HSBC France	**1.11**	1.03	0.96
	HSBC Finance	**5.78**	4.50	6.19
Hong Kong	Hang Seng Bank	**2.13**	2.10	1.97
	The Hongkong and Shanghai Banking Corporation	**1.36**	1.45	1.35
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	**2.06**	2.06	2.13
	HSBC Bank Malaysia	**2.58**	2.62	2.68
MENA	HSBC Bank Middle East	**2.51**	2.64	2.95
North America	HSBC Bank USA	**1.44**	1.74	2.40
	HSBC Finance	**4.99**	5.93	7.10
	HSBC Bank Canada	**1.58**	1.75	1.91
Latin America	HSBC Mexico	**5.88**	5.75	5.68
	Brazilian operations[57]	**7.60**	7.61	6.59
	HSBC Bank Argentina	**9.88**	11.74	9.98

Distribution of average total assets

		2013	2012	2011
		%	%	%
Europe	HSBC Bank	**40.1**	44.8	41.5
	HSBC Private Banking Holdings (Suisse)	**2.0**	1.7	2.1
	HSBC France	**11.4**	11.5	10.3
	HSBC Finance			0.1
Hong Kong	Hang Seng Bank	**5.3**	4.8	4.5
	The Hongkong and Shanghai Banking Corporation	**13.1**	12.0	11.0
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	**11.9**	11.3	10.6
	HSBC Bank Malaysia	**1.0**	1.0	0.8
MENA	HSBC Bank Middle East	**2.0**	1.8	1.6
North America	HSBC Bank USA	**8.7**	10.2	9.7
	HSBC Finance	**1.7**	2.1	2.7
	HSBC Bank Canada	**3.2**	3.2	3.0
Latin America	HSBC Mexico	**1.5**	1.5	1.5
	Brazilian operations[57]	**2.3**	2.7	3.0
	HSBC Bank Argentina		0.2	0.2

Other operations (including consolidation adjustments)	**(4.2)**	(8.8)	(2.6)
	100.0	100.0	100.0

For footnotes, see page 133a.

69g

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Analysis of changes in net interest income and net interest expense

The following tables allocate changes in net interest income and net interest expense between volume and rate for 2013 compared with 2012, and for 2012 compared with 2011. We isolate volume variances and allocate any change arising from both volume and rate to rate.

Interest income

			Increase/(decrease) in 2013 compared with 2012			Increase/(decrease) in 2012 compared with 2011		
		2013	Volume	Rate	2012	Volume	Rate	2011
		US$m	US$m	US$m	US$m	US$m	US$m	US$m
Short-term funds and loans and advances to banks								
Europe	HSBC Bank	**938**	**212**	**(314)**	1,040	456	(602)	1,186
	HSBC Private Banking Holdings (Suisse)	**10**	**57**	**(56)**	9	1	(6)	14
	HSBC France	**127**	**19**	**(68)**	176	(37)	(264)	477
Hong Kong	Hang Seng Bank	**251**	**2**	**(34)**	283	(26)	(25)	334
	The Hongkong and Shanghai Banking Corporation	**192**	**(25)**	**(7)**	224	(39)	30	233
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	**853**	**73**	**(25)**	805	25	(140)	920
	HSBC Bank Malaysia	**173**	**14**	**2**	157	(19)	2	174
MENA	HSBC Bank Middle East	**34**	**(2)**	**(5)**	41	14	(15)	42
North America	HSBC Bank USA	**87**	**6**	**(25)**	106	(13)	22	97
	HSBC Bank Canada	**30**	**15**	**(2)**	17	(10)	4	23
Latin America	HSBC Mexico	**114**	**(3)**	**(2)**	119	(13)	2	130
	Brazilian operations[57]	**788**	**(280)**	**(87)**	1,155	(467)	(414)	2,036
	HSBC Bank Argentina	**31**	**107**	**(121)**	45	5	7	33
Other operations		**27**	**(69)**	**(34)**	130	55	(86)	161
		3,655	**394**	**(1,046)**	4,307	319	(1,872)	5,860
Loans and advances to customers								
Europe	HSBC Bank	**10,686**	**603**	**(513)**	10,596	(347)	718	10,225
	HSBC Private Banking Holdings (Suisse)	**194**	**42**	**(47)**	199	(35)	(21)	255
	HSBC France	**1,670**	**(49)**	**6**	1,713	(167)	(207)	2,087
	HSBC Finance	**10**	**(34)**	**2**	42	(40)	(16)	98
Hong Kong	Hang Seng Bank	**2,179**	**223**	**61**	1,895	42	284	1,569
	The Hongkong and Shanghai Banking Corporation	**2,631**	**331**	**(110)**	2,410	195	240	1,975
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	**5,427**	**805**	**(609)**	5,231	469	(101)	4,863
	HSBC Bank Malaysia	**683**	**25**	**(49)**	707	73	(23)	657
MENA	HSBC Bank Middle East	**1,124**	**77**	**(167)**	1,214	87	(169)	1,296
North America	HSBC Bank USA	**1,786**	**(47)**	**91**	1,742	(381)	(1,103)	3,226
	HSBC Finance	**3,064**	**(867)**	**27**	3,904	(1,559)	(379)	5,842
	HSBC Bank Canada	**1,497**	**35**	**(126)**	1,588	6	(101)	1,683
Latin America	HSBC Mexico	**1,658**	**103**	**(58)**	1,613	14	(31)	1,630
	Brazilian operations[57]	**4,608**	**(374)**	**(486)**	5,468	(565)	(551)	6,584
	HSBC Bank Argentina	**799**	**(6)**	**87**	718	51	143	524

Other operations	**704**	**(761)**	**(538)**	2,003	659	(1,392)	2,736
	38,720	**531**	**(2,854)**	41,043	(509)	(3,698)	45,250

69h

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Interest income (continued)

		2013 US$m	Increase/(decrease) in 2013 compared with 2012 Volume US$m	Rate US$m	2012 US$m	Increase/(decrease) in 2012 compared with 2011 Volume US$m	Rate US$m	2011 US$m
Financial investments								
Europe	HSBC Bank	**1,223**	**125**	**(177)**	1,275	(257)	(99)	1,631
	HSBC Private Banking Holdings (Suisse)	**183**	**146**	**(70)**	107	(143)	3	247
	HSBC France	**94**	**29**	**(65)**	130	187	(190)	133
Hong Kong	Hang Seng Bank	**601**	**44**	**(33)**	590	74	(80)	596
	The Hongkong and Shanghai Banking Corporation	**291**	**50**	**(79)**	320	(28)	(51)	399
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	**1,490**	**76**	**(87)**	1,501	215	(136)	1,422
	HSBC Bank Malaysia	**72**	**13**		59	26		33
MENA	HSBC Bank Middle East	**113**	**17**	**(17)**	113	(9)	(28)	150
North America	HSBC Bank USA	**884**	**(93)**	**(115)**	1,092	277	(435)	1,250
	HSBC Finance		**(67)**		67	(71)	34	104
	HSBC Bank Canada	**279**	**(11)**	**(7)**	297	58	(68)	307
Latin America	HSBC Mexico	**351**	**(11)**	**(17)**	379	(85)	(9)	473
	Brazilian operations[57]	**740**	**(227)**	**(52)**	1,019	(65)	(122)	1,206
	HSBC Bank Argentina	**71**	**(34)**	**9**	96	8	(11)	99
Other operations		**1,610**	**(658)**	**235**	2,033	162	(308)	2,179
		8,002	**140**	**(1,216)**	9,078	87	(1,238)	10,229

Interest expense

		2013 US$m	Increase/(decrease) in 2013 compared with 2012 Volume US$m	Rate US$m	2012 US$m	Increase/(decrease) in 2012 compared with 2011 Volume US$m	Rate US$m	2011 US$m
Deposits by banks								
Europe	HSBC Bank	**209**	**26**	**(252)**	435	(95)	1	529
	HSBC Private Banking Holdings (Suisse)	**1**	**(1)**		2			2
	HSBC France	**85**	**(39)**	**(47)**	171	(45)	(180)	396
Hong Kong	Hang Seng Bank	**15**	**(2)**	**2**	15	(2)	10	7
	The Hongkong and Shanghai Banking Corporation	**13**	**(2)**	**3**	12	(1)		13
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	**103**	**(14)**	**(42)**	159	1	(1)	159
	HSBC Bank Malaysia	**20**	**(2)**	**2**	20	15	(4)	9
MENA	HSBC Bank Middle East	**4**		**(2)**	6			6

North America	HSBC Bank USA	**17**	**2**	**(4)**	19		1	18
	HSBC Bank Canada	**22**	**5**	**8**	9	17	(23)	15
Latin America	HSBC Mexico	**64**	**12**		52	(3)	(7)	62
	Brazilian operations[57]	**103**	**(39)**	**(52)**	194	(109)	(28)	331
	HSBC Bank Argentina	**2**	**(2)**	**1**	3	2	(1)	2
Other operations		**33**		**(30)**	63	(22)	43	42
		691	**(74)**	**(395)**	1,160	(199)	(232)	1,591

For footnote, see page 133a.

69i

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

		2013 US$m	Increase/(decrease) in 2013 compared with 2012 Volume US$m	Rate US$m	2012 US$m	Increase/(decrease) in 2012 compared with 2011 Volume US$m	Rate US$m	2011 US$m
Customer accounts								
Europe	HSBC Bank	**2,296**	**323**	**(472)**	2,445	29	29	2,387
	HSBC Private Banking Holdings (Suisse)	**70**	**3**	**(17)**	84	(45)	(34)	163
	HSBC France	**255**	**15**	**(163)**	403	(18)	(229)	650
Hong Kong	Hang Seng Bank	**360**	**27**	**(32)**	365	9	14	342
	The Hongkong and Shanghai Banking Corporation	**254**	**24**	**(20)**	250	17	2	231
Rest of Asia Pacific	The Hongkong and Shanghai Banking Corporation	**2,300**	**125**	**(206)**	2,381	154	(50)	2,277
	HSBC Bank Malaysia	**296**	**3**	**(18)**	311	7	5	299
MENA	HSBC Bank Middle East	**106**	**8**	**(65)**	163		(74)	237
North America	HSBC Bank USA	**115**	**(8)**	**(101)**	224	(63)	(53)	340
	HSBC Bank Canada	**340**	**(17)**	**13**	344	2	(16)	358
Latin America	HSBC Mexico	**455**	**(28)**	**(45)**	528	(12)	2	538
	Brazilian operations[57]	**1,545**	**(695)**	**(171)**	2,411	(1,176)	(884)	4,471
	HSBC Bank Argentina	**343**	**(21)**	**96**	268	28	40	200
Other operations		**328**	**(82)**	**(291)**	701	8	(270)	963
		9,063	**534**	**(2,349)**	10,878	(70)	(2,508)	13,456
Financial liabilities designated at fair value own debt issued		**967**	**(47)**	**(311)**	1,325	25	(13)	1,313
Debt securities in issue								
Europe	HSBC Bank	**768**	**(68)**	**(153)**	989	(128)	135	982
	HSBC France	**54**	**(11)**	**(53)**	118	(47)	(95)	260
Hong Kong	Hang Seng Bank	**12**	**(2)**	**(1)**	15	2		13
Rest of Asia Pacific	The Hongkong and Shanghai Banking Corporation	**186**	**(7)**	**(48)**	241	(6)	(16)	263
	HSBC Bank Malaysia	**26**	**(1)**	**2**	25	14	(7)	18
MENA	HSBC Bank Middle East	**64**	**(16)**	**(3)**	83	(2)	8	77
North America	HSBC Bank USA	**415**	**39**	**(14)**	390	6	(11)	395
	HSBC Finance	**739**	**(338)**	**18**	1,059	(398)	44	1,413
	HSBC Bank Canada	**342**	**15**	**(63)**	390	20	(22)	392
Latin America	HSBC Mexico	**41**	**(5)**	**(5)**	51	(9)	3	57
	Brazilian operations[57]	**863**	**148**	**(17)**	732	237	(213)	708
	HSBC Bank Argentina	**10**	**(11)**	**1**	20	9		11
Other operations		**662**	**(1,154)**	**1,174**	642	(333)	304	671
		4,182	**(306)**	**(267)**	4,755	(588)	83	5,260

For footnote, see page 133a.

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Short-term borrowings

We include short-term borrowings within customer accounts, deposits by banks, debt securities in issue and trading liabilities and do not show short-term borrowings separately on the balance sheet. Short-term borrowings are defined by the US Securities and Exchange Commission as Federal funds purchased and securities sold under agreements to repurchase, commercial paper and other short-term borrowings.

Our only significant short-term borrowings are securities sold under agreements to repurchase and certain debt securities in issue. For securities sold under agreements to repurchase, we run matched repo and reverse repo trading books. We generally observe lower year-end demand in our reverse repo lending business which results in lower repo balances at the balance sheet date. Additional information on these is provided in the table below.

Repos and short-term bonds

	2013 US$m	2012 US$m	2011 US$m
Securities sold under agreements to repurchase			
Outstanding at 31 December	**181,641**	170,790	135,239
Average amount outstanding during the year	**218,580**	206,352	236,290
Maximum quarter-end balance outstanding during the year	**210,452**	176,162	202,305
Weighted average interest rate during the year	**0.3%**	0.4%	0.6%
Weighted average interest rate at the year-end	**0.5%**	0.5%	1.0%
Short-term bonds			
Outstanding at 31 December	**40,667**	44,240	35,415
Average amount outstanding during the year	**46,455**	40,349	40,679
Maximum quarter-end balance outstanding during the year	**54,933**	44,240	42,785
Weighted average interest rate during the year	**1.4%**	1.4%	1.9%
Weighted average interest rate at the year-end	**0.7%**	1.3%	2.2%

Contractual obligations

The table below provides details of our material contractual obligations as at 31 December 2013.

	Payments due by period				
	Total US$m	Less than 1 year US$m	1 3 years US$m	3 5 years US$m	More than 5 years US$m
Long-term debt obligations	**210,509**	**59,855**	**56,428**	**28,467**	**65,759**
Term deposits and certificates of deposit	**129,172**	**122,673**	**4,328**	**1,142**	**1,029**
Capital (finance) lease obligations	**376**	**59**	**101**	**31**	**185**

Operating lease obligations	**5,496**	**971**	**1,482**	**1,031**	**2,012**
Purchase obligations	**402**	**212**	**12**	**178**	
Short positions in debt securities and equity shares	**74,052**	**53,030**	**5,469**	**4,271**	**11,282**
Current tax liability	**607**	**607**			
Pension/healthcare obligation	**18,959**	**1,618**	**3,328**	**3,605**	**10,408**
	439,573	**239,025**	**71,148**	**38,725**	**90,675**

69k

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Loan maturity and interest sensitivity analysis

At 31 December 2013, 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$m	MENA US$m	North America US$m	Latin America US$m	Total US$m
Maturity of 1 year or less							
Loans and advances to banks	67,104	32,242	49,476	6,037	29,982	12,244	197,085
Commercial loans to customers							
Manufacturing and international trade and services	94,400	44,139	45,007	9,222	8,407	14,356	215,531
Real estate and other property related	13,517	13,757	7,144	1,474	4,356	1,614	41,862
Non-bank financial institutions	64,616	5,980	7,535	238	38,694	864	117,927
Governments	2,204		102	1,280	169	319	4,074
Other commercial	41,448	3,314	10,083	2,245	2,904	2,736	62,730
	216,185	67,190	69,871	14,459	54,530	19,889	442,124
Maturity after 1 year but within 5 years							
Loans and advances to banks	6,187	1,706	1,125	406	157	549	10,130
Commercial loans to customers							
Manufacturing and international trade and services	28,981	9,731	9,841	1,989	13,306	5,652	69,500
Real estate and other property related	19,148	23,083	8,618	453	6,575	775	58,652
Non-bank financial institutions	8,576	1,592	987	2,294	3,512	495	17,456
Governments	344	187	143	163	387	197	1,421
Other commercial	15,445	7,729	5,576	1,372	5,968	2,548	38,638
	72,494	42,322	25,165	6,271	29,748	9,667	185,667
Interest rate sensitivity of loans and advances to banks and commercial loans to customers							
Fixed interest rate	14,968	195	1,817	1,341	5,558	3,303	27,182
Variable interest rate	63,713	43,833	24,473	5,336	24,347	6,913	168,615
	78,681	44,028	26,290	6,677	29,905	10,216	195,797
Maturity after 5 years							
Loans and advances to banks	613	1,202	36		25	2,488	4,364
Commercial loans to customers							
Manufacturing and international trade and services	9,652	753	655	598	1,816	501	13,975
Real estate and other property related	5,969	8,064	1,041	45	3,685	360	19,164
Non-bank financial institutions	2,358	38			385	17	2,798
Governments	792	552	37		8	458	1,847
Other commercial	10,207	3,523	819	919	3,004	672	19,144
	28,978	12,930	2,552	1,562	8,898	2,008	56,928
Interest rate sensitivity of loans and advances to banks and commercial loans to customers							

Fixed interest rate	**7,283**	**1,089**	**62**	**358**	**773**	**382**	**9,947**
Variable interest rate	**22,308**	**13,043**	**2,526**	**1,204**	**8,150**	**4,114**	**51,345**
	29,591	**14,132**	**2,588**	**1,562**	**8,923**	**4,496**	**61,292**

691

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Deposits

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

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

Deposits by banks

	2013 Average balance US$m	2013 Average rate %	2012 Average balance US$m	2012 Average rate %	2011 Average balance US$m	2011 Average rate %
Europe	**63,213**		64,497		75,890	
Demand and other non-interest bearing	**13,198**		9,377		10,788	
Demand interest bearing	**5,154**	**0.5**	8,988	0.4	16,492	0.8
Time	**17,465**	**1.1**	24,698	1.5	19,893	2.2
Other	**27,396**	**0.4**	21,434	1.1	28,717	1.3
Hong Kong	**14,686**		13,355		13,222	
Demand and other non-interest bearing	**7,271**		4,727		3,047	
Demand interest bearing	**6,217**	**0.1**	5,643	0.1	6,052	0.1
Time	**1,072**	**0.7**	2,013	0.4	3,347	0.3
Other	**126**	**3.2**	972	0.6	776	0.1
Rest of Asia-Pacific	**12,919**		14,485		13,650	
Demand and other non-interest bearing	**2,334**		2,495		2,535	
Demand interest bearing	**5,965**	**1.0**	6,190	1.1	5,802	1.2
Time	**3,210**	**0.8**	3,879	1.5	4,218	1.6
Other	**1,410**	**2.5**	1,921	3.1	1,095	3.0
Middle East and North Africa	**2,546**		1,892		2,060	
Demand and other non-interest bearing	**1,058**		301		548	
Demand interest bearing	**12**		8	6.5	20	
Time	**1,422**	**0.2**	1,543	0.4	1,424	0.4
Other	**54**	**1.9**	40	1.8	68	1.6
North America	**15,820**		13,695		11,904	
Demand and other non-interest bearing	**3,488**		4,470		2,367	
Demand interest bearing	**2,787**	**0.1**	2,996	0.1	3,849	0.1

Time	**5,110**	**0.3**	4,756	0.4	4,797	0.4
Other	**4,435**	**0.5**	1,473	0.5	891	1.3
Latin America	**5,166**		6,463		8,819	
Demand and other non-interest bearing	**118**		212		161	
Demand interest bearing	**333**	**4.5**	333	3.9	545	3.7
Time	**2,783**	**3.1**	3,665	3.7	4,924	4.3
Other	**1,932**	**4.8**	2,253	6.1	3,189	6.0
Total	**114,350**		114,385		125,545	
Demand and other non-interest bearing	**27,467**		21,582		19,446	
Demand interest bearing	**20,468**	**0.5**	24,157	0.5	32,760	0.7
Time	**31,062**	**1.1**	40,553	1.4	38,603	2.0
Other	**35,353**	**0.7**	28,093	1.7	34,736	1.7

69m

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Customer accounts

	2013 Average balance US$m	2013 Average rate %	2012 Average balance US$m	2012 Average rate %	2011 Average balance US$m	2011 Average rate %
Europe	**508,783**		467,472		467,393	
Demand and other non-interest bearing	**75,480**		71,342		72,743	
Demand interest bearing	**272,973**	**0.4**	242,769	0.4	220,314	0.4
Savings	**63,585**	**1.4**	62,626	1.8	57,070	1.7
Time	**50,010**	**1.1**	59,034	1.3	67,499	1.5
Other	**46,735**	**0.3**	31,701	0.5	49,767	0.7
Hong Kong	**351,790**		325,909		307,513	
Demand and other non-interest bearing	**36,336**		34,714		31,694	
Demand interest bearing	**264,508**		236,198		219,581	
Savings	**38,447**	**0.9**	39,752	0.8	38,283	0.7
Time	**11,396**	**0.8**	14,252	1.0	16,910	1.0
Other	**1,103**	**0.2**	993	0.3	1,045	0.3
Rest of Asia-Pacific	**181,386**		179,587		170,008	
Demand and other non-interest bearing	**22,687**		20,914		19,283	
Demand interest bearing	**83,019**	**0.8**	78,563	1.0	74,636	1.1
Savings	**65,652**	**2.9**	67,424	2.9	63,500	2.8
Time	**9,581**	**0.7**	12,381	1.0	11,815	1.0
Other	**447**	**2.0**	305	3.6	774	2.2
Middle East and North Africa	**40,451**		37,604		36,105	
Demand and other non-interest bearing	**16,801**		14,564		13,016	
Demand interest bearing	**13,248**	**0.4**	10,967	0.6	9,887	0.6
Savings	**9,981**	**2.6**	11,555	3.0	12,596	3.2
Time	**357**	**1.4**	452	2.2	530	2.5
Other	**64**		66	1.5	76	
North America	**157,549**		153,057		165,779	
Demand and other non-interest bearing	**27,992**		28,403		26,524	
Demand interest bearing	**37,837**	**0.3**	38,419	0.3	35,440	0.3
Savings	**63,565**	**0.6**	68,039	0.7	75,866	0.8
Time	**7,673**	**0.3**	9,587	0.4	13,835	0.4
Other	**20,482**	**0.1**	8,609	0.2	14,114	0.1
Latin America	**57,066**		73,323		89,603	
Demand and other non-interest bearing	**13,084**		14,203		14,815	
Demand interest bearing	**7,237**	**1.8**	8,258	2.2	8,374	1.7
Savings	**24,652**	**7.4**	35,294	7.5	47,197	9.8
Time	**9,459**	**4.4**	13,095	4.0	16,567	3.9
Other	**2,634**	**6.2**	2,473	4.7	2,650	7.2

Total	**1,297,032**		1,236,953		1,236,401	
Demand and other non-interest bearing	**192,388**		184,140		178,075	
Demand interest bearing	**678,821**	**0.3**	615,175	0.4	568,232	0.4
Savings	**265,882**	**2.1**	284,690	2.4	294,512	2.9
Time	**88,477**	**1.3**	108,801	1.5	127,156	1.6
Other	**71,464**	**0.4**	44,147	0.7	68,426	0.9

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Customer accounts by country

	At 31 December 2013	2012
	US$m	US$m
Europe	**644,816**	555,009
UK[34]	**504,984**	426,144
France[35]	**65,844**	55,578
Germany	**16,615**	15,611
Malta	**6,222**	5,957
Switzerland	**16,796**	20,211
Turkey	**7,795**	7,629
Other	**26,560**	23,879
Hong Kong	**365,993**	346,208
Rest of Asia-Pacific	**182,626**	183,621
Australia	**19,812**	20,430
India	**11,549**	10,415
Indonesia	**5,865**	6,512
Mainland China	**40,579**	35,572
Malaysia	**17,139**	17,641
Singapore	**43,988**	47,862
Taiwan	**12,758**	12,497
Vietnam	**2,426**	2,147
Other	**28,510**	30,545
Middle East and North Africa		
(excluding Saudi Arabia)	**38,683**	39,583
Egypt	**7,401**	7,548
Qatar	**2,861**	2,704
UAE	**18,433**	18,448
Other	**9,988**	10,883
North America	**196,495**	149,037
US[34]	**135,531**	90,627
Canada	**48,065**	47,049
Bermuda	**12,899**	11,361
Latin America	**54,199**	66,556
Argentina	**4,468**	5,351
Brazil	**24,353**	30,144
Mexico	**23,975**	22,724
Panama		5,940
Other	**1,403**	2,397

Total	**1,482,812**	1,340,014

For footnotes, see page 132.

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Certificates of deposit and other money market instruments

	2013		2012		2011	
	Average balance US$m	Average rate %	Average balance US$m	Average rate %	Average balance US$m	Average rate %
Europe	**28,680**	**0.5**	32,602	0.4	46,641	0.6
Hong Kong	**1,400**	**0.7**	1,458	0.9	932	1.0
Rest of Asia-Pacific	**1,799**	**2.9**	3,863	3.0	3,951	3.4
North America	**5,583**	**0.6**	9,339	0.6	10,936	0.5
Latin America	**9,335**	**8.3**	7,344	8.5	5,499	9.2
	46,797	**2.3**	54,606	1.8	67,959	1.4

Certificates of deposit and other time deposits

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

	At 31 December 2013				
	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	**57,584**	**9,610**	**7,326**	**4,298**	**78,818**
Certificates of deposit	**8,910**	**5,070**	**1,779**		**15,759**
Time deposits:					
banks	**12,778**	**595**	**516**	**1,074**	**14,963**
customers	**35,896**	**3,945**	**5,031**	**3,224**	**48,096**
Hong Kong	**10,713**	**783**	**743**	**47**	**12,286**
Certificates of deposit		**21**	**5**		**26**
Time deposits:					
banks	**354**	**36**			**390**
customers	**10,359**	**726**	**738**	**47**	**11,870**
Rest of Asia-Pacific	**11,219**	**963**	**358**	**1,159**	**13,699**
Certificates of deposit	**1,582**	**317**	**111**	**617**	**2,627**
Time deposits:					

banks	**3,281**	**399**	**1**	**25**	**3,706**
customers	**6,356**	**247**	**246**	**517**	**7,366**
Middle East and North Africa	**1,372**	**45**	**122**	**36**	**1,575**
Time deposits:					
banks	**742**	**10**	**14**		**766**
customers	**630**	**35**	**108**	**36**	**809**
North America	**9,673**	**733**	**267**	**228**	**10,901**
Time deposits:					
banks	**3,747**	**3**			**3,750**
customers	**5,926**	**730**	**267**	**228**	**7,151**
Latin America	**9,169**	**1,087**	**906**	**731**	**11,893**
Certificates of deposit	**11**		**228**	**463**	**702**
Time deposits:					
banks	**784**	**583**	**404**	**244**	**2,015**
customers	**8,374**	**504**	**274**	**24**	**9,176**
Total	**99,730**	**13,221**	**9,722**	**6,499**	**129,172**
Certificates of deposit	**10,503**	**5,408**	**2,123**	**1,080**	**19,114**
Time deposits:					
banks	**21,686**	**1,626**	**935**	**1,343**	**25,590**
customers	**67,541**	**6,187**	**6,664**	**4,076**	**84,468**

70a

Report of the Directors: Financial Review (continued)

Reconciliation of RoRWA measures

Performance Management

We target a return on average ordinary shareholders equity of 12% 15%. For internal management purposes we monitor global businesses and geographical regions by pre-tax return on RWAs, a metric which combines return on equity and regulatory capital efficiency objectives.

In addition to measuring return on average risk-weighted assets (RoRWA) we measure our performance internally using the non-GAAP measure of underlying RoRWA, which is underlying profit before tax as a percentage of average risk-weighted assets adjusted for the effects of foreign currency translation differences and business disposals. Underlying RoRWA adjusts performance for certain items which distort year-on-year performance as explained on page 47.

We also present the non-GAAP measure of underlying RoRWA adjusted for the effect of operations which are not regarded as contributing to the longer-term performance of the Group. These include the run-off portfolios and the CRS business which was sold in 2012.

The CRS average RWAs in the table below represent the average of the associated operational risk RWAs that were not immediately released on disposal and have not already been adjusted as part of the underlying RoRWA calculation. The 2012 pre-tax loss for CRS primarily relates to litigation expenses incurred after the sale of the business that have not been adjusted as part of the underlying RoRWA calculation.

Reconciliation of underlying RoRWA (excluding run-off portfolios and Card and Retail Services)

	2013			2012		
	Pre-tax return US\$m	**Average RWAs[36] US\$bn**	**RoRWA[37] %**	Pre-tax return US\$m	Average RWAs[36] US\$bn	RoRWA[37] %
Reported	**22,565**	**1,104**	**2.0**	20,649	1,172	1.8
Underlying[37]	**21,586**	**1,088**	**2.0**	15,286	1,078	1.4
Run-off portfolios	**68**	**124**	**0.1**	(1,624)	166	(1.0)
Legacy credit in GB&M	**185**	**33**	**0.6**	(274)	45	(0.6)
US CML and other[38]	**(117)**	**91**	**(0.1)**	(1,350)	121	(1.1)
Card and Retail Services		**4**		(150)	5	(3.0)
	21,518	**960**	**2.2**	17,060	906	1.9

Underlying (excluding run-off portfolios and Card and Retail Services)

Reconciliation of reported and underlying average risk-weighted assets

	Year ended 31 December		
	2013	2012	Change
	US$bn	US$bn	%
Average reported RWAs[36]	**1,104**	1,172	(6)
Currency translation adjustment[32]		(6)	
Acquisitions, disposals and dilutions	**(16)**	(88)	
Average underlying RWAs[36]	**1,088**	1,078	1

For footnotes, see page 132.

Report of the Directors: Financial Review (continued)

Ratio of earnings to fixed charges[62]

	2013	2012	2011	2010	2009
Ratio of earnings to fixed charges					
excluding interest on deposits[63]	**3.84**	3.03	2.82	2.71	1.53
including interest on deposits	**2.09**	1.76	1.68	1.73	1.22
Ratio of earnings to combined fixed charges and preference share dividends					
excluding interest on deposits[63]	**3.50**	2.79	2.64	2.56	1.48
including interest on deposits	**2.01**	1.71	1.64	1.69	1.20

For footnotes, see page 133a.

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Critical accounting policies

(Audited)

Introduction

The results of HSBC are sensitive to the accounting policies, assumptions and estimates that underlie the preparation of our consolidated financial statements. The significant accounting policies are described in Note 2 on the Financial Statements.

The accounting policies that are deemed critical to our results and financial position, in terms of the materiality of the items to which the policies are applied and the high degree of judgement involved, including the use of assumptions and estimation, are discussed below.

Impairment of loans and advances

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

Management is required to exercise judgement in making assumptions and estimates when calculating loan impairment allowances on both individually and collectively assessed loans and advances.

The largest concentration of collectively assessed loan impairment allowances are in North America, where they were US$3.8bn, representing 47% (2012: US$5.2bn; 54%) of the Group s total collectively assessed loan impairment allowances and 25% of the Group s total impairment allowances. Of the North American collective impairment allowances approximately 79% (2012: 86%) related to the US CML portfolio.

The methods used to calculate collective impairment allowances on homogeneous groups of loans and advances that are not considered individually significant are disclosed in Note 2g on the Financial Statements. They are subject to estimation uncertainty, in part because it is not practicable to identify losses on an individual loan basis because of the large number of individually insignificant loans in the portfolio.

The estimation methods include the use of statistical analyses of historical information, supplemented with significant management judgement, to assess whether current economic and credit conditions are such that the actual level of

incurred losses is likely to be greater or less than that suggested by historical experience. Where changes in economic, regulatory or behavioural conditions result in the most recent trends in portfolio risk factors being not fully reflected in the statistical models, risk factors are taken into account by adjusting the impairment allowances derived solely from historical loss experience.

Risk factors include loan portfolio growth, product mix, unemployment rates, bankruptcy trends, geographical concentrations, loan product features, economic conditions such as national and local trends in housing markets, the level of interest rates, portfolio seasoning, account management policies and practices, changes in laws and regulations, and other influences on customer payment patterns. Different factors are applied in different regions and countries to reflect local economic conditions, laws and regulations. The methodology and the assumptions used in calculating impairment losses are reviewed regularly in the light of differences between loss estimates and actual loss experience. For example, roll rates, loss rates and the expected timing of future recoveries are regularly benchmarked against actual outcomes to ensure they remain appropriate.

During 2013, we reviewed the impairment allowance methodology used for retail banking and small business portfolios across the Group to ensure that the assumptions used in our collective impairment assessment models continue to appropriately reflect the periods of time between a loss event occurring, the discovery of the loss event and the eventual write off. As a result of this review, the collective impairment allowances were increased by US$251m.

Where loans are individually assessed for impairment, management judgement is required in determining whether there is objective evidence that a loss event has occurred and, if so, the measurement of the impairment allowance. In determining whether there is objective evidence that a loss event has occurred, judgement is exercised in evaluating all relevant information on indicators of impairment, which is not restricted to the consideration of whether payments are contractually past-due but includes broader consideration of factors indicating deterioration in the financial condition and outlook of borrowers affecting their ability to pay. A higher level of judgement is required for loans to borrowers showing signs of financial difficulty in market sectors experiencing economic stress, particularly

Report of the Directors: Financial Review (continued)

where the likelihood of repayment is affected by the prospects for refinancing or the sale of a specified asset. For those loans where objective evidence of impairment exists, management determine the size of the allowance required based on a range of factors such as the realisable value of security, the likely dividend available on liquidation or bankruptcy, the viability of the customer s business model and the capacity to trade successfully out of financial difficulties and generate sufficient cash flow to service debt obligations.

Under certain specified conditions, we provide loan forbearance to borrowers experiencing financial difficulties by agreeing to modify the contractual payment terms of loans in order to improve the management of customer relationships, maximise collection opportunities and, if possible, avoid default or repossession. Where forbearance activities are significant, higher levels of judgement and estimation uncertainty are involved in determining their effects on loan impairment allowances. Judgements are involved in differentiating the credit risk characteristics of forbearance cases, including those which return to performing status following renegotiation. Where collectively assessed loan portfolios include significant levels of loan forbearance, portfolios are segmented to reflect the different credit risk characteristics of forbearance cases, and estimates are made of the incurred losses inherent within the forbearance portfolio segments at the reporting date. Forbearance activities take place in both retail and wholesale loan portfolios, but our largest concentration is in the US, in HSBC Finance s CML portfolio.

The exercise of judgement requires the use of assumptions which are highly subjective and very sensitive to the risk factors, in particular to changes in economic and credit conditions across a large number of geographical areas. Many of the factors have a high degree of interdependency and there is no single factor to which our loan impairment allowances as a whole are sensitive, though they are particularly sensitive to general economic and credit conditions in North America. For example, a 10% increase in impairment allowances on collectively assessed loans and advances in North America would have increased loan impairment allowances by US$0.4bn at 31 December 2013 (2012: US$0.5bn).

It is possible that the outcomes within the next financial year could differ from the assumptions used, and this could result in a material adjustment to the carrying amount of loans and advances.

Goodwill impairment

Our accounting policy for goodwill is described in Note 2p on the Financial Statements. Note 22 on the Financial Statements lists our cash generating units (CGU s) by geographical region and global business. HSBC s total goodwill amounted to US$21bn at 31 December 2013 (2012: US$21bn).

The review of goodwill for impairment reflects management s best estimate of the future cash flows of the CGUs and the rates used to discount these cash flows, both of which are subject to uncertain factors as follows:

- the future cash flows of the CGUs are sensitive to the cash flows projected for the periods for which detailed forecasts are available and to assumptions regarding the long-term pattern of sustainable cash flows thereafter. Forecasts are compared with actual performance and verifiable economic data, but they necessarily reflect management s view of future business prospects at the time of the assessment; and

- the rates used to discount future expected cash flows are based on the costs of capital assigned to individual CGUs and the rates can have a significant effect on their valuation. The cost of capital percentage is generally derived from a Capital Asset Pricing Model, which incorporates inputs reflecting a number of financial and economic variables, including the risk-free interest rate in the country concerned and a premium for the risk of the business being evaluated. These variables are subject to fluctuations in external market rates and economic conditions beyond our control and are consequently subject to uncertainty and require the exercise of significant judgement.

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

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

Report of the Directors: Financial Review (continued)

During 2013, no impairment of goodwill was identified (2012: nil). In addition to the annual impairment test which was performed as at 1 July 2013, management reviewed the current and expected performance of the CGUs as at 31 December 2013 and determined that there was no indication of impairment of the goodwill allocated to them, except for the GPB Europe CGU, for which reduced forecast profitability triggered the re-testing of the related goodwill as at 31 December 2013. Although the results of the goodwill impairment testing for this CGU are more sensitive to key assumptions used, the re-test of the goodwill concluded that there was no impairment.

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.

Interests in associates

Under the equity accounting method, investments in associates are initially stated at cost, and are adjusted thereafter for the post-acquisition change in HSBC s share of the net assets of the associate. An investment in an associate is tested for impairment when there is an indication that the investment may be impaired. At 31 December 2013, the fair value of HSBC s investment in BoCom had been below the carrying amount for approximately 20 months, apart from a short period in 2013. The conclusion of the impairment test, based on the assessment of the value in use, was that the investment is not impaired. The measurement of value in use involves significant judgement in estimating the present values of cash flows expected to arise from continuing to hold the investment. Note 21 on the Financial Statements includes detailed information on HSBC s investment in BoCom. It provides a description of the key assumptions used in estimating value in use, the sensitivity of the value in use calculation to different assumptions and a sensitivity analysis that shows the changes in key assumptions that would reduce the excess of value in use over the carrying amount (headroom) to nil.

Valuation of financial instruments

Our accounting policy for determining the fair value of financial instruments is described in Note 2d on the Financial Statements. The best evidence of fair value is a quoted price for the instrument being measured 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 include one or more significant inputs that are unobservable. Valuation techniques that rely to a greater extent on unobservable inputs require a higher level of management judgement to calculate a fair value than those based wholly on observable inputs.

Valuation techniques used to calculate fair values are discussed in Note 15 on the Financial Statements. The main assumptions and estimates which management consider when applying a model with valuation techniques are:

- the likelihood and expected timing of future cash flows on the instrument. These cash flows are estimated based on the terms of the instrument, and 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. The determination of this rate is based on an assessment of what a market participant would regard as the appropriate spread of the rate for the instrument over the appropriate risk-free rate; and judgement to determine what model to use to calculate fair value in areas where the choice of valuation model is particularly subjective, for example, when valuing complex derivative products.

When applying a model with unobservable inputs, estimates are made to reflect uncertainties in fair values resulting from a lack of market data inputs, for example, as a result of illiquidity in

Report of the Directors: Financial Review (continued)

the market. For these instruments, the fair value measurement is less reliable. Inputs into valuations based on unobservable data are inherently uncertain because there is little or no current market data available from which to determine the level at which an arm s length transaction would occur under normal business conditions. However, in most cases there is some market data available on which to base a determination of fair value, for example historical data, and the fair values of most financial instruments are based on some market observable inputs even when unobservable inputs are significant.

The fair values of financial assets and liabilities of US$547bn (2012: US$718bn) and US$467bn (2012: US$622bn), respectively, were determined using valuation techniques and represented 53% (2012: 60%) and 82% (2012: 83%), respectively, of financial assets and liabilities measured at fair value.

The types and amounts of adjustments made in determining the fair value of financial instruments measured at fair value using valuation techniques, and a sensitivity analysis of fair values for financial instruments with significant unobservable inputs to reasonably possible alternative assumptions, are described in Note 15 on the Financial Statements.

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

HSBC does not include a funding spread in the discount rate applied to the fair value measurement of uncollateralised derivatives. The application of such a funding fair value adjustment is under consideration by the financial services industry, although no consensus has yet emerged. In the future, and possibly in 2014, HSBC may adopt a funding fair value adjustment to reflect funding of uncollateralised derivatives at rates other than interbank offer rates.

Deferred tax assets

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

The most significant judgements concern the US deferred tax asset, given the recent history of losses in our US operations. The net US deferred tax asset amounted to US$4.4bn or 59% (2012: US$4.6bn; 61%) of deferred tax assets recognised on the Group s balance sheet. These judgements take into consideration the reliance placed on the use of tax planning strategies.

The most significant tax planning strategy is the retention of capital in our US operations to ensure the realisation of the deferred tax assets. The principal strategy involves generating future taxable profits through the retention of capital in the US in excess of normal regulatory requirements in order to reduce deductible funding expenses or otherwise deploy such capital or increase levels of taxable income. Management expects that, with this strategy, the US operations will generate sufficient future profits to support the recognition of the deferred tax assets. If HSBC Holdings were to decide not to provide this ongoing support, the full recovery of the deferred tax asset may no longer be probable and could result in a significant reduction of the deferred tax asset which would be recognised as a charge in the income statement.

Provisions

The accounting policy for provisions is described in Note 2w on the Financial Statements. Note 31 on the Financial Statements discloses the major categories of provisions recognised. The closing balance of provisions amounted to US$5.2bn (2012: US$5.3bn), of which US$1.8bn

(2012: US$1.7bn) related to legal proceedings and regulatory matters and US$2.4bn (2012: US$2.4bn) related to customer remediation.

Report of the Directors: Financial Review (continued)

Judgement is involved in determining whether a present obligation exists and in estimating the probability, timing and amount of any outflows. Professional expert advice is taken on litigation provisions, property provisions (including onerous contracts) and similar liabilities.

Provisions for legal proceedings and regulatory matters typically require a higher degree of judgement than other types of provisions. When matters are at an early stage, accounting judgements can be difficult because of the high degree of uncertainty associated with determining whether a present obligation exists, and estimating the probability and amount of any outflows that may arise. As matters progress through various stages of development, management and legal advisers evaluate on an ongoing basis whether provisions should be recognised and their estimated amounts, revising previous judgements and estimates as appropriate. At more advanced stages, it is typically possible to make judgements and estimates around a better defined set of possible outcomes. However, such judgements can be very difficult and the amount of any provision can be very sensitive to the assumptions used. There could be a wide range of possible outcomes for any pending legal proceedings, investigations or inquiries. As a result, it is often not practicable to quantify a range of

possible outcomes for individual matters. It is also not practicable to meaningfully quantify ranges of potential outcomes in aggregate for these types of provisions because of the diverse nature and circumstances of such matters and the wide range of uncertainties involved. For a detailed description of the nature of uncertainties and assumptions and the effect on the amount and timing of possible cash outflows on material matters, see Note 43 on the Financial Statements.

Provisions for customer remediation also require significant levels of estimation and judgement. The amounts of provisions recognised depend on a number of different assumptions, for example, the volume of inbound complaints, the projected period of inbound complaint volumes, the decay rate of complaint volumes, the population identified as systemically mis-sold and the number of policies per customer complaint.

In view of the inherent uncertainties and the high level of subjectivity involved in the recognition and measurement of provisions, it is possible that the outcomes in the next financial year could differ from those on which management s estimates are based, resulting in materially different amounts of provisions recognised and outflows of economic benefits from those estimated by management for the purposes of the 2013 Financial Statements.

Report of the Directors: Financial Review (continued)

Global businesses

Summary

HSBC reviews operating activity on a number of bases, including by geographical region and by global business.

The commentaries below present global businesses followed by geographical regions (page 96). Performance is discussed in this order because certain strategic themes, business initiatives and trends affect more than one geographical region.

All commentaries are on a constant currency basis (page 47) unless stated otherwise, while tables are on a reported basis.

Basis of preparation

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

The expense of the UK bank levy is included in the Europe geographical region as HSBC regards the levy as a cost of being headquartered in the UK. For the purposes of the segmentation by global business, the cost of the levy is included in Other .

Profit/(loss) before tax

	2013		2012		2011	
	US$m	**%**	US$m	%	US$m	%
Retail Banking and Wealth Management	**6,649**	**29.5**	9,575	46.4	4,270	19.6
Commercial Banking	**8,441**	**37.4**	8,535	41.3	7,947	36.3
Global Banking and Markets	**9,441**	**41.8**	8,520	41.3	7,049	32.2
Global Private Banking	**193**	**0.9**	1,009	4.9	944	4.3
Other[39]	**(2,159)**	**(9.6)**	(6,990)	(33.9)	1,662	7.6
	22,565	**100.0**	20,649	100.0	21,872	100.0

Total assets[40]

	At 31 December			
	2013		2012	
	US$m	**%**	US$m	%
Retail Banking and Wealth Management	**517,085**	**19.4**	536,244	19.9
Commercial Banking	**360,623**	**13.5**	363,659	13.5
Global Banking and Markets	**1,975,509**	**74.0**	1,942,470	72.1
Global Private Banking	**97,655**	**3.7**	118,440	4.4
Other	**171,812**	**6.4**	201,741	7.5
Intra-HSBC items	**(451,366)**	**(17.0)**	(470,016)	(17.4)
	2,671,318	**100.0**	2,692,538	100.0

For footnotes, see page 132.

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Risk-weighted assets

	At 31 December			
	2013		2012	
	US$bn	**%**	US$bn	%
Retail Banking and Wealth Management	**233.5**	**21.4**	276.6	24.6
Commercial Banking	**391.7**	**35.8**	397.0	35.3
Global Banking and Markets	**422.3**	**38.6**	403.1	35.9
Global Private Banking	**21.7**	**2.0**	21.7	1.9
Other	**23.5**	**2.2**	25.5	2.3
	1,092.7	**100.0**	1,123.9	100.0

Selected items included in profit before tax by global business

The table below shows the gain or loss on disposal or dilution and any associated gain or loss on reclassification or impairment recognised in the year incurred, and the operating profit or loss of the

acquired, disposed of or diluted subsidiaries, associates, joint ventures and businesses which are eliminated from underlying results so that results can be viewed on a like-for-like basis.

Acquisitions, disposals and dilutions[41]

	2013	2012
	US$m	US$m
Retail Banking and Wealth Management	**264**	5,565
Commercial Banking	**541**	922
Global Banking and Markets	**404**	516
Global Private Banking	**1**	57
Other[39]	**1,015**	3,106
	2,225	10,166

For footnotes, see page 132.

Principal RBWM business

The Principal RBWM business measure excludes the effects of the US run-off portfolio and the disposed of US CRS business. We believe that looking at the Principal RBWM business without the run-off and disposed of businesses allows management to more clearly discuss the cause of material changes from

year-to-year in the ongoing business and to assess the factors and trends in the business which are anticipated to have a material effect in future years. Tables which reconcile reported RBWM financial measures to Principal RBWM financial measures are provided in the Form 20-F filed with the SEC, which is available on www.hsbc.com.

Report of the Directors: Financial Review (continued)

Products and services

Retail Banking and Wealth Management

RBWM serves over 50 million personal customers. We take deposits and provide transactional banking services to enable customers to manage their day-to-day finances and save for the future. We selectively offer credit facilities to assist customers in their short or longer-term borrowing requirements; and we provide financial advisory, broking, insurance and investment services to help them to manage and protect their financial futures.

We develop products designed to meet the needs of specific customer segments, which may include a range of different services and delivery channels.

Typically, customer offerings include:

liability-driven services: deposits and account services;

asset-driven services: credit and lending, both secured and unsecured; and

fee-driven and other services: financial advisory, broking, life insurance manufacturing and asset management.

We deliver services through four principal channels: branches, self-service terminals, telephone service centres and digital (internet and mobile). Customers can transact with the bank via a combination of these channels, through the following offerings:

HSBC Premier**:** we provide preferential banking services and global recognition to our mass affluent customers and their immediate families with a dedicated relationship manager, specialist wealth advice and tailored solutions. Customers can access emergency travel assistance, priority telephone banking and an online global view of their Premier accounts around the world.

HSBC Advance**:** we provide a range of preferential products and services to simplify the banking needs of customers and to help them manage and plan their money to achieve their financial goals and ambitions.

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

Basic banking**:** we increasingly provide globally standardised but locally delivered, reliable, easy to understand, good-value banking products and services using global product platforms and globally set service standards.

Total RBWM comprises our Principal RBWM business and the US run-off portfolio.

Commercial Banking

Our CMB business is segmented into large corporates, mid-market companies and Business Banking. This allows us to provide an appropriate level of support to companies with more sophisticated needs and SMEs as they grow both domestically and internationally, and ensures a clear focus on internationally aspirant customers.

We place particular emphasis on international connectivity to meet the needs of our business customers. We aim to be recognised as the leading international trade and business bank by focusing on faster-growing markets, repositioning towards international business and enhancing collaboration across the Group. This will be underpinned by reducing complexity and operational risk and driving efficiency gains through adopting a global operating model.

Credit and Lending**:** we offer a broad range of domestic and cross-border financing, including overdrafts, corporate cards, term loans and syndicated, leveraged, acquisition and project finance. Asset finance is also offered in selected countries.

Global Trade and Receivables Finance**:** we provide the services and finance our clients need throughout the trade cycle including; letters of credit, collections, guarantees; receivables finance; supply chain solutions; commodity and structured finance; and risk distribution. HSBC is supporting the development of renminbi as a trade currency, with renminbi capabilities in more than 50 markets.

Payments and Cash Management**:** we are a leading provider of domestic and cross-border payments, collections, liquidity management and account services offering local, regional and global solutions delivered via e-enabled platforms designed to address the current and future needs of our clients.

Insurance and Investments**:** we offer business and financial protection, trade insurance, employee benefits, corporate wealth management and a variety of other commercial risk insurance products in selected countries.

GB&M**:** our CMB franchise represents a key client base for GB&M products and services, including foreign exchange and interest rate products, together with capital raising on debt and equity markets and advisory services.

Report of the Directors: Financial Review (continued)

Global Banking and Markets

GB&M provides tailored financial solutions to major government, corporate and institutional clients worldwide. Managed as a global business with regional oversight, GB&M operates a long-term relationship management approach to build a full understanding of clients financial requirements. Sector-focused client service teams comprising relationship managers and product specialists develop financial solutions to meet individual client needs. With a presence in over 60 countries/territories and access to HSBC s worldwide presence and capabilities, this business serves subsidiaries and offices of our clients on a global basis.

In August 2013, GB&M was reshaped to more effectively focus resources on clients and enhance relationships, and to better capture growth opportunities which create greater value for our clients and our shareholders.

GB&M is managed within the following framework:

Client Coverage contains relationship managers organised by sector, region and country who work to understand client needs and provide holistic solutions by bringing together HSBC s broad array of product capabilities.

Markets provides sales and trading services which are categorised as follows:

Credit and Rates sell, trade and distribute fixed income securities to clients including corporates, financial institutions, sovereigns, agencies and public sector issuers. They also offer clients risk management solutions.

Foreign Exchange provides spot and derivative products to meet the investment demands of institutional investors, the hedging needs of SMEs, MMEs and large corporates in GB&M and CMB, and the needs of RBWM customers in our branches. Foreign Exchange trades on behalf of clients in over 90 currencies.

Equities provides sales and trading services for clients, including direct market access and financing and hedging solutions.

Capital Financing offers financing and advisory services. Products include debt and equity capital raising, advisory, corporate lending, leveraged finance, asset and structured finance, real estate, infrastructure and project finance, and export credit.

Payments and Cash Management products include non-retail deposit taking and international, regional and domestic payments and cash management services.

Securities Services provides custody and clearing services to corporate and institutional clients and funds administration to both domestic and cross-border investors.

Global Trade and Receivables Finance provides trade services for our clients.

Balance Sheet Management is responsible for the management of liquidity and funding. It also manages structural interest rate positions within the Markets limit structure.

Global Private Banking

GPB provides investment management and trustee solutions to high net worth individuals and their families in the Group s priority markets. We aim to meet the needs of our clients by providing excellent customer service and offering a comprehensive suite of solutions.

Drawing on the strength of the HSBC Group and the most suitable products from the marketplace, we work with our clients to provide solutions to grow, manage, and preserve wealth for today and for the future.

Private Banking services comprise multicurrency and fiduciary deposits, account services, and credit and specialist lending. GPB also accesses HSBC s universal banking capabilities to offer products and services such as credit cards, internet banking, and corporate and investment banking solutions.

Investment Management comprises advisory and discretionary investment services, as well as brokerage across asset classes. This includes a complete range of investment vehicles, portfolio management, securities services and alternatives.

Private Trust Solutions comprise trusts and estate planning, designed to protect wealth and preserve it for future generations through structures tailored to meet the individual needs of each client.

Report of the Directors: Financial Review (continued)

Retail Banking and Wealth Management

RBWM provides banking and wealth management services for our personal customers to help them secure their future prosperity and realise their ambitions.

	2013 US$m	2012 US$m	2011 US$m
Net interest income	**18,339**	20,298	24,101
Net fee income	**7,021**	7,205	8,226
Other income[7]	**1,380**	6,358	1,206
Net operating income[4]	**26,740**	33,861	33,533
LICs[42]	**(3,227)**	(5,515)	(9,319)
Net operating income	**23,513**	28,346	24,214
Total operating expenses	**(17,248)**	(19,769)	(21,202)
Operating profit	**6,265**	8,577	3,012
Income from associates[43]	**384**	998	1,258
Profit before tax	**6,649**	9,575	4,270
RoRWA[36]	**2.6%**	3.1%	1.2%

77%

of profit before tax from

Hong Kong, Rest of Asia-Pacific, Latin America

and Middle East and North Africa

Managing the US run-off portfolio

releasing over US$28bn **of RWAs**

Best Wealth Management Firm

(Banker Middle East Industry Awards, 2013)

Strategic direction

RBWM provides retail banking and wealth management services for personal customers in markets where we have, or can build, the scale in our target customer segments to do so cost effectively.

We focus on three strategic imperatives:

- building a consistent, high standard, customer needs-driven wealth management service for retail customers drawing on our Insurance and Asset Management businesses;
- leveraging global expertise to improve customer service and productivity, to provide a high standard of banking solutions and service to our customers efficiently; and
- simplifying and re-shaping the RBWM portfolio of businesses globally, to focus our capital and resources on key markets.

Our three growth priorities are customer growth in target segments, deepening customer relationships through wealth management and relationship-led lending, and enhancing distribution capabilities, including digital.

Implementing Global Standards, enhancing risk management control models and simplifying processes also remain top priorities for RBWM.

For footnotes, see page 132.

The commentary is on a constant currency basis unless stated otherwise, while tables are on a reported basis.

Review of performance

- RBWM reported profit before tax of US$6.6bn compared with US$9.6bn in 2012 on a reported basis and US$9.5bn on a constant currency basis. The decrease arose from lower net gains on sale, most notably following the sale of the CRS business and US branches (US$3.7bn) in 2012, and the absence of profits from non-strategic businesses sold or closed in that year, including Ping An.
- On an underlying basis, profit before tax increased by US$2.4bn, driven by a fall in loan impairment charges in the US run-off portfolio. In addition, operating expenses declined, mainly driven by a reduction in customer redress provisions in the UK.
- In the US run-off portfolio, the loss before tax decreased due to lower loan impairment charges reflecting improvements in housing market conditions, decreased lending balances, reduced new impaired loans and lower delinquency levels. Revenue reduced, reflecting lower average lending balances from the continued run-off of the CML portfolio, losses on early termination of cash flow hedges and portfolio disposals. These factors were partly offset by favourable movements in the fair value of non-qualifying hedges in HSBC Finance of US$315m, compared with adverse movements of US$227m in 2012.

The commentary that follows reflects performance in our Principal RBWM business (see page 78).

- Profit before tax fell by US$208m, reflecting lower net gains on sale of our non-strategic operations and the reduction in profit following these disposals. This was largely offset by a decrease in operating expenses which reflected lower customer redress provisions in the UK and sustainable cost savings resulting from our organisational effectiveness programmes.

Revenue declined by 4% reflecting lower net gains on sale of our non-strategic operations (most notably the US branches), the loss on sale of the HFC Bank UK secured lending portfolio and the consequent reduction in operating revenue. Excluding these, revenue grew by 1%, mainly in Hong Kong and Europe.

Net interest income increased by 1% despite lower revenue from businesses that had been disposed of or closed since the beginning of 2012. The increase was driven by improved mortgage spreads and growth in mortgage

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

RBWM profit/(loss) before tax

	Total RBWM US$m	US CRS US$m	US run-off portfolio US$m	Principal RBWM US$m
2013				
Net interest income	**18,339**		**2,061**	**16,278**
Net fee income	**7,021**		**11**	**7,010**
Other income/(expense)[7]	**1,380**		**(400)**	**1,780**
Net operating income[4]	**26,740**		**1,672**	**25,068**
LICs[42]	**(3,227)**		**(705)**	**(2,522)**
Net operating income	**23,513**		**967**	**22,546**
Total operating expenses	**(17,248)**		**(1,166)**	**(16,082)**
Operating profit/(loss)	**6,265**		**(199)**	**6,464**
Income/(expense) from associates[43]	**384**		**(1)**	**385**
Profit/(loss) before tax	**6,649**		**(200)**	**6,849**
RoRWA[36]	**2.6%**		**(0.2%)**	**4.4%**
2012				
Net interest income	20,298	1,267	2,563	16,468
Net fee income	7,205	395	33	6,777
Other income/(expense)[7]	6,358	3,155	(200)	3,403
Net operating income[4]	33,861	4,817	2,396	26,648
LICs[42]	(5,515)	(322)	(2,569)	(2,624)
Net operating income/(expense)	28,346	4,495	(173)	24,024
Total operating expenses	(19,769)	(729)	(1,103)	(17,937)
Operating profit/(loss)	8,577	3,766	(1,276)	6,087
Income from associates[43]	998		2	996
Profit/(loss) before tax	9,575	3,766	(1,274)	7,083
RoRWA[36]	3.1%	14.7%	(1.1%)	4.2%
2011				
Net interest income	24,101	4,128	2,990	16,983
Net fee income/(expense)	8,226	1,273	(49)	7,002
Other income/(expense)[7]	1,206	61	(1,196)	2,341
Net operating income[4]	33,533	5,462	1,745	26,326
LICs[42]	(9,319)	(1,600)	(4,982)	(2,737)
Net operating income/(expense)	24,214	3,862	(3,237)	23,589
Total operating expenses	(21,202)	(1,801)	(1,238)	(18,163)

Operating profit/(expense)	3,012	2,061	(4,475)	5,426
Income from associates[43]	1,258		3	1,255
Profit/(loss) before tax	4,270	2,061	(4,472)	6,681
RoRWA[36]	1.2%	3.9%	(3.3%)	4.0%

For footnotes, see page 132.

balances in Hong Kong, the UK and France, although the rate of balance growth in Hong Kong began to slow in 2013 as transaction volumes in the property market reduced. In Hong Kong, the increase was also driven by growth in the insurance investment portfolio. Deposit balances increased, particularly in the UK and Hong Kong, though the benefit was more than offset by deposit spread compression, particularly in Hong Kong, reflecting the sustained low interest rate environment.

Net fee income grew by 5%, primarily due to higher sales of investment products in Hong Kong, where growth in unit trusts and brokerage income was driven by favourable market sentiment and strong customer demand. This was supported by increased foreign exchange revenue in the UK and higher management fees reflecting growth in average assets under management, most notably in North America and Hong Kong.

Other income declined by US$1.5bn as a result of portfolio rationalisations and other items described above. The decline also reflected a fall in sales of manufactured insurance products, which led to lower favourable value of new business movements in the PVIF asset in Europe, Hong Kong and Rest of Asia-Pacific. Lower favourable PVIF movements also reflected the non-recurrence of the recognition of a PVIF asset in Brazil in 2012 and adverse experience and assumption changes in Latin America in 2013.

LICs increased by 1%, mainly driven by higher collective provisions resulting from model changes and assumption revisions for restructured loans in Brazil and assumption changes to our emergence period methodology across all regions (see page 72). Impairments also increased in Mexico and Turkey reflecting higher lending balances. These increases were largely offset by better underlying credit quality in Brazil, improvements in housing market conditions, and lower charge-offs in North America and recoveries from debt sales in the UK.

Operating expenses decreased by US$1.4bn, mainly as a result of lower customer redress provisions in the UK of US$953m compared with US$1.8bn in 2012, sustainable cost savings of over US$300m from organisational effectiveness programmes, and the disposal and run-off of businesses in 2012 and 2013. In addition, we recorded an accounting gain of US$189m relating to changes in delivering ill-

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

health benefits in 2013. These were partly offset by higher staff and premises costs in Latin America and Hong Kong, driven by inflationary pressures.

Income from associates and joint ventures decreased following the disposal of our associate Ping An in December 2012 and the reclassification of Industrial Bank as a financial investment in 2013. On an underlying basis, income from associates rose, primarily in BoCom reflecting balance sheet growth and increased fee income, and in Hong Kong due to the price appreciation of real estate properties.

Growth priorities

Grow in priority markets and deepen customer relationships

Our focus remains on growing the number of customers in our target segments and serving their domestic and international needs whilst de-risking the overall portfolio. HSBC Premier (Premier) is our core retail Wealth offering, and our strategy continues to be to grow the number of customers in this segment and generate more business from the existing client base. Growth and development of this area represents a significant opportunity and is key to reaching our US$3bn incremental Wealth revenue target by 2016, of which US$0.9bn has been achieved to date. In 2013, Wealth revenue of US$6.3bn remained broadly unchanged, with favourable investment sales in Hong Kong and higher foreign exchange income in the UK and Hong Kong being offset by lower insurance revenue, mainly in Latin America.

The total number of active customers in our Principal RBWM business decreased by 5% to 50.4m following business closures and disposals, most notably the sale of the UK HFC Bank lending portfolio and the business in Panama. However, we made good progress in refining and rebalancing the Premier portfolio towards quality long-term sustainable relationships and grew our Premier client base in mainland China, Hong Kong, France and Turkey. Overall, Premier customer numbers remained broadly unchanged at 4.2m as new account growth was offset by reclassification of non-qualifying customers.

At the beginning of the year we introduced a new incentive plan for our Wealth Management relationship managers (RM s) globally. This new plan removes the formulaic link between product sales and variable pay and is instead premised on RM activities that support meeting customer needs, improving customer experience and sales quality. This represents a significant shift in our approach to remuneration and we believe better aligns customer and staff interests, with a focus on building total relationship balances rather than product volume.

We provide our customers with access to a range of wealth management products and are able to leverage HSBC Group-wide capabilities in extending managed solutions, delivering research, expanding renminbi offerings and improving foreign exchange services online. We are also increasing the number of senior RMs dealing with our Premier customers to improve client contact.

Distribution

We continued to invest heavily in enhancing our digital capabilities. The global mobile application which was launched in the fourth quarter of 2012 was deployed in 25 markets by the end of 2013 as we migrated customers to digital channels. This application was downloaded by 2.5m customers, with over 1.1m downloads in the fourth quarter of 2013 alone. Benefits to customers include the ability to engage in stock trading and foreign exchange transactions, bill payment and fund transfers, and increased options to purchase products with improved speed and security.

We deployed digital tools to our front-line staff to raise financial planning standards and gain a more detailed understanding of clients aspirations, risk appetites and investment horizons. We invested significantly in our Wealth Platform with the aim of improving both RM efficiency and customer experience. We rolled out tablet-based tools and applications to RMs in France, UAE and Indonesia with plans to deploy these in 6 further markets in 2014.

We have made good progress in consolidating our Internet Banking systems, reducing the number from 59 to 41 with plans to implement a global solution by the end of 2015. In the third quarter of 2012, we launched the product range review programme and have subsequently reduced the number of retail banking products currently offered from just under 1,000 to 730. We will continue to review our product range to simplify and standardise our offering and to optimise customer choice, increase efficiencies and lower transactional costs.

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Commercial Banking

CMB offers a full range of commercial financial services and tailored solutions to more than three million customers ranging from small and medium-sized enterprises to publicly quoted companies in almost 60 countries.

	2013 US$m	2012 US$m	2011 US$m
Net interest income	**10,200**	10,361	9,931
Net fee income	**4,717**	4,470	4,291
Other income[7]	**1,448**	1,720	1,389
Net operating income[4]	**16,365**	16,551	15,611
LICs[42]	**(2,384)**	(2,099)	(1,738)
Net operating income	**13,981**	14,452	13,873
Total operating expenses	**(7,049)**	(7,598)	(7,221)
Operating profit/(loss)	**6,932**	6,854	6,652
Income from associates[43]	**1,509**	1,681	1,295
Profit/(loss) before tax	**8,441**	8,535	7,947
RoRWA[36]	**2.2%**	2.2%	2.2%

5%

growth in customer lending balances

on a constant currency basis

11%

increase in gross revenues from sales

of GB&M products to CMB customers

Best Transaction Banking House

and Best Cash Management Bank

(Euromoney Poll 2013)

Strategic direction

CMB aims to be the banking partner of choice for international businesses by building on our rich heritage, international capabilities and relationships to enable connectivity and support trade and capital flows around the world, thereby strengthening our leading position in international business and trade.

We have three growth priorities:

- grow coverage in faster growing markets;
- drive revenue growth through our international network; and
- grow collaboration revenues.

Implementing Global Standards, enhancing risk management controls models and simplifying processes also remain top priorities for CMB.

For footnotes, see page 132.

The commentary is on a constant currency basis unless stated otherwise, while tables are on a reported basis.

Review of performance

In 2013, CMB reported a profit before tax of US$8.4bn, which was marginally lower on a reported basis and was broadly unchanged on a constant currency basis compared with 2012. 2013 results included gains of US$470m mainly from the sale of our operations in Panama, compared with gains of US$468m in 2012 which included the sales of branches in the US. Share of profit in associates was lower due to the reclassification of Industrial Bank from an associate to a financial investment and the disposal of our investment in Ping An.

On an underlying basis, which excludes the disposal gains and associated operating results, profit before tax rose by 5%. This was driven by increased revenues, a reduction in operating expenses, and higher income from our associates, partly offset by a rise in loan impairment charges.

Revenue on a constant currency basis remained broadly unchanged compared with 2012. Disposal gains in Latin America and increased revenue in Europe were largely offset by the effect of business disposals in the US in 2012. On an underlying basis revenue increased by 2%, with growth in Hong Kong and Europe partly offset by falls in North America and Latin America. Higher net interest income from average balance sheet growth was partly offset by spread compression. Higher net fee income was driven by an increase in lending fees and enhanced collaboration with GB&M.

Management view of revenue

	2013	2012	2011
	US$m	US$m	US$m
Global Trade and Receivables Finance	**2,929**	2,968	2,019
Credit and Lending	**6,103**	6,246	6,329
Payments and Cash Management, current accounts and savings deposits	**5,287**	5,369	4,584
Other	**2,046**	1,968	2,679

Net operating income[4]	**16,365**	16,551	15,611

For footnote, see page 132.

Global Trade and Receivables Finance revenue was broadly unchanged compared with 2012. Double digit lending growth, primarily in Hong Kong and Rest of Asia-Pacific, was offset by spread compression, particularly in Hong Kong and Latin America, reflecting competition and increased liquidity in the markets.

84

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Credit and Lending revenue remained largely unchanged, as higher average balances in Hong Kong and increased net fee income were broadly offset by lower average balances in Latin America and spread compression in Europe, Middle East and North Africa and North America.

Payments and Cash Management revenue remained broadly unchanged compared with 2012. This reflected liability growth, notably in Hong Kong and the UK, which was driven by new mandates and increased transaction volumes and supported by our focus on international customers, offset by the effect of business disposals in the US.

The movement in Other reflected the gains on business disposals recorded in both 2012 and 2013.

LICs increased by US$344m, driven by higher individually assessed loan impairments in Latin America, in particular specific impairments in Mexico relating to homebuilders from a change in public housing policy and in Brazil relating to certain corporate exposures. In Europe, lower individual impairments, mainly in the UK and Greece, were partly offset by higher provisions in Spain due to the continued challenging economic conditions.

Operating expenses decreased by 5%, primarily in Europe due to an accounting gain arising from a change in the basis of delivering ill-health benefits in 2013 of US$161m and lower customer redress provisions of US$148m (2012: US$258m). Operating expenses also decreased due to the effects of business disposals. In 2013, we generated over US$80m of sustainable savings. These factors were partly offset by increased costs in Hong Kong and Rest of Asia-Pacific due to inflationary pressures and investment for growth.

Income from associates declined by 12%, reflecting the reclassification of Industrial Bank as an investment and the disposal of our investment in Ping An. Excluding these events, income from associates grew by 11% as BoCom benefited from a rise in lending and associated fee income.

Growth priorities

Grow coverage in faster-growing markets

Revenues in Hong Kong, Rest of Asia-Pacific, Latin America and Middle East and North Africa increased by 3% compared with 2012 and represented over 55% of our revenues in 2013. CMB s top 20 markets contributed around 90% of our profit before tax in 2013.

Our global network helps connect customers internationally. For example, we expanded our renminbi offering to Latin America as trade with mainland China gathered pace. In addition, we opened the first China desk in Argentina to support mainland Chinese businesses operating in Argentina as well as local companies interested in doing business in mainland China.

Drive revenue growth through our international network

HSBC has a competitive advantage by being present and able to capture business at both ends of the top twenty global trade corridors. The opportunities this presents to generate additional revenues has helped us grow underlying revenue faster than GDP growth in Europe, Hong Kong and Rest of Asia-Pacific.

In addition, we continue to invest in organic growth in city clusters with international business opportunities as we have done in the US, mainland China, Germany and other markets.

We continued to expand our international relationship managers (IRM) programme and now have almost 500 IRMs supporting SME clients with international growth ambitions, having extended our programme from three markets in 2012 to 12 in 2013. The new markets include Hong Kong, US, Canada, Egypt, Singapore, India, Argentina, UAE and Turkey. There are plans to expand the model into a further five key Business Banking markets next year.

We continued to support SMEs by launching funds to support those businesses that trade or aspire to trade internationally. SME funds were launched in the first half of 2013 in the UK,

Table of Contents

France and Mexico, and subsequently we launched two SME funds of US$1bn in US and Canada. In the UAE, a fourth SME fund of AED1bn (US$272m) targeted at international trade customers was also launched.

Grow collaboration revenues

CMB s ongoing collaboration with HSBC s other global businesses resulted in revenue growth of over US$0.3bn for the Group, a 9% increase compared with 2012. Our collaboration with global businesses has now delivered US$1.3bn in incremental revenue for the Group since 2010, achieving 65% of our medium-term target. Gross revenues from sales of GB&M products to CMB customers, which are shared by the two global businesses, grew by 11%,
mainly driven by sales of foreign exchange products and debt capital markets activities. Close collaboration across international borders and global businesses resulted in a number of high-profile deals in 2013.

To serve our clients in each segment better, and to further enhance the collaboration efforts with GB&M, we have created two senior management roles Global Head of Large Corporates and Global Head of Mid-market and Business Banking to focus on our largest clients who are internationally connected and prime candidates for collaboration activities with an emphasis on markets and capital financing. This should ensure better coverage of our target segments in the future.

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Global Banking and Markets

GB&M provides tailored financial solutions to major government, corporate and institutional clients worldwide.

	2013 US$m	2012 US$m	2011 US$m
Net interest income	**6,766**	6,960	7,263
Net fee income	**3,482**	3,329	3,227
Net trading income[44]	**6,780**	5,690	5,204
Other income	**2,148**	2,294	1,363
Net operating income[4]	**19,176**	18,273	17,057
LICs[42]	**(207)**	(670)	(984)
Net operating income	**18,969**	17,603	16,073
Total operating expenses	**(9,960)**	(9,907)	(9,722)
Operating profit	**9,009**	7,696	6,351
Income from associates[43]	**432**	824	698
Profit before tax	**9,441**	8,520	7,049
RoRWA[36]	**2.3%**	2.1%	1.8%

Resilient performance in

a challenging environment

Increased client flows in the majority

of our customer-facing businesses

Best Global Emerging

Market Investment Bank

(Euromoney Awards for Excellence 2013)

Strategic direction

GB&M continues to pursue its emerging markets-led and financing-focused strategy, with the objective of being a top 5 bank to our priority clients. This strategy has evolved to include a greater emphasis on connectivity between the global businesses, across the regions and within GB&M, leveraging the Group s extensive distribution network.

We focus on four growth priorities:

- leveraging our distinctive geographical network which connects developed and faster-growing regions;
- connecting clients to global growth opportunities;
- continuing to be well positioned in products that will benefit from global trends; and
- enhancing collaboration with other global businesses to appropriately service the needs of our international client base.

Implementing Global Standards, enhancing risk management controls and simplifying processes also remain top priorities for GB&M.

For footnotes, see page 132.

The commentary is on a constant currency basis unless stated otherwise, while tables are on a reported basis.

Review of performance

GB&M reported profit before tax of US$9.4bn, 11% higher than in 2012. Reported results in 2013 included a number of gains on disposal, particularly of our business in Panama. Reported results in 2012 included income from associates Industrial Bank and Ping An. On an underlying basis, which excludes these items, the results of other disposed of operations and the effect of currency movements, profit before tax rose by 15%. This was driven by increased revenue and significantly lower impairment charges and other credit risk provisions.

Revenue rose by 6%, in part reflecting resilient performance in the majority of our customer facing businesses. 2013 revenue included a DVA of US$105m and a gain on disposal of our operations in Panama of US$316m. In 2012, revenue included a reported net charge of US$385m as a result of a change in estimation methodology in respect of CVAs of US$903m, and a DVA of US$518m to reflect evolving market practices.

LICs decreased significantly by US$458m or 69%. Credit risk provisions declined, driven by net releases on available-for-sale ABSs in our legacy portfolio compared with impairment charges in 2012, and the non-recurrence of impairments on certain available-for-sale debt securities in Principal Investments. Impairment charges in the legacy credit loans and advances portfolio also declined.

Operating expenses increased marginally by 2%, despite a decline in performance-related costs and sustainable savings of US$74m achieved from identifying savings and simplifying our processes. There was an increase in 2013 in litigation-related costs, primarily Madoff-related, of US$293m, coupled with an increase in investment in regulatory and compliance resources. These costs were offset in part by a lower customer redress provision relating to interest rate protection products of US$134m (2012: US$329m) and an accounting gain of US$81m relating to changes in delivering employee ill-health benefits.

Income from associates was lower, largely due to the reclassification of Industrial Bank as a financial investment and following the sale of our shareholding in Ping An.

Report of the Directors: Financial Review (continued)

Management view of total operating income[45]

	2013 US$m	2012 US$m	2011 US$m
Markets[46]	**6,935**	6,105	5,749
Credit	**796**	485	133
Rates	**1,653**	1,607	1,238
Foreign Exchange	**3,186**	3,215	3,269
Equities	**1,300**	798	1,109
Capital Financing	**3,994**	3,758	3,711
Payments and Cash Management	**1,770**	1,680	1,561
Securities Services	**1,662**	1,623	1,669
Global Trade and Receivables Finance	**741**	740	601
Balance Sheet Management	**3,110**	3,738	3,418
Principal Investments	**512**	188	277
Debit valuation adjustment	**105**	518	
Other[47]	**347**	(77)	71
Net operating income[4]	**19,176**	18,273	17,057

The management view of income above reflects the new management structure of GB&M which has been in place since 12 August 2013 (comparatives have been re-presented for this change).

For footnotes, see page 132.

Markets reported a resilient performance with revenue of US$6.9bn. Revenue in Credit increased, reflecting higher secondary market activity and improved investor appetite, along with revaluation gains from price appreciation on assets in the legacy portfolio. Despite competitive pressure, revenue in primary credit rose. We also increased market share and improved our league table position, particularly in the issue of sterling and Hong Kong dollar bonds in which we led the market.

Despite difficult market conditions, Equities revenue rose, in part, due to increased client flows and larger market share in Hong Kong. Equities also reported increased revaluation gains along with minimal fair value movements on own credit spreads on structured liabilities, compared with adverse movements in 2012.

Foreign Exchange income was broadly in line with 2012. Revenues rose due to increased client demand for foreign exchange hedging solutions, which benefited from GB&M s
collaboration with CMB. This was partly offset, however by margin compression and reduced market volatility in the second half of 2013.

Revenue in Rates in 2012 included a charge as a result of the change in estimation methodology in respect of CVAs, as noted above. In 2013, we won new client mandates and improved market share, despite price compression, particularly in European government bonds. This was coupled with smaller adverse fair value movements on our own credit spreads on structured liabilities compared with 2012. These factors were broadly offset, as revenue in 2012 benefited from the significant tightening of spreads following the ECB liquidity intervention. Revenue in 2013 was affected by uncertainty regarding the tapering of quantitative easing in the US.

Revenue in Capital Financing rose due to higher volumes and spreads in Credit and Lending and gains on sale of equity positions compared with losses on syndicated loans in 2012. In addition, income grew in Project and Export Finance, in part due to increased market share in export credit agency financing, and revenue rose, due to increased issuance demand in debt capital markets.

Payments and Cash Management revenue also grew, in part due to increased customer activity reflecting new mandates, with growth in deposit balances and transaction volumes compared with 2012.

As expected, Balance Sheet Management revenue decreased as proceeds from the sale and maturity of investments were reinvested at prevailing rates which were lower, together with reduced gains on the disposal of available-for-sale debt securities.

Revenue in Principal Investments rose during the year, mainly driven by lower equity impairments. In addition, there were higher gains on disposal of units held in third-party managed private equity funds than in 2012 due to increased refinancing and exit opportunities as market conditions improved.

Other included a gain on the disposal of our operations in Panama of US$316m in 2013.

Report of the Directors: Financial Review (continued)

Growth priorities

Leveraging our distinctive geographical network which connects developed and faster-growing regions

As a universal bank with a distinctive international network and business model, we have provided innovative solutions to multinational corporates including advisory, financing and foreign exchange services.

We advised on the largest M&A transaction by a foreign company in India for a stake enhancement in an India-listed subsidiary. Examples like this reinforce our ability to execute complex cross-border M&A transactions.

We also acted as sole bookrunner on a *dim sum* bond issuance for the first foreign government to issue in the mainland China market, highlighting our leading role in the internationalisation of the renminbi.

Connecting clients to global growth opportunities

GB&M s product expertise supports our clients in the growth of their business activities. In equity capital markets, we were joint lead manager and bookrunner for a large Chinese bank initial public offering (IPO) in Hong Kong and also led the Hong Kong advisory market. This demonstrated our strength in providing cross-border capital markets access and advisory services to clients in mainland China.

We were voted Best for Innovation in Securities Services by *The Banker* magazine following the redesign and development of our Securities Services web portal. This is now more intuitive, consistent across product lines, multi-lingual and accessible from tablets. The award recognised our commitment to innovation and connecting clients to information using new technology.

Continuing to be well positioned in products that will benefit from global trends

We continued to build on the strength of our product offering, with a particular focus on renminbi, which became the second most utilised trade finance currency in 2013. We were voted Best Overall for Products and Services by *Asiamoney* Offshore RMB Services Survey 2013, for the second consecutive year.

We also delivered a broad range of GB&M products in a number of transactions relating to resource and energy companies. This included providing advisory and financing services to a consortium in the acquisition of an energy from waste company, and to a liquified natural gas company.

We remain focused on opportunities in Project and Export Finance, which will benefit as emerging countries pursue economic growth through infrastructure investment and as institutional investors seek out long-term real assets. We were voted Best Project Finance House in Asia, Africa and Latin America by *Euromoney* and Best Global Export Finance Arranger by *Trade Finance* magazine.

With globalisation increasing the number of cross-border payment flows, our leadership in Payments and Cash Management was recognised by *Euromoney*, who named HSBC the Best Global Cash Manager for the second consecutive year.

Enhancing collaboration with other global businesses to appropriately service the needs of our customers

We continued to strengthen collaboration with other global businesses to better meet the needs of our customers across the Group. Gross revenues from sales of GB&M products to CMB customers, which are shared by the two global businesses, grew by 11% mainly driven by sales of foreign exchange products. Revenue from equity capital markets activities for CMB clients also increased significantly as a result of a larger number of deals.

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Global Private Banking

GPB serves high net worth individuals and families with complex and international needs within the Group s priority markets.

	2013 US$m	2012 US$m	2011 US$m
Net interest income	**1,146**	1,294	1,439
Net fee income	**1,150**	1,232	1,382
Other income	**143**	646	471
Net operating income[4]	**2,439**	3,172	3,292
LICs[42]	**(31)**	(27)	(86)
Net operating income	**2,408**	3,145	3,206
Total operating expenses	**(2,229)**	(2,143)	(2,266)
Operating profit	**179**	1,002	940
Income from associates[43]	**14**	7	4
Profit before tax	**193**	1,009	944
RoRWA[36]	**0.9%**	4.6%	3.9%

Profit before tax was significantly lower

as we continued to address legacy issues

and reposition the customer base

Approximately US$50m **of**

sustainable cost savings, on top of about

US$90m already delivered in 2011 and 2012

Best Private Bank in Hong Kong

(The Banker Global Private Banking Awards)

Strategic direction

GPB aims to build on HSBC s commercial banking heritage to be the leading private bank for high net worth business owners.

We have two growth priorities:

- repositioning the business to concentrate on home and priority markets, particularly onshore, aligned with Group priorities; and
- capturing growth opportunities from Group collaboration, particularly by accessing owners and principals of CMB and GB&M clients.

Implementing Global Standards, enhancing risk management controls, tax transparency and simplifying processes also remain top priorities for GPB.

For footnotes, see page 132.

The commentary is on a constant currency basis unless stated otherwise, while tables are on a reported basis.

Review of performance

- Reported profit before tax of US$193m was US$816m lower than in 2012 and US$800m lower on a constant currency basis.
- On an underlying basis, which excludes the gain on the sale of our operations in Japan in 2012 of US$67m and associated operating results, profit before tax was US$744m lower, primarily due to reduced revenue.
- *Revenue* declined by 23%, mainly due to the loss on write-off of goodwill relating to our Monaco business of US$279m and the non-recurrence of the sale of our operations in Japan and our headquarters building in Switzerland (US$120m) reported in 2012. Net interest income fell as higher-yielding positions matured and opportunities for reinvestment were limited by prevailing rates. Narrower lending spreads coupled with a decline in average deposit balances also contributed to the fall in net interest income. In addition, brokerage fees decreased, reflecting a fall in client transaction volumes due to lower volatility, and account services fees were lower due to the reduction in client numbers and client assets as we repositioned our client base. Trading income also fell, in part due to lower foreign exchange volumes and lower volatility in the market, notably in the second half of 2013.
- *Operating expenses* increased by 4%, primarily due to regulatory investigation provisions of US$352m, partly offset by lower staff costs from a managed reduction in average staff numbers, reduced performance costs and the non-recurrence of customer redress provisions and costs relating to the merger of pension funds in Switzerland. We also delivered further sustainable savings of approximately US$50m in 2013.

Client assets[48]

	2013 **US$bn**	2012 US$bn
At 1 January	**398**	377
Net new money	**(26)**	(7)
Value change	**12**	17
Exchange and other	**(2)**	11
At 31 December	**382**	398

Report of the Directors: Financial Review (continued)

Client assets, which include funds under management and cash deposits, decreased by US$16bn in 2013 primarily due to negative net new money, the effects of the disposal of our operations in Panama and ongoing client transfers in relation to the disposal of our HSBC Trinkaus & Burkhardt AG (HSBC Trinkaus) business in Luxembourg, partly offset by favourable market movements. Negative net new money was mainly driven by the repositioning of our business by moving from offshore to domestic banking, refocusing our client base towards higher net worth relationships, and adopting new compliance and tax transparency standards. There were also a large number of client withdrawals, notably in Switzerland. However, we attracted positive net new money of US$4.6bn from clients in Asia.

Our return on assets, defined as the percentage of revenue to average client assets, was 62bps in 2013 compared with 79bps in 2012. The reduction was primarily due to the write-off of goodwill noted above and the non-recurrence of the gains on the sale of our operations in Japan and our headquarters in Switzerland reported in 2012. Excluding the effect of these items, our return on assets was 69bps in 2013 compared with 76bps in 2012, primarily reflecting the fall in net interest income.

Growth priorities

Repositioning the business

The repositioning of GPB s business model and target client base that commenced in 2012 was accelerated in 2013. Our focus remained on home and priority growth markets where wealth creation is strong and where the Group s presence could be leveraged.

During 2013, we began to implement Global Standards and continued to reposition our business through the adoption of new compliance and tax transparency standards. In addition, we initiated a detailed review of our portfolio which will continue in 2014.

We also took actions to simplify and rationalise our portfolio. For example, we agreed to sell our HSBC Trinkaus private banking and related fund business in Luxembourg. We also reviewed our operations in Monaco following receipt of unsolicited expressions of interest, though it was decided in July to retain the business. Furthermore, to help integrate GPB with HSBC s other global businesses, we transferred the ownership of our operations in Asia and the Channel Islands into the main banking entities in these areas to more closely align management responsibility.

Capturing growth opportunities

Referral flows from collaboration with other global businesses generated net new money of US$5bn in 2013. An enhanced strategy based on closer alignment with CMB will focus on driving collaboration in 12 priority markets where both GPB and CMB have significant scale. Staff will be dedicated to focusing on identifying new prospects and an improved coverage model will be implemented in 2014 to pursue opportunities.

The Global Priority Clients initiative a collaborative venture between GPB, GB&M and CMB for the Group s most significant dual banked clients was redefined during the second half of 2013. By ensuring an effective and enhanced coverage model to meet the private and corporate needs of our most significant and complex clients, supported by dedicated senior management, we will deepen our client relationships and drive incremental revenue opportunities.

We continued to enhance our product offering to clients through the strengthening of the Alternatives platform, with six product launches during 2013 comprising three private equity funds, two real estate club deals and a fund of hedge funds.

In addition, we continued to focus on enhancing the service offering to clients. For example, recently we significantly upgraded the relationship management systems used by all front-office staff in Switzerland. We are also establishing a common banking platform which will provide consistent, tailored products and services globally. This will initially be implemented across continental Europe (including in Switzerland in 2015), and in other countries shortly thereafter.

In 2014, we will be developing our digital strategy to provide an upgraded multi-channel offering enabling us to keep pace with changing industry dynamics and competitor developments as well as meet clients growing digital expectations.

Report of the Directors: Financial Review (continued)

Other[40]

Other contains the results of certain property transactions, unallocated investment activities, centrally held investment companies, movements in fair value of own debt, central support and functional costs with associated recoveries, HSBC s holding company and financing operations.

	2013 US$m	2012 US$m	2011 US$m
Net interest expense	**(737)**	(730)	(911)
Net fee income	**64**	194	34
Net trading income/(expense)[44]	**6**	(537)	(355)
Changes in fair value of long-term debt issued and related derivatives	**(1,228)**	(4,327)	4,161
Changes in other financial instruments designated at fair value	**(576)**	(1,136)	78
Net income/(expense) from financial instruments designated at fair value	**(1,804)**	(5,463)	4,239
Other income	**8,122**	8,868	6,138
Net operating income[4]	**5,651**	2,332	9,145
LICs[42]			
Net operating income	**5,651**	2,332	9,145
Total operating expenses	**(7,796)**	(9,369)	(7,492)
Operating profit/(loss)	**(2,145)**	(7,037)	1,653
Income/(expense) from associates[43]	**(14)**	47	9
Profit/(loss) before tax	**(2,159)**	(6,990)	1,662

For footnotes, see page 132.

The commentary is on a constant currency basis unless stated otherwise, while tables are on a reported basis.

Notes

Reported loss before tax of US$2.2bn compared with a loss of US$7.0bn in 2012. On a constant currency basis, the pre-tax loss decreased by US$5.0bn.

These results included lower adverse movements on the fair value of our own debt as credit spreads tightened to a lesser extent, notably in Europe and North America. Reported results also included a number of gains and losses on disposal totalling US$1.1bn (see page 49). These included a gain of US$1.1bn arising from the reclassification of Industrial Bank as a financial investment following its issue of additional share capital to third parties. Reported profits in 2012 included a gain of US$3.0bn on the disposal of our associate, Ping An, and a gain on disposal of US$130m from the sale of our shareholding in a property company in the Philippines.

On an underlying basis, excluding the gains and losses on disposal noted above and the associated operating results, the pre-tax loss of US$1.9bn decreased by US$3.1bn, driven by the non-recurrence of charges for US AML, BSA and OFAC investigations of US$1.9bn. In addition, we recognised a net gain of US$553m on completion of the sale of our investment in Ping An in 2013, compared with adverse fair value movements of US$553m on the Ping An contingent forward sale contract recorded in 2012.

Net fee income decreased by US$130m, reflecting the expiring of most of the transition services agreement entered into during 2012 following the sale of the CRS business in North America. We received fee income relating to the above agreement while the associated costs were reported in Operating expenses .

Net trading income of US$6m in 2013 compared with a net trading expense of US$538m in 2012, driven by foreign exchange gains of US$442m relating to sterling debt issued by HSBC Holdings. In addition, there were favourable fair value movements on non-qualifying hedges, notably in Europe, mainly related to the cross-currency swaps used to economically hedge fixed rate long-term debt, compared with adverse movements in 2012. This was partly offset by adverse fair value movements of US$682m on the contingent forward sale contract relating to Ping An in 2013 compared with US$553m in 2012.

Report of the Directors: Financial Review (continued)

Net expense from financial instruments designated at fair value reduced by US$3.6bn. We reported adverse movements of US$1.2bn on the fair value of our own debt attributable to a tightening of credit spreads in 2013, notably in Europe and North America, compared with adverse movements of US$5.2bn in 2012. Excluding this, net expense increased due to higher adverse fair value movements from interest and exchange rate ineffectiveness in the hedging of long-term debt designated at fair value issued principally by HSBC Holdings and its European subsidiaries.

Gains less losses from financial investments increased by US$868m, driven by a gain of US$1.2bn on the disposal of our investment in Ping An, partly offset by the non-recurrence of gains of US$314m from the sale of our shares in four Indian banks in 2012.

Dividend income increased by US$124m on a reported basis, mainly due to dividends received from Industrial Bank following its reclassification as a financial investment.

Other operating income increased by US$1.5bn, driven by an accounting gain of US$1.1bn arising from the reclassification of Industrial Bank as a financial investment.

Operating expenses reduced by US$1.5bn, mainly from the non-recurrence of the US fines and penalties noted above, together with lower restructuring costs across all our regions. These factors were partly offset by the UK bank levy charge of US$904m in 2013, which was higher than the charge of US$571m in 2012, mainly due to an increase in the rate of the levy. In addition, operating expenses in both years included adjustments relating to the previous year s bank levy charge (2013: US$12m adverse adjustment; 2012: US$99m favourable adjustment).

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

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

Retail Banking and Wealth Management

2013 compared with 2012

	2012 as reported US$m	Currency translation adjustment[1] US$m	2012 at 2013 exchange rates US$m	**2013 as reported US$m**	**Reported change[2] %**	**Constant currency change[2] %**
Net interest income	20,298	(368)	19,930	**18,339**	**(10)**	**(8)**
Net fee income	7,205	(113)	7,092	**7,021**	**(3)**	**(1)**
Net trading income	304	(18)	286	**686**	**126**	**140**
Net income from financial instruments designated at fair value	1,893	(26)	1,867	**1,638**	**(13)**	**(12)**
Gains on disposal of US branch network and cards business	3,735		3,735		**(100)**	**(100)**
Gains less losses from financial investments	96	(7)	89	**55**	**(43)**	**(38)**
Net earned insurance premiums	11,191	(68)	11,123	**10,543**	**(6)**	**(5)**
Other operating income (including dividend income)	1,496	(34)	1,462	**565**	**(62)**	**(61)**
Total operating income	46,218	(634)	45,584	**38,847**	**(16)**	**(15)**
Net insurance claims incurred and movement in liabilities to policyholders	(12,357)	44	(12,313)	**(12,107)**	**2**	**2**
Net operating income[4]	33,861	(590)	33,271	**26,740**	**(21)**	**(20)**
LICs[42]	(5,515)	135	(5,380)	**(3,227)**	**41**	**40**
Net operating income	28,346	(455)	27,891	**23,513**	**(17)**	**(16)**
Operating expenses	(19,769)	415	(19,354)	**(17,248)**	**13**	**11**
Operating profit	8,577	(40)	8,537	**6,265**	**(27)**	**(27)**
Income from associates[43]	998	14	1,012	**384**	**(62)**	**(62)**
Profit before tax	9,575	(26)	9,549	**6,649**	**(31)**	**(30)**

For footnotes, see page 132.

2012 compared with 2011

	2011 as reported	Currency translation adjustment[1]	2011 at 2012 exchange rates	2012 as reported	Reported change[2]	Constant currency change[2]
	US$m	US$m	US$m	US$m	%	%
Net interest income	24,101	(702)	23,399	20,298	(16)	(13)
Net fee income	8,226	(187)	8,039	7,205	(12)	(10)
Gains on disposal of US branch network and cards business				3,735		
Other income[7]	1,206	(100)	1,106	2,623	117	137
Net operating income[4]	33,533	(989)	32,544	33,861	1	4
LICs[42]	(9,319)	181	(9,138)	(5,515)	41	40
Net operating income	24,214	(808)	23,406	28,346	17	21
Operating expenses	(21,202)	712	(20,490)	(19,769)	7	4
Operating profit	3,012	(96)	2,916	8,577	185	194
Income from associates[43]	1,258	25	1,283	998	(21)	(22)
Profit before tax	4,270	(71)	4,199	9,575	124	128

For footnotes, see page 132.

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Reconciliation of reported and underlying items

	Year ended 31 December					
	2013 US$m	2012 US$m	Change[2] %	2012 US$m	2011 US$m	Change[2] %
Net interest income						
Reported	**18,339**	20,298	(10)	20,298	24,101	(16)
Currency translation adjustment[1]		(368)			(701)	
Acquisitions, disposals and dilutions	**(151)**	(1,735)		(1,504)	(4,611)	
Underlying	**18,188**	18,195		18,794	18,789	
Other operating income						
Reported	**544**	1,472	(63)	1,472	907	62
Currency translation adjustment[1]		(33)			(38)	
Acquisitions, disposals and dilutions	**(312)**	(395)		(363)	(159)	
Underlying	**232**	1,044	(78)	1,109	710	56
Revenue[4]						
Reported	**26,740**	33,861	(21)	33,861	33,533	1
Currency translation adjustment[1]		(590)			(989)	
Acquisitions, disposals and dilutions	**(494)**	(6,447)		(6,164)	(6,427)	
Underlying	**26,246**	26,824	(2)	27,697	26,117	6
LICs[42]						
Reported	**(3,227)**	(5,515)	41	(5,515)	(9,319)	41
Currency translation adjustment[1]		135			181	
Acquisitions, disposals and dilutions	**33**	377		339	1,616	
Underlying	**(3,194)**	(5,003)	36	(5,176)	(7,522)	31
Operating expenses						
Reported	**(17,248)**	(19,769)	13	(19,769)	(21,202)	7
Currency translation adjustment[1]		415			712	
Acquisitions, disposals and dilutions	**203**	1,176		873	2,429	
Underlying	**(17,045)**	(18,178)	6	(18,896)	(18,061)	(5)
Underlying cost efficiency ratio	**64.9%**	67.8%		68.2%	69.2%	
Share of profit in associates and joint ventures						
Reported	**384**	998	(62)	998	1,258	(21)
Currency translation adjustment[1]		14			25	
Acquisitions, disposals and dilutions	**(6)**	(670)		(622)	(946)	
Underlying	**378**	342	11	376	337	12
Profit before tax						
Reported	**6,649**	9,575	(31)	9,575	4,270	124
Currency translation adjustment[1]		(26)			(71)	
Acquisitions, disposals and dilutions	**(264)**	(5,565)		(5,574)	(3,328)	
Underlying	**6,385**	3,984	60	4,001	871	359

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Principal Retail Banking and Wealth Management business

2013 compared with 2012

	2012 as reported	Currency translation adjustment[1]	2012 at 2013 exchange rates	**2013 as reported**	**Reported change[2]**	**Constant currency change[2]**
	US$m	US$m	US$m	**US$m**	**%**	**%**
Net interest income	16,468	(368)	16,100	**16,278**	**(1)**	**1**
Net fee income	6,777	(113)	6,664	**7,010**	**3**	**5**
Other income[7]	3,403	(109)	3,294	**1,780**	**(48)**	**(46)**
Net operating income[4]	26,648	(590)	26,058	**25,068**	**(6)**	**(4)**
LICs[42]	(2,624)	135	(2,489)	**(2,522)**	**4**	**(1)**
Net operating income	24,024	(455)	23,569	**22,546**	**(6)**	**(4)**
Total operating expenses	(17,937)	415	(17,522)	**(16,082)**	**10**	**8**
Operating profit	6,087	(40)	6,047	**6,464**	**6**	**7**
Income from associates[43]	996	14	1,010	**385**	**(61)**	**(62)**
Profit before tax	7,083	(26)	7,057	**6,849**	**(3)**	**(3)**

For footnotes, see page 132.

Analysis of reported RBWM and Principal RBWM business

	2013	2012	Change[2]	2012	2011	Change[2]
	US$m	US$m	%	US$m	US$m	%
Net interest income						
Reported RBWM	**18,339**	20,298	(10)	20,298	24,101	(16)
US CRS		1,267	(100)	1,267	4,128	(69)
US run-off portfolio	**2,061**	2,563	(20)	2,563	2,990	(14)
Principal RBWM business	**16,278**	16,468	(1)	16,468	16,983	(3)
Net fee income						
Reported RBWM	**7,021**	7,205	(3)	7,205	8,226	(12)
US CRS		395	(100)	395	1,273	(69)
US run-off portfolio	**11**	33	(67)	33	(49)	
Principal RBWM business	**7,010**	6,777	3	6,777	7,002	(3)
Other income/(expense)[7]						

Reported RBWM	**1,380**	6,358	(78)	6,358	1,206	427
US CRS		3,155	(100)	3,155	61	5,072
US run-off portfolio	**(400)**	(200)	(100)	(200)	(1,196)	83
Principal RBWM business	**1,780**	3,403	(48)	3,403	2,341	45
Net operating income[4]						
Reported RBWM	**26,740**	33,861	(21)	33,861	33,533	1
US CRS		4,817	(100)	4,817	5,462	(12)
US run-off portfolio	**1,672**	2,396	(30)	2,396	1,745	37
Principal RBWM business	**25,068**	26,648	(6)	26,648	26,326	1
LICs[42]						
Reported RBWM	**(3,227)**	(5,515)	41	(5,515)	(9,319)	41
US CRS		(322)	100	(322)	(1,600)	80
US run-off portfolio	**(705)**	(2,569)	73	(2,569)	(4,982)	48
Principal RBWM business	**(2,522)**	(2,624)	4	(2,624)	(2,737)	4
Net operating income						
Reported RBWM	**23,513**	28,346	(17)	28,346	24,214	17
US CRS		4,495	(100)	4,495	3,862	16
US run-off portfolio	**967**	(173)		(173)	(3,237)	95
Principal RBWM business	**22,546**	24,024	(6)	24,024	23,589	2

93c

Report of the Directors: Financial Review (continued)

	2013 US$m	2012 US$m	Change[2] %	2012 US$m	2011 US$m	Change[2] %
Total operating expenses						
Reported RBWM	**(17,248)**	(19,769)	13	(19,769)	(21,202)	7
US CRS		(729)	100	(729)	(1,801)	60
US run-off portfolio	**(1,166)**	(1,103)	(6)	(1,103)	(1,238)	11
Principal RBWM business	**(16,082)**	(17,937)	10	(17,937)	(18,163)	1
Operating profit/(loss)						
Reported RBWM	**6,265**	8,577	(27)	8,577	3,012	185
US CRS		3,766	(100)	3,766	2,061	83
US run-off portfolio	**(199)**	(1,276)	84	(1,276)	(4,475)	71
Principal RBWM business	**6,464**	6,087	6	6,087	5,426	12
Income from associates[43]						
Reported RBWM	**384**	998	(62)	998	1,258	(21)
US CRS						
US run-off portfolio	**(1)**	2		2	3	(33)
Principal RBWM business	**385**	996	(61)	996	1,255	(21)
Profit/(loss) before tax						
Reported RBWM	**6,649**	9,575	(31)	9,575	4,270	124
US CRS		3,766	(100)	3,766	2,061	83
US run-off portfolio	**(200)**	(1,274)	84	(1,274)	(4,472)	72
Principal RBWM business	**6,849**	7,083	(3)	7,083	6,681	6

For footnotes, see page 132.

Retail Banking and Wealth Management   Reconciliation of reported and underlying items

HSBC Finance

	Year ended 31 December					
	2013 US$m	2012 US$m	Change[2] %	2012 US$m	2011 US$m	Change[2] %
Revenue[4]						
Reported	**1,672**	7,251	(77)	7,251	7,216	
Acquisitions, disposals and dilutions	**105**	(4,888)		(4,830)	(5,462)	
Underlying	**1,777**	2,363	(25)	2,421	1,754	38
Profit/(loss) before tax						
Reported	**(200)**	2,443		2,443	(2,405)	
Acquisitions, disposals and dilutions	**120**	(3,889)		(3,916)	(2,061)	
Underlying	**(80)**	(1,446)	94	(1,473)	(4,466)	67

	US run-off			*Principal business*		
	Year ended 31 December			Year ended 31 December		
	2013	2012	Change[2]	**2013**	2012	Change[2]
	US$m	US$m	%	**US$m**	US$m	%
Revenue[4]						
Reported	**1,672**	2,396	(30)	**25,068**	26,648	(6)
Currency translation adjustment					(590)	
Acquisitions, disposals and dilutions	**105**			**(599)**	(1,630)	
Underlying	**1,777**	2,396	(26)	**24,469**	24,428	

For footnotes, see page 132.

93d

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Commercial Banking

2013 compared with 2012

	2012 as reported	Currency translation adjustment[1]	2012 at 2013 exchange rates	2013 as reported	Reported change[2]	Constant currency change[2]
	US$m	US$m	US$m	US$m	%	%
Net interest income	10,361	(220)	10,141	**10,200**	**(2)**	**1**
Net fee income	4,470	(69)	4,401	**4,717**	**6**	**7**
Net trading income	633	(15)	618	**649**	**3**	**5**
Net income from financial instruments designated at fair value	250	(17)	233	**332**	**33**	**42**
Gains on disposal of US branch network and cards business	277		277		**(100)**	**(100)**
Gains less losses from financial investments	22	(2)	20	**1**	**(95)**	**(95)**
Net earned insurance premiums	1,786	(49)	1,737	**1,375**	**(23)**	**(21)**
Other operating income (including dividend income)	554	(10)	544	**636**	**15**	**17**
Total operating income	18,353	(382)	17,971	**17,910**	**(2)**	
Net insurance claims incurred and movement in liabilities to policyholders	(1,802)	53	(1,749)	**(1,545)**	**15**	**12**
Net operating income[4]	16,551	(329)	16,222	**16,365**	**(1)**	**1**
LICs[42]	(2,099)	59	(2,040)	**(2,384)**	**(14)**	**(17)**
Net operating income	14,452	(270)	14,182	**13,981**	**(3)**	**(1)**
Operating expenses	(7,598)	149	(7,449)	**(7,049)**	**7**	**5**
Operating profit	6,854	(121)	6,733	**6,932**	**1**	**3**
Income from associates[43]	1,681	25	1,706	**1,509**	**(10)**	**(12)**
Profit before tax	8,535	(96)	8,439	**8,441**	**(1)**	

For footnotes, see page 132.

2012 compared with 2011

	2011 as reported	Currency translation	2011 at 2012	2012 as reported	Reported change[2]	Constant currency

	US$m	adjustment[1] US$m	exchange rates US$m	US$m	%	change[2] %
Net interest income	9,931	(381)	9,550	10,361	4	8
Net fee income	4,291	(132)	4,159	4,470	4	7
Gains on disposal of US branch network				277		
Other income[7]	1,389	(58)	1,331	1,443	4	8
Net operating income[4]	15,611	(571)	15,040	16,551	6	10
LICs[42]	(1,738)	81	(1,657)	(2,099)	(21)	(27)
Net operating income	13,873	(490)	13,383	14,452	4	8
Operating expenses	(7,221)	288	(6,933)	(7,598)	(5)	(10)
Operating profit	6,652	(202)	6,450	6,854	3	6
Income from associates[43]	1,295	22	1,317	1,681	30	28
Profit before tax	7,947	(180)	7,767	8,535	7	10

For footnotes, see page 132.

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Reconciliation of reported and underlying items

	Year ended 31 December					
	2013 US$m	2012 US$m	Change[2] %	2012 US$m	2011 US$m	Change[2] %
Net interest income						
Reported	**10,200**	10,361	(2)	10,361	9,931	4
Currency translation adjustment[1]		(220)			(381)	
Acquisitions, disposals and dilutions	**(92)**	(211)		(83)	(139)	
Underlying	**10,108**	9,930	2	10,278	9,411	9
Other operating income						
Reported	**621**	536	16	536	483	11
Currency translation adjustment[1]		(10)			(10)	
Acquisitions, disposals and dilutions	**(470)**	(187)		(203)	6	
Underlying	**151**	339	(55)	333	479	(30)
Revenue[4]						
Reported	**16,365**	16,551	(1)	16,551	15,611	6
Currency translation adjustment[1]		(329)			(571)	
Acquisitions, disposals and dilutions	**(593)**	(762)		(605)	(232)	
Underlying	**15,772**	15,460	2	15,946	14,808	8
LICs[42]						
Reported	**(2,384)**	(2,099)	(14)	(2,099)	(1,738)	(21)
Currency translation adjustment[1]		59			81	
Acquisitions, disposals and dilutions	**(1)**			(1)	3	
Underlying	**(2,385)**	(2,040)	(17)	(2,100)	(1,654)	(27)
Operating expenses						
Reported	**(7,049)**	(7,598)	7	(7,598)	(7,221)	(5)
Currency translation adjustment[1]		149			288	
Acquisitions, disposals and dilutions	**63**	191		100	162	
Underlying	**(6,986)**	(7,258)	4	(7,498)	(6,771)	(11)
Underlying cost efficiency ratio	**44.3%**	46.9%		47.0%	45.7%	
Share of profit in associates and joint ventures						
Reported	**1,509**	1,681	(10)	1,681	1,295	30
Currency translation adjustment[1]		25			21	
Acquisitions, disposals and dilutions	**(10)**	(351)		(88)	(9)	
Underlying	**1,499**	1,355	11	1,593	1,307	22
Profit before tax						
Reported	**8,441**	8,535	(1)	8,535	7,947	7
Currency translation adjustment[1]		(96)			(180)	
Acquisitions, disposals and dilutions	**(541)**	(922)		(594)	(76)	
Underlying	**7,900**	7,517	5	7,941	7,691	3

For footnotes, see page 132.

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Global Banking and Markets

2013 compared with 2012

	2012 as reported	Currency translation adjustment[1]	2012 at 2013 exchange rates	**2013 as reported**	**Reported change[2]**	**Constant currency change[2]**
	US$m	US$m	US$m	**US$m**	**%**	**%**
Net interest income	6,960	(127)	6,833	**6,766**	**(3)**	**(1)**
Net fee income	3,329	(22)	3,307	**3,482**	**5**	**5**
Net trading income	5,690	(90)	5,600	**6,780**	**19**	**21**
Net income from financial instruments designated at fair value	1,094	(13)	1,081	**599**	**(45)**	**(45)**
Gains less losses from financial investments	730	(8)	722	**747**	**2**	**3**
Net earned insurance premiums	25	(3)	22	**6**	**(76)**	**(73)**
Other operating income (including dividend income)	461	9	470	**799**	**73**	**70**
Total operating income	18,289	(254)	18,035	**19,179**	**5**	**6**
Net insurance claims incurred and movement in liabilities to policyholders	(16)	1	(15)	**(3)**	**81**	**80**
Net operating income[4]	18,273	(253)	18,020	**19,176**	**5**	**6**
LICs[42]	(670)	5	(665)	**(207)**	**69**	**69**
Net operating income	17,603	(248)	17,355	**18,969**	**8**	**9**
Operating expenses	(9,907)	95	(9,812)	**(9,960)**	**(1)**	**(2)**
Operating profit	7,696	(153)	7,543	**9,009**	**17**	**19**
Income from associates[43]	824	6	830	**432**	**(48)**	**(48)**
Profit before tax	8,520	(147)	8,373	**9,441**	**11**	**13**

For footnotes, see page 132.

2012 compared with 2011

	2011 as reported	Currency translation	2011 at 2012	2012 as reported	Reported change[2]	Constant currency

	US$m	adjustment[1] US$m	exchange rates US$m	US$m	%	change[2] %
Net interest income	7,263	(197)	7,066	6,960	(4)	(2)
Net fee income	3,227	(92)	3,135	3,329	3	6
Net trading income	5,204	(116)	5,088	5,690	9	12
Other income[7]	1,363	(26)	1,337	2,294	68	72
Net operating income[4]	17,057	(431)	16,626	18,273	7	10
LICs[42]	(984)	14	(970)	(670)	32	31
Net operating income	16,073	(417)	15,656	17,603	10	12
Operating expenses	(9,722)	208	(9,514)	(9,907)	(2)	(4)
Operating profit	6,351	(209)	6,142	7,696	21	25
Income from associates[43]	698	9	707	824	18	17
Profit before tax	7,049	(200)	6,849	8,520	21	24

For footnotes, see page 132.

Report of the Directors: Financial Review (continued)

Reconciliation of reported and constant currency management view of total operating income of Global Banking and Markets

2013 compared with 2012

	2012 as reported US$m	Currency translation adjustment[1] US$m	2012 at 2013 exchange rates US$m	**2013 as reported US$m**	**Reported change[2] %**	**Constant currency change[2] %**
Markets[46]	6,105	(75)	6,030	**6,935**	**14**	**15**
Credit	485	(2)	483	**796**	**64**	**65**
Rates	1,607	(18)	1,589	**1,653**	**3**	**4**
Foreign Exchange	3,215	(54)	3,161	**3,186**	**(1)**	**1**
Equities	798	(1)	797	**1,300**	**63**	**63**
Capital Financing	3,758	(34)	3,724	**3,994**	**6**	**7**
Payments and Cash Management	1,680	(32)	1,648	**1,770**	**5**	**7**
Securities Services	1,623	(20)	1,603	**1,662**	**2**	**4**
Global Trade and Receivables Finance	740	(14)	726	**741**		**2**
Balance Sheet Management	3,738	(64)	3,674	**3,110**	**(17)**	**(15)**
Principal Investments	188	(3)	185	**512**	**172**	**177**
Debit valuation adjustment	518	(6)	512	**105**	**(80)**	**(79)**
Other[47]	(77)	(5)	(82)	**347**		
Total operating income	18,273	(253)	18,020	**19,176**	**5**	**6**

For footnotes, see page 132.

2012 compared with 2011

	2011 as reported US$m	Currency translation adjustment[1] US$m	2011 at 2012 exchange rates	2012 as reported US$m	Reported change[2] %	Constant currency change[2] %

			US$m			
Markets[46]	5,749	(138)	5,611	6,104	6	9
Credit	133	(6)	127	485	265	282
Rates	1,238	(16)	1,222	1,607	30	32
Foreign Exchange	3,269	(77)	3,192	3,214	(2)	1
Equities	1,109	(39)	1,070	798	(28)	(25)
Capital Financing	3,711	(114)	3,597	3,758	1	4
Payments and Cash Management	1,561	(27)	1,534	1,679	8	9
Securities Services	1,669	(44)	1,625	1,624	(3)	
Global Trade and Receivables Finance	601	(18)	583	740	23	27
Balance Sheet Management	3,418	(73)	3,345	3,738	9	12
Principal Investments	277	(7)	270	188	(32)	(31)
Debit valuation adjustment				518		
Other[47]	71	(10)	61	(76)		
Total operating income	17,057	(431)	16,626	18,273	7	10

The management view of income above reflects the new management structure of GB&M which has been in place since 12 August 2013 (comparatives have been re-presented for this change).

For footnotes, see page 132.

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Reconciliation of reported and underlying items

	Year ended 31 December					
	2013	2012	Change[2]	2012	2011	Change[2]
	US$m	US$m	%	US$m	US$m	%
Net interest income						
Reported	**6,766**	6,960	(3)	6,960	7,263	(4)
Currency translation adjustment[1]		(127)			(198)	
Acquisitions, disposals and dilutions	**(26)**	(56)		(24)	(31)	
Underlying	**6,740**	6,777	(1)	6,936	7,034	(1)
Other operating income						
Reported	**670**	313	114	313	577	(46)
Currency translation adjustment[1]		10			(10)	
Acquisitions, disposals and dilutions	**(407)**	(78)		(30)	7	
Underlying	**263**	245	7	283	574	(51)
Revenue[4]						
Reported	**19,176**	18,273	5	18,273	17,057	7
Currency translation adjustment[1]		(253)			(431)	
Acquisitions, disposals and dilutions	**(460)**	(219)		(107)	(81)	
Underlying	**18,716**	17,801	5	18,166	16,545	10
LICs[42]						
Reported	**(207)**	(670)	69	(670)	(984)	32
Currency translation adjustment[1]		5			14	
Acquisitions, disposals and dilutions						
Underlying	**(207)**	(665)	69	(670)	(970)	31
Operating expenses						
Reported	**(9,960)**	(9,907)	(1)	(9,907)	(9,722)	(2)
Currency translation adjustment[1]		95			208	
Acquisitions, disposals and dilutions	**54**	107		21	34	
Underlying	**(9,906)**	(9,705)	(2)	(9,886)	(9,480)	(4)
Underlying cost efficiency ratio	**52.9%**	54.5%		54.4%	57.3%	
Share of profit in associates and joint ventures						
Reported	**432**	824	(48)	824	698	18
Currency translation adjustment[1]		6			9	
Acquisitions, disposals and dilutions	**2**	(404)		(63)	(67)	
Underlying	**434**	426	2	761	640	19
Profit before tax						
Reported	**9,441**	8,520	11	8,520	7,049	21
Currency translation adjustment[1]		(147)			(200)	
Acquisitions, disposals and dilutions	**(404)**	(516)		(149)	(114)	
Underlying	**9,037**	7,857	15	8,371	6,735	24

For footnotes, see page 132.

93i

Report of the Directors: Financial Review (continued)

Balance sheet data significant to Global Banking and Markets

	Europe US$m	Hong Kong US$m	Rest of Asia-Pacific US$m	MENA US$m	North America US$m	Latin America US$m	Total US$m
At 31 December 2013							
Trading assets[64]	**212,941**	**27,998**	**11,942**	**432**	**38,709**	**6,660**	**298,682**
Derivative assets[65]	**227,985**	**34,353**	**24,558**	**1,143**	**57,131**	**5,971**	**351,141**
Trading liabilities	**137,448**	**10,377**	**3,958**	**1,230**	**38,850**	**2,823**	**194,686**
Derivative liabilities[65]	**273,086**	**32,269**	**23,597**	**1,158**	**55,105**	**5,499**	**390,714**
At 31 December 2012							
Trading assets[64]	242,175	31,614	22,804	530	95,347	9,506	401,976
Derivative assets[65]	287,427	28,531	22,700	1,417	80,096	5,117	425,288
Trading liabilities	176,838	9,345	4,470	1,081	94,943	5,950	292,627
Derivative liabilities[65]	292,711	27,720	22,900	1,430	79,437	4,899	429,097
At 31 December 2011							
Trading assets[64]	180,790	38,637	19,167	938	69,568	14,370	323,470
Derivative assets[65]	272,756	25,203	23,056	1,275	86,619	4,825	413,734
Trading liabilities	157,934	8,282	3,781	757	70,288	5,014	246,056
Derivative liabilities[65]	274,803	25,186	23,877	1,245	86,697	4,469	416,277

For footnotes, see page 133a.

Report of the Directors: Financial Review (continued)

Global Private Banking

2013 compared with 2012

	2012 as reported	Currency translation adjustment[1]	2012 at 2013 exchange rates	**2013 as reported**	**Reported change[2]**	**Constant currency change[2]**
	US$m	US$m	US$m	**US$m**	**%**	**%**
Net interest income	1,294	(6)	1,288	**1,146**	**(11)**	**(11)**
Net fee income	1,232	1	1,233	**1,150**	**(7)**	**(7)**
Net trading income	490	(1)	489	**394**	**(20)**	**(19)**
Net income from financial instruments designated at fair value				**4**		
Gains less losses from financial investments	(3)		(3)	**(3)**		
Net earned insurance premiums	42	2	44	**16**	**(62)**	**(64)**
Other operating income/(expense) (including dividend income)	157	(13)	144	**(231)**		
Total operating income	3,212	(17)	3,195	**2,476**	**(23)**	**(23)**
Net insurance claims incurred and movement in liabilities to policyholders	(40)	(2)	(42)	**(37)**	**8**	**12**
Net operating income[4]	3,172	(19)	3,153	**2,439**	**(23)**	**(23)**
LICs[42]	(27)	1	(26)	**(31)**	**(15)**	**(19)**
Net operating income	3,145	(18)	3,127	**2,408**	**(23)**	**(23)**
Operating expenses	(2,143)	2	(2,141)	**(2,229)**	**(4)**	**(4)**
Operating profit	1,002	(16)	986	**179**	**(82)**	**(82)**
Income from associates[43]	7		7	**14**	**100**	**100**
Profit before tax	1,009	(16)	993	**193**	**(81)**	**(81)**

For footnotes, see page 132.

2012 compared with 2011

2011 as reported US$m	Currency translation adjustment[1]	2011 at 2012 exchange	2012 as reported US$m	Reported change[2] %	Constant currency change[2]

		US$m	rates			%
			US$m			
Net interest income	1,439	(12)	1,427	1,294	(10)	(9)
Net fee income	1,382	(19)	1,363	1,232	(11)	(10)
Other income[7]	471	(4)	467	646	37	38
Net operating income[4]	3,292	(35)	3,257	3,172	(4)	(3)
LICs[42]	(86)	1	(85)	(27)	69	68
Net operating income	3,206	(34)	3,172	3,145	(2)	(1)
Operating expenses	(2,266)	26	(2,240)	(2,143)	5	4
Operating profit	940	(8)	932	1,002	7	8
Income from associates[43]	4		4	7	75	75
Profit before tax	944	(8)	936	1,009	7	8

For footnotes, see page 132.

93k

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Reconciliation of reported and underlying items

	Year ended 31 December					
	2013 US$m	2012 US$m	Change[2] %	2012 US$m	2011 US$m	Change[2] %
Net interest income						
Reported	**1,146**	1,294	(11)	1,294	1,439	(10)
Currency translation adjustment[1]		(6)			(11)	
Acquisitions, disposals and dilutions	**(4)**	(13)		(7)	(14)	
Underlying	**1,142**	1,275	(10)	1,287	1,414	(9)
Other operating income						
Reported	**(239)**	151		151	30	403
Currency translation adjustment[1]		(13)			(1)	
Acquisitions, disposals and dilutions	**(1)**	(56)		(56)		
Underlying	**(240)**	82		95	29	228
Revenue[4]						
Reported	**2,439**	3,172	(23)	3,172	3,292	(4)
Currency translation adjustment[1]		(19)			(35)	
Acquisitions, disposals and dilutions	**(5)**	(72)		(65)	(28)	
Underlying	**2,434**	3,081	(21)	3,107	3,229	(4)
LICs[42]						
Reported	**(31)**	(27)	(15)	(27)	(86)	69
Currency translation adjustment[1]		1			1	
Acquisitions, disposals and dilutions						
Underlying	**(31)**	(26)	(19)	(27)	(85)	68
Operating expenses						
Reported	**(2,229)**	(2,143)	(4)	(2,143)	(2,266)	5
Currency translation adjustment[1]		2			26	
Acquisitions, disposals and dilutions	**4**	15		10	37	
Underlying	**(2,225)**	(2,126)	(5)	(2,133)	(2,203)	3
Underlying cost efficiency ratio	**91.4%**	69.0%		68.7%	68.2%	
Profit before tax						
Reported	**193**	1,009	(81)	1,009	944	7
Currency translation adjustment[1]		(16)			(8)	
Acquisitions, disposals and dilutions	**(1)**	(57)		(55)	9	
Underlying	**192**	936	(79)	954	945	1

For footnotes, see page 132.

931

Report of the Directors: Financial Review (continued)

Other

2013 compared with 2012

	2012 as reported	Currency translation adjustment[1]	2012 at 2013 exchange rates	**2013 as reported**	**Reported change[2]**	**Constant currency change[2]**
	US$m	US$m	US$m	**US$m**	**%**	**%**
Net interest income	(730)	(4)	(734)	**(737)**	**(1)**	
Net fee income	194		194	**64**	**(67)**	**(67)**
Net trading income	(537)	(1)	(538)	**6**		
Own credit spread[3]	(5,215)	12	(5,203)	**(1,246)**	**76**	**76**
Other expense from financial instruments designated at fair value	(248)	7	(241)	**(558)**	**(125)**	**(132)**
Net expense from financial instruments designated at fair value	(5,463)	19	(5,444)	**(1,804)**	**67**	**67**
Gains on disposal of US branch network, US cards business and Ping An	3,012		3,012		**(100)**	**(100)**
Gains less losses from financial investments	344		344	**1,212**	**252**	**252**
Other operating income (including dividend income)	5,512	(210)	5,302	**6,910**	**25**	**30**
Total operating income	2,332	(196)	2,136	**5,651**	**142**	**165**
Net insurance claims incurred and movement in liabilities to policyholders						
Net operating income[4]	2,332	(196)	2,136	**5,651**	**142**	**165**
LICs[42]						
Net operating income	2,332	(196)	2,136	**5,651**	**142**	**165**
Operating expenses	(9,369)	81	(9,288)	**(7,796)**	**17**	**16**
Operating loss	(7,037)	(115)	(7,152)	**(2,145)**	**70**	**70**
Income from associates[43]	47		47	**(14)**		
Loss before tax	(6,990)	(115)	(7,105)	**(2,159)**	**69**	**70**

For footnotes, see page 132.

2012 compared with 2011

	2011 as	Currency	2011	2012 as	Reported	Constant

	reported US$m	translation adjustment[1] US$m	at 2012 exchange rates US$m	reported US$m	change[2] %	currency change[2] %
Net interest income	(911)	35	(876)	(730)	20	17
Net fee income	34	(6)	28	194	471	593
Own credit spread[3]	3,933	(35)	3,898	(5,215)		
Gains on disposal of Ping An				3,012		
Other income[7]	6,089	(119)	5,970	5,071	(17)	(15)
Net operating income[4]	9,145	(125)	9,020	2,332	(74)	(74)
LICs[42]						
Net operating income	9,145	(125)	9,020	2,332	(74)	(74)
Operating expenses	(7,492)	122	(7,370)	(9,369)	(25)	(27)
Operating profit/(loss)	1,653	(3)	1,650	(7,037)		
Income from associates[43]	9	(1)	8	47	422	488
Profit/(loss) before tax	1,662	(4)	1,658	(6,990)		

For footnotes, see page 132.

93m

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Reconciliation of reported and underlying items

	Year ended 31 December					
	2013 US$m	2012 US$m	Change[2] %	2012 US$m	2011 US$m	Change[2] %
Revenue[4]						
Reported	**5,651**	2,332	142	2,332	9,145	(74)
Currency translation adjustment[1]		(209)			(90)	
Own credit spread[3]	**1,246**	5,215		5,215	(3,933)	
Acquisitions, disposals and dilutions	**(1,044)**	(3,107)		(3,107)	(208)	
Underlying	**5,853**	4,231	38	4,440	4,914	(10)
Operating expenses						
Reported	**(7,796)**	(9,369)	17	(9,369)	(7,492)	(25)
Currency translation adjustment[1]		81			122	
Acquisitions, disposals and dilutions	**29**	1			4	
Underlying	**(7,767)**	(9,287)	16	(9,369)	(7,366)	(27)
Underlying cost efficiency ratio	**132.7%**	219.5%		211.0%	149.9%	
Profit/(loss) before tax						
Reported	**(2,159)**	(6,990)	69	(6,990)	1,662	
Currency translation adjustment[1]		(127)			31	
Own credit spread[3]	**1,246**	5,215		5,215	(3,933)	
Acquisitions, disposals and dilutions	**(1,015)**	(3,106)		(3,107)	(141)	
Underlying	**(1,928)**	(5,008)	62	(4,882)	(2,381)	(105)

For footnotes, see page 132.

93n

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Analysis by global business

HSBC profit/(loss) before tax and balance sheet data

	2013						
	Retail Banking and Wealth Management	Commercial Banking	Global Banking and Markets	Global Private Banking	Other[39]	Inter segment elimination[49]	Total
	US$m	US$m	US$m	US$m	US$m	US$m	US$m
Profit/(loss) before tax							
Net interest income/(expense)	18,339	10,200	6,766	1,146	(737)	(175)	35,539
Net fee income	7,021	4,717	3,482	1,150	64		16,434
Trading income/(expense) excluding net interest income	689	649	4,953	390	(38)		6,643
Net interest income/(expense) on trading activities	(3)		1,827	4	44	175	2,047
Net trading income[44]	686	649	6,780	394	6	175	8,690
Changes in fair value of long- term debt issued and related derivatives					(1,228)		(1,228)
Net income/(expense) from other financial instruments designated at fair value	1,638	332	599	4	(576)	(1)	1,996
Net income/(expense) from financial instruments designated at fair value	1,638	332	599	4	(1,804)	(1)	768
Gains less losses from financial investments	55	1	747	(3)	1,212		2,012
Dividend income	21	15	129	8	149		322
Net earned insurance premiums	10,543	1,375	6	16			11,940
Other operating income/ (expense)	544	621	670	(239)	6,761	(5,725)	2,632
Total operating income	38,847	17,910	19,179	2,476	5,651	(5,726)	78,337
Net insurance claims[50]	(12,107)	(1,545)	(3)	(37)			(13,692)
Net operating income[4]	26,740	16,365	19,176	2,439	5,651	(5,726)	64,645
Loan impairment charges and other credit risk provisions	(3,227)	(2,384)	(207)	(31)			(5,849)
Net operating income	23,513	13,981	18,969	2,408	5,651	(5,726)	58,796

Employee expenses[51]	(5,219)	(2,327)	(3,549)	(776)	(7,325)		(19,196)
Other operating expenses	(12,029)	(4,722)	(6,411)	(1,453)	(471)	5,726	(19,360)
Total operating expenses	(17,248)	(7,049)	(9,960)	(2,229)	(7,796)	5,726	(38,556)
Operating profit/(loss)	6,265	6,932	9,009	179	(2,145)		20,240
Share of profit/(loss) in associates and joint ventures	384	1,509	432	14	(14)		2,325
Profit/(loss) before tax	6,649	8,441	9,441	193	(2,159)		22,565
	%	%	%	%	%		%
Share of HSBC s profit before tax	29.5	37.4	41.8	0.9	(9.6)		100.0
Cost efficiency ratio	64.5	43.1	51.9	91.4	138.0		59.6
Balance sheet data[40]							
	US$m	US$m	US$m	US$m	US$m		US$m
Loans and advances to customers (net)	375,115	297,852	360,659	44,224	2,454		1,080,304
Total assets	517,085	360,623	1,975,509	97,655	171,812	(451,366)	2,671,318
Customer accounts	579,994	354,298	450,315	96,770	1,435		1,482,812

94

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

	2012						
	Retail Banking and Wealth Management	Commercial Banking	Global Banking and Markets	Global Private Banking	Other[39]	Inter segment elimination[49]	Total
	US$m	US$m	US$m	US$m	US$m	US$m	US$m
Profit before tax							
Net interest income/(expense)	20,298	10,361	6,960	1,294	(730)	(511)	37,672
Net fee income	7,205	4,470	3,329	1,232	194		16,430
Trading income/(expense) excluding net interest income	276	617	3,588	476	(549)		4,408
Net interest income on trading activities	28	16	2,102	14	12	511	2,683
Net trading income/(expense)[44]	304	633	5,690	490	(537)	511	7,091
Changes in fair value of long- term debt issued and related derivatives					(4,327)		(4,327)
Net income/(expense) from other financial instruments designated at fair value	1,893	250	1,094		(1,136)		2,101
Net income/(expense) from financial instruments designated at fair value	1,893	250	1,094		(5,463)		(2,226)
Gains less losses from financial investments	96	22	730	(3)	344		1,189
Dividend income	24	18	148	6	25		221
Net earned insurance premiums	11,191	1,786	25	42			13,044
Gains on disposal of US branch network, US cards business and Ping An	3,735	277			3,012		7,024
Other operating income	1,472	536	313	151	5,487	(5,859)	2,100
Total operating income	46,218	18,353	18,289	3,212	2,332	(5,859)	82,545
Net insurance claims[50]	(12,357)	(1,802)	(16)	(40)			(14,215)
Net operating income[4]	33,861	16,551	18,273	3,172	2,332	(5,859)	68,330
Loan impairment charges and other credit risk provisions	(5,515)	(2,099)	(670)	(27)			(8,311)
Net operating income	28,346	14,452	17,603	3,145	2,332	(5,859)	60,019
Employee expenses[51]	(5,532)	(2,247)	(3,764)	(915)	(8,033)		(20,491)
Other operating expenses	(14,237)	(5,351)	(6,143)	(1,228)	(1,336)	5,859	(22,436)
Total operating expenses	(19,769)	(7,598)	(9,907)	(2,143)	(9,369)	5,859	(42,927)
Operating profit/(loss)	8,577	6,854	7,696	1,002	(7,037)		17,092
Share of profit in associates and joint ventures	998	1,681	824	7	47		3,557
Profit/(loss) before tax	9,575	8,535	8,520	1,009	(6,990)		20,649
	%	%	%	%	%		%
Share of HSBC s profit before tax	46.4	41.3	41.3	4.9	(33.9)		100.0

Cost efficiency ratio	58.4	45.9	54.2	67.6			62.8
Balance sheet data[40]							
	US$m	US$m	US$m	US$m	US$m		US$m
Loans and advances to customers (net)	378,040	288,033	283,842	45,213	2,495		997,623
Total assets	536,244	363,659	1,942,470	118,440	201,741	(470,016)	2,692,538
Customer accounts	562,151	338,405	332,115	105,772	1,571		1,340,014

For footnotes, see page 132.

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

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

	2011						
	Retail Banking and Wealth Management	Commercial Banking	Global Banking and Markets	Global Private Banking	Other[39]	Inter-segment elimination[49]	Total
	US$m	US$m	US$m	US$m	US$m	US$m	US$m
Profit before tax							
Net interest income/(expense)	24,101	9,931	7,263	1,439	(911)	(1,161)	40,662
Net fee income	8,226	4,291	3,227	1,382	34		17,160
Trading income/(expense) excluding net interest income	(562)	565	3,306	415	(441)		3,283
Net interest income on trading activities	43	19	1,898	16	86	1,161	3,223
Net trading income/(expense)[44]	(519)	584	5,204	431	(355)	1,161	6,506
Changes in fair value of long- term debt issued and related derivatives					4,161		4,161
Net income/(expense) from other financial instruments designated at fair value	(761)	33	(72)		78		(722)
Net income/(expense) from financial instruments designated at fair value	(761)	33	(72)		4,239		3,439
Gains less losses from financial investments	124	20	761	3	(1)		907
Dividend income	27	15	75	7	25		149
Net earned insurance premiums	10,882	1,956	47		(13)		12,872
Other operating income	907	483	577	30	6,127	(6,358)	1,766
Total operating income	42,987	17,313	17,082	3,292	9,145	(6,358)	83,461
Net insurance claims[50]	(9,454)	(1,702)	(25)				(11,181)
Net operating income[4]	33,533	15,611	17,057	3,292	9,145	(6,358)	72,280
Loan impairment charges and other credit risk provisions	(9,319)	(1,738)	(984)	(86)			(12,127)
Net operating income	24,214	13,873	16,073	3,206	9,145	(6,358)	60,153
Employee expenses[51]	(6,538)	(2,184)	(4,196)	(1,351)	(6,897)		(21,166)
Other operating expenses	(14,664)	(5,037)	(5,526)	(915)	(595)	6,358	(20,379)
Total operating expenses	(21,202)	(7,221)	(9,722)	(2,266)	(7,492)	6,358	(41,545)
Operating profit	3,012	6,652	6,351	940	1,653		18,608
Share of profit in associates and joint ventures	1,258	1,295	698	4	9		3,264

Profit before tax	4,270	7,947	7,049	944	1,662		21,872
	%	%	%	%	%		%
Share of HSBC s profit before tax	19.6	36.3	32.2	4.3	7.6		100.0
Cost efficiency ratio	63.2	46.3	57.0	68.8	81.9		57.5
Balance sheet data[40]							
	US$m	US$m	US$m	US$m	US$m		US$m
Loans and advances to customers (net)	357,907	262,039	276,463	41,856	2,164		940,429
Total assets	540,548	334,966	1,877,627	119,839	180,126	(497,527)	2,555,579
Customer accounts	529,017	306,174	306,454	111,814	466		1,253,925

For footnotes, see page 132.

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Geographical regions

Summary

Additional information on results in 2013 may be found in the Financial Summary on pages 47 to 76.

In the analysis of profit by geographical regions that follows, operating income and operating expenses include intra-HSBC items of US$3,377m (2011: US$3,358m; 2010: US$3,421m).

All commentaries are on a constant currency basis (page 47) unless otherwise stated, while tables are on a reported basis.

Profit/(loss) before tax

	2013		2012		2011	
	US$m	%	US$m	%	US$m	%
Europe	**1,825**	**8.1**	(3,414)	(16.5)	4,671	21.3
Hong Kong	**8,089**	**35.9**	7,582	36.7	5,823	26.6
Rest of Asia-Pacific	**7,764**	**34.4**	10,448	50.6	7,471	34.2
Middle East and North Africa	**1,694**	**7.5**	1,350	6.5	1,492	6.8
North America	**1,221**	**5.4**	2,299	11.1	100	0.5
Latin America	**1,972**	**8.7**	2,384	11.6	2,315	10.6
	22,565	**100.0**	20,649	100.0	21,872	100.0

Total assets[40]

	At 31 December			
	2013		2012	
	US$m	**%**	US$m	%
Europe	**1,392,959**	**52.1**	1,389,240	51.6
Hong Kong	**555,413**	**20.8**	518,334	19.3
Rest of Asia-Pacific	**335,937**	**12.6**	342,269	12.7
Middle East and North Africa	**60,810**	**2.3**	62,605	2.3
North America	**432,035**	**16.2**	490,247	18.2
Latin America	**113,999**	**4.3**	131,277	4.9
Intra-HSBC items	**(219,835)**	**(8.3)**	(241,434)	(9.0)
	2,671,318	**100.0**	2,692,538	100.0

Risk-weighted assets[52]

	At 31 December			
	2013		2012	
	US$bn	**%**	US$bn	%
Total	**1,092.7**		1,123.9	
Europe	**300.1**	**27.1**	314.7	27.6
Hong Kong	**138.3**	**12.5**	111.9	9.8
Rest of Asia-Pacific	**292.4**	**26.4**	302.2	26.4
Middle East and North Africa	**62.5**	**5.7**	62.2	5.4
North America	**223.8**	**20.2**	253.0	22.2
Latin America	**89.5**	**8.1**	97.9	8.6

For footnotes, see page 132.

Report of the Directors: Financial Review (continued)

Selected items included in profit before tax by geographical region

Fair value movements arising from changes in own credit spreads[3]

	2013 US$m	2012 US$m	2011 US$m
Europe	**(1,015)**	(4,110)	2,947
Hong Kong	**(1)**		
Rest of Asia-Pacific	**(1)**	(3)	2
Middle East and North Africa	**(4)**	(12)	14
North America	**(225)**	(1,090)	970
	(1,246)	(5,215)	3,933

Acquisitions, disposals and dilutions[41]

The table below shows the gain or loss on disposal or dilution and any associated gain or loss on reclassification or impairment recognised in the year incurred, and the operating profit or loss of

the acquired, disposed of or diluted subsidiaries, associates, joint ventures and businesses which are eliminated from underlying results so that results can be viewed on a like-for-like basis.

	2013 US$m	2012 US$m
Europe	**18**	(10)
Hong Kong		420
Rest of Asia-Pacific	**1,086**	4,649
Middle East and North Africa		(18)
North America	**(103)**	4,861
Latin America	**1,224**	264
	2,225	10,166

For footnotes, see page 132.

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Europe

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

	2013 US$m	2012 US$m	2011 US$m
Net interest income	**10,693**	10,394	11,001
Net fee income	**6,032**	6,169	6,236
Net trading income	**4,423**	2,707	2,161
Other income/(expense)	**(181)**	(1,662)	4,848
Net operating income[4]	**20,967**	17,608	24,246
LICs[42]	**(1,530)**	(1,921)	(2,512)
Net operating income	**19,437**	15,687	21,734
Total operating expenses	**(17,613)**	(19,095)	(17,069)
Operating profit/(loss)	**1,824**	(3,408)	4,665
Income/(expense) from associates[43]	**1**	(6)	6
Profit/(loss) before tax	**1,825**	(3,414)	4,671
Cost efficiency ratio	**84.0%**	108.4%	70.4%
RoRWA[36]	**0.6%**	(1.0%)	1.5%
Year-end staff numbers	**68,334**	70,061	74,892

Best Export Finance Arranger EMEA

(Trade Finance Magazine 2013)

Best Bank Mortgage Provider Award

(Moneyfacts Awards, 2013)

Fifth consecutive year

Resilient GB&M performance

in a challenging market

For footnotes, see page 132.

The commentary is on a constant currency basis unless stated otherwise, while tables are on a reported basis.

Economic background

UK Gross Domestic Product (GDP) growth rose to 1.9% in 2013, higher than in previous years, though the level of real GDP remained below the level seen prior to the recession. The recovery was driven in part by stronger household consumption. The Bank of England policy rate remained at 0.5% and the Asset Purchase Scheme came to a halt. The Bank of England announced a forward guidance policy in August in which it indicated Bank Rate would not rise until unemployment had fallen towards 7%. Labour market conditions improved more rapidly than expected and the headline unemployment rate fell to 7.1% in December. The annual rate of Consumer Prices Index (CPI) inflation fell in December to 2.0%, the lowest level of inflation in almost four years.

The **eurozone** emerged from recession in the second quarter of 2013 with the improvement early in the year driven by Germany and France. However, activity failed to gain momentum since quarterly GDP growth averaged just 2.0% in the second half of the year. Domestic demand improved on the back of improving real wage growth and a slower pace of austerity but recovery remained heavily dependent on external demand. Given the weakness of the economy in early 2013, the ECB cut its refinancing rate from 0.75% to 0.5% in May and then in July adopted a forward guidance policy under which it committed to keep rates at present or lower levels for an extended period. Despite the return to growth, CPI inflation dropped to 0.7% in October 2013 prompting the ECB to cut the refinancing rate by a further 0.25% in November. A combination of improving growth and the ECB s Outright Monetary Transactions programme, which enables it to buy eurozone government bonds in time of market stress, helped alleviate the sovereign crisis evident in former years and bond yields in Italy and Spain fell to their lowest levels since 2010.

Review of performance

Our European operations reported a profit before tax of US$1.8bn in 2013 compared with a loss of US$3.4bn in 2012 (US$3.3bn on a constant currency basis). On an underlying basis, excluding fair value movements on own debt, the effects of foreign currency translation and acquisitions and disposals, profit before tax increased by US$2.1bn. This was due to significantly lower operating expenses, driven by a decrease in charges relating to UK customer redress programmes, an accounting gain of US$430m relating to changes in delivering

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

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

	Retail Banking and Wealth Management US$m	Commercial Banking US$m	Global Banking and Markets US$m	Global Private Banking US$m	Other US$m	Total US$m
2013						
UK	**1,471**	**1,684**	**1,246**	**252**	**(3,493)**	**1,160**
France[35]	**285**	**255**	**351**	**21**	**(162)**	**750**
Germany	**30**	**70**	**183**	**44**	**(25)**	**302**
Malta	**34**	**51**	**35**			**120**
Switzerland		**2**	**2**	**(291)**		**(287)**
Turkey	**(74)**	**36**	**108**	**(1)**	**1**	**70**
Other	**7**	**(10)**	**(124)**	**(190)**	**27**	**(290)**
	1,753	**2,088**	**1,801**	**(165)**	**(3,652)**	**1,825**
2012						
UK	343	832	(111)	235	(6,355)	(5,056)
France[35]	135	203	514	(11)	(263)	578
Germany	29	64	283	40	(72)	344
Malta	39	52	31			122
Switzerland		2	1	133		136
Turkey	(32)	71	104		1	144
Other	(5)	(16)	164	102	73	318
	509	1,208	986	499	(6,616)	(3,414)
2011						
UK	1,330	1,227	(265)	192	1,037	3,521
France[35]	69	192	(194)	16	18	101
Germany	36	69	203	28	16	352
Malta	31	72	21			124
Switzerland		(8)		225		217
Turkey	7	62	87	2		158
Other	(151)	73	225	94	(43)	198
	1,322	1,687	77	557	1,028	4,671

For footnote, see page 132.

ill-health benefits to certain employees in the UK and sustainable cost savings in 2013.

In the UK, we continued to support the housing market during 2013, approving £14.4bn (US$22.5bn) of new mortgage lending to over 135,000 customers. This included £3.8bn (US$6.0bn) to over 30,000 first time buyers. The loan-to-value ratio on new lending was 59.5% compared with an average of 48.3% for the total mortgage portfolio. In addition, we implemented the Global Wealth Incentive Plan to better align customer and business interests.

CMB repositioned its Business Banking segment towards international and internationally aspirant customers while streamlining and re-engineering core processes, which enabled it to obtain efficiencies in a number of areas and supported its continued investment in corporate banking and Global Trade and Receivables Finance. Following the success of the 2012 International SME fund, CMB launched a further fund in 2013, continuing its support for UK businesses that trade or aspire to trade internationally with approved lending of £4.8bn (US$7.5bn), including the renewal

of overdraft and other lending facilities. In addition, CMB won awards for Best Service from a Business Bank and Best Online Banking Provider at the *Business Moneyfacts* awards. GB&M s debt capital markets activity in the Credit and Capital Financing businesses was successful in capturing growth in issuance demand, which resulted in leading market positions and increased market share in the sterling markets. We were ranked first by Bloomberg for primary debt capital market issuances in 2013.

In France, CMB launched a similar SME fund to that in the UK, targeted at international trade customers, approving 1.5bn (US$2.0bn) of lending in 2013. GB&M acted as joint book runner of a 6.2bn (US$8.2bn) hybrid bond for a premier French corporate client, demonstrating our ability to deliver large and complex transactions. In RBWM, we increased our market share in the highly competitive home loans market.

In Turkey, unsecured lending grew in RBWM, notably in the credit card business due to new product features and channel capabilities including mobile banking. We launched a similar SME fund to

Report of the Directors: Financial Review (continued)

those in the UK and France targeted at international trade customers, approving Turkish lira 1.1bn (US$0.6bn) of lending in 2013.

We continued to support the programme of renminbi internationalisation during the year with flagship client events taking place in the UK, France and Germany.

In Switzerland we continued to address legacy issues and reposition the customer base.

Net interest income increased by 3%, primarily in the UK. In GB&M, Balance Sheet Management net interest income was higher, reflecting both portfolio growth from rising deposit balances and reduced funding costs. In addition, net interest income increased due to higher lending spreads in Capital Financing and a rise in legacy credit. In RBWM net interest income increased, driven by growth in residential mortgage balances and improved lending spreads. RBWM customer account balances also increased as customers held balances in readily accessible current and savings accounts, although the benefit was restricted by deposit spread compression. In CMB, net interest income in the UK rose as a result of growth in term lending revenue from higher spreads on new and renewed business, as well as deposit growth in Payments and Cash Management. The spreads resulted in increased portfolio margins overall.

In France, net interest income increased due to improved spreads and growth in home loan balances.

These factors were partly offset by a decline, mainly in Switzerland in GPB, as higher yielding positions matured and opportunities for reinvestment were limited by lower prevailing yields. Narrower lending and deposit spreads and reduced average deposit balances also contributed to a fall in net interest income in Switzerland.

Net fee income decreased by US$138m, mainly in Switzerland in GPB with lower brokerage fees due to a reduction in client transaction volumes, in part reflecting decreased market volatility and fewer large deals.

In the UK, net fee income decreased in RBWM due to higher fees payable under partnership agreements and lower creditor insurance fees. In GB&M, net fee income fell because of higher fees paid to other regions relating to increased foreign exchange trading activities. This was partly offset by increased issuance demand in debt capital markets and event-driven fee income in equity underwriting from increased deal volumes. In addition, we experienced a rise in lending fees in CMB.

In Turkey, net fee income rose due to the growth in card revenue as the business expanded.

Net trading income increased by US$1.7bn to US$4.4bn. This was primarily in the UK, driven in part by lower adverse foreign exchange movements on assets held as economic hedges of foreign currency debt designated at fair value, with the offset reported in Net income from financial instruments designated at fair value . In addition, there was a foreign exchange gain on sterling debt issued by HSBC Holdings and increased favourable fair value movements on non-qualifying hedges compared with 2012.

In GB&M, net trading income included a favourable DVA of US$65m in 2013. 2012 included a net charge of US$312m as a result of a change in estimation methodology in respect of CVAs of US$615m and DVAs of US$303m, reflecting evolving market practices.

Also in GB&M, Foreign Exchange income rose following increased customer activity, although the rise was offset in part by margin compression and reduced market volatility in the second half of 2013. Net trading income was also higher in the Equities business due to increased deal volumes and revaluation gains. Rates revenue declined due to the benefit in 2012 from tightening spreads following the ECB liquidity intervention, despite new client mandates and increased market participation, particularly in European government bonds. We also experienced lower adverse fair value movements from own credit spreads on structured liabilities.

In France, trading income on non-qualifying hedges increased as long-term interest rates rose.

Net income from financial instruments designated at fair value was US$0.4bn compared with net expense of US$2.2bn in 2012. In the UK, we reported lower adverse movements on the fair value of our own debt of US$1.0bn, compared with adverse movements of US$4.1bn in 2012. Excluding this, net income declined, driven by lower favourable foreign exchange movements on foreign currency debt than in 2012, with the offset reported in Net trading income . In addition, there were higher adverse fair value movements from interest and exchange rate ineffectiveness in the hedging of long-term debt issued principally by HSBC Holdings and its European subsidiaries than in 2012.

By contrast, in the UK and France, we recognised higher net investment gains on the fair value of assets held to meet liabilities under insurance and investment contracts than in 2012, as market conditions improved.

Report of the Directors: Financial Review (continued)

Gains less losses from financial investments increased by US$19m as in the UK we reported gains in RBWM in the Asset Management Group. In GB&M, higher disposal gains and lower impairments on available-for-sale equity securities in Principal Investments were more than offset by lower net gains on the disposal of available-for-sale debt securities in Balance Sheet Management, as part of structural interest rate risk management of the balance sheet.

Net earned insurance premiums decreased by 15%, mainly in RBWM in France reflecting lower sales of investment contracts with DPF and the run-off of business from independent financial adviser channels in 2013.

Other operating income decreased by US$600m due to a loss recognised in GPB following the write-off of goodwill relating to our Monaco business and a loss on sale in RBWM on the disposal of an HFC Bank UK secured loan portfolio.

Net insurance claims incurred and movement in liabilities to policyholders was broadly in line with 2012. Lower reserves established for new business, reflecting the decline in net premium income in France, were partly offset by higher net investment gains on the fair value of assets held to support policyholder contracts in 2013 than in 2012.

LICs decreased by 20% to US$1.5bn. In the UK, GB&M recorded net releases of credit risk provisions on available-for-sale ABSs compared with impairment charges in 2012, offset in part by higher individually assessed provisions. In addition, loan impairment charges in CMB fell due to lower collectively and individually assessed provisions, and in RBWM due to lower collectively assessed provisions reflecting recoveries from debt sales.

In other countries in Europe, lower individually assessed impairment provisions in Greece were

partly offset by increases in Turkey, where there was growth in unsecured lending in RBWM, and a rise in Spain, where the challenging economic conditions continued to affect the market.

Operating expenses decreased by 7%, driven by lower charges relating to UK customer redress programmes, with US$1.2bn reported in 2013 compared with US$2.3bn (US$2.3bn as reported) in 2012. The charges in 2013 included additional estimated redress for possible mis-selling in previous years of US$756m in respect of PPI compared with US$1.7bn in 2012, US$261m in respect of interest rate protection products compared with US$586m in 2012 and US$149m in respect of Wealth Management products in 2013. Restructuring costs also fell by US$78m from 2012. In addition, 2012 included a charge relating to the US OFAC investigation of US$375m in HSBC Holdings which did not recur.

Excluding these items, operating expenses were broadly unchanged compared with 2012. We benefited from sustainable cost savings of over US$650m as we continued to streamline the business, and a decline in performance-related costs, notably in GB&M. In addition, we reported an accounting gain of US$430m relating to changes in delivering ill-health benefits to certain employees in the UK. These factors were partially offset by the higher UK bank levy charge of US$904m in respect of 2013 compared with a charge of US$571m in 2012, mainly due to an increase in its rate. In addition, operating expenses in both years included adjustments relating to the prior year charge (2013: US$12m adverse adjustment; 2012: US$99m favourable adjustment). In other countries in the region, we experienced higher Madoff-related litigation charges in GB&M in Ireland and a provision in respect of regulatory investigations in GPB in Switzerland.

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Reconciliation of reported and constant currency profit/(loss) before tax   Europe

	2012 as reported US$m	Currency translation adjustment[1] US$m	2012 at 2013 exchange rates US$m	**2013 as reported US$m**	**Reported change[2] %**	**Constant currency change[2] %**
Net interest income	10,394	(38)	10,356	**10,693**	**3**	**3**
Net fee income	6,169	1	6,170	**6,032**	**(2)**	**(2)**
Net trading income	2,707	(19)	2,688	**4,423**	**63**	**65**
Own credit spread[3]	(4,110)	12	(4,098)	**(1,015)**	**75**	**75**
Other income from financial instruments designated at fair value	1,895	12	1,907	**1,433**	**(24)**	**(25)**
Net income/(expense) from financial instruments designated at fair value	(2,215)	24	(2,191)	**418**		
Gains less losses from financial investments	364	(4)	360	**379**	**4**	**5**
Net earned insurance premiums	3,630	85	3,715	**3,158**	**(13)**	**(15)**
Other operating income (including dividend income)	1,189	49	1,238	**604**	**(49)**	**(51)**
Total operating income	22,238	98	22,336	**25,707**	**16**	**15**
Net insurance claims incurred and movement in liabilities to policyholders	(4,630)	(121)	(4,751)	**(4,740)**	**(2)**	
Net operating income[4]	17,608	(23)	17,585	**20,967**	**19**	**19**
LICs[42]	(1,921)	15	(1,906)	**(1,530)**	**20**	**20**
Net operating income	15,687	(8)	15,679	**19,437**	**24**	**24**
Operating expenses	(19,095)	74	(19,021)	**(17,613)**	**8**	**7**
Operating profit/(loss)	(3,408)	66	(3,342)	**1,824**		
Income/(loss) from associates[43]	(6)	(1)	(7)	**1**		
Profit/(loss) before tax	(3,414)	65	(3,349)	**1,825**		

For footnotes, see page 132.

Reconciliation of reported and underlying items   Europe

	Year ended 31 December **2013** US$m	2012 US$m	Change %
Net interest income			
Reported	**10,693**	10,394	3
Currency translation adjustment[1]		(38)	

Acquisitions, disposals and dilutions	**17**	15	
Underlying	**10,710**	10,371	3
Other operating income			
Reported	**529**	1,080	(51)
Currency translation adjustment[1]		49	
Acquisitions, disposals and dilutions	**(69)**	(54)	
Underlying	**460**	1,075	(57)
Revenue[4]			
Reported	**20,967**	17,608	19
Currency translation adjustment[1]		(35)	
Own credit spread[3]	**1,015**	4,110	
Acquisitions, disposals and dilutions	**(51)**	(36)	
Underlying	**21,931**	21,647	1

Report of the Directors: Financial Review (continued)

	Year ended 31 December		
	2013	2012	Change[2]
	US$m	US$m	%
LICs[42]			
Reported	**(1,530)**	(1,921)	20
Currency translation adjustment[1]		15	
Acquisitions, disposals and dilutions			
Underlying	**(1,530)**	(1,906)	20
Operating expenses			
Reported	**(17,613)**	(19,095)	8
Currency translation adjustment[1]		74	
Acquisitions, disposals and dilutions	**28**	46	
Underlying	**(17,585)**	(18,975)	7
Underlying cost efficiency ratio	**80.2%**	87.7%	
Profit/(loss) before tax			
Reported	**1,825**	(3,414)	
Currency translation adjustment[1]		53	
Own credit spread[3]	**1,015**	4,110	
Acquisitions, disposals and dilutions	**(18)**	10	
Underlying	**2,822**	759	272

For footnotes, see page 132.

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

2012 compared with 2011

Economic background

The **UK** economy remained weak in 2012, with little growth in underlying activity. Preliminary data showed that the level of real Gross Domestic Product (GDP) contracted by 0.3% in the fourth quarter, as economic activity fell back after a boost related to the Olympic Games. Despite the lacklustre economy, the labour market remained fairly resilient, with the unemployment rate in the three months to December down to 7.8% from 8.4% in the same period in 2011. In response to the stagnating economy, the Bank of England (BoE) increased the size of its Asset Purchase Facility to £375bn (US$606bn) and launched a new scheme, Funding for Lending, aimed at increasing the supply of credit. Consumer Prices Index (CPI) inflation fell during the first half of the year but remained above the BoE s 2% target. In the fourth quarter, it rose back to 2.7%, partly due to increases in tuition fees and energy prices.

The **eurozone** returned to recession in 2012 as the initial resilience in France and Germany was more than offset by deepening contractions in the periphery, where domestic demand was dragged down by austerity and private sector deleveraging. Inflation slowed from 2.7% at the end of 2011 to 2.2% in 2012 and the European Central Bank (ECB) cut the refinance (refi) rate by 0.25% to 0.75% in July. The sovereign crisis worsened again in the first half of 2012 but early signs of a roadmap for future integration of the economic and monetary union, additional support for Greece and, most importantly, the ECB s commitment to supporting the euro through its Outright Monetary Transactions bond-buying programme succeeded in lowering peripheral government bond spreads to their lowest level since March 2012.

Review of performance

Our operations in Europe reported a pre-tax loss of US$3.4bn, compared with a profit of US$4.7bn in 2011. On a constant currency basis, pre-tax profits declined by US$8.0bn.

In 2012, there were adverse movements of US$4.1bn on our own debt designated at fair value, resulting from changes in credit spreads, compared with favourable movements of US$2.9bn in 2011. On an underlying basis, pre-tax profits decreased by US$930m due to higher operating expenses reflecting a US$1.4bn increase in the provision for customer redress programmes in the UK, in particular relating to the possible mis-selling of PPI and interest rate protection products. This was partly offset by higher GB&M revenues, notably in the

Rates and Credit businesses as spreads on eurozone bonds tightened and investor sentiment improved. In addition, impairment charges fell due to lower credit risk provisions in GB&M, notably in the legacy credit portfolio, and improved delinquency rates in RBWM in the UK as we continued to improve the quality of these portfolios with a higher proportion of secured lending.

We made significant progress in reshaping our business in Europe. The disposal of non-core businesses simplified our European portfolio, allowing us to concentrate resources on businesses where we can deliver sustainable profits and growth while managing risks effectively. We exited from Hungary, Georgia, Slovakia, and RBWM in Russia and Poland, and sold Property Vision in the UK, our insurance and reinsurance businesses in Ireland and the retail equities brokerage in Greece.

During 2012, we made progress with our restructuring programme to align our businesses in each country to their respective global business operating models in order to reduce complexity and lower our costs in a sustainable way. Total restructuring costs (including impairment of assets) of US$299m were incurred across Europe as a result of organisational effectiveness and other initiatives, which delivered sustainable cost savings of approximately US$770m.

In RBWM, we continued to drive strong growth in mortgage lending in the UK through the success of our competitive offerings and marketing campaigns. Our share of new UK mortgage lending in 2012 was 12%, up from the 10% share of new lending in 2011, while maintaining a loan-to-value ratio of 58%. We have approved new mortgage lending of £19bn (US$32bn) during 2012, compared with our original lending commitment of £15bn (US$24bn), with £5bn (US$8bn) approved for first time buyers. Wealth Management revenue was marginally lower during the year reflecting the challenging economic environment. Our Wealth Management products and services were redesigned in accordance with the FSA s Retail Distribution Review, which was introduced on 1 January 2013, and we continue to offer a competitive fee-based financial advice service to Premier customers. The expansion of the RBWM business continued in Turkey, where we are targeting mass affluent customers.

In CMB, we continued to invest in the UK, and have increased the number of International Relationship Managers to over 200 during the year. In the first half of 2012, we launched an International SME fund in the UK to support UK

Report of the Directors: Financial Review (continued)

businesses that trade, or aspire to trade, internationally. By the end of 2012, we had approved lending through the fund of £5.1bn (US$8.2bn), exceeding the original target of £4.0bn (US$6.5bn), and provided £12bn (US$20bn) of gross new lending to UK SMEs, including the renewal of overdraft and other lending facilities. Over 80% of small business lending applications received during the year were approved. Revenue from international customers increased and our focus on this client base, together with targeted growth initiatives such as deposit acquisition and regional pricing strategies, led to a rise in Payments and Cash Management and Global Trade and Receivable Finance income.

Revenues from CMB s collaboration with GB&M increased primarily from sales of foreign exchange products. During the year, we made a provision for the possible mis-selling of interest rate protection products and the sale of these products to customers in our Business Banking segment, which serves SMEs, was withdrawn.

GB&M continued to develop cross-product capabilities in the growing renminbi market. Early in the year, we issued the first international renminbi bond outside sovereign Chinese territory. Since then, a number of significant transactions were supported by in-depth collaboration between European and other regional teams which reinforced our position as the leading house for international renminbi issuance. In Foreign Exchange, the focus remained on enhancing product offerings in our e-FX platforms for a broader client base, particularly to RBWM and CMB customers. This included the launch of a Dynamic Currency Conversion product within the transactional Foreign Exchange business. To enhance coverage efforts in Global Banking, the Corporate Finance Group was established to strengthen the financial advisory and event financing business. Payments and Cash Management won a number of mandates and implemented the Global Liquidity Solutions platform to provide advanced liquidity management functionality for its clients. In addition, our legacy credit exposure was reduced in Europe by exiting from certain positions and the business will reduce the size of this portfolio further as opportunities arise.

In GPB, we revised our medium-term strategic plan to focus the business on investing in priority markets with a redefined client offering that builds on product strengths and leverages Group capabilities. We concentrated on higher net worth international and domestic customers, enhancing our compliance and risk framework and improving alignment with the other global businesses.

Our activities are likely to be affected by proposed legislation in the UK arising from the recommendations of the UK Independent Commission on Banking (ICB) to ring-fence the retail bank from wholesale operations and to require the retail bank to have a greater primary loss absorbing capacity. Proposed changes in regulations are likely to affect how we conduct activities, with the potential to curtail the types of business we carry out and increase the costs of doing business. The implementation of any proposed changes will take a considerable amount of time and involve significant cost (see page 132).

The following commentary is on a constant currency basis.

Net interest income decreased by 3%. Balance Sheet Management revenues declined, principally in the UK, as yield curves continued to flatten and liquidity arising from maturities and sales of available-for-sale debt securities was re-invested at lower prevailing rates. In addition we placed a greater portion of our liquidity with central banks. GPB was similarly affected as higher yielding positions matured and as we managed selectively our exposures to eurozone sovereign debt. Legacy credit revenues in the UK also fell as a result of higher interest expense on structured debt issued at the end of 2011, coupled with lower effective yields on assets. RBWM net interest income declined mainly in the UK due to lower deposit spreads reflecting strong competition in the low interest rate environment. This was partly offset by strong growth in average residential mortgage balances and improved lending spreads in the UK, along with higher personal lending and cards balances in Turkey as the business expanded. In addition, net interest income in CMB benefited from higher average customer account balances as we continued to attract deposits through our Payments and Cash Management products as a result of competitive pricing, while average lending balances also rose, mainly in the UK, despite muted demand for credit.

Net fee income increased by 2%. CMB fee income rose due to higher transaction volumes reflecting new mandates in Payments and Cash Management. RBWM fee income also increased due to lower commissions paid as a result of the run-off and subsequent disposal of the insurance businesses in Ireland. These increases were partly offset by a fall in brokerage fees in GPB, reflecting a reduction in client transaction volumes, due in part to lower market volatility. Fees from assets under management and account services also declined, as challenging market conditions in the latter half of 2011 led to a fall in average client assets in 2012,

Report of the Directors: Financial Review (continued)

coupled with a reduction in client numbers as we repositioned our target client base.

Net trading income increased by 27%, primarily due to significantly higher Rates trading revenues in the UK and France, and higher Credit trading revenues, mainly in the UK, as spreads tightened and investor sentiment improved following stimuli by central banks. This was despite significant adverse fair value movements in Rates, including a charge from own credit spreads on structured liabilities as spreads tightened which compared with a gain reported in 2011, together with a charge as a result of a change in estimation methodology in respect of credit valuation adjustments on derivative assets (see Note 15 on the Financial Statements). Revenues in our legacy credit portfolio increased due to price appreciation and redemption at par of certain assets. Foreign Exchange income was also stronger due to higher income from GB&M s ongoing collaboration with CMB, and increased volumes from improvements in our electronic pricing and distribution capabilities, although this was partly offset by the effect of less volatile markets in 2012. In addition, trading income benefited from the change in estimation methodology for debit valuation adjustments on derivative liabilities (see Note 15 on the Financial Statements).

There were lower adverse fair value movements on non-qualifying hedges, driven by favourable fair value movements on non-qualifying hedges in HSBC Holdings, compared with adverse fair value movements in 2011, reflecting the less pronounced decline in long-term US interest rates relative to sterling and euro interest rates than in 2011. This was partly offset by higher adverse movements on non-qualifying hedges in European operating entities as interest rates fell.

Adverse foreign exchange movements were reported on assets held as economic hedges of foreign currency debt designated at fair value compared with favourable movements in 2011. These offset favourable foreign exchange movements on the foreign currency debt which are reported in Net expense from financial instruments designated at fair value .

Net expense from financial instruments designated at fair value increased by US$4.8bn. Excluding adverse fair value movements due to the change in credit spreads on our own debt held at fair value, net income from financial instruments designated at fair value of US$1.9bn in 2012 compared with a net expense of US$374m in 2011. This reflected favourable foreign exchange movements on foreign currency debt designated

at fair value issued as part of our overall funding strategy compared with adverse movements in 2011, with an offset reported in Net trading income . In addition, net investment gains were recognised on the fair value of assets held to meet liabilities under insurance and investment contracts as market conditions improved, compared with net investment losses in 2011. The corresponding movement in liabilities to customers is recorded under Net insurance claims incurred and movement in liabilities to policyholders to the extent that these investment gains or losses are attributable to policyholders holding unit-linked insurance policies and insurance or investment contracts with DPF.

Gains less losses from financial investments decreased by US$133m. This was driven by higher impairments in GB&M in the UK of available-for-sale equity securities due to significant write-downs in 2012 on three holdings, two of which were in our direct investment business in run-off. The decline was also driven by losses on the disposal of legacy assets, also in GB&M in the UK (see page 27), together with the non-recurrence of gains in 2011 on the disposal of available-for-sale debt securities in our Insurance business in RBWM. These factors were partly offset by higher gains on the disposal of available-for-sale debt securities in Balance Sheet Management, mainly in the UK, as part of structural interest rate risk management activities, coupled with a rise in disposal gains in Principal Investments in GB&M.

Net earned insurance premiums decreased by 6%. This mainly reflected lower life insurance sales in RBWM in France as a result of the adverse economic environment and increased competition from other banking products. The run-off and subsequent disposal of the insurance businesses in Ireland in 2012 also contributed to the decline. This was partly offset by a rise in net earned premiums in the UK due, in part, to the sale of a unit-linked insurance product through two new third party platforms.

Other operating income decreased by US$95m. GB&M incurred losses on the sale of certain syndicated loans in the UK. In addition, gains in 2011 on the disposal of a property fund did not recur.

Net insurance claims incurred and movement in liabilities to policyholders increased by 40%, driven by net investment gains on the fair value of the assets held to support policyholder contracts, compared with net losses in 2011. This was partly offset by lower reserves established for new

Report of the Directors: Financial Review (continued)

business, reflecting the decline in premiums in France.

Loan impairment charges and other credit risk provisions decreased by 22% to US$1.9bn. GB&M reported lower credit risk provisions, mainly in the UK, on available-for-sale ABSs, driven by an improvement in underlying asset prices, as well as lower charges on Greek sovereign debt. These were coupled with a reduction in loan impairment charges in RBWM, notably in the UK, as we continued to pro-actively identify and monitor customers facing financial hardship and focused on growing higher quality lending. As a result, delinquency rates improved across both the secured and unsecured lending portfolios. This was partly offset by an increase in loan impairment charges in RBWM in Turkey, reflecting business expansion. In addition, there were higher individually assessed provisions in CMB reflecting, mainly, the challenging economic conditions in the UK, Greece, Spain and Turkey.

Operating expenses increased by 15%, driven by higher charges relating to UK customer redress programmes with US$2.3bn reported in 2012, compared with a charge of US$890m (US$898m as reported) in 2011. In 2012 we included an additional charge of US$1.7bn for estimated redress for the possible mis-selling of PPI policies and US$598m in relation to the possible mis-selling of interest rate protection products in previous years, of which

US$268m related to the estimated redress to be paid to customers and the remainder to costs of closing out these positions and related administration costs. A charge relating to the US Office of Foreign Asset Control (OFAC) investigation of US$375m was also incurred in HSBC Holdings, along with the UK bank levy of US$571m. This was partly offset by an adjustment of US$99m in the 2011 bank levy charge of US$570m as the basis of calculation was clarified. In addition, 2011 included a credit of US$570m (US$587m as reported) arising from the defined benefit pension obligations in the UK which did not recur. Restructuring costs of US$299m were US$92m lower than in 2011, as the review initiated in 2011 to improve cost efficiency continued to be implemented and we completed disposals and exits in Europe.

Excluding these items, operating expenses marginally increased compared with 2011. Our organisational effectiveness initiatives progressed, delivering sustainable cost savings of approximately US$770m in 2012. This enabled us to reinvest in, and reallocate capital, to our designated growth businesses such as our mortgage offering, our international CMB business and our home and priority growth markets (UK, France, Germany and Turkey), as well as launching the M&S Bank in the UK.

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Reconciliation of reported and constant currency profit/(loss) before tax Europe

	2011 as reported	Currency translation adjustment[1]	2011 at 2012 exchange rates	2012 as reported	Reported change[2]	Constant currency change[2]
	US$m	US$m	US$m	US$m	%	%
Net interest income	11,001	(325)	10,676	10,394	(6)	(3)
Net fee income	6,236	(205)	6,031	6,169	(1)	2
Own credit spread[3]	2,947	(35)	2,912	(4,110)		
Other income[7]	4,062	(17)	4,045	5,155	27	27
Net operating income[4]	24,246	(582)	23,664	17,608	(27)	(26)
LICs[42]	(2,512)	54	(2,458)	(1,921)	24	22
Net operating income	21,734	(528)	21,206	15,687	(28)	(26)
Operating expenses	(17,069)	406	(16,663)	(19,095)	(12)	(15)
Operating profit/(loss)	4,665	(122)	4,543	(3,408)		
Income/(loss) from associates[43]	6	(8)	(2)	(6)		(200)
Profit/(loss) before tax	4,671	(130)	4,541	(3,414)		

For footnotes, see page 132.

Reconciliation of reported and underlying items Europe

	Year ended 31 December 2012	2011	Change[2]
	US$m	US$m	%
Revenue[4]			
Reported	17,608	24,246	(27)
Currency translation adjustment[1]		(547)	
Own credit spread[3]	4,110	(2,947)	
Acquisitions, disposals and dilutions	3		
Underlying	21,721	20,752	5
LICs[42]			
Reported	(1,921)	(2,512)	24
Currency translation adjustment[1]		54	
Acquisitions, disposals and dilutions			
Underlying	(1,921)	(2,458)	22
Operating expenses			
Reported	(19,095)	(17,069)	(12)

Currency translation adjustment[1]		406	
Acquisitions, disposals and dilutions			
Underlying	(19,095)	(16,663)	(15)
Underlying cost efficiency ratio	87.9%	80.3%	
Profit/(loss) before tax			
Reported	(3,414)	4,671	
Currency translation adjustment[1]		(95)	
Own credit spread[3]	4,110	(2,947)	
Acquisitions, disposals and dilutions	3		
Underlying	699	1,629	(57)

For footnotes, see page 132.

101g

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Profit/(loss) before tax and balance sheet data *Europe*

	2013						
	Retail Banking and Wealth Management US$m	Commercial Banking US$m	Global Banking and Markets US$m	Global Private Banking US$m	Other US$m	Inter-segment elimination[49] US$m	Total US$m
Profit/(loss) before tax							
Net interest income/(expense)	5,600	3,353	1,774	722	(694)	(62)	10,693
Net fee income/(expense)	2,545	1,789	957	744	(3)		6,032
Trading income excluding net interest income	206	30	2,181	192	698		3,307
Net interest income on trading activities	2	5	1,013	4	30	62	1,116
Net trading income[44]	208	35	3,194	196	728	62	4,423
Changes in fair value of long- term debt issued and related derivatives					(936)		(936)
Net income/(expense) from other financial instruments designated at fair value	1,059	271	591	4	(570)	(1)	1,354
Net income/(expense) from financial instruments designated at fair value	1,059	271	591	4	(1,506)	(1)	418
Gains less losses from financial investments	52		344	(17)			379
Dividend income	4	2	65	4			75
Net earned insurance premiums	2,782	361	(1)	16			3,158
Other operating income/(expense)	(103)	9	110	(253)	766		529
Total operating income/(expense)	12,147	5,820	7,034	1,416	(709)	(1)	25,707
Net insurance claims[50]	(4,136)	(567)		(37)			(4,740)
Net operating income/(expense)[4]	8,011	5,253	7,034	1,379	(709)	(1)	20,967
Loan impairment charges and other credit risk provisions	(329)	(935)	(242)	(24)			(1,530)
Net operating income/(expense)	7,682	4,318	6,792	1,355	(709)	(1)	19,437
Total operating expenses	(5,934)	(2,231)	(4,987)	(1,519)	(2,943)	1	(17,613)
Operating profit/(loss)	1,748	2,087	1,805	(164)	(3,652)		1,824
Share of profit/(loss) in associates and joint ventures	5	1	(4)	(1)			1
Profit/(loss) before tax	1,753	2,088	1,801	(165)	(3,652)		1,825

	%	%	%	%	%		%
Share of HSBC s profit before tax	7.8	9.2	8.0	(0.7)	(16.2)		8.1
Cost efficiency ratio	74.1	42.5	70.9	110.2	(415.1)		84.0
Balance sheet data[40]							
	US$m	US$m	US$m	US$m	US$m		US$m
Loans and advances to customers (net)[34]	177,357	105,498	193,226	27,289	830		504,200
Total assets	238,499	124,242	1,054,506	75,718	72,174	(172,180)	1,392,959
Customer accounts[34]	205,288	134,120	254,598	49,789	1,021		644,816

102

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

	2012						
	Retail Banking and Wealth Management	Commercial Banking	Global Banking and Markets	Global Private Banking	Other	Inter-segment elimination[49]	Total
	US$m	US$m	US$m	US$m	US$m	US$m	US$m
Profit/(loss) before tax							
Net interest income/(expense)	5,437	3,228	1,409	820	(543)	43	10,394
Net fee income	2,622	1,658	1,032	848	9		6,169
Trading income excluding net interest income	67	26	848	216	25		1,182
Net interest income on trading activities	7	14	1,500	14	33	(43)	1,525
Net trading income[44]	74	40	2,348	230	58	(43)	2,707
Changes in fair value of long- term debt issued and related derivatives					(3,091)		(3,091)
Net income/(expense) from other financial instruments designated at fair value	770	139	1,073		(1,106)		876
Net income/(expense) from financial instruments designated at fair value	770	139	1,073		(4,197)		(2,215)
Gains less losses from financial investments	(5)	(1)	375	(3)	(2)		364
Dividend income		1	104	3	3		111
Net earned insurance premiums	3,150	438		42			3,630
Other operating income	84	58	88	61	796	(9)	1,078
Total operating income/(expense)	12,132	5,561	6,429	2,001	(3,876)	(9)	22,238
Net insurance claims[50]	(4,054)	(536)		(40)			(4,630)
Net operating income/(expense)[4]	8,078	5,025	6,429	1,961	(3,876)	(9)	17,608
Loan impairment charges and other credit risk provisions	(347)	(1,109)	(436)	(29)			(1,921)
Net operating income/(expense)	7,731	3,916	5,993	1,932	(3,876)	(9)	15,687
Total operating expenses	(7,225)	(2,708)	(4,999)	(1,431)	(2,741)	9	(19,095)
Operating profit/(loss)	506	1,208	994	501	(6,617)		(3,408)
Share of profit/(loss) in associates and joint ventures	3		(8)	(2)	1		(6)
Profit/(loss) before tax	509	1,208	986	499	(6,616)		(3,414)
	%	%	%	%	%		%
Share of HSBC s profit before tax	2.5	5.9	4.8	2.4	(32.0)		(16.5)
Cost efficiency ratio	89.4	53.9	77.8	73.0	(70.7)		108.4

Balance sheet data[40]

	US$m	US$m	US$m	US$m	US$m		US$m
Loans and advances to customers (net)	170,002	105,796	156,798	29,963	881		463,440
Total assets	240,744	132,718	1,044,507	76,145	75,513	(180,387)	1,389,240
Customer accounts	191,024	121,648	184,473	57,125	739		555,009

For footnotes, see page 132.

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

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

	2011						
	Retail Banking and Wealth Management	Commercial Banking	Global Banking and Markets	Global Private Banking	Other	Inter-segment elimination[49]	Total
	US$m	US$m	US$m	US$m	US$m	US$m	US$m
Profit before tax							
Net interest income/(expense)	5,653	3,107	2,102	936	(574)	(223)	11,001
Net fee income	2,633	1,640	989	942	32		6,236
Trading income/(expense) excluding net interest income	40	5	602	191	(201)		637
Net interest income on trading activities	11	16	1,205	16	53	223	1,524
Net trading income/(expense)[44]	51	21	1,807	207	(148)	223	2,161
Changes in fair value of long- term debt issued and related derivatives					3,180		3,180
Net income/(expense) from other financial instruments designated at fair value	(672)	(21)	(65)		46		(712)
Net income/(expense) from financial instruments designated at fair value	(672)	(21)	(65)		3,226		2,468
Gains less losses from financial investments	51	(1)	453	1	11		515
Dividend income	1	1	42	4	1		49
Net earned insurance premiums	3,768	381			(13)		4,136
Other operating income	95	58	187	5	760	74	1,179
Total operating income	11,580	5,186	5,515	2,095	3,295	74	27,745
Net insurance claims[50]	(3,212)	(287)					(3,499)
Net operating income[4]	8,368	4,899	5,515	2,095	3,295	74	24,246
Loan impairment (charges)/recoveries and other credit risk provisions	(596)	(960)	(876)	(82)	2		(2,512)
Net operating income	7,772	3,939	4,639	2,013	3,297	74	21,734
Total operating expenses	(6,450)	(2,252)	(4,569)	(1,456)	(2,268)	(74)	(17,069)
Operating profit	1,322	1,687	70	557	1,029		4,665
Share of profit in associates and joint ventures			7		(1)		6
Profit before tax	1,322	1,687	77	557	1,028		4,671
	%	%	%	%	%		%

Share of HSBC s profit before tax	6.0	7.7	0.4	2.5	4.7		21.3
Cost efficiency ratio	77.1	46.0	82.8	69.5	68.8		70.4

Balance sheet data[40]

	US$m	US$m	US$m	US$m	US$m		US$m
Loans and advances to customers (net)	150,205	98,154	156,903	28,378	696		434,336
Total assets	210,140	124,049	1,021,486	77,410	63,141	(214,281)	1,281,945
Customer accounts	176,134	104,530	154,208	58,265	267		493,404

For footnotes, see page 132.

Report of the Directors: Financial Review (continued)

Hong Kong

HSBC s principal banking subsidiaries in Hong Kong are The Hongkong and Shanghai Banking Corporation Limited and Hang Seng Bank Limited. The former is the largest bank incorporated in Hong Kong and is our flagship bank in the Asia-Pacific region. It is one of Hong Kong s three note-issuing banks, accounting for nearly 60% by value of banknotes in circulation in 2013.

	2013 US$m	2012 US$m	2011 US$m
Net interest income	**5,993**	5,316	4,691
Net fee income	**3,877**	3,335	3,097
Net trading income	**1,570**	1,463	1,189
Other income	**1,763**	2,308	1,705
Net operating income[4]	**13,203**	12,422	10,682
LICs[42]	**(137)**	(74)	(156)
Net operating income	**13,066**	12,348	10,526
Total operating expenses	**(5,045)**	(4,848)	(4,758)
Operating profit	**8,021**	7,500	5,768
Income from associates[43]	**68**	82	55
Profit before tax	**8,089**	7,582	5,823
Cost efficiency ratio	**38.2%**	39.0%	44.5%
RoRWA[36]	**6.4%**	7.0%	5.3%
Year-end staff numbers	**28,367**	27,742	28,984

10%

growth in underlying revenue

Strong performance in CMB

with lending growth of

18%

Best M&A House in Hong Kong 2013

(The Asset)

For footnotes, see page 132.

The commentary is on a constant currency basis unless stated otherwise, while tables are on a reported basis.

Economic background

Hong Kong s GDP grew at a faster pace in 2013 than in 2012. This was driven mainly by domestic demand, which offset an ongoing weakness in external orders. Labour market conditions remained resilient and strong nominal wage growth continued to support private consumption. Measures announced in February 2013 by the government and the Hong Kong Monetary Authority to dampen demand in the property market led to a softening in prices and some moderation of demand in the third quarter of the year. Headline CPI inflation fell in the fourth quarter, largely due to lower food prices and housing costs. Underlying inflation averaged 4% in 2013, lower than it was in 2012.

Review of performance

Our operations in Hong Kong reported a pre-tax profit of US$8.1bn compared with US$7.6bn in 2012, an increase of 7%. This reflected higher revenue, driven by balance sheet growth, and increased net fees from unit trusts and debt issuance. Excluding the effect of disposals in 2012, underlying profit before tax increased by 13%.

In RBWM, we grew our average mortgage balances by 8% with average loan-to-value ratios of 44% on new mortgage drawdowns and an estimated 32% on the portfolio as a whole. We continued to develop our digital capabilities and launched our mobile banking application. We also developed our Wealth Management capabilities, growing revenue by over 10%. In addition, we enhanced our wealth management systems, simplified the product range and implemented the Global Wealth Incentive Plan to better align customer and business interests.

In CMB, we further strengthened the collaboration with GB&M, raising financing for our clients of over US$14bn from debt capital markets and nearly US$4bn from equity capital markets, including the largest IPO in Hong Kong for a mainland Chinese consumer company. In addition, we were awarded Best Trade Finance Bank in Hong Kong by *Global Finance*.

In GB&M, we continued to lead the market in Hong Kong dollar bond issuance and are now one of the top five houses for both equity capital markets and mergers and acquisitions. We were voted Best Debt House in Hong Kong in the *Euromoney* 2013 Awards for Excellence and were involved in seven of the ten largest IPOs in Hong Kong this year.

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Profit/(loss) before tax by global business

	2013 US$m	2012 US$m	2011 US$m
Retail Banking and Wealth Management	**3,742**	3,694	3,022
Commercial Banking	**2,110**	2,188	1,608
Global Banking and Markets	**1,971**	1,518	1,316
Global Private Banking	**208**	249	188
Other	**58**	(67)	(311)
	8,089	7,582	5,823

We led the market in offshore renminbi (RMB) bond issuance, including the RMB3bn (US$491m) government bond issue in December 2013 by mainland China s Ministry of Finance, and were voted Best provider of offshore renminbi products and services for the second year running by *Asiamoney*. We also won the award for RMB House of the Year from *Asia Risk*.

We announced the sale of our shareholding in Bank of Shanghai in 2013, a transaction which is expected to complete in the first half of 2014.

Net interest income rose by US$677m compared with 2012, led by RBWM and supported by GB&M and CMB. The increase was mainly due to higher average lending balances, wider spreads on mortgages in RBWM reflecting lower funding costs, and growth in the insurance debt securities portfolio.

There was strong loan growth in both CMB and GB&M, driven by trade-related lending in the first half of 2013 and an increase in commercial real estate and other property-related lending in the second half of the year, though the benefit of this growth was partly offset by spread compression reflecting competition and increased liquidity in the markets. Mortgage lending in RBWM also increased, although the rate of growth began to slow during 2013 as transaction volumes in the property market reduced.

Average deposit balances increased, in part reflecting new Premier customers in RBWM and increased Payments and Cash Management balances in CMB, though the benefit of this growth was more than offset by narrower deposit spreads due to a fall in short-term interbank interest rates.

Net fee income rose by US$542m in 2013, led by RBWM as strong customer demand and favourable market sentiment led to higher fees from unit trusts and increased brokerage income. Fee income increased due to a rise in debt and equity underwriting and corporate finance activity compared with 2012, in part reflecting collaboration

between GB&M and CMB. Fee income also rose in CMB as trade and Payments and Cash Management volumes increased.

Net trading income rose by US$107m in 2013. Rates revenue rose due to greater corporate flow, increased holdings of debt securities and a net favourable movement in respect of the valuation adjustments on derivatives compared with a net charge in 2012. Equities revenues rose from warrant market making as volumes increased while foreign exchange revenue grew due to improved margins and higher customer trading volumes.

Net income from financial instruments designated at fair value was US$258m compared with US$447m in 2012, primarily due to lower net investment returns on assets held by the insurance business reflecting weaker equity markets and falling bond prices. To the extent that these investment returns were attributed to policyholders holding unit-linked insurance policies and insurance contracts with DPF, there was a corresponding movement in *Net insurance claims incurred and movement in liabilities to policyholders*.

Gains less losses from financial investments were US$53m in 2013 compared with US$322m in 2012, largely due to the non-recurrence of the gain on sale of our shares in four Indian banks in 2012.

Dividend income was US$150m compared with US$24m in 2012, mainly due to the dividend from Industrial Bank following its reclassification as a financial investment during the year.

Net earned insurance premiums grew by 2% due to increased renewals of deferred annuity and unit-linked insurance contracts, partly offset by the absence of non-life insurance premiums following the disposal of the HSBC and Hang Seng Bank general insurance businesses in 2012 and lower new business premiums. The growth in premiums resulted in a corresponding increase in *Net insurance claims incurred and movement in liabilities to policyholders*.

Report of the Directors: Financial Review (continued)

Other operating income was US$131m lower than in 2012 due to the non-recurrence of the gains on sale of Global Payments Asia-Pacific Limited and the non-life insurance businesses reported in 2012, totalling US$375m on a reported basis. This more than offset higher revaluation and disposal gains on investment properties, which in part reflected the strong commercial property market, and a larger increase in the PVIF asset. The latter arose in 2013 due to favourable interest rate assumption updates, although this was more than offset in *Net insurance claims incurred and movement in liabilities to policyholders*.

LICs were US$63m higher due to a revision to the assumptions used in our collective assessment models in RBWM and a rise in individual

impairment charges in CMB, although these remained low. This was partly offset by collective provision releases in CMB from lower historical loss rates and individual impairment releases in GB&M.

Operating expenses rose by US$197m in 2013, reflecting higher marketing spend, costs relating to the introduction of updated payment cards and information technology platforms as well as increased property rental and maintenance costs. In addition, staff costs increased as a result of changes to the recognition of pension costs.

Share of profit from associates and joint ventures was US$15m lower, primarily due to the effect of the disposal of our interest in Global Payments Asia-Pacific Ltd in 2012.

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Reconciliation of reported and constant currency profit before tax Hong Kong

	2012 as reported US$m	Currency translation adjustment[1] US$m	2012 at 2013 exchange rates US$m	2013 as reported US$m	Reported change[2] %	Constant currency change[2] %
Net interest income	5,316		5,316	**5,993**	**13**	**13**
Net fee income	3,335		3,335	**3,877**	**16**	**16**
Net trading income	1,463		1,463	**1,570**	**7**	**7**
Own credit spread[3]						
Other income from financial instruments designated at fair value	447		447	**258**	**(42)**	**(42)**
Net income from financial instruments designated at fair value	447		447	**258**	**(42)**	**(42)**
Gains less losses from financial investments	322		322	**53**	**(84)**	**(84)**
Net earned insurance premiums	5,957	1	5,958	**6,081**	**2**	**2**
Other operating income (including dividend income)	1,948	(2)	1,946	**1,941**		
Total operating income	18,788	(1)	18,787	**19,773**	**5**	**5**
Net insurance claims incurred and movement in liabilities to policyholders	(6,366)	(1)	(6,367)	**(6,570)**	**(3)**	**(3)**
Net operating income[4]	12,422	(2)	12,420	**13,203**	**6**	**6**
LICs[42]	(74)		(74)	**(137)**	**(85)**	**(85)**
Net operating income	12,348	(2)	12,346	**13,066**	**6**	**6**
Operating expenses	(4,848)		(4,848)	**(5,045)**	**(4)**	**(4)**
Operating profit	7,500	(2)	7,498	**8,021**	**7**	**7**
Income from associates[43]	82	1	83	**68**	**(17)**	**(18)**
Profit before tax	7,582	(1)	7,581	**8,089**	**7**	**7**

For footnotes, see page 132.

Reconciliation of reported and underlying items Hong Kong

	Year ended 31 December 2013 US$m	2012 US$m	Change[2] %
Net interest income			
Reported	**5,993**	5,316	13
Currency translation adjustment[1]			
Acquisitions, disposals and dilutions		(9)	
Underlying	**5,993**	5,307	13

Other operating income			
Reported	**1,791**	1,924	(7)
Currency translation adjustment[1]		(2)	
Acquisitions, disposals and dilutions		(375)	
Underlying	**1,791**	1,547	16
Revenue[4]			
Reported	**13,203**	12,422	6
Currency translation adjustment[1]		(2)	
Own credit spread[3]			
Acquisitions, disposals and dilutions		(445)	
Underlying	**13,203**	11,975	10

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

	Year ended 31 December		
	2013	2012	Change[2]
LICs[42]			
Reported	**(137)**	(74)	(85)
Currency translation adjustment[1]			
Acquisitions, disposals and dilutions			
Underlying	**(137)**	(74)	(85)
Operating expenses			
Reported	**(5,045)**	(4,848)	(4)
Currency translation adjustment[1]			
Acquisitions, disposals and dilutions		34	
Underlying	**(5,045)**	(4,814)	(5)
Underlying cost efficiency ratio	**38.2%**	40.2%	
Profit before tax			
Reported	**8,089**	7,582	7
Currency translation adjustment[1]		(1)	
Own credit spread[6]			
Acquisitions, disposals and dilutions		(420)	
Underlying	**8,089**	7,161	13

For footnotes, see page 132.

106b

Report of the Directors: Financial Review (continued)

2012 compared with 2011

Economic background

The **Hong Kong** economy started 2012 on a strong footing, but lost momentum in the second quarter as global trade flows slowed and the mainland Chinese economy cooled, causing GDP to contract slightly. Domestic demand stayed resilient, however, supported by continued wage growth, and firm job market conditions and asset prices. This underpinned investment and private consumption growth, leading the economy back into expansion in the third quarter (0.6%, quarter-on-quarter, seasonally adjusted). Slower economic momentum and deflationary pressures in mainland China allowed the pressure on Hong Kong s asset prices to ease through most of 2012, resulting in reduced CPI inflation of 4.1%, compared with 5.3% in 2011.

Review of performance

Reported pre-tax profits from our operations in Hong Kong were US$7.6bn compared with US$5.8bn in 2011, an increase of 30% on both a reported and a constant currency basis.

Reported profits included gains on the sale of our shares in Global Payments Asia-Pacific Ltd of US$212m and the HSBC and Hang Seng Bank general insurance businesses of US$117m and US$46m, respectively. Excluding these gains and associated operating results, underlying profit of US$7.2bn increased by 24%, driven by higher net interest income in CMB and RBWM, the gain of US$314m on the sale of non-strategic investments in India, higher trading revenues in GB&M, increased fee income in both CMB and GB&M, and a reduction in loan impairment charges. These favourable movements were partly offset by higher operating expenses.

In RBWM, we continue to develop our Wealth Management services for our retail customers and launched new investment funds, including the Global High Yield Bond Fund which attracted over US$1bn of subscriptions by the end of the year. The sale of the general insurance businesses enabled us to focus on life insurance manufacturing, where we maintained our market leadership position. We also led the market in deposits, mortgages, mandatory provident funds and credit cards. We maintained our prudent lending approach with average loan-to-value ratios of 48% on new mortgage drawdowns and an estimated 32% on the portfolio as a whole. We now offer renminbi current accounts for non-residents and launched the first mobile payment solution in the region, enabling contactless credit card transactions through Visa payWave terminals.

In CMB, we capitalised on our international connectivity and our standing as a leading trade finance bank to grow trade-related revenues by 10%, particularly with mainland China. The collaboration between CMB and GB&M continued to strengthen, with revenue growth of 13%, most notably from the provision of foreign exchange products to our corporate customers. We won the *FinanceAsia* award for Best Commercial Bank 2012 and ten *Asiamoney* awards for Payments and Cash Management, including the Best Local Cash Management Bank for small, medium and large corporates.

In GB&M, we led the market in Hong Kong dollar bond issuance and were the leading bookrunner for corporate high yield bonds in Asia excluding Japan. We continued to lead the market in offshore renminbi bond issuance with several high-profile deals completed in 2012 for multinationals accessing the market.

We also reinforced our position as a leading international bank for offshore renminbi products, winning the *Asia Risk* Renminbi House of the Year award and all seven product categories in *Asiamoney* s Offshore Renminbi Survey .

The following commentary is on a constant currency basis.

Net interest income was 13% higher than in 2011, notably in CMB and RBWM, driven by increased customer loans and deposit balances and by growth in the insurance portfolio.

In RBWM, we continued to grow our average mortgage balances, reflecting continued strength in the property market. In CMB, average term and trade-related lending balances were higher as we capitalised on trade and capital flows.

Asset spreads in CMB were marginally wider than in 2011 on trade-related and other lending due to repricing, though they began to narrow towards the end of the year.

Net interest income also rose due to higher average deposit balances, notably in RBWM, in part reflecting reduced net outflows from customer accounts into investments. In addition, deposit spreads widened.

Net fee income of US$3.3bn was 7% higher than in 2011. Fees rose from increased transaction volumes in trade services, remittances and account services as we continued to intermediate international trade and capital flows. Fee income also increased in both CMB and GB&M as we arranged more debt issues for our customers to

Report of the Directors: Financial Review (continued)

satisfy their funding requirements while the market for corporate debt improved. In RBWM, fees from unit trusts rose reflecting increased sales volumes, despite customers increasingly preferring lower risk products with lower fees. These increases were largely offset by a reduction in brokerage income from lower market turnover as a result of weaker investor sentiment.

Net trading income increased by 23% from lower adverse fair value movements on derivatives relating to certain provident funds, following reductions in long-term investment returns in 2011. There was also a strong performance in GB&M, notably in Rates trading activities, which reflected increased client demand for risk management products, particularly in yen and renminbi, in part from increased cross-currency debt issuance by corporates. Credit trading revenues also rose, in part due to increased client activity. This was partly offset by a net charge as a result of a change in estimation methodology in respect of the valuation adjustments on derivatives.

Net income from financial instruments designated at fair value was US$447m compared with an expense of US$540m in 2011, due to net investment gains on assets held by the Insurance business (compared with net losses in 2011) as a result of more favourable equity market conditions. To the extent that these investment gains were attributed to policyholders of unit-linked insurance policies and insurance contracts with DPF, there was a corresponding increase in *Net insurance claims incurred and movement in liabilities to policyholders*.

Gains less losses from financial investments were US$322m compared with US$25m in 2011, largely from the gain of US$314m on the sale of our shares in four non-strategic investments in India.

Net earned insurance premiums grew by 17% following increased new sales and renewals of life insurance products. The growth in premiums

resulted in a corresponding increase in Net insurance claims incurred and movement in liabilities to policyholders.

Other operating income of US$1.9bn was US$235m higher than in 2011. We completed the sale of our shares in Global Payments Asia-Pacific Ltd and the HSBC and Hang Seng Bank general insurance businesses, realising gains of US$212m, US$117m and US$46m, respectively. While the value of the PVIF asset rose, this was not to the same extent as in 2011 as increased insurance sales in 2012 were more than offset by lower positive assumption updates during 2012 compared with 2011and the non-recurrence of the benefit from the refinement to the PVIF asset calculation in 2011.

Net insurance claims incurred and movement in liabilities to policyholders increased by 38%, driven by net investment gains on fair value of the assets held to support policyholder contracts, compared with net losses in 2011. In addition, policyholder liabilities were established for new business, reflecting the higher premiums, though this was partly offset by the disposal of the insurance businesses in 2012.

Loan impairment charges and other credit risk provisions reduced to US$74m from US$157m in 2011, largely due to lower specific impairment charges in CMB and the non-recurrence of charges relating to available-for-sale Greek sovereign debt securities.

Operating expenses increased by 2%, primarily due to higher systems implementation and processing costs as we continued to invest in our technology infrastructure, and increased property rental costs. Salaries and wages were broadly unchanged as wage inflation was largely offset by reduced average staff numbers as we continued to improve efficiency across our operations, generating sustainable annual savings of approximately US$190m.

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Reconciliation of reported and constant currency profit before tax Hong Kong

	2011 as reported	Currency translation adjustment[1]	2011 at 2012 exchange rates	2012 as reported	Reported change[2]	Constant currency change[2]
	US$m	US$m	US$m	US$m	%	%
Net interest income	4,691	20	4,711	5,316	13	13
Net fee income	3,097	11	3,108	3,335	8	7
Other income[7]	2,894	8	2,902	3,771	30	30
Net operating income[4]	10,682	39	10,721	12,422	16	16
LICs[42]	(156)	(1)	(157)	(74)	53	53
Net operating income	10,526	38	10,564	12,348	17	17
Operating expenses	(4,758)	(18)	(4,776)	(4,848)	(2)	(2)
Operating profit	5,768	20	5,788	7,500	30	30
Income from associates[43]	55		55	82	49	49
Profit before tax	5,823	20	5,843	7,582	30	30

For footnotes, see page 132.

Reconciliation of reported and underlying items Hong Kong

	Year ended 31 December 2012	2011	Change[2]
	US$m	US$m	%
Revenue[4]			
Reported	12,422	10,682	16
Currency translation adjustment[1]		39	
Own credit spread[3]			
Acquisitions, disposals and dilutions	(445)	(109)	
Underlying	11,977	10,612	13
LICs[42]			
Reported	(74)	(156)	53
Currency translation adjustment[1]		(1)	
Acquisitions, disposals and dilutions			
Underlying	(74)	(157)	53
Operating expenses			
Reported	(4,848)	(4,758)	(2)
Currency translation adjustment[1]		(18)	

Acquisitions, disposals and dilutions	34	40	
Underlying	(4,814)	(4,736)	(2)
Underlying cost efficiency ratio	40.2%	44.6%	
Profit before tax			
Reported	7,582	5,823	30
Currency translation adjustment[1]		20	
Own credit spread[3]			
Acquisitions, disposals and dilutions	(420)	(82)	
Underlying	7,162	5,761	24

For footnotes, see page 132.

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Profit/(loss) before tax and balance sheet data Hong Kong

	2013						
	Retail Banking and Wealth Management	Commercial Banking	Global Banking and Markets	Global Private Banking	Other	Inter-segment elimination[49]	Total
	US$m	US$m	US$m	US$m	US$m	US$m	US$m
Profit before tax							
Net interest income/(expense)	3,177	1,729	1,338	124	(347)	(28)	5,993
Net fee income	2,030	963	697	179	8		3,877
Trading income/(expense) excluding net interest income	139	182	779	134	(17)		1,217
Net interest income on trading activities	3		307		15	28	353
Net trading income/(expense)[44]	142	182	1,086	134	(2)	28	1,570
Changes in fair value of long- term debt issued and related derivatives							
Net income/(expense) from other financial instruments designated at fair value	256		7		(5)		258
Net income/(expense) from financial instruments designated at fair value	256		7		(5)		258
Gains less losses from financial investments			42	10	1		53
Dividend income		1	6		143		150
Net earned insurance premiums	5,612	469					6,081
Other operating income	619	91	78	9	1,302	(308)	1,791
Total operating income	11,836	3,435	3,254	456	1,100	(308)	19,773
Net insurance claims[50]	(6,025)	(545)					(6,570)
Net operating income[4]	5,811	2,890	3,254	456	1,100	(308)	13,203
Loan impairment (charges)/recoveries and other credit risk provisions	(137)	(16)	20	(4)			(137)
Net operating income	5,674	2,874	3,274	452	1,100	(308)	13,066
Total operating expenses	(1,999)	(764)	(1,304)	(244)	(1,042)	308	(5,045)
Operating profit	3,675	2,110	1,970	208	58		8,021
Share of profit in associates and joint ventures	67		1				68
Profit before tax	3,742	2,110	1,971	208	58		8,089

	%	%	%	%	%		%
Share of HSBC s profit before tax	**16.6**	**9.4**	**8.7**	**0.9**	**0.3**		**35.9**
Cost efficiency ratio	**34.4**	**26.4**	**40.1**	**53.5**	**94.7**		**38.2**
Balance sheet data[40]							
	US$m	**US$m**	**US$m**	**US$m**	**US$m**		**US$m**
Loans and advances to customers (net)	**64,990**	**74,125**	**48,117**	**6,928**	**1,387**		**195,547**
Total assets	**103,816**	**84,143**	**311,771**	**8,020**	**59,970**	**(12,307)**	**555,413**
Customer accounts	**213,471**	**97,191**	**35,617**	**19,428**	**286**		**365,993**

107

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

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

	2012						
	Retail Banking and Wealth Management	Commercial Banking	Global Banking and Markets	Global Private Banking	Other	Inter-segment elimination[49]	Total
	US$m	US$m	US$m	US$m	US$m	US$m	US$m
Profit/(loss) before tax							
Net interest income/(expense)	2,851	1,629	1,087	149	(482)	82	5,316
Net fee income	1,769	850	548	155	13		3,335
Trading income/(expense) excluding net interest income	176	163	666	170	(2)		1,173
Net interest income on trading activities	10	2	352		8	(82)	290
Net trading income[44]	186	165	1,018	170	6	(82)	1,463
Changes in fair value of long- term debt issued and related derivatives							
Net income/(expense) from other financial instruments designated at fair value	511	(53)	23		(34)		447
Net income/(expense) from financial instruments designated at fair value	511	(53)	23		(34)		447
Gains less losses from financial investments			2	7	313		322
Dividend income		1	5		18		24
Net earned insurance premiums	5,294	655	8				5,957
Other operating income	711	253	77	13	1,152	(282)	1,924
Total operating income	11,322	3,500	2,768	494	986	(282)	18,788
Net insurance claims[50]	(5,757)	(602)	(7)				(6,366)
Net operating income[4]	5,565	2,898	2,761	494	986	(282)	12,422
Loan impairment (charges)/recoveries and other credit risk provisions	(97)	3	17	3			(74)
Net operating income	5,468	2,901	2,778	497	986	(282)	12,348
Total operating expenses	(1,819)	(719)	(1,263)	(248)	(1,081)	282	(4,848)
Operating profit/(loss)	3,649	2,182	1,515	249	(95)		7,500
Share of profit in associates and joint ventures	45	6	3		28		82
Profit/(loss) before tax	3,694	2,188	1,518	249	(67)		7,582

	%	%	%	%	%		%
Share of HSBC s profit before tax	17.9	10.6	7.3	1.2	(0.3)		36.7
Cost efficiency ratio	32.7	24.8	45.7	50.2	109.6		39.0

Balance sheet data[40]

	US$m	US$m	US$m	US$m	US$m		US$m
Loans and advances to customers (net)	62,533	62,944	40,223	6,464	1,449		173,613
Total assets	96,185	72,056	256,295	20,705	81,085	(7,992)	518,334
Customer accounts	201,649	90,152	34,171	19,566	670		346,208

For footnotes, see page 132.

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

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

	2011						
	Retail Banking and Wealth Management	Commercial Banking	Global Banking and Markets	Global Private Banking	Other	Inter-segment elimination[49]	Total
	US$m	US$m	US$m	US$m	US$m	US$m	US$m
Profit/(loss) before tax							
Net interest income/(expense)	2,571	1,317	1,051	173	(464)	43	4,691
Net fee income	1,741	706	475	160	15		3,097
Trading income/(expense) excluding net interest income	120	169	652	135	(116)		960
Net interest income on trading activities	9	1	246		16	(43)	229
Net trading income/(expense)[44]	129	170	898	135	(100)	(43)	1,189
Changes in fair value of long- term debt issued and related derivatives							
Net income/(expense) from other financial instruments designated at fair value	(475)	(72)	(5)		15		(537)
Net income/(expense) from financial instruments designated at fair value	(475)	(72)	(5)		15		(537)
Gains less losses from financial investments	3	10	21		(10)		24
Dividend income		1	14		24		39
Net earned insurance premiums	4,317	758	13				5,088
Other operating income	505	175	79	8	1,185	(268)	1,684
Total operating income	8,791	3,065	2,546	476	665	(268)	15,275
Net insurance claims[50]	(3,887)	(697)	(9)				(4,593)
Net operating income[4]	4,904	2,368	2,537	476	665	(268)	10,682
Loan impairment (charges)/recoveries and other credit risk provisions	(77)	(66)	23	(36)			(156)
Net operating income	4,827	2,302	2,560	440	665	(268)	10,526
Total operating expenses	(1,811)	(703)	(1,248)	(252)	(1,012)	268	(4,758)
Operating profit/(loss)	3,016	1,599	1,312	188	(347)		5,768
Share of profit in associates and joint ventures	6	9	4		36		55
Profit/(loss) before tax	3,022	1,608	1,316	188	(311)		5,823

	%	%	%	%	%		%
Share of HSBC s profit before tax	13.8	7.3	6.0	0.9	(1.4)		26.6
Cost efficiency ratio	36.9	29.7	49.2	52.9	152.2		44.5

Balance sheet data[40]

	US$m	US$m	US$m	US$m	US$m		US$m
Loans and advances to customers (net)	56,296	54,986	39,667	5,447	1,269		157,665
Total assets	85,866	63,516	238,892	20,680	84,782	(20,712)	473,024
Customer accounts	181,316	79,225	35,283	19,622	(101)		315,345

For footnotes, see page 132.

Report of the Directors: Financial Review (continued)

Rest of Asia-Pacific

We offer a full range of banking and financial services in mainland China, mainly through our local subsidiary, HSBC Bank (China) Company Limited. We also participate indirectly in mainland China through our associate, Bank of Communications.

Outside mainland China, we conduct business in 18 countries and territories in the Rest of Asia-Pacific region, primarily through branches and subsidiaries of The Hongkong and Shanghai Banking Corporation, with particularly strong coverage in Australia, India, Indonesia, Malaysia and Singapore.

	2013 US$m	2012 US$m	2011 US$m
Net interest income	**5,439**	5,391	5,102
Net fee income	**2,059**	2,083	2,111
Net trading income	**456**	1,053	1,658
Other income	**4,024**	5,057	1,842
Net operating income[4]	**11,978**	13,584	10,713
LICs[42]	**(361)**	(436)	(267)
Net operating income	**11,617**	13,148	10,446
Total operating expenses	**(5,640)**	(5,806)	(5,806)
Operating profit	**5,977**	7,342	4,640
Income from associates[43]	**1,787**	3,106	2,831
Profit before tax	**7,764**	10,448	7,471
Cost efficiency ratio	**47.1%**	42.7%	54.2%
RoRWA[36]	**2.7%**	3.5%	3.1%
Year-end staff numbers	**85,334**	85,024	91,051

13%

growth in customer lending balances

on a constant currency basis

Market leader in mainland China s

state-owned enterprise bond issuances

Domestic Bond House of the Year

(IFR Asia)

For footnotes, see page 132.

The commentary is on a constant currency basis unless stated otherwise, while tables are on a reported basis.

Economic background

In **mainland China**, the annual pace of GDP growth was unchanged at 7.7% in 2013, above the official GDP growth target of 7.5%. The rebound in activity in the second half of the year was mainly due to measures announced by the government during the summer. Export growth remained moderate through most of 2013, only accelerating in the final months. Annual growth in fixed asset investment remained steady at an annual rate of nearly 20% and consumer spending remained resilient. Headline annual CPI inflation rose modestly to 2.6%, remaining below the government s target of 3.5%. The People s Bank of China maintained a relatively restrictive credit policy but overall liquidity conditions remained loose as the M2 measure of money growth expanded by 13.6% on the year.

Economic activity in **Japan** picked up considerably in 2013, thanks to large-scale stimuli from both the government and the Bank of Japan. Annualised growth slowed to just over 1% in the third quarter although it accelerated in the final months of the year as consumer spending rose in advance of the sales tax increase due in April 2014.

During the course of the summer, there were concerns in financial markets that global liquidity may become more expensive and less abundant as the US Federal Reserve Board indicated it may begin to taper its purchases of financial assets. Interest rates on US Treasuries rose, attracting global capital back to developed markets. Some emerging economies suffered considerable capital outflows with large declines in the value of their currencies against the US dollar and central banks were forced to raise interest rates to attract capital. This in turn led to a slowdown in activity.

In Asia-Pacific, India and Indonesia were most affected. The current account positions of both economies had significantly deteriorated in recent years, leaving them vulnerable to changes in external financing conditions. In **India**, structural constraints on growth, including infrastructure bottlenecks, also contributed to a slowdown in activity. The central bank tightened monetary policy during the second half of 2013 in response to concerns over inflation.

Similar constraints in **Indonesia** saw GDP growth slow in 2013. However, concerted measures to reduce fuel subsidies and narrow the current account deficit should make the economy more resilient to any tightening in monetary conditions in the West. Economic activity also reduced in **Malaysia** as the boost to growth in 2012 from public spending abated. In **Thailand**, the economy slowed

Report of the Directors: Financial Review (continued)

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

	Retail Banking and Wealth Management US$m	Commercial Banking US$m	Global Banking and Markets US$m	Global Private Banking US$m	Other US$m	Total US$m
2013						
Australia	**100**	**131**	**189**		**26**	**446**
India	**(21)**	**113**	**418**	**7**	**136**	**653**
Indonesia	**12**	**106**	**126**		**36**	**280**
Mainland China	**223**	**1,536**	**842**	**(4)**	**1,644**	**4,241**
Malaysia	**148**	**105**	**236**		**25**	**514**
Singapore	**147**	**120**	**262**	**74**	**22**	**625**
Taiwan	**7**	**30**	**158**		**5**	**200**
Vietnam	**86**	**(34)**	**25**		**(12)**	**65**
Other	**(25)**	**241**	**448**	**(1)**	**77**	**740**
	677	**2,348**	**2,704**	**76**	**1,959**	**7,764**
2012						
Australia	97	38	184		(44)	275
India	41	89	497	7	175	809
Indonesia	29	124	146		7	306
Mainland China	838	1,724	1,257	(4)	2,525	6,340
Malaysia	183	131	242		8	564
Singapore	201	139	296	97	(65)	668
Taiwan	62	36	136			234
Vietnam	9	45	57		9	120
Other	57	276	510	59	230	1,132
	1,517	2,602	3,325	159	2,845	10,448
2011						
Australia	88	106	108		5	307
India	(14)	122	539	5	161	813
Indonesia	6	89	157		7	259
Mainland China	1,112	1,340	1,116	(4)	117	3,681
Malaysia	173	118	228	1	9	529
Singapore	183	133	189	97	(7)	595
Taiwan	45	23	130		12	210
Vietnam		51	79		24	154
Other	48	264	543	(8)	76	923
	1,641	2,246	3,089	91	404	7,471

Analysis of mainland China

	Retail Banking and Wealth Management US$m	Commercial Banking US$m	Global Banking and Markets US$m	Global Private Banking US$m	Other US$m	Total US$m
2013						
Industrial Bank					**1,089**	**1,089**
Ping An					**553**	**553**
Other associates	**247**	**1,360**	**284**		**(38)**	**1,853**
Other mainland China	**(24)**	**176**	**558**	**(4)**	**40**	**746**
	223	**1,536**	**842**	**(4)**	**1,644**	**4,241**
2012						
Industrial Bank	54	273	343			670
Ping An	622	82	60		2,459	3,223
Other associates	214	1,193	248			1,655
Other mainland China	(52)	176	606	(4)	66	792
	838	1,724	1,257	(4)	2,525	6,340
2011						
Industrial Bank	52	229	190			471
Ping An	946		63		117	1,126
Other associates	181	921	276			1,378
Other mainland China	(67)	190	587	(4)		706
	1,112	1,340	1,116	(4)	117	3,681

Report of the Directors: Financial Review (continued)

following the rapid post-flood recovery in 2012 and, more recently, political uncertainty. Elsewhere in the ASEAN region GDP growth improved during 2013. **Singapore s** economic recovery gathered pace, led by net external demand, and the **Philippines** continued to grow robustly in the year, led by household spending. The devastating typhoon that hit the country in November disrupted activity in the fourth quarter, but will also induce reconstruction spending in 2014.

Growth in **South Korea** stabilised in 2013 supported by a monetary and fiscal stimulus package delivered at the start of the year. Exports remained resilient. **Taiwan s** trade-dependent economy was weak in the first half of 2013, but strengthened in the second half as global trade improved.

Australian GDP growth slowed to an annual rate of around 2.5% in 2013 and unemployment rose to 5.7% towards the end of the year. This reflected a slowdown in mining investment after years of strong growth. To stimulate growth elsewhere, the Reserve Bank of Australia cut its cash rate from 3.0% to 2.5% during the year. Low interest rates drove a strong rise in housing prices. The Australian dollar remained well above its long run average levels in 2013, but fell towards the end of the year.

Review of performance

In Rest of Asia-Pacific, reported profit before tax was US$7.8bn compared with US$10.4bn in 2012. On a constant currency basis, profit before tax decreased by US$2.5bn.

The decrease in reported profits was mainly due to the gain on disposal of our shareholding in Ping An in 2012 of US$3.0bn and a reduction in our share of profit from associates of US$1.4bn due to the disposal of Ping An and the reclassification of Industrial Bank as a financial investment following its issue of share capital to third parties. These items were partly offset by the accounting gain of US$1.1bn in 2013 on the reclassification of Industrial Bank.

On an underlying basis, which excludes the items above as well as other disposals and the results of disposed of operations, profit before tax increased by 20% due to the net gain of US$553m on completion of the sale of our investment in Ping An in 2013, compared with adverse fair value movements of US$553m on the Ping An contingent forward sale contract recorded in 2012. Excluding these items, underlying profit before tax was marginally lower as increased operating expenses and lower revenues were offset by reduced loan

impairment charges and increased income from associates.

The implementation of our strategy to reduce fragmentation across the region continued, leading to the disposal of non-core insurance businesses in Vietnam, South Korea, Taiwan and Singapore, and we announced the closure of a retail brokerage in India and our retail banking operations in South Korea. We also completed the sale of our investment in Ping An.

In mainland China, where we continued to expand our branch network, we had 162 HSBC outlets, 23 HSBC rural bank outlets and 48 Hang Seng Bank outlets at the end of the year. We expanded our wealth management capabilities, and were one of the first foreign banks to be approved to distribute domestic funds to retail investors. We were the market leader in mainland China s state-owned enterprise bond issuances and we were awarded Best Foreign Commercial Bank in China by *FinanceAsia*.

We continued to promote the internationalisation of the renminbi as regulations developed. We were the first foreign bank in mainland China to implement a customised renminbi cross-border centralised settlement solution and were also the first foreign bank to complete a two-way cross-border renminbi lending transaction.

In India, we revised our Wealth Management product offering to ensure customers needs were being met and to improve customer satisfaction levels. In Payments and Cash Management, we were awarded the Best Domestic Cash Management Bank in 2013 by *Euromoney*. Our strength in debt capital markets (DCM) continued, acting as a joint lead manager and bookrunner for the largest US dollar-denominated single tranche bond issuance by an Indian corporate in 2013.

In Singapore, we led the market in foreign currency DCM issuance, continuing to demonstrate our ability to structure DCM transactions. In CMB, we began to offer a renminbi settlement service.

We continued to develop our Payments and Cash Management product offering across the region and were awarded the Best Cash Management House in Asia by *Euromoney*. We also strengthened our Project and Export Finance capabilities and were named the Best Project Finance House in Asia by *Euromoney* for the third consecutive year. Our strength in DCM continued we were the No.1 bookrunner in Asia-ex Japan bonds. We were awarded the Domestic Bond House of the Year by *IFR Asia*.

Report of the Directors: Financial Review (continued)

Net interest income increased by US$167m from balance sheet growth, partly offset by spread compression in many countries from competition and increased liquidity.

Average residential mortgage balances grew, primarily in mainland China and Australia, as we focused on secured lending and in Singapore reflecting lending growth in 2012. Term and trade-related lending in CMB rose, notably in mainland China, Singapore and Indonesia, from continued client demand. Increased average loan balances were broadly offset by lending spread compression, notably on trade finance lending, reflecting competitive pressures and increased liquidity in the market.

We grew average deposit balances in both Payments and Cash Management and RBWM, though the benefit of this growth was partly offset by narrower liability spreads in many countries following central bank interest rate cuts and increased liquidity.

Net fee income rose by US$53m, primarily in GB&M, in part from increased activity in bond sales in Singapore and in CMB from increased credit facilities, notably in mainland China. These factors were partly offset by reductions in RBWM, notably in India, from lower Wealth Management sales as we revised our product offerings.

Net trading income was US$541m lower, in part from further adverse fair value movements on the Ping An contingent forward sale contract of US$682m, compared with US$553m in 2012. Rates revenues decreased, largely from reduced bond holdings in a number of countries and revaluation losses as bond yields rose, notably in mainland China. Foreign Exchange revenues also fell as market conditions in 2012 were not repeated.

Net income from financial instruments designated at fair value was US$56m compared with US$108m in 2012 from lower gains on assets held by the insurance business in Singapore driven by rising bond yields.

Gains less losses from financial investments were US$1.2bn higher, due to the gain on disposal

of our investment in Ping An of US$1.2bn, which was partly offset by the adverse fair value movement of US$682m on the contingent forward sale contract included in Net trading income leading to a net gain of US$553m.

We reported a *gain on disposal of Ping An* of US$3.0bn in 2012.

Other operating income increased by US$1.0bn. We recorded an accounting gain of US$1.1bn on the reclassification of Industrial Bank as a financial investment following its issue of additional share capital to third parties and a gain on the disposal of our investment in Bao Viet Holdings of US$104m. In 2012, we recorded gains totalling US$305m on a reported basis on the sale of our RBWM business in Thailand, our GPB business in Japan and our interest in a property company in the Philippines.

LICs decreased by US$63m as 2012 included a large individually assessed impairment of a corporate exposure in Australia and a credit risk provision on an available-for-sale debt security in GB&M. These factors were partly offset by an increase in individually assessed impairments in GB&M and CMB in a number of countries across the region.

Operating expenses increased by US$38m. Costs rose in India from increased use of the service centres and in mainland China from wage inflation, higher staff numbers and branch expansion. These increases were offset by the partial write back of a litigation provision in Singapore and Australia compared with a charge in 2012. In addition, in 2013 there were lower restructuring and other related costs, including termination benefits, than in 2012, and the non-recurrence of costs following the sale or closure of operations.

Share of profit from associates and joint ventures reduced by US$1.4bn following the disposal of Ping An, the reclassification of Industrial Bank as a financial investment and an impairment charge of US$106m on our banking associate in Vietnam. Excluding these factors, income from associates rose, primarily in BoCom as a result of balance sheet growth and increased fee income, partly offset by higher operating expenses and a rise in loan impairment charges.

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Reconciliation of reported and constant currency profit before tax Rest of Asia-Pacific

	2012 as reported US$m	Currency translation adjustment[1] US$m	2012 at 2013 exchange rates US$m	2013 as reported US$m	Reported change[2] %	Constant currency change[2] %
Net interest income	5,391	(119)	5,272	**5,439**	**1**	**3**
Net fee income	2,083	(77)	2,006	**2,059**	**(1)**	**3**
Net trading income	1,053	(56)	997	**456**	**(57)**	**(54)**
Own credit spread[3]	(3)		(3)	**(1)**	**67**	**67**
Other income from financial instruments designated at fair value	109	2	111	**57**	**(48)**	**(49)**
Net income from financial instruments designated at fair value	106	2	108	**56**	**(47)**	**(48)**
Gains on disposal of Ping An	3,012		3,012		**(100)**	**(100)**
Gains less losses from financial investments	16	(1)	15	**1,222**	**7,538**	**8,047**
Net earned insurance premiums	812	(1)	811	**837**	**3**	**3**
Other operating income (including dividend income)	1,829	(237)	1,592	**2,635**	**44**	**66**
Total operating income	14,302	(489)	13,813	**12,704**	**(11)**	**(8)**
Net insurance claims incurred and movement in liabilities to policyholders	(718)	1	(717)	**(726)**	**(1)**	**(1)**
Net operating income[4]	13,584	(488)	13,096	**11,978**	**(12)**	**(9)**
LICs[42]	(436)	12	(424)	**(361)**	**17**	**15**
Net operating income	13,148	(476)	12,672	**11,617**	**(12)**	**(8)**
Operating expenses	(5,806)	204	(5,602)	**(5,640)**	**3**	**(1)**
Operating profit	7,342	(272)	7,070	**5,977**	**(19)**	**(15)**
Income from associates[43]	3,106	45	3,151	**1,787**	**(42)**	**(43)**
Profit before tax	10,448	(227)	10,221	**7,764**	**(26)**	**(24)**

For footnotes, see page 132.

Reconciliation of reported and underlying items Rest of Asia-Pacific

	Year ended 31 December 2013 US$m	2012 US$m	Change[2] %
Net interest income			
Reported	**5,439**	5,391	1
Currency translation adjustment[1]		(119)	
Own credit spread[3]	**1**	3	

Acquisitions, disposals and dilutions		(22)	
Underlying	**5,440**	5,253	4
Other operating income			
Reported	**2,633**	1,823	44
Currency translation adjustment[1]		(233)	
Acquisitions, disposals and dilutions	**(1,139)**	(299)	
Underlying	**1,494**	1,291	
Revenue[4]			
Reported	**11,978**	13,584	(12)
Currency translation adjustment[1]		(488)	
Own credit spread[3]	**1**	3	
Acquisitions, disposals and dilutions	**(1,139)**	(3,342)	
Underlying	**10,840**	9,757	11

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

	Year ended 31 December		
	2013	2012	Change[2]
	US$m	US$m	%
LICs[42]			
Reported	**(361)**	(436)	17
Currency translation adjustment[1]		12	
Acquisitions, disposals and dilutions		(2)	
Underlying	**(361)**	(426)	15
Operating expenses			
Reported	**(5,640)**	(5,806)	3
Currency translation adjustment[1]		204	
Acquisitions, disposals and dilutions	**72**	111	
Underlying	**(5,568)**	(5,491)	(1)
Underlying cost efficiency ratio	**51.4%**	56.3%	
Share of profit in associates and joint ventures			
Reported	**1,787**	3,106	(42)
Currency translation adjustment[1]		45	
Acquisitions, disposals and dilutions	**(19)**	(1,416)	
Underlying	**1,768**	1,735	2
Profit before tax			
Reported	**7,764**	10,448	(26)
Currency translation adjustment[1]		(227)	
Own credit spread[3]	**1**	3	
Acquisitions, disposals and dilutions	**(1,086)**	(4,649)	
Underlying	**6,679**	5,575	20

For footnotes, see page 132.

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

2012 compared with 2011

Economic background

In mainland **China**, economic growth slowed through the first three quarters of 2012 due to a decline in external demand driven by the eurozone crisis, the effect of tightening domestic monetary policy measures and sharp de-stocking by industry. This greater than expected deceleration and increasing pressure on the labour market prompted policy makers to ease monetary policy in the summer of 2012, following two interest rate cuts totalling 50bps and two cuts in the reserve requirement ratio amounting to 100bps in the first half of the year, and speeded up the approval of new infrastructure projects. As these measures took effect, the mainland Chinese economy began to show signs of recovery in the fourth quarter of 2012. GDP slowed to 7.8% in 2012 from 9.3% in 2011, but remained above Beijing s target of 7.5%. CPI inflation was a modest 2.6%.

Japan s economy experienced a turbulent 2012. After a very strong start supported by reconstruction demand and government subsidies, growth turned sharply negative in the third quarter as tepid overseas demand prompted a deep slump in exports and manufacturing. Sentiment improved by the end of 2012. The Bank of Japan took steps to ease monetary policy in 2012, establishing a 1% inflation goal in February 2012 and expanding its Asset Purchase Programme by JPY46 trillion (US$534bn).

Slowing global trade reduced growth in the Rest of Asia-Pacific region. **South Korea s** full-year growth slowed to 2.1% in 2012, the lowest annual rate for three years, as the slowdown in global trade hit the export-dependent economy hard in the third quarter. To support domestic demand, the Bank of Korea lowered its policy rate from 3.25% to 2.75%. **Singapore s** economy slowed notably, with GDP growth declining to 1.2% in 2012 from 5% the year before. 2012 was a tumultuous year for **Taiwan s** export-reliant economy, as both western and mainland China demand weakened, particularly from April onwards. However, the impetus provided by key electronic product launches helped to maintain manufacturing activity and jobs, enabling domestic demand to underpin growth more effectively than it did in earlier recessions. The other ASEAN (Association of Southeast Asian Nations) countries demonstrated more resilience, supported by domestic growth. Growth in **Indonesia** was driven by favourable demographics and a growing middle-income class. In **Thailand**, rebuilding activity and policy support after the floods in 2011 led to a rebound in economic activity. Growth in **India**

continued to slow during the course of 2012, with weaker external demand, the lagged effects of monetary policy normalisation and the absence in recent years of structural policies and infrastructure investment playing a role in the slowdown. Encouragingly, the government embarked on a reform programme towards the end of the year which helped lift sentiment and stabilise growth.

Growth in the **Australian** economy was uneven in 2012 as it absorbed a mining boom which had the effect of slowing investment in other sectors. For 2012 as a whole, growth was strong at around 3.5%. Unemployment edged up to 5.4%. In response to the global slowdown and to help re-balance growth away from mining and towards the non-mining sectors, the Reserve Bank of Australia reduced its cash rate from 4.25% to 3.00%.

Review of performance

Our operations in the Rest of Asia-Pacific region reported pre-tax profits of US$10.4bn compared with US$7.5bn in 2011, an increase of 40% or 41% on a constant currency basis.

Reported profits included a gain on the disposal of our associate, Ping An of US$3.0bn. Our remaining shareholding has been classified as a financial investment (see Note 26 on the Financial Statements). Reported profits also included gains from the sale of the RBWM business in Thailand (US$108m), the GPB business in Japan (US$67m) and our interest in a property company in the Philippines (US$130m). Reported profits in 2011 included an accounting gain of US$181m arising from the dilution of our shareholding in Ping An, offset by a remeasurement loss of US$48m on its consolidation of Ping An Bank (formerly Shenzhen Development Bank).

On an underlying basis, which excludes the items described above and the associated operating results, pre-tax profit rose by 2%. This was driven by higher net interest income, notably from Balance Sheet Management in GB&M in mainland China, and strong growth in average lending balances across most of the region, as well as increased profits from our associates in mainland China. These factors were partly offset by adverse fair value movements of US$553m on the contingent forward sale contract related to the Ping An sale, the effect of which was offset in 2013 on completion of the transaction, and higher operating expenses, in part due to restructuring costs arising from the ongoing strategic review of our businesses and support functions in the region. Loan impairment charges also rose from a small number of specific corporate impairment

Report of the Directors: Financial Review (continued)

charges, but remained low as credit quality remained broadly stable.

We maintained our focus on our key priority growth markets in the region. In mainland China, we continued to invest in our branch network and at the end of the year had 141 HSBC China outlets, 20 HSBC rural bank outlets and 46 Hang Seng Bank outlets. We invested a further US$1.7bn in BoCom to maintain our interest of 19.03% in this strategically important associate and reinforce our position as the leading foreign bank in mainland China.

In Malaysia, we now have the largest branch network amongst foreign banks and were designated Best Bank for the 10th consecutive year by the *Asset Triple A Country Awards*.

In RBWM, we made progress in re-shaping the business in line with our strategy, completing the disposal of the non-strategic business in Thailand and announcing the sale of our life insurance business in Taiwan. With our focus on secured lending, we recorded mortgage growth in mainland China, Singapore, Australia and Malaysia, reflecting the continued strength of the property market and the expansion of our distribution network.

In CMB, trade revenues grew as we capitalised on our global network to capture cross-border trade and capital flows, particularly with mainland China. We continued to strengthen our infrastructure to capture the outbound opportunities from mainland China and now have 14 China desks established globally to assist customers with their international trade requirements. Significant new mandates in 2012 in CMB and GB&M reflected investment in our Payments and Cash Management infrastructure. We were recognised as Best Domestic Cash Management Bank by *Euromoney* in fourteen countries across the region, Best Overall Cash Management Bank in Asia by *Global Finance* and Best International Trade Bank in China by *Trade Finance Magazine*.

In GB&M, we continued to be a key participant in the internationalisation of the renminbi and enhanced our Payments and Cash Management systems with renminbi capabilities. We continued to build our debt and equity capital markets capabilities in key countries in the region and were involved in several significant government and large corporate issues in Australia, Singapore, India and Indonesia. Revenues from the collaboration between CMB and GB&M increased by 13% as we enhanced sales coordination between the global businesses.

The following commentary is on a constant currency basis.

Net interest income increased by 8%, notably in mainland China from Balance Sheet Management, arising from growth in the debt securities portfolio and improved yields, as well as from increased trade-related and term lending in CMB and GB&M.

We grew average deposit balances, notably in GB&M and CMB reflecting new Payments and Cash Management mandates, and in RBWM from deposit acquisition. The benefit of this growth was partly offset by narrower liability spreads reflecting rate cuts and liquidity easing measures by central banks.

In RBWM, residential mortgage balances grew, primarily in Singapore, Australia, Malaysia and mainland China, reflecting the continued strength of property markets and expansion of our distribution network. However, net interest income was broadly unchanged due to the effect of the sale of the RBWM business in Thailand and narrower asset spreads in a number of countries attributable to competitive pricing pressures.

Net fee income increased by US$29m, primarily in GB&M, from higher fee income from our participation in more debt capital markets transactions across the region as we continued to strengthen our capabilities in this area, and lower regulatory fee expenses on Foreign Exchange and Rates transactions in mainland China as volumes reduced. RBWM reported higher income from cards in Australia from increased spending and card issuance and Wealth Management fees in mainland China. The increase from cards was more than offset by the discontinuation of our Premier business in Japan, the sale of our RBWM business in Thailand, and a fall in fund management fees as we saw a move into lower yielding products reflecting investor s lower risk appetite.

Net trading income decreased by 34% compared with 2011, mainly from adverse fair value movements on the contingent forward sale contract of US$553m relating to Ping An (see Note 26 on the Financial Statements). Trading income was also lower, primarily in mainland China due to lower GB&M revenues in Foreign Exchange reflecting reduced volatility. These were partly offset by a net favourable movement as a result of a change in estimation methodology in respect of the valuation adjustments on derivatives.

Net income from financial instruments designated at fair value was US$110m in 2012 compared with a net expense of US$19m in 2011. This was driven by

Report of the Directors: Financial Review (continued)

net investment gains on assets held by the Insurance business, primarily in Singapore, due to positive equity market movements. To the extent that these investment gains were attributed to policyholders of unit-linked insurance policies and insurance contracts with DPF, there was a corresponding increase in *Net insurance claims incurred and movement in liabilities to policyholders*.

Gains less losses from financial investments were US$16m compared with net losses of US$23m in 2011, due to a disposal gain on investments managed by a private equity fund and a gain on the sale of government debt securities in India.

Net earned insurance premiums rose by 7% to US$812m as a result of increased renewals and new business volumes in mainland China, Singapore and Taiwan. The growth in premiums resulted in a corresponding increase in Net insurance claims incurred and movement in liabilities to policyholders.

We reported a *Gain on disposal of Ping An*, an associate of Mainland China, of US$3.0bn. Our remaining shareholding has been classified as a financial investment.

Other operating income increased by US$201m due to gains on the sale of our RBWM business in Thailand of US$108m, our GPB business in Japan of US$67m and our interest in a property company in the Philippines of US$130m. These were partly offset by the non-recurrence of an accounting gain of US$181m arising from the dilution of our shareholding in Ping An in 2011.

Net insurance claims incurred and movement in liabilities to policyholders increased by 22%, driven by net investment gains on the fair value of the assets held to support the policyholder contracts compared with net losses in 2011. In addition, policyholder liabilities were established for new business, reflecting the rise in premiums across mainland China, Singapore and Taiwan.

Loan impairment charges and other credit risk provisions increased by US$170m as a result of individually assessed impairments on a single corporate exposure in Australia and a small number of corporate exposures in other countries in the region as well as a credit risk provision on an available-for-sale debt security in GB&M. These were partly offset by an impairment release in Singapore compared with a charge in 2011.

Operating expenses increased by 3%, due to restructuring and other related costs of US$131m (2011: US$45m) incurred across several countries as part of the ongoing strategic review of our businesses and support functions in the region. This resulted in a net reduction of approximately 6,000 FTE staff numbers and generated sustainable annual savings of approximately US$200m, which were more than offset by inflationary pressures and investment for business growth, including branch expansion in mainland China. Costs also increased from a litigation provision of US$98m made in respect of a long-standing court case and the write down by US$51m of our interest in a joint venture.

Share of profit from associates and joint ventures increased by US$212m, driven by higher profits from BoCom and Industrial Bank which reflected loan growth and higher fee income, partly offset by increased operating expenses and loan impairment charges. The contribution from Ping An reduced due to market valuation losses on equity securities held by their insurance business, which reflected volatile domestic equity markets, partly offset by increased income from the banking business, Ping An Bank. The disposal of Ping An and the dilution of our holding in Industrial Bank, following its issue of additional share capital to third parties on 7 January 2013, are expected to have a significant impact on future profits in the region.

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Reconciliation of reported and constant currency profit before tax   Rest of Asia-Pacific

	2011 as reported US$m	Currency translation adjustment[1] US$m	2011 at 2012 exchange rates US$m	2012 as reported US$m	Reported change[2] %	Constant currency change[2] %
Net interest income	5,102	(111)	4,991	5,391	6	8
Net fee income	2,111	(57)	2,054	2,083	(1)	1
Own credit spread[3]	2		2	(3)		
Gains on disposal of Ping An				3,012		
Other income[7]	3,498	(148)	3,350	3,101	(11)	(7)
Net operating income[4]	10,713	(316)	10,397	13,584	27	31
LICs[42]	(267)	1	(266)	(436)	(63)	(64)
Net operating income	10,446	(315)	10,131	13,148	26	30
Operating expenses	(5,806)	173	(5,633)	(5,806)		(3)
Operating profit	4,640	(142)	4,498	7,342	58	63
Income from associates[43]	2,831	63	2,894	3,106	10	7
Profit before tax	7,471	(79)	7,392	10,448	40	41

For footnotes, see page 132.

Reconciliation of reported and underlying items   Rest of Asia-Pacific

	Year ended 31 December 2012 US$m	2011 US$m	Change[2] %
Revenue[4]			
Reported	13,584	10,713	27
Currency translation adjustment[1]		(316)	
Own credit spread[3]	3	(2)	
Acquisitions, disposals and dilutions	(3,342)	(295)	
Underlying	10,245	10,100	1
LICs[42]			
Reported	(436)	(267)	(63)
Currency translation adjustment[1]		1	
Acquisitions, disposals and dilutions	(2)	4	

Underlying	(438)	(262)	(67)
Operating expenses			
Reported	(5,806)	(5,806)	
Currency translation adjustment[1]		173	
Acquisitions, disposals and dilutions	60	96	
Underlying	(5,746)	(5,537)	(4)
Underlying cost efficiency ratio	56.1%	54.8%	
Profit before tax			
Reported	10,448	7,471	40
Currency translation adjustment[1]		(79)	
Own credit spread[3]	3	(2)	
Acquisitions, disposals and dilutions	(4,048)	(1,141)	
Underlying	6,403	6,249	2

For footnotes, see page 132.

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Profit before tax and balance sheet data *Rest of Asia-Pacific*

	2013						
	Retail Banking and Wealth Management	Commercial Banking	Global Banking and Markets	Global Private Banking	Other	Inter-segment elimination[49]	Total
	US$m	US$m	US$m	US$m	US$m	US$m	US$m
Profit before tax							
Net interest income	1,718	1,374	1,907	81	223	136	5,439
Net fee income/(expense)	728	555	722	70	(16)		2,059
Trading income/(expense) excluding net interest income	99	195	704	41	(722)		317
Net interest income/(expense) on trading activities	(19)	(6)	301		(1)	(136)	139
Net trading income/(expense)[44]	80	189	1,005	41	(723)	(136)	456
Changes in fair value of long- term debt issued and related derivatives					(1)		(1)
Net income/(expense) from other financial instruments designated at fair value	59				(2)		57
Net income/(expense) from financial instruments designated at fair value	59				(3)		56
Gains less losses from financial investments	(1)		16	4	1,203		1,222
Dividend income					2		2
Net earned insurance premiums	651	185	1				837
Other operating income	145	6	85	3	2,569	(175)	2,633
Total operating income	3,380	2,309	3,736	199	3,255	(175)	12,704
Net insurance claims[50]	(584)	(142)					(726)
Net operating income[4]	2,796	2,167	3,736	199	3,255	(175)	11,978
Loan impairment charges and other credit risk provisions	(210)	(128)	(23)				(361)
Net operating income	2,586	2,039	3,713	199	3,255	(175)	11,617
Total operating expenses	(2,139)	(1,022)	(1,256)	(123)	(1,275)	175	(5,640)
Operating profit	447	1,017	2,457	76	1,980		5,977
Share of profit/(loss) in associates and joint ventures	230	1,331	247		(21)		1,787
Profit before tax	677	2,348	2,704	76	1,959		7,764
	%	%	%	%	%		%

Share of HSBC s profit before tax	**3.0**	**10.4**	**12.0**	**0.3**	**8.7**		**34.4**
Cost efficiency ratio	**76.5**	**47.2**	**33.6**	**61.8**	**39.2**		**47.1**
Balance sheet data[40]							
	US$m	**US$m**	**US$m**	**US$m**	**US$m**		**US$m**
Loans and advances to customers (net)	**46,808**	**48,757**	**48,023**	**3,976**	**233**		**147,797**
Total assets	**54,640**	**62,755**	**203,252**	**4,974**	**22,483**	**(12,167)**	**335,937**
Customer accounts	**64,921**	**44,767**	**61,065**	**11,822**	**51**		**182,626**

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Profit before tax and balance sheet data Rest of Asia-Pacific (continued)

	2012						
	Retail Banking and Wealth Management US$m	Commercial Banking US$m	Global Banking and Markets US$m	Global Private Banking US$m	Other US$m	Inter-segment elimination[49] US$m	Total US$m
Profit before tax							
Net interest income	1,787	1,396	2,156	102	137	(187)	5,391
Net fee income/(expense)	854	499	666	71	(7)		2,083
Trading income/(expense) excluding net interest income	96	188	1,002	67	(592)		761
Net interest income/(expense) on trading activities	(6)	(3)	100		14	187	292
Net trading income/(expense)[44]	90	185	1,102	67	(578)	187	1,053
Changes in fair value of long-term debt issued and related derivatives					(4)		(4)
Net income/(expense) from other financial instruments designated at fair value	109	1	(3)		3		110
Net income/(expense) from financial instruments designated at fair value	109	1	(3)		(1)		106
Gains less losses from financial investments	(1)	2	(10)		25		16
Dividend income			1		4		5
Net earned insurance premiums	569	243					812
Gain on disposal of Ping An					3,012		3,012
Other operating income	211	64	82	68	1,571	(172)	1,824
Total operating income	3,619	2,390	3,994	308	4,163	(172)	14,302
Net insurance claims[50]	(523)	(195)					(718)
Net operating income[4]	3,096	2,195	3,994	308	4,163	(172)	13,584
Loan impairment charges and other credit risk provisions	(234)	(154)	(48)				(436)
Net operating income	2,862	2,041	3,946	308	4,163	(172)	13,148
Total operating expenses	(2,238)	(993)	(1,279)	(149)	(1,319)	172	(5,806)
Operating profit	624	1,048	2,667	159	2,844		7,342
Share of profit in associates and joint ventures	893	1,554	658		1		3,106
Profit before tax	1,517	2,602	3,325	159	2,845		10,448
	%	%	%	%	%		%
Share of HSBC s profit before tax	7.3	12.6	16.1	0.8	13.8		50.6
Cost efficiency ratio	72.3	45.2	32.0	48.4	31.7		42.7
Balance sheet data[40]							
	US$m	US$m	US$m	US$m	US$m		US$m

Loans and advances to customers (net)	46,027	43,968	44,721	3,238	165		138,119
Total assets	55,509	59,123	201,774	12,142	24,534	(10,813)	342,269
Customer accounts	63,230	44,865	64,392	11,095	39		183,621

For footnotes, see page 132.

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Profit/(loss) before tax and balance sheet data Rest of Asia-Pacific (continued)

	2011						
	Retail Banking and Wealth Management US$m	Commercial Banking US$m	Global Banking and Markets US$m	Global Private Banking US$m	Other US$m	Inter-segment elimination[49] US$m	Total US$m
Profit before tax							
Net interest income	1,838	1,254	1,964	116	123	(193)	5,102
Net fee income/(expense)	904	513	621	82	(9)		2,111
Trading income/(expense) excluding net interest income	94	156	1,153	66	(90)		1,379
Net interest income/(expense) on trading activities	(2)	1	76		11	193	279
Net trading income/(expense)[44]	92	157	1,229	66	(79)	193	1,658
Changes in fair value of long- term debt issued and related derivatives					4		4
Net income/(expense) from other financial instruments designated at fair value	(38)	2	1		15		(20)
Net income/(expense) from financial instruments designated at fair value	(38)	2	1		19		(16)
Gains less losses from financial investments		2	(25)	1	(1)		(23)
Dividend income			2				2
Net earned insurance premiums	493	266					759
Other operating income	145	72	75	5	1,592	(178)	1,711
Total operating income	3,434	2,266	3,867	270	1,645	(178)	11,304
Net insurance claims[50]	(351)	(240)					(591)
Net operating income[4]	3,083	2,026	3,867	270	1,645	(178)	10,713
Loan impairment (charges)/recoveries and other credit risk provisions	(222)	10	(57)	2			(267)
Net operating income	2,861	2,036	3,810	272	1,645	(178)	10,446
Total operating expenses	(2,409)	(945)	(1,268)	(181)	(1,181)	178	(5,806)
Operating profit	452	1,091	2,542	91	464		4,640
Share of profit/(loss) in associates and joint ventures	1,189	1,155	547		(60)		2,831
Profit before tax	1,641	2,246	3,089	91	404		7,471
	%	%	%	%	%		%
Share of HSBC s profit before tax	7.5	10.3	14.1	0.4	1.9		34.2
Cost efficiency ratio	78.1	46.6	32.8	67.0	71.8		54.2

Balance sheet data[40]

	US$m	US$m	US$m	US$m	US$m		US$m
Loans and advances to customers (net)	40,970	38,404	41,114	3,190	190		123,868
Total assets	54,484	50,688	195,549	12,879	16,616	(12,400)	317,816
Customer accounts	60,831	40,423	60,855	11,872	31		174,012

For footnotes, see page 132.

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Middle East and North Africa

The network of branches of HSBC Bank Middle East Limited, together with HSBC s subsidiaries and associates, gives us the widest coverage in the region. Our associate in Saudi Arabia, The Saudi British Bank (40% owned), is the Kingdom s fifth largest bank by total assets.

	2013 US$m	2012 US$m	2011 US$m
Net interest income	**1,486**	1,470	1,432
Net fee income	**622**	595	627
Net trading income	**357**	390	482
Other income	**38**	(25)	66
Net operating income[4]	**2,503**	2,430	2,607
LICs[42]	**42**	(286)	(293)
Net operating income	**2,545**	2,144	2,314
Total operating expenses	**(1,289)**	(1,166)	(1,159)
Operating profit	**1,256**	978	1,155
Income from associates[43]	**438**	372	337
Profit before tax	**1,694**	1,350	1,492
Cost efficiency ratio	**51.5%**	48.0%	44.5%
RoRWA[36]	**2.7%**	2.2%	2.6%
Year-end staff numbers	**8,618**	8,765	8,373

Best Regional Cash Management Provider in the Middle East

(Euromoney)

Fifth consecutive year

Best Trade Bank in the Middle East

(Trade and Forfaiting Review Excellence awards 2013)

Improvement in the financial position of key customers and loan portfolios contributed to lower loan impairment charges

Approximately

US$40m

of sustainable cost savings from our

organisational effectiveness programmes

For footnotes, see page 132.

The commentary is on a constant currency basis unless stated otherwise, while tables are on a reported basis.

Economic background

Real GDP in the Middle East and North Africa grew by an estimated 4.0% in 2013, led by the Gulf Cooperation Council (GCC) and Saudi Arabia s expansionary fiscal policy and infrastructure investment programme. With oil prices steady in the US$100-110 per barrel range throughout the year, revenues were more than sufficient to fund this spending, and the region ended 2013 with both current and fiscal accounts amply in surplus. The **UAE** saw an accelerating recovery in 2013 led by real estate and services, but boosted towards the end of the year by an increasingly expansionary fiscal policy. Despite strong demand and loose fiscal policy, inflation remained very subdued across the region throughout 2013, apart from UAE real estate.

For **Egypt**, political uncertainty gave rise to a third year of sub-par growth and rising unemployment. Real GDP grew by 2.2% in the 2012/13 fiscal year, while the budget deficit widened to 14% of GDP. The country s external position improved substantially in July, following the receipt of concessionary financing from the GCC. However, while reserves and the currency stabilised, stringent exchange rate and capital controls were still in place at the end of December 2013.

Review of performance

Our operations in the Middle East and North Africa reported a profit before tax of US$1.7bn, an increase of 25% compared with 2012. On a constant currency basis, pre-tax profits increased by 29%.

Our reported results in 2013 included adverse movements of US$4m on our own debt designated at fair value resulting from tightening of credit spreads. Our reported results in 2012 included an investment loss on a subsidiary of US$85m and adverse movements of US$12m on our own debt designated at fair value resulting from tightening credit spreads, partly offset by gains recognised on acquisitions totalling US$21m. On an underlying basis, excluding the items noted above and the results of a deconsolidated subsidiary and the Private Equity business disposed of in 2012, profit before tax increased by 26%, mainly due to lower loan impairment charges and higher income from our associate, The Saudi British Bank.

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

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

	Retail Banking and Wealth Management US$m	Commercial Banking US$m	Global Banking and Markets US$m	Global Private Banking US$m	Other US$m	Total US$m
2013						
Egypt	**31**	**37**	**166**		**(29)**	**205**
Qatar	**10**	**37**	**62**			**109**
United Arab Emirates	**142**	**290**	**275**	**1**	**(72)**	**636**
Other	**(7)**	**135**	**178**			**306**
MENA (excluding Saudi Arabia)	**176**	**499**	**681**	**1**	**(101)**	**1,256**
Saudi Arabia	**82**	**146**	**188**	**15**	**7**	**438**
	258	**645**	**869**	**16**	**(94)**	**1,694**
2012						
Egypt	67	71	157		(5)	290
Qatar	9	36	84			129
United Arab Emirates	143	235	141	1	(56)	464
Other	(27)	125	29		(37)	90
MENA (excluding Saudi Arabia)	192	467	411	1	(98)	973
Saudi Arabia	60	120	170	9	18	377
	252	587	581	10	(80)	1,350
2011						
Egypt	43	55	129		(2)	225
Qatar	(4)	35	81			112
United Arab Emirates	134	240	200	(6)	7	575
Other	17	109	93			219
MENA (excluding Saudi Arabia)	190	439	503	(6)	5	1,131
Saudi Arabia	57	98	140	4	62	361
	247	537	643	(2)	67	1,492

In the UAE, we inaugurated a new strategic plan for growth with investment committed across all businesses, and with commensurate investment in the risk management functions including Regulatory and Financial Crime Compliance. In RBWM, we focused on improving our retail customer experience through the new Customer at the Heart campaign and were ranked number one in the Customer Recommendation Index for banks in the UAE. We also invested in mobile and digital technologies to enhance our Wealth Management offering and to grow our retail foreign exchange revenues.

In CMB, our fourth international trade fund for SMEs of AED1bn (US$272m) was launched to support new and existing customers with cross-border trading requirements or with aspirations to grow internationally.

In GB&M, there was a focus on cross-border connectivity and CMB collaboration, with tailored risk management solutions. We supported sovereign wealth funds and government-related entities and won several *Euromoney* awards including The Best Investment Bank in Middle East , The Best Risk Advisor in Middle East , Best Cash Management House in the Middle East and No 1 Debt House for MENA and GCC issuer bonds .

We were awarded the Best Trade Bank in the MENA region by *GTR Leaders in Trade 2013* and we enhanced Global Trade and Receivables Finance by investing in sales staff and giving priority to commodity structured trade finance and receivables finance. The level of service provided by our Payments and Cash Management business was reflected in our fifth consecutive *Euromoney* award.

In Egypt, we continued to manage risk in the uncertain political and economic environment. Surplus liquidity levels in Egyptian pounds, which arose following the introduction of foreign currency restrictions at the end of 2012, were managed through the downward re-pricing of deposits. Despite these difficult operating conditions, we continued to invest in the business, through the deployment of new automated teller machines (ATMs) and the launch of a new mobile banking application. Our RBWM business was ranked number 1 in the Customer Recommendation Index while our CMB business launched an Egypt SME Fund for EGP300m (US$44m) targeting international SME growth and trade customers.

We renewed our primary dealer licence for trading in Government of Egypt treasury bills and

Report of the Directors: Financial Review (continued)

bonds, ranking as one of the largest primary dealers in the Egyptian market.

In Oman, following the completion of the merger in June 2012 with OIB, we completed the conversion to HSBC systems of our merged operation. We made a number of improvements to our mobile banking and internet banking applications, introducing enhanced security features including the HSBC secure key for internet banking. We also upgraded our e-platform for cash management services for our corporate banking customers. HSBC Bank Oman won *Euromoney* s Best Domestic Cash Management Bank in Oman award for the second consecutive year.

In Saudi Arabia, our associate, The Saudi British Bank, won *The Banker* magazine s award as The Best Bank in Saudi Arabia, 2013 and achieved a record net profit before tax exceeding US$1bn.

In line with our commitment to drive growth and improve returns in businesses that do not meet our six filters criteria (see page 15), we entered into an agreement to sell our operation in Jordan. The transaction is expected to complete in 2014.

Net interest income rose by 4%, mainly in Egypt in GB&M, driven by higher yields and balances on available-for-sale investment portfolios and higher balances on corporate deposits as more liquid assets were held in the volatile political environment. In Oman, net interest income increased, notably in RBWM, following the merger with OIB in June 2012. The higher net interest income in the UAE from growth in GB&M in the Credit and Lending portfolio and in RBWM from the Lloyds business acquired in 2012, was more than offset by a decline in CMB, where the business was repositioned to lower risk segments.

Net fee income increased by 7%, primarily in the UAE in GB&M due to an increase in advisory mandates in Capital Financing and higher institutional equities fee income from increased deal volumes, partially offset by lower fees from reduced volumes on Global Trade and Receivables Finance products in CMB. In Egypt, net fee income increased, notably in RBWM from cards and consumer loan fees.

Net trading income decreased by 6%, notably in Egypt from lower foreign exchange revenues, reflecting the political instability, and lower Rates trading income driven by a reduction in deal volumes. The decrease in trading income also reflected the deconsolidation of a subsidiary in 2012. These factors were partly offset by CVA releases on trading positions relating to a small number of exposures in the UAE in GB&M, compared with charges in 2012.

Gains less losses from financial investments decreased by US$27m, driven by losses on the disposal of the available-for-sale debt securities in Egypt in the first half of 2013 as we adjusted our risk positions.

Other operating income increased by US$76m, due to the non-recurrence of an US$85m investment loss on a subsidiary in 2012.

A net *loan impairment release* of US$42m was recorded in 2013 compared with a charge of US$282m in 2012. There were provision releases, mainly in GB&M, for a small number of UAE related exposures, reflecting an overall improvement in the loan portfolio compared with charges in 2012. In addition, loan impairment charges declined, due to lower individually assessed loan impairments in the UAE in CMB and lower provisions in RBWM on residential mortgages following a repositioning of the book towards higher quality lending and improved property prices.

Operating expenses increased by 13%, mainly in the UAE from the Lloyds business acquired in 2012, expenses for regulatory projects, operational losses and charges from a customer redress programme in RBWM relating to fees charged on overseas credit card transactions. Expenses also increased in Egypt from changes in the interpretation of tax regulations and in Oman following the merger with OIB. These factors were partly offset by approximately US$40m of sustainable savings from our organisational effectiveness programmes.

Share of profits from associates and joint ventures increased by 18%, mainly from The Saudi British Bank. This was driven by higher revenue resulting from strong balance sheet growth, and the effective management of costs.

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Reconciliation of reported and constant currency profit before tax Middle East and North Africa

	2012 as reported US$m	Currency translation adjustment[1] US$m	2012 at 2013 exchange rates US$m	**2013 as reported US$m**	**Reported change[2] %**	**Constant currency change[2] %**
Net interest income	1,470	(43)	1,427	**1,486**	**1**	**4**
Net fee income	595	(11)	584	**622**	**5**	**7**
Net trading income	390	(9)	381	**357**	**(8)**	**(6)**
Own credit spread[3]	(12)		(12)	**(4)**	**67**	**67**
Other income from financial instruments designated at fair value				**2**		
Net expense from financial instruments designated at fair value	(12)		(12)	**(2)**	**83**	**83**
Gains less losses from financial investments	9		9	**(18)**		
Net earned insurance premiums						
Other operating income/(expense) (including dividend income)	(22)		(22)	**58**		
Total operating income	2,430	(63)	2,367	**2,503**	**3**	**6**
Net insurance claims incurred and movement in liabilities to policyholders						
Net operating income[4]	2,430	(63)	2,367	**2,503**	**3**	**6**
LICs[42]	(286)	4	(282)	**42**		
Net operating income	2,144	(59)	2,085	**2,545**	**19**	**22**
Operating expenses	(1,166)	23	(1,143)	**(1,289)**	**(11)**	**(13)**
Operating profit	978	(36)	942	**1,256**	**28**	**33**
Income from associates[43]	372		372	**438**	**18**	**18**
Profit before tax	1,350	(36)	1,314	**1,694**	**25**	**29**

For footnotes, see page 132.

Reconciliation of reported and underlying items Middle East and North Africa

	Year ended 31 December **2013** US$m	2012 US$m	Change[2] %
Net interest income			
Reported	**1,486**	1,470	1
Currency translation adjustment[1]		(43)	
Acquisitions, disposals and dilutions		(8)	
Underlying	**1,486**	1,419	5

Other operating income			
Reported	**49**	(27)	
Currency translation adjustment[1]			
Acquisitions, disposals and dilutions		64	
Underlying	**49**	37	32
Revenue[4]			
Reported	**2,503**	2,430	3
Currency translation adjustment[1]		(63)	
Own credit spread[3]	**4**	12	
Acquisitions, disposals and dilutions		3	
Underlying	**2,507**	2,382	5

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

	Year ended 31 December		
	2013	2012	Change[2]
	US$m	US$m	%
LICs[42]			
Reported	**42**	(286)	
Currency translation adjustment[1]		4	
Acquisitions, disposals and dilutions			
Underlying	**42**	(282)	
Operating expenses			
Reported	**(1,289)**	(1,166)	(11)
Currency translation adjustment[1]		23	
Acquisitions, disposals and dilutions		15	
Underlying	**(1,289)**	(1,128)	(14)
Underlying cost efficiency ratio	**51.4%**	47.4%	
Profit before tax			
Reported	**1,694**	1,350	25
Currency translation adjustment[1]		(36)	
Own credit spread[3]	**4**	12	
Acquisitions, disposals and dilutions		18	
Underlying	**1,698**	1,344	26

For footnotes, see page 132.

Report of the Directors: Financial Review (continued)

2012 compared with 2011

Economic background

Real GDP in the **Middle East and North Africa** region grew by an estimated 4.5% in 2012. However, this weighted aggregate figure masked a wide disparity between oil producers (5.1%) and non-oil producers (2.9%). For the Gulf Cooperation Council s top performers, energy output volumes remained high and revenues rose, fuelling government spending-driven domestic demand which fed through to a stronger non-oil private sector performance, job creation and a recovery in bank lending. **Saudi Arabia** (which recorded growth of nearly 7% in 2012), **Qatar** (6%) and **Oman** (5%) fell into this category. In the **UAE**, more muted fiscal and monetary stimuli meant overall growth was slower, but Dubai s export-oriented service sector recorded a good recovery in 2012, and Abu Dhabi picked up in the second half of the year. Despite the strong growth, inflation remained low across the Gulf region.

In **Egypt**, growth remained weak, held back by ongoing political uncertainty which continued to weigh on domestic and foreign investment and consumption. Pressure on public finances and Egypt s external accounts remained pronounced, with the Egyptian pound weakening significantly. Elsewhere in the oil importing parts of the region, the pressures were not as great, but in Lebanon, Jordan, Morocco and Tunisia, growth fell and their external balances deteriorated, with the latter three, following a significant worsening of public finances, approaching the International Monetary Fund for assistance by the end of the year.

Review of performance

Our operations in the Middle East and North Africa reported a profit before tax of US$1.4bn, a decrease of 10% compared with 2011. On a constant currency basis, pre-tax profits decreased by 9%.

Our reported results in 2012 included an investment loss on a subsidiary of US$85m and adverse movements of US$12m on our own debt designated at fair value resulting from tightening credit spreads, partly offset by gains recognised on acquisitions totalling US$21m. Reported profits in 2011 included a dilution gain of US$27m on our holding in HSBC Saudi Arabia Ltd following its merger with SABB Securities Ltd and a loss of US$7m relating to the disposal of our Private Equity business. On an underlying basis, excluding the items noted above, profit before tax decreased by 3% as a result of a small number of significant impairments on GB&M exposures.

During 2012, we focused on simplifying our operations in the Middle East and North Africa by disposing of non-strategic businesses and continuing to improve our organisational efficiency while investing in strategic acquisitions.

We made significant progress in integrating our operations in Oman with OIB following the merger in June 2012. The combined entity, HSBC Bank Oman S.A.O.G., of which we own 51%, is now the third largest bank in the Sultanate. We also completed the acquisition of the onshore retail and commercial banking business of Lloyds Banking Group in the UAE in the fourth quarter of 2012. Lloyds strong presence in expatriate retail banking and commercial banking was a good strategic fit with our position as the leading international bank in the UAE. We also completed the disposal of 80.1% of our Private Equity business in December. We announced in September our agreement to sell our operations in Pakistan and, in October, the restructuring of our Amanah business in the region outside Saudi Arabia.

We remained focused on our priority markets, delivering profit growth in Egypt and Saudi Arabia. The strong performance in Egypt was driven by robust deposit growth in RBWM which led to higher net interest income. We also achieved growth in profits from our associates, mainly The Saudi British Bank, which won the *Euromoney* award for excellence as The Best Bank in Saudi Arabia and The Best Debt House in Saudi Arabia . Although profit before tax declined in the UAE as a result of the impairments in GB&M noted above, it remains a priority market for HSBC and the economy continued to improve in 2012.

Delivery of sustainable cost savings remained a priority for 2012. Our organisational effectiveness initiatives included streamlining procedures by delayering our management structure and transferring additional operational processes to our global service centres. We realised about US$70m in sustainable savings from our organisational effectiveness programmes.

In RBWM, we remained focused on growing Wealth Management revenues. We entered into a strategic alliance with Zurich Life International (Zurich) in 2012 to provide wealth and general insurance products to our customers in the region. Our focus on foreign exchange resulted in increased transaction volumes, which provided us with higher Wealth Management revenues for 2012. In addition, we enhanced our internet banking capabilities in the UAE to provide improved security and rolled out our

Report of the Directors: Financial Review (continued)

digital solution for mobile banking in the region to allow customers greater accessibility.

In CMB, we continued to support internationally oriented SMEs. This was evidenced by the launch of our third SME fund in the UAE of AED1bn (US$272m), targeted at international trade customers. We continued to invest in the Global Trade and Receivables Finance client service and business development teams, and enhanced our Receivables Finance products across the region. We endeavoured to strengthen this position by holding mainland China and Turkey events to focus on these emerging trade routes.

Our Payments and Cash Management business continued to record strong revenue growth, and was named The Best Cash Management House in the Middle East 2012 in the *Euromoney* awards for excellence for the fourth consecutive year.

In GB&M, we continued to focus on South-South connectivity. We leveraged our global expertise to provide access to Asian investors for issuers in the region with funding requirements with our dedicated coverage teams on our mainland China, South Korea and India desks in the UAE and Saudi Arabia. We also completed a significant number of bond issuances, reflecting the continuing investor appetite for the region s debt. We won several *Euromoney* awards for excellence including The Best Debt House in the Middle East and The Best Flow House in the Middle East . GB&M also won *Global Investor s* The Best Domestic Custodian .

The following commentary is on a constant currency basis.

Net interest income rose by 3%, driven by higher average deposit balances in RBWM, primarily savings accounts in Egypt, reflecting the competitive pricing introduced at the beginning of the year. Despite this, we benefited from wider spreads as interest rates rose in Egypt. Net interest income in CMB was in line with 2011 as higher income resulting from the merger with OIB was offset by competitive asset pricing across most of the region.

Net fee income decreased by 4% due to a decline in credit and lending, Securities Services and advisory fees in GB&M, which were affected by lower levels of deal activity and the challenging political and economic environment. Fees also declined in RBWM due to higher reward scheme charges in the UAE following revisions to the agreement with our partner aimed at improving card utilisation, partly offset by higher insurance revenues

as a result of the strategic alliance with Zurich. The decline in fees was also attributable to our exit from domestic private banking in the UAE. These factors were partly offset by higher trade import fees in CMB in Algeria, Oman and Jordan driven by higher volumes from targeted sales activity.

Net trading income decreased by 18%, mainly due to unfavourable credit valuation adjustments on trading positions relating to a small number of exposures in GB&M. We also reported adverse fair value movements on certain economic hedges as well as on structured liabilities as credit spreads tightened. This was partly offset by higher revaluation gains on equity holdings in Principal Investments.

Gains less losses from financial investments increased by US$17m, driven by the non-recurrence of impairments on two available-for-sale equity securities in 2011, together with gains on the disposal of available-for-sale equity and debt securities in 2012.

Other operating income decreased by US$89m, driven by the US$85m investment loss on a subsidiary.

Loan impairment charges and other credit risk provisions decreased by US$6m. Lower impairments in RBWM attributable to an improvement in delinquency rates reflected the repositioning of the book towards higher quality lending in previous years. In addition, CMB recorded a modest reduction in loan impairment charges as higher customer recoveries were largely offset by individually assessed impairments. These were partly offset by significant loan impairment charges recorded for a small number of large exposures in GB&M.

Operating expenses increased by 1% as a result of employee and legal costs relating to the merger of our Omani operations with OIB and the acquisition of the onshore retail and commercial banking business of Lloyds Banking Group in the UAE. This was partially offset by the benefit arising from sustainable cost saving initiatives implemented in 2011 and throughout 2012. Excluding the effect of the two acquisitions, we reduced both our employee numbers and our cost base.

Share of profits from associates and joint ventures increased by 10%, mainly from The Saudi British Bank. This was driven by higher revenue resulting from strong balance sheet growth, together with lower costs derived from effective control and monitoring.

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Reconciliation of reported and constant currency profit before tax Middle East and North Africa

	2011 as reported	Currency translation adjustment[1]	2011 at 2012 exchange rates	2012 as reported	Reported change[2]	Constant currency change[2]
	US$m	US$m	US$m	US$m	%	%
Net interest income	1,432	(9)	1,423	1,470	3	3
Net fee income	627	(4)	623	595	(5)	(4)
Own credit spread[3]	14		14	(12)		
Other income[7]	534	(1)	533	377	(29)	(29)
Net operating income[4]	2,607	(14)	2,593	2,430	(7)	(6)
LICs[42]	(293)	1	(292)	(286)	2	2
Net operating income	2,314	(13)	2,301	2,144	(7)	(7)
Operating expenses	(1,159)	6	(1,153)	(1,166)	(1)	(1)
Operating profit	1,155	(7)	1,148	978	(15)	(15)
Income from associates[43]	337		337	372	10	10
Profit before tax	1,492	(7)	1,485	1,350	(10)	(9)

For footnotes, see page 132.

Reconciliation of reported and underlying items Middle East and North Africa

	Year ended 31 December 2012	2011	Change[2]
	US$m	US$m	%
Revenue[4]			
Reported	2,430	2,607	(7)
Currency translation adjustment[1]		(14)	
Own credit spread[3]	12	(14)	
Acquisitions, disposals and dilutions	3	(79)	
Underlying	2,445	2,500	(2)
LICs[42]			
Reported	(286)	(293)	2
Currency translation adjustment[1]		1	
Acquisitions, disposals and dilutions			
Underlying	(286)	(292)	2

Operating expenses			
Reported	(1,166)	(1,159)	(1)
Currency translation adjustment[1]		6	
Acquisitions, disposals and dilutions	15	25	
Underlying	(1,151)	(1,128)	(2)
Underlying cost efficiency ratio	47.1%	45.1%	
Profit before tax			
Reported	1,350	1,492	(10)
Currency translation adjustment[1]		(7)	
Own credit spread[3]	12	(14)	
Acquisitions, disposals and dilutions	18	(54)	
Underlying	1,380	1,417	(3)

For footnotes, see page 132.

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Profit/(loss) before tax and balance sheet data Middle East and North Africa

	2013						
	Retail Banking and Wealth Management US$m	Commercial Banking US$m	Global Banking and Markets US$m	Global Private Banking US$m	Other US$m	Inter-segment elimination[49] US$m	Total US$m
Profit/(loss) before tax							
Net interest income	585	486	390		4	21	1,486
Net fee income/(expense)	161	269	197		(5)		622
Trading income excluding net interest income	59	85	220				364
Net interest income/(expense) on trading activities			14			(21)	(7)
Net trading income[44]	59	85	234			(21)	357
Net income from financial instruments designated at fair value					(2)		(2)
Gains less losses from financial investments			(18)				(18)
Dividend income			9				9
Other operating income	25	30	15		99	(120)	49
Total operating income	830	870	827		96	(120)	2,503
Net insurance claims[50]							
Net operating income[4]	830	870	827		96	(120)	2,503
Loan impairment (charges)/recoveries and other credit risk provisions	(49)	(20)	110	1			42
Net operating income	781	850	937	1	96	(120)	2,545
Total operating expenses	(606)	(350)	(256)		(197)	120	(1,289)
Operating profit/(loss)	175	500	681	1	(101)		1,256
Share of profit in associates and joint ventures	83	145	188	15	7		438
Profit/(loss) before tax	258	645	869	16	(94)		1,694
	%	%	%	%	%		%
Share of HSBC s profit before tax	1.1	2.9	3.8	0.1	(0.4)		7.5
Cost efficiency ratio	73.0	40.2	31.0		205.2		51.5
Balance sheet data[40]							
	US$m	US$m	US$m	US$m	US$m		US$m
Loans and advances to customers (net)	6,152	11,814	9,241		4		27,211
Total assets	7,016	13,776	39,302	64	3,340	(2,688)	60,810
Customer accounts	18,771	12,402	7,432	1	77		38,683

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

	2012						
	Retail Banking and Wealth Management US$m	Commercial Banking US$m	Global Banking and Markets US$m	Global Private Banking US$m	Other US$m	Inter-segment elimination[49] US$m	Total US$m
Profit/(loss) before tax							
Net interest income	597	492	367	1	42	(29)	1,470
Net fee income/(expense)	164	279	160	1	(9)		595
Trading income excluding net interest income	68	94	208		3		373
Net interest income/(expense) on trading activities		2	30		(44)	29	17
Net trading income[44]	68	96	238		(41)	29	390
Net income from financial instruments designated at fair value					(12)		(12)
Gains less losses from financial investments			9				9
Dividend income			5				5
Other operating income/(expense)	(16)	21	14	1	47	(94)	(27)
Total operating income	813	888	793	3	27	(94)	2,430
Net insurance claims[50]							
Net operating income[4]	813	888	793	3	27	(94)	2,430
Loan impairment charges and other credit risk provisions	(55)	(110)	(119)	(2)			(286)
Net operating income	758	778	674	1	27	(94)	2,144
Total operating expenses	(561)	(311)	(264)		(124)	94	(1,166)
Operating profit/(loss)	197	467	410	1	(97)		978
Share of profit in associates and joint ventures	55	120	171	9	17		372
Profit/(loss) before tax	252	587	581	10	(80)		1,350
	%	%	%	%	%		%
Share of HSBC s profit before tax	1.2	2.8	2.8		(0.3)		6.5
Cost efficiency ratio	69.0	35.0	33.3		459.3		48.0
Balance sheet data[40]							
	US$m	US$m	US$m	US$m	US$m		US$m
Loans and advances to customers (net)	5,828	13,559	8,699				28,086
Total assets	6,562	15,651	36,582	50	6,840	(3,080)	62,605
Customer accounts	19,802	12,826	6,880	3	72		39,583

For footnotes, see page 132.

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Profit/(loss) before tax and balance sheet data   Middle East and North Africa (continued)

	2011						
	Retail Banking and Wealth Management US$m	Commercial Banking US$m	Global Banking and Markets US$m	Global Private Banking US$m	Other US$m	Inter-segment elimination[49] US$m	Total US$m
Profit/(loss) before tax							
Net interest income	589	496	371	2	2	(28)	1,432
Net fee income/(expense)	173	271	173	13	(3)		627
Trading income/(expense) excluding net interest income	62	95	266	1	(1)		423
Net interest income/(expense) on trading activities			32		(1)	28	59
Net trading income/(expense)[44]	62	95	298	1	(2)	28	482
Net income from financial instruments designated at fair value					10		10
Gains less losses from financial investments	1	1	(7)		(3)		(8)
Dividend income	1	1	3				5
Other operating income/(expense)	22	11	11	(1)	124	(108)	59
Total operating income	848	875	849	15	128	(108)	2,607
Net insurance claims[50]							
Net operating income[4]	848	875	849	15	128	(108)	2,607
Loan impairment charges and other credit risk provisions	(126)	(116)	(51)				(293)
Net operating income	722	759	798	15	128	(108)	2,314
Total operating expenses	(535)	(320)	(295)	(21)	(96)	108	(1,159)
Operating profit/(loss)	187	439	503	(6)	32		1,155
Share of profit in associates and joint ventures	60	98	140	4	35		337
Profit/(loss) before tax	247	537	643	(2)	67		1,492
	%	%	%	%	%		%
Share of HSBC s profit before tax	1.1	2.5	2.9		0.3		6.8
Cost efficiency ratio	63.1	36.6	34.7	140.0	75.0		44.5
Balance sheet data[40]							
	US$m	US$m	US$m	US$m	US$m		US$m
Loans and advances to customers (net)	4,921	12,446	8,479	26	3		25,875
Total assets	6,549	14,556	34,676	72	4,792	(3,181)	57,464
Customer accounts	18,549	10,943	6,703	114	113		36,422

For footnotes, see page 132.

Report of the Directors: Financial Review (continued)

North America

Our North American businesses are located in the US, Canada and Bermuda. Operations in the US are primarily conducted through HSBC Bank USA, N.A., and HSBC Finance, a national consumer finance company. HSBC Markets (USA) Inc. is the intermediate holding company of, *inter alia*, HSBC Securities (USA) Inc. HSBC Bank Canada and HSBC Bank Bermuda operate in their respective countries.

	2013 US$m	2012 US$m	2011 US$m
Net interest income	**5,742**	8,117	11,480
Net fee income	**2,143**	2,513	3,308
Net trading income/(expense)	**948**	507	(362)
Gains on disposals of US branch network and cards business		4,012	
Other income/(expense)	**(30)**	(456)	1,574
Net operating income[4]	**8,803**	14,693	16,000
LICs[42]	**(1,197)**	(3,457)	(7,016)
Net operating income	**7,606**	11,236	8,984
Total operating expenses	**(6,416)**	(8,940)	(8,919)
Operating profit	**1,190**	2,296	65
Income from associates[43]	**31**	3	35
Profit before tax	**1,221**	2,299	100
Cost efficiency ratio	**72.9**	60.8%	55.7%
RoRWA[36]	**0.5%**	0.8%	
Year-end staff numbers	**20,871**	22,443	30,981

14%

growth in revenues from collaboration

between CMB and GB&M

Completed sales:

US$5.7bn **of real estate secured loans;**

US$3.7bn **non-real estate**

personal loan portfolio; and

US$1.6bn **US insurance business**

Best Regional Cash Manager

in North America

(Euromoney Awards for Excellence 2013)

For footnotes, see page 132.

The commentary is on a constant currency basis unless stated otherwise, while tables are on a reported basis.

Economic background

In the **US**, real GDP rose by 1.9% in 2013, after 2.8% growth in 2012. Both consumer spending and business fixed investment grew at a moderate pace in 2013. Residential investment rose by 12.1% in 2013, following 12.9% growth in 2012. Sales of new and existing homes increased in 2013, and average national home prices rose over the course of the year. Export growth slowed to 2.8% in 2013 from 3.5% in 2012. Budgetary caps on federal spending contributed to a 5.1% decline in federal government expenditure in 2013, in real terms. State and local government expenditure also contracted, though by less than in 2012. The unemployment rate fell during the year reaching 6.7% in December although, in part, this reflected the long-term unemployed leaving the labour market rather than job creation. Both headline and core CPI inflation moderated in 2013 as subdued growth in hourly wages continued to constrain labour costs. A lack of consensus between the main political parties about how best to reduce the US fiscal deficit led to a government shutdown on 1 October. An agreement was finally reached on 16 October which allowed the US debt ceiling to be raised and ended the shutdown. The Federal Reserve Board continued to pursue a highly accommodative monetary policy in 2013, keeping the Federal Funds rate in a zero to 0.25% range. It continued with monthly purchases of longer-term treasury securities and agency mortgage-backed securities but announced in December that it would begin to taper asset purchases from January 2014.

The **Canadian** economy grew by 1.6% during the first three quarters of 2013, down from 1.9% in the comparable period in 2012. Led by auto sales, consumer spending rose by 1.8%, contributing 1.2 percentage points to the expansion in 2013. Exports grew by 1.0% in 2013, which was well below the 3% export growth in 2012. Housing starts fell by 14% in 2013 though the level of activity improved during the year after a very weak start. The annual rate of CPI inflation remained close to 1% throughout the year, well below the Bank of Canada s 2% inflation target. The Bank of Canada s policy rate has remained at 1% since September 2010.

Review of performance

Our operations in North America reported a profit before tax of US$1.2bn in 2013, compared with US$2.3bn in 2012 on both a reported and constant currency basis.

Reported profits in both years included gains and losses on disposal of businesses not aligned to our long-term strategy, notably gains in the US of

Report of the Directors: Financial Review (continued)

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

	Retail Banking and Wealth Management US$m	Commercial Banking US$m	Global Banking and Markets US$m	Global Private Banking US$m	Other US$m	Total US$m
2013						
US	**(358)**	**296**	**633**	**53**	**(350)**	**274**
Canada	**131**	**506**	**280**		**(3)**	**914**
Bermuda	**20**	**(16)**	**16**	**4**	**9**	**33**
	(207)	**786**	**929**	**57**	**(344)**	**1,221**
2012						
US	2,746	637	661	72	(2,901)	1,215
Canada	207	577	314	(1)	(16)	1,081
Bermuda	42	(15)	(18)	1	(7)	3
	2,995	1,199	957	72	(2,924)	2,299
2011						
US	(2,861)	431	567	83	782	(998)
Canada	147	545	265		8	965
Bermuda	49	26	43	7	9	134
Other					(1)	(1)
	(2,665)	1,002	875	90	798	100

US$3.1bn and US$864m following the sales of the CRS business and 195 non-strategic retail branches, respectively, in 2012.

On an underlying basis, pre-tax profit was US$1.6bn in 2013 compared with a pre-tax loss of US$1.5bn in 2012. This was mainly due to a decline in loan impairment charges in 2013 in the US, primarily in the CML portfolio, and a reduction in operating expenses, as 2012 included a US$1.5bn expense as part of the settlement of investigations into inadequate compliance with AML laws in the past. These were partly offset by losses on certain portfolio disposals described further below.

Underlying profit before tax in Canada reduced due to the closure to new business in 2012 of the Canadian consumer finance company and lower revenues, reflecting spread compression due to the low interest rate environment and competitive market. These were partly offset by lower costs following cost control and sustainable savings from organisational effectiveness initiatives.

We continued to make progress in our strategy to accelerate the run-off and sales of our CML portfolio, and simplify operations. We completed the sale of the CML non-real estate personal loan portfolio with an unpaid principal balance of US$3.7bn on 1 April 2013 and recognised a loss on sale of US$271m. We completed the sales of several tranches of real estate secured accounts with an aggregate unpaid principal balance of US$5.7bn during 2013 and recognised a cumulative loss on sale of US$153m. Gross lending balances in the CML portfolio, including loans held for sale, at 31 December 2013 were US$30.4bn, a decline of US$12.3bn from 31 December 2012.

We identified real estate secured loan balances with unpaid principal of US$3.5bn that we plan to actively market in multiple transactions over the next 15 months. The carrying value of these loans was approximately US$230m greater than their estimated fair value at 31 December 2013.

In the US, we made progress on re-engineering our processes, such as account opening and customer information management, creating standardisation and alignment with our target business and operating models and a simpler relationship experience for our customers. The US has been at the forefront of foundational work to implement Global Standards. We also launched a US$1bn SME fund in CMB to support those businesses that trade or aspire to trade internationally.

In Canada, we continued to deliver internationally oriented organic business growth and streamlined processes and procedures. In CMB, we focused on positioning ourselves as the leading international trade and business bank, and deployed several new Global Trade products to assist international clients with working capital management. In GB&M, we launched Project and Export Financing and had a strong pipeline of business going into 2014. In RBWM, we continued to work on increasing the Premier customer base, resulting in 3% growth.

Report of the Directors: Financial Review (continued)

Net interest income decreased by 29% to US$5.7bn, primarily due to the sale of the CRS business and retail branches, lower average lending balances from the continued run-off of the CML portfolio and other portfolio disposals during the year, lower reinvestment rates in Balance Sheet Management and the closure of the Canada consumer finance company to new business in 2012.

Net fee income decreased by 14% to US$2.1bn, primarily due to the sale of the CRS business and the retail branches in 2012 and the expiry of the majority of the Transition Servicing Agreements with the buyer of the CRS business. This was partly offset by favourable adjustments to mortgage servicing rights valuations as a result of interest rate increases in 2013.

Net trading income was US$948m, an increase of 89%, primarily due to favourable fair value movements on non-qualifying hedges in HSBC Finance of US$315m in 2013 due to a rise in interest rates (compared with adverse movements of US$227m in 2012) and lower provisions for mortgage loan repurchase obligations related to loans previously sold. The increase was partly offset by a loss of US$199m arising from the early termination of qualifying accounting hedges in 2013 as a result of expected changes in funding.

Net trading income increased in GB&M as a result of favourable fair value movements on structured liabilities, in addition to higher Credit trading revenue from revaluation gains on securities, monoline reserve releases in the legacy portfolio and reduced losses from credit default swaps. Net trading income also benefited from the performance of economic hedges used to manage interest rate risk, which was positively affected by favourable interest rate movements. This was partly offset by lower Foreign Exchange revenue as a result of reduced trading volumes, and lower Rates trading revenue due to a decline in trading activities.

Net expense from financial instruments designated at fair value was US$288m compared with US$1.2bn in 2012. The increase was due to lower adverse fair value movements on our own debt designated at fair value as credit spreads tightened to a lesser extent in 2013 than in 2012.

Gains less losses from financial investments increased by 18% as Balance Sheet Management recognised higher gains on sales of available-for-sale debt securities as a result of the continued re-balancing of the portfolio for risk management purposes in the low interest rate environment.

Net earned insurance premiums decreased by US$159m due to the sale of our US insurance business. The reduction in net earned insurance premiums resulted in a corresponding decrease in *Net insurance claims incurred and movement in liabilities to policyholders*.

Other operating expense was US$108m in 2013 compared with income of US$408m in 2012. This was primarily due to the loss of US$424m on the sales of the CML non-real estate personal loan portfolio and several tranches of real estate secured loans. In addition, the decrease reflected the sale of our US insurance business and the non-recurrence of the gain on sale of the full service retail brokerage business in Canada in 2012.

LICs decreased by US$2.3bn to US$1.2bn, mainly in the US due in part to improvements in housing market conditions. In addition, the decrease reflected lower lending balances from continued run-off and loan sales, and reduced levels of new impaired loans and delinquency in the CML portfolio. US$322m of the decline in loan impairment charges was due to the sale of the CRS business in 2012. These factors were partly offset by an increase of US$130m relating to a rise in the estimated average period of time from a loss event occurring to writing off real estate loans to 12 months (previously a period of 10 months was used). In CMB, loan impairment charges increased by US$77m, reflecting higher collectively assessed charges in the US as a result of increased lending balances in key growth markets and higher individually assessed impairments on a small number of exposures mainly in Canada.

Operating expenses were US$2.5bn, 28% lower than in 2012, primarily due to the non-recurrence of a US$1.5bn settlement of investigations into inadequate compliance with AML laws in the past, lower average staff numbers and costs following business disposals in the US and Canada, and a reduction in litigation provisions and consultancy expenses in relation to US mortgage foreclosure servicing matters. Resources working on the independent foreclosure review were no longer required following the February 2013 Independent Foreclosure Review Settlement Agreement. We also achieved over US$330m of sustainable cost savings, primarily reflecting organisational effectiveness initiatives.

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Reconciliation of reported and constant currency profit before tax North America

	2012 as reported	Currency translation adjustment[1]	2012 at 2013 exchange rates	2013 as reported	Reported change[2]	Constant currency change[2]
	US$m	US$m	US$m	US$m	%	%
Net interest income	8,117	(42)	8,075	**5,742**	**(29)**	**(29)**
Net fee income	2,513	(18)	2,495	**2,143**	**(15)**	**(14)**
Net trading income	507	(6)	501	**948**	**87**	**89**
Own credit spread[3]	(1,090)		(1,090)	**(226)**	**79**	**79**
Other expense from financial instruments designated at fair value	(129)		(129)	**(62)**	**52**	**52**
Net income/(expense) from financial instruments designated at fair value	(1,219)		(1,219)	**(288)**	**76**	**76**
Gains on disposal of US branch network and US cards business	4,012		4,012		**(100)**	**(100)**
Gains less losses from financial investments	251	(1)	250	**294**	**17**	**18**
Net earned insurance premiums	193		193	**34**	**(82)**	**(82)**
Other operating income/(expense)(including dividend income)	467	3	470	**(31)**		
Total operating income	14,841	(64)	14,777	**8,842**	**(40)**	**(40)**
Net insurance claims incurred and movement in liabilities to policyholders	(148)		(148)	**(39)**	**74**	**74**
Net operating income[4]	14,693	(64)	14,629	**8,803**	**(40)**	**(40)**
LICs[42]	(3,457)	6	(3,451)	**(1,197)**	**65**	**65**
Net operating income	11,236	(58)	11,178	**7,606**	**(32)**	**(32)**
Operating expenses	(8,940)	30	(8,910)	**(6,416)**	**28**	**28**
Operating profit	2,296	(28)	2,268	**1,190**	**(48)**	**(48)**
Income from associates[43]	3		3	**31**	**933**	**933**
Profit before tax	2,299	(28)	2,271	**1,221**	**(47)**	**(46)**

For footnotes, see page 132.

Reconciliation of reported and underlying items North America

	Year ended 31 December		
	2013	2012	Change[2]
	US$m	US$m	%
Net interest income			
Reported	**5,742**	8,117	(29)
Currency translation adjustment[1]		(42)	
Acquisitions, disposals and dilutions	**(14)**	(1,433)	

Underlying	**5,728**	6,642	(14)
Other operating income/(expense)			
Reported	**(108)**	406	
Currency translation adjustment[1]		3	
Acquisitions, disposals and dilutions	**97**	(134)	
Underlying	**(11)**	275	
Revenue[4]			
Reported	**8,803**	14,693	(40)
Currency translation adjustment[1]		(64)	
Own credit spread[3]	**226**	1,090	
Acquisitions, disposals and dilutions	**89**	(5,982)	
Underlying	**9,118**	9,737	(6)

Report of the Directors: Financial Review (continued)

	Year ended 31 December		
	2013	2012	Change[2]
	US$m	US$m	%
LICs[42]			
Reported	**(1,197)**	(3,457)	65
Currency translation adjustment[1]		6	
Acquisitions, disposals and dilutions		325	
Underlying	**(1,197)**	(3,126)	62
Operating expenses			
Reported	**(6,416)**	(8,940)	28
Currency translation adjustment[1]		30	
Acquisitions, disposals and dilutions	**14**	796	
Underlying	**(6,402)**	(8,114)	21
Underlying cost efficiency ratio	**70.2%**	83.3%	
Profit/(loss) before tax			
Reported	**1,221**	2,299	(47)
Currency translation adjustment[1]		(28)	
Own credit spread[3]	**226**	1,090	
Acquisitions, disposals and dilutions	**103**	(4,861)	
Underlying	**1,550**	(1,500)	

For footnotes, see page 132.

Report of the Directors: Financial Review (continued)

2012 compared with 2011

Economic background

In the **US**, real GDP expanded by 2.2% in 2012, following 1.8% growth in 2011. Consumer spending increased at a moderate pace as households continued to pay down debt and rebuild wealth. The housing market improved in 2012. Residential investment rose by 11.9%, climbing from a multi-decade low in 2011. Sales of new and existing homes also increased, and house prices rose modestly during the year. The growth in fixed investment by business faltered in the middle of 2012, evidenced by a slowdown in capital equipment orders, but began to recover towards the end of the year. Export growth slowed to 3.2% in 2012, about half the growth recorded in 2011. Fiscal consolidation continued to hold back the economy. Budgetary caps on spending contributed to a 2.2% decline in federal government expenditure in 2012, in real terms. State and local government expenditure also continued to contract, though the severity of the cutbacks diminished compared with 2011.

Inflation was generally subdued in 2012. Headline and core CPI inflation for the year were each recorded at 2.1%. High unemployment and low wage growth continued to hold back labour costs. In addition, prices for goods imported into the US experienced very little inflation in 2012. The Federal Reserve continued to pursue a highly supportive monetary policy. At meetings in January, September, and December, the Federal Open Market Committee adjusted its forward guidance for an exceptionally low federal funds rate and agreed on open-ended purchases of longer-term securities in an effort to maintain downward pressure on interest rates, support mortgage markets and help make broader financial conditions more accommodating.

In **Canada**, GDP growth slowed in 2012 to 2.0% from 2.6% in 2011. The slowdown in economic activity was particularly notable in the second half of the year. One factor contributing to the slowdown, which took effect in July 2012, was the introduction of measures by the federal government to cool the housing market by tightening mortgage lending conditions. House prices, home sales and housing starts declined after those initiatives came into force. In addition, exports fell sharply with the deceleration in global manufacturing activity and global trade, and temporary disruptions in energy production in Eastern Canada and capacity constraints on Western Canada pipelines. An uncertain US economic outlook together with weakness in key Canadian commodity prices and a sharp decline in corporate

performance weighed on business investment. Headline CPI inflation fell steadily through the year to 1.5%, from 2.9% in 2011. Though the Bank of Canada slightly tightened monetary policy early in 2012, the economic slowdown and the decline in the rate of CPI inflation led the Bank to leave rates on hold throughout the year.

Review of performance

Our operations in North America reported a profit before tax of US$2.3bn in 2012, compared with US$100m in 2011. Our reported profits included gains in the US of US$3.1bn and US$864m on completion of the sale of the Card and Retail Services business in May 2012 and the 195 non-strategic retail branches in May and August 2012, respectively. Also included in our reported profits was US$618m relating to profit before tax in Card and Retail Services prior to the disposal (2011: US$2.1bn). In addition, we recorded a gain of US$83m from the sale of the full service retail brokerage business in Canada. We also recognised US$1.2bn of adverse movements on our own debt designated at fair value resulting from tightening in credit spreads, compared with favourable movements of US$964m in 2011.

On an underlying basis, our pre-tax loss of US$1.5bn in 2012 compared with a pre-tax loss of US$3.1bn in 2011. This was due to lower loan impairment charges, primarily in CML, reflecting a decline in lending balances as the portfolio continued to run off, lower delinquency levels, and higher revenue mainly driven by lower adverse movements on non-qualifying hedges in HSBC Finance. This was partly offset by higher operating expenses due to fines and penalties paid of US$1.5bn by HNAH and its subsidiaries as part of the settlement of investigations into inadequate compliance with anti-money laundering laws in the past.

Underlying profit before tax in Canada rose, as revenues benefited from an increase in fees from commercial lending activities and collaboration with GB&M, higher Rates revenue due to increased trading volumes, and higher revenues in Balance Sheet Management reflecting an increase in gains on sales of available-for-sale assets. These results were partly offset by lower net interest income due to the closure of the Canadian consumer finance company to new business, spread compression from strong competition and the prolonged low interest rate environment. Our operations in Bermuda reported a significantly reduced profit before tax, primarily due to higher loan impairment charges on a small number of exposures in GB&M and CMB.

Report of the Directors: Financial Review (continued)

We made significant progress in disposing of businesses not aligned with our long-term strategy. On completing the sale of our US Card and Retail Services business, we transferred over 5,000 employees and certain real estate facilities to the purchaser. In addition, we entered into a transition services agreement to support some of the account servicing operations until all systems, processes and equipment are integrated into the purchaser s existing infrastructure. We also completed the sale of the retail branches, principally in upstate New York, recognising gains of US$586m in RBWM and US$278m in CMB.

In Canada, we completed the sale of the full service retail brokerage business. We also announced the closure of our consumer finance business, which had net customer loan balances of US$1.5bn at 31 December 2012, and ceased the origination of loans as this business did not fit with our core strategy.

We continued to manage the run-off of lending balances in our CML portfolio and, in the third quarter of 2012, we reclassified non-real estate personal loan balances of US$3.7bn, net of impairment allowances, from our CML portfolio to Assets held for sale as we actively marketed the portfolio. We also identified real estate secured loan balances, with a carrying amount of US$3.8bn, which, as part of our strategy, we have announced we plan to actively market in multiple transactions over the next two years. At 31 December 2012, the carrying value of the non-real estate and the real estate secured loans which we intend to sell was approximately US$1bn greater than their estimated fair value. We expect to recognise a loss on sale for these loans over the next few years, the actual amount of which will depend on market conditions at the time of the sales. It is expected that reduction in these loans in our CML portfolio will be capital accretive and will reduce funding requirements, accelerate the winding down of the portfolio and also alleviate some of the operational burdens, given that these loans are servicing intensive and subject to foreclosure delays.

At 31 December 2012, lending balances in CML, including loans held for sale, were US$43bn, a decline of 14% from December 2011, of which 8% was attributable to the balances written off.

We incurred costs of US$221m in 2012 (2011: US$235m) as a result of restructuring activities in the region. These costs were mainly related to the business disposals, the closure of our consumer finance operations in Canada and the continuation of

our organisational effectiveness initiatives. We also achieved approximately US$230m of additional sustainable cost savings in 2012, primarily derived from operational efficiencies.

Following the disposals noted above, we are reshaping our US operations to focus on core activities and are continuing to reposition our businesses in both the US and Canada towards international customers.

In RBWM, we continued to develop our Wealth Management capabilities across the region, targeting internationally connected customers in key US and Canadian urban centres. Our relationship-based model offers a suite of wealth services incorporating HSBC and third-party products, enabling our internationally-minded customers to invest in global markets. In the US, we launched a renminbi fixed income fund to provide investors with the opportunity to access mainland China s bond market.

In CMB, we increased the number of relationship managers and specialist sales staff in 2012 in areas with strong international connectivity, notably the West Coast, South East and Midwest of the US, leading to higher lending balances than in 2011. In Canada, we introduced the first renminbi currency account. We also established dedicated sales teams to enhance CMB s collaboration with GB&M. In addition, in CMB and GB&M, we continued to target companies with international banking requirements, leading to a rise in Global Trade and Receivables Finance revenues in both the US and Canada.

In GB&M, we continued to work on delivering integrated solutions for our customers across the region, increasing our lending to Latin American corporates. In addition, we actively reduced our legacy credit exposure in the US by exiting certain positions. We will continue to reduce the size of this portfolio as opportunities arise.

The following commentary is on a constant currency basis.

Net interest income decreased by 29% to US$8.1bn, due to the loss of income from the Card and Retail Services business together with the continued reduction of the CML portfolio in run-off. Also contributing to the decrease was a change in composition of our lending book towards higher levels of lower yielding real estate loans.

Net fee income decreased by 24% to US$2.5bn, primarily due to the sale of the Card and Retail Services business, the retail branches and the full service retail brokerage business in Canada. This

Report of the Directors: Financial Review (continued)

was partly offset by fees from the transition service agreement with the purchaser of the Card and Retail Services business and increased revenues from debt capital markets origination activity due to the strong debt issuance market.

Net trading income of US$507m was US$871m higher than in 2011, primarily due to lower adverse fair value movements on non-qualifying hedges in RBWM as long-term interest rates declined to a lesser extent than in 2011. This was partly offset by an increase from US$92m in 2011 to US$134m in 2012 of loss provisions for mortgage loan repurchase obligations related to loans previously sold.

Net trading income increased in GB&M during 2012 as a result of the improved performance of economic hedges used to manage interest rate risk, which benefited from a more stable interest rate environment. Rates revenue was higher due to increased trading volumes. In addition, credit market conditions generally reflected tighter credit spreads, which led to higher income from our credit-related products. These factors were partly offset by adverse fair value movements on structured liabilities as own credit spreads tightened, together with the closure of our bank notes business in 2011, and a reduction in foreign exchange revenue as a result of lower trading volumes in less volatile markets.

Net loss from financial instruments designated at fair value was US$1.2bn compared with net gains of US$964m in 2011. We recognised adverse fair value movements on our own debt designated at fair value as credit spreads tightened during 2012, having widened in 2011. In addition, there were adverse fair value movements from interest rate ineffectiveness in the economic hedging of our long-term debt during the year.

Gains on disposal of US branch network and cards business included a gain of US$3.1bn from the sale of the Card and Retail Services business and US$864m from the sale of 195 retail branches in upstate New York.

Other operating income increased by US$176m to US$405m, reflecting lower losses on foreclosed properties due to the reduction in foreclosure activity, less deterioration in housing prices during 2012 and, in some markets, improvements in pricing compared with 2011.

Loan impairment charges and other credit risk provisions decreased by 51% to US$3.5bn, mainly in the US, reflecting lower lending balances in CML as we continued to run off the portfolio, and lower delinquency levels. Loan impairment charges remained adversely affected by delays in expected cash flows from mortgage loans due, in part, to delays in foreclosure processing and the higher costs to obtain and realise collateral, although the effects were less pronounced than in 2011. In addition, loan impairment charges declined by US$1.3bn due to the sale of the Card and Retail Services business. These decreases were partly offset by an adjustment made following a review completed in the fourth quarter of 2012 which concluded that the estimated average period of time from current status to write-off was ten months for real estate loans (previously a period of seven months was used).

In CMB and GB&M, loan impairment charges increased, mainly in Bermuda, due to individually assessed impairments on a small number of exposures. Credit quality in Canada remained broadly unchanged.

Operating expenses increased by less than 1% to US$8.9bn, primarily due to a US$1.5bn charge for the settlement of investigations noted above. Compliance costs increased by US$307m, mainly due to investment in process enhancements and infrastructure related to anti-money laundering and Bank Secrecy Act consent orders, along with actions to address the regulatory consent orders relating to foreclosure activities. In addition, following a review of our mortgage foreclosure process, we entered into an agreement in principle with US regulators to pay into a fund and provide other customer assistance to help eligible borrowers who were active in foreclosure during 2009 and 2010 and were financially disadvantaged during the process, for which we recognised a US$104m expense in 2012. These increases were partly offset by the effect of the sale of the Card and Retail Services business and organisational effectiveness initiatives to reduce costs as we achieved approximately US$230m of additional sustainable cost savings primarily derived from operational efficiencies. Average employee numbers decreased from organisational effectiveness initiatives and business disposals. In addition, marketing costs fell and costs of holding foreclosed properties declined, while software impairment charges in 2011 did not recur.

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Reconciliation of reported and constant currency profit before tax North America

	2011 as reported US$m	Currency translation adjustment[1] US$m	2011 at 2012 exchange rates US$m	2012 as reported US$m	Reported change[2] %	Constant currency change[2] %
Net interest income	11,480	(17)	11,463	8,117	(29)	(29)
Net fee income	3,308	(7)	3,301	2,513	(24)	(24)
Own credit spread[3]	970		970	(1,090)		
Gains on disposal of US branch network and cards business				4,012		
Other income[7]	242		242	1,141	371	371
Net operating income[4]	16,000	(24)	15,976	14,693	(8)	(8)
LICs[42]	(7,016)	1	(7,015)	(3,457)	51	51
Net operating income	8,984	(23)	8,961	11,236	25	25
Operating expenses	(8,919)	9	(8,910)	(8,940)		
Operating profit	65	(14)	51	2,296		
Income from associates[43]	35		35	3	(91)	(91)
Profit before tax	100	(14)	86	2,299		

For footnotes, see page 132.

Reconciliation of reported and underlying items North America

	Year ended 31 December 2012 US$m	2011 US$m	Change[2] %
Revenue[4]			
Reported	14,693	16,000	(8)
Currency translation adjustment[1]		(24)	
Own credit spread[3]	1,090	(970)	
Acquisitions, disposals and dilutions	(5,924)	(6,001)	
Underlying	9,859	9,005	9
LICs[42]			
Reported	(3,457)	(7,016)	51
Currency translation adjustment[1]		1	
Acquisitions, disposals and dilutions	324	1,599	
Underlying	(3,133)	(5,416)	42

Operating expenses			
Reported	(8,940)	(8,919)	
Currency translation adjustment[1]		9	
Acquisitions, disposals and dilutions	712	2,210	
Underlying	(8,228)	(6,700)	(23)
Underlying cost efficiency ratio	83.5%	74.4%	
Profit/(loss) before tax			
Reported	2,299	100	
Currency translation adjustment[1]		(14)	
Own credit spread[3]	1,090	(970)	
Acquisitions, disposals and dilutions	(4,888)	(2,192)	
Underlying	(1,499)	(3,076)	51

For footnotes, see page 132.

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Profit/(loss) before tax and balance sheet data North America

	2013						
	Retail Banking and Wealth Management US$m	Commercial Banking[53] US$m	Global Banking and Markets US$m	Global Private Banking US$m	Other US$m	Inter-segment elimination[49] US$m	Total US$m
Profit/(loss) before tax							
Net interest income	3,483	1,430	582	195	89	(37)	5,742
Net fee income	605	593	741	125	79		2,143
Trading income excluding net interest income	48	40	613	19	7		727
Net interest income on trading activities	11	1	172			37	221
Net trading income[44]	59	41	785	19	7	37	948
Changes in fair value of long- term debt issued and related derivatives					(288)		(288)
Net income from other financial instruments designated at fair value							
Net expense from financial instruments designated at fair value					(288)		(288)
Gains less losses from financial investments	4		282		8		294
Dividend income	12	9	48	4	4		77
Net earned insurance premiums	34						34
Other operating income/(expense)	(454)		229	1	1,829	(1,713)	(108)
Total operating income	3,743	2,073	2,667	344	1,728	(1,713)	8,842
Net insurance claims[50]	(39)						(39)
Net operating income[4]	3,704	2,073	2,667	344	1,728	(1,713)	8,803
Loan impairment charges and other credit risk provisions	(950)	(223)	(20)	(4)			(1,197)
Net operating income	2,754	1,850	2,647	340	1,728	(1,713)	7,606
Total operating expenses	(2,960)	(1,096)	(1,718)	(283)	(2,072)	1,713	(6,416)
Operating profit/(loss)	(206)	754	929	57	(344)		1,190
Share of profit/(loss) in associates and joint ventures	(1)	32					31
Profit/(loss) before tax	(207)	786	929	57	(344)		1,221
	%	%	%	%	%		%
Share of HSBC s profit before tax	(0.9)	3.5	4.1	0.3	(1.6)		5.4
Cost efficiency ratio	79.9	52.9	64.4	82.3	119.9		72.9
Balance sheet data[40]							

	US$m	US$m	US$m	US$m	US$m		US$m
Loans and advances to customers (net)[34]	**66,192**	**37,735**	**51,746**	**5,956**			**161,629**
Total assets	**82,530**	**45,706**	**313,701**	**8,542**	**13,211**	**(31,655)**	**432,035**
Customer accounts reported in:							
customer accounts[34]	**53,600**	**49,225**	**79,799**	**13,871**			**196,495**

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

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

	2012						
	Retail Banking and Wealth Management US$m	Commercial Banking[53] US$m	Global Banking and Markets US$m	Global Private Banking US$m	Other US$m	Inter-segment elimination[49] US$m	Total US$m
Profit/(loss) before tax							
Net interest income	5,481	1,443	948	192	118	(65)	8,117
Net fee income	923	562	716	124	188		2,513
Trading income/(expense) excluding net interest income	(216)	47	466	20	16		333
Net interest income on trading activities	17	1	91			65	174
Net trading income/(expense)[44]	(199)	48	557	20	16	65	507
Changes in fair value of long- term debt issued and related derivatives					(1,219)		(1,219)
Net income from other financial instruments designated at fair value							
Net expense from financial instruments designated at fair value					(1,219)		(1,219)
Gains less losses from financial investments	27		223	(7)	8		251
Dividend income	15	11	32	3			61
Net earned insurance premiums	193						193
Gains on disposal of US branch network and cards business	3,735	277					4,012
Other operating income	173	149	191	5	1,787	(1,899)	406
Total operating income	10,348	2,490	2,667	337	898	(1,899)	14,841
Net insurance claims[50]	(148)						(148)
Net operating income[4]	10,200	2,490	2,667	337	898	(1,899)	14,693
Loan impairment (charges)/recoveries and other credit risk provisions	(3,241)	(148)	(71)	3			(3,457)
Net operating income	6,959	2,342	2,596	340	898	(1,899)	11,236
Total operating expenses	(3,966)	(1,144)	(1,639)	(268)	(3,822)	1,899	(8,940)
Operating profit/(loss)	2,993	1,198	957	72	(2,924)		2,296
Share of profit in associates and joint ventures	2	1					3
Profit/(loss) before tax	2,995	1,199	957	72	(2,924)		2,299
	%	%	%	%	%		%
Share of HSBC s profit before tax	14.5	5.8	4.6	0.3	(14.2)		11.1
Cost efficiency ratio	38.9	45.9	61.5	79.5	425.6		60.8

Balance sheet data[40]

	US$m	US$m	US$m	US$m	US$m		US$m
Loans and advances to customers (net)	76,414	36,387	22,498	5,457			140,756
Total assets	101,103	48,604	345,040	8,828	12,659	(25,987)	490,247
Customer accounts reported in:							
customer accounts	57,758	48,080	29,595	13,553	51		149,037

For footnotes, see page 132.

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

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

	2011						
	Retail Banking and Wealth Management US$m	Commercial Banking[57] US$m	Global Banking and Markets US$m	Global Private Banking US$m	Other US$m	Inter-segment elimination[49] US$m	Total US$m
Profit/(loss) before tax							
Net interest income	8,931	1,528	893	187	9	(68)	11,480
Net fee income/(expense)	1,836	551	773	149	(1)		3,308
Trading income/(expense) excluding net interest income	(946)	34	261	17	(26)		(660)
Net interest income/(expense) on trading activities	25	1	205		(1)	68	298
Net trading income/(expense)[44]	(921)	35	466	17	(27)	68	(362)
Changes in fair value of long- term debt issued and related derivatives					967		967
Net income/(expense) from other financial instruments designated at fair value			(5)		2		(3)
Net income/(expense) from financial instruments designated at fair value			(5)		969		964
Gains less losses from financial investments	58	7	195		2		262
Dividend income	15	9	13	3			40
Net earned insurance premiums	236						236
Other operating income	(125)	110	193	11	2,244	(2,207)	226
Total operating income	10,030	2,240	2,528	367	3,196	(2,207)	16,154
Net insurance claims[50]	(154)						(154)
Net operating income[4]	9,876	2,240	2,528	367	3,196	(2,207)	16,000
Loan impairment (charges)/recoveries and other credit risk provisions	(6,929)	(105)	(11)	30	(1)		(7,016)
Net operating income	2,947	2,135	2,517	397	3,195	(2,207)	8,984
Total operating expenses	(5,615)	(1,166)	(1,642)	(307)	(2,396)	2,207	(8,919)
Operating profit/(loss)	(2,668)	969	875	90	799		65
Share of profit/(loss) in associates and joint ventures	3	33			(1)		35
Profit/(loss) before tax	(2,665)	1,002	875	90	798		100
	%	%	%	%	%		%
Share of HSBC s profit before tax	(12.2)	4.6	4.0	0.4	3.7		0.5
Cost efficiency ratio	56.9	52.1	65.0	83.7	75.0		55.7

Balance sheet data[40]

	US$m	US$m	US$m	US$m	US$m		US$m
Loans and advances to customers (net) reported in:							
loans and advances to customers (net)	86,490	32,215	19,289	4,753			142,747
assets held for sale (disposal groups)	31,058	520					31,578
Total assets	144,278	43,747	320,783	7,138	10,378	(22,022)	504,302
Customer accounts reported in:							
customer accounts	63,558	47,003	30,465	14,862	94		155,982
liabilities of disposal groups held for sale	10,104	5,040					15,144

For footnotes, see page 132.

Report of the Directors: Financial Review (continued)

Latin America

Our operations in Latin America principally comprise HSBC Bank Brasil S.A.-Banco Múltiplo, HSBC México, S.A. and HSBC Bank Argentina S.A. In addition to banking services, we operate insurance businesses in Brazil, Mexico and Argentina.

	2013	2012	2011
	US$m	US$m	US$m
Net interest income	**6,186**	6,984	6,956
Net fee income	**1,701**	1,735	1,781
Net trading income	**936**	971	1,378
Other income	**1,745**	1,261	1,338
Net operating income[4]	**10,568**	10,951	11,453
LICs[42]	**(2,666)**	(2,137)	(1,883)
Net operating income	**7,902**	8,814	9,570
Total operating expenses	**(5,930)**	(6,430)	(7,255)
Operating profit	**1,972**	2,384	2,315
Income from associates[43]			
Profit before tax	**1,972**	2,384	2,315
Cost efficiency ratio	**56.1%**	58.7%	63.3%
RoRWA[36]	**2.0%**	2.4%	2.3%
Year-end staff numbers	**42,542**	46,556	54,035

Best Infrastructure Bank

in Latin America

(LatinFinance Awards, 2013)

Gain of

US$1.1bn

on the sale of our

operations in Panama

Over

US$200m

of sustainable cost savings

For footnotes, see page 132.

The commentary is on a constant currency basis unless stated otherwise, while tables are on a reported basis.

Economic background

In Latin America, average GDP growth fell to 2.4% in 2013 from 2.9% in 2012. **Brazil** s GDP growth accelerated from 1% in 2012 to above 2% by the end of 2013. However, this was the third year of below-trend growth. Brazil s growing current account deficit raised concerns during the summer. The resulting capital flight and decline in the currency served to put further upward pressure on prices, pushing CPI inflation above the mid-point of the central bank s target for the fourth consecutive year.

Mexico saw a material slowdown in economic activity in 2013, with GDP growth likely to have slowed to 1.3% from 3.9% in 2012. Inflationary pressures remained subdued and Banco de México cut its key policy rate to 3.5% from 4.5% at the start of the year. However, a significant number of structural reforms should aid the long-term performance of the Mexican economy.

The **Argentinian** economy accelerated in 2013 following a good agricultural harvest and a modest recovery in the Brazilian economy. Structural problems became increasingly evident with high inflation and, eventually, currency weakness.

Review of performance

In Latin America, reported profit before tax of US$2.0bn was US$412m lower than in 2012, and US$239m lower on a constant currency basis.

On an underlying basis, which excludes the US$1.1bn gain on the sale of our operations in Panama and the effect of other non-strategic business disposals, pre-tax profits decreased by US$1.2bn. This was driven by a US$714m rise in loan impairment charges and a decline in revenue of US$348m, in part reflecting adverse movements in the PVIF asset compared with 2012.

We made significant progress on repositioning our business in the region, with a particular focus on our priority growth markets of Brazil, Mexico and Argentina. We also completed the disposal of operations in Panama, Peru and Paraguay, along with the sale of a portfolio of our non-life insurance assets and liabilities and a non-strategic business in Mexico. We expect to complete the sale of our operations in Colombia and Uruguay in 2014, subject to regulatory approvals.

While our performance was affected by slower economic growth and inflationary pressures, we continued to implement the Group s strategy in our core priority markets in order to reposition our portfolios. We made significant progress in exiting

Report of the Directors: Financial Review (continued)

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

	Retail Banking and Wealth Management US$m	Commercial Banking US$m	Global Banking and Markets US$m	Global Private Banking US$m	Other US$m	Total US$m
2013						
Argentina	**97**	**142**	**170**		**(1)**	**408**
Brazil	**(114)**	**(43)**	**514**	**5**	**(11)**	**351**
Mexico	**154**	**(160)**	**115**	**(3)**	**11**	**117**
Panama	**335**	**522**	**362**	**2**	**(37)**	**1,184**
Other	**(46)**	**3**	**6**	**(3)**	**(48)**	**(88)**
	426	**464**	**1,167**	**1**	**(86)**	**1,972**
2012						
Argentina	209	169	174		(46)	506
Brazil	94	359	696	17	(43)	1,123
Mexico	338	176	201	2	(18)	699
Panama	29	62	48	2		141
Other	(62)	(15)	34	(1)	(41)	(85)
	608	751	1,153	20	(148)	2,384
2011						
Argentina	91	107	148		(2)	344
Brazil	241	566	515	13	(105)	1,230
Mexico	403	129	268	4	(178)	626
Panama	23	59	52	3	(9)	128
Other	(55)	6	66		(30)	(13)
	703	867	1,049	20	(324)	2,315

certain businesses and products, strengthening transaction monitoring and account opening, and investing in improved compliance across the region.

In Brazil, we focused on growing secured lending balances for corporates and Premier customers in order to increase connectivity and reduce our risk exposure. We tightened origination criteria in unsecured lending in RBWM, resulting in slower loan growth, and in Business Banking, where volumes declined. We were awarded Best Debt House in Brazil by *Euromoney*, and received the Best Infrastructure Financing in Brazil award from *LatinFinance* in GB&M.

In Mexico, we increased our market share in personal lending, and launched a successful residential mortgage campaign in RBWM. In CMB, we launched a new US$1bn SME fund to support businesses that trade or aspire to trade internationally, and approved lending of US$274m. We grew revenue from collaboration between CMB and GB&M by 11%, were awarded the Best Domestic Cash Manager award by *Euromoney* and won two awards for Infrastructure Financing from *LatinFinance*.

In Argentina, we continued to manage our business conservatively as the economic environment remained challenging. We focused on GB&M and corporate CMB customers, and

tightened credit origination criteria and strengthened our collections capabilities in Business Banking and RBWM.

Net interest income decreased by US$358m, driven by the effect of the disposal of non-strategic businesses and a decline in Brazil, partly offset by growth in Argentina.

Net interest income decreased in Brazil due to a shift to lower yielding assets in CMB with reduced lending balances in Business Banking as we focused on growing secured balances for corporates. The reduction in net interest income in RBWM reflected lower average lending balances as a result of more restrictive origination criteria, which included reducing credit limits where appropriate, the rundown of non-strategic portfolios and a change in the product mix towards more secured assets. In addition, spreads were narrower in CMB reflecting competition, notably in working capital products. Net interest income also decreased in Balance Sheet Management due to lower reinvestment rates.

In Argentina, higher net interest income was driven by increased average credit card and personal lending balances, coupled with higher deposits in RBWM and CMB, both reflecting successful sales and marketing campaigns launched during 2013.

In Mexico, net interest income remained broadly unchanged. It decreased in CMB reflecting large

Report of the Directors: Financial Review (continued)

prepayments relating to a small number of corporates, and in GB&M as maturing investments were renewed at lower reinvestment rates. These falls were offset by an increase in RBWM as the launch of successful sales campaigns resulted in higher average lending balances, notably in payroll and personal lending.

Net fee income increased by 4%, mainly in Argentina. This was driven by business growth, notably in Payments and Cash Management, and the sale of the non-life insurance business which resulted in the non-recurrence of sales commissions previously paid to third party distribution channels. In Brazil and Mexico, fees rose, mainly in RBWM, where higher volumes and re-pricing initiatives drove fee increases in current accounts and credit cards.

Net trading income increased by US$39m, primarily reflecting favourable results in GB&M in Argentina and Brazil. This was partly offset by lower average trading assets as maturing investments in Brazil were not renewed.

Net income from financial instruments designated at fair value decreased by US$274m, notably in Brazil, as a result of lower investment gains due to market movements. To the extent that these investment gains were attributed to policyholders there was a corresponding movement in *Net insurance claims incurred and movement in liabilities to policyholders*.

Gains less losses from financial investments fell by 62% due to lower gains on disposal of available-for-sale government debt securities in Balance Sheet Management and the non-recurrence of the gain on sale of shares in a non-strategic investment in 2012.

Net earned insurance premiums decreased by 19%, driven by lower sales of unit-linked pension products in Brazil. Premiums also fell in Argentina

as a result of the sale of the non-life insurance business in 2012. The reduction in net earned insurance premiums resulted in a corresponding decrease in *Net insurance claims incurred and movement in liabilities to policyholders*.

Other operating income increased by US$910m, driven by the US$1.1bn gain on the sale of our operations in Panama. This was partly offset by a significant reduction in the PVIF asset due to an increase in lapse rates and interest rate movements in Brazil and Mexico, and the non-recurrence of the favourable effect of the recognition of a PVIF asset in Brazil in 2012.

LICs increased by US$693m, primarily in Mexico due to specific impairments in CMB relating to homebuilders from a change in the public housing policy, and higher collective impairments in RBWM as a result of increased volumes and higher delinquency in our unsecured lending portfolio. In Brazil, LICs increased due to changes to the impairment model and assumption revisions for restructured loan account portfolios in RBWM and CMB, following a realignment of local practices to Group standard policy. LICs were also adversely affected by higher specific impairments in CMB across a number of corporate exposures. These factors were partly offset by improvements in credit quality in Brazil following the modification of credit strategies in previous years to mitigate rising delinquency rates.

Operating expenses decreased by US$112m as a result of business disposals, continued strict cost control and progress with our organisational effectiveness programmes which resulted in sustainable cost savings of over US$200m. The decrease was largely offset by the effect of inflationary pressures, union-agreed salary increases in Brazil and Argentina, and higher compliance and risk costs from the implementation of Global Standards and portfolio repositioning, notably in Mexico.

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Reconciliation of reported and constant currency profit/(loss) before tax Latin America

	2012 as reported US$m	Currency translation adjustment[1] US$m	2012 at 2013 exchange rates US$m	2013 as reported US$m	Reported change[2] %	Constant currency change[2] %
Net interest income	6,984	(440)	6,544	**6,186**	**(11)**	**(5)**
Net fee income	1,735	(98)	1,637	**1,701**	**(2)**	**4**
Net trading income	971	(74)	897	**936**	**(4)**	**4**
Own credit spread[3]						
Other income/(expense) from financial instruments designated at fair value	667	(67)	600	**326**	**(51)**	**(46)**
Net income/(expense) from financial instruments designated at fair value	667	(67)	600	**326**	**(51)**	**(46)**
Gains less losses from financial investments	227	(11)	216	**82**	**(64)**	**(62)**
Net earned insurance premiums	2,452	(203)	2,249	**1,830**	**(25)**	**(19)**
Other operating income (including dividend income)	268	(49)	219	**1,124**	**319**	**413**
Total operating income	13,304	(942)	12,362	**12,185**	**(8)**	**(1)**
Net insurance claims incurred and movement in liabilities to policyholders	(2,353)	217	(2,136)	**(1,617)**	**31**	**24**
Net operating income[4]	10,951	(725)	10,226	**10,568**	**(3)**	**3**
LICs[42]	(2,137)	164	(1,973)	**(2,666)**	**(25)**	**(35)**
Net operating income	8,814	(561)	8,253	**7,902**	**(10)**	**(4)**
Operating expenses	(6,430)	388	(6,042)	**(5,930)**	**8**	**2**
Operating profit	2,384	(173)	2,211	**1,972**	**(17)**	**(11)**
Income from associates[43]						
Profit before tax	2,384	(173)	2,211	**1,972**	**(17)**	**(11)**

For footnotes, see page 132.

Reconciliation of reported and underlying items Latin America

	Year ended 31 December		
	2013 US$m	2012 US$m	Change[2] %
Net interest income			
Reported net interest income	**6,186**	6,984	(11)
Currency translation adjustment[1]		(440)	

Acquisitions, disposals and dilutions	**(277)**	(561)	
Underlying net interest income	**5,909**	5,983	(1)
Other operating income			
Reported other operating income	**1,115**	253	341
Currency translation adjustment[1]		(48)	
Acquisitions, disposals and dilutions	**(1,123)**	(14)	
Underlying other operating income	**(8)**	191	
Revenue[4]			
Reported revenue	**10,568**	10,951	(3)
Currency translation adjustment[1]		(725)	
Acquisitions, disposals and dilutions	**(1,495)**	(805)	
Underlying revenue	**9,073**	9,421	(4)

127a

Report of the Directors: Financial Review (continued)

	Year ended 31 December		
	2013	2012	Change[2]
	US$m	US$m	%
LICs[42]			
Reported	**(2,666)**	(2,137)	(25)
Currency translation adjustment[1]		164	
Acquisitions, disposals and dilutions	**32**	53	
Underlying	**(2,634)**	(1,920)	(37)
Operating expenses			
Reported	**(5,930)**	(6,430)	8
Currency translation adjustment[1]		388	
Acquisitions, disposals and dilutions	**239**	488	
Underlying	**(5,691)**	(5,554)	(2)
Underlying cost efficiency ratio	**62.7%**	59.0%	
Profit before tax			
Reported	**1,972**	2,384	(17)
Currency translation adjustment[1]		(173)	
Acquisitions, disposals and dilutions	**(1,224)**	(264)	
Underlying	**748**	1,947	(62)

For footnotes, see page 132.

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

2012 compared with 2011

Economic background

Brazil s GDP growth slowed further in 2012, mostly due to the effects of higher input costs, concern about global financial stability, and domestic regulatory uncertainty. Despite growth remaining low, consumer inflation remained above the 4.5% inflation target pursued by the Central Bank, ending 2012 at 5.8%.

By contrast, growth held up well in **Mexico** in 2012 led, in particular, by favourable industrial exports to the US. Enhanced competitiveness helped Mexican exports to gain a larger share of total US imports. Domestically, demand stayed largely unchanged, encouraged by labour reforms passed by the new administration. Despite the growth figures, inflation ended 2012 slightly below 4% and converging on the 3% inflation target pursued by Banco de Mexico.

Argentina reported a sharp slowdown in 2012. Balance of payments restrictions gradually escalated from capital flows to the current account, including imports of intermediate goods, which generated disruption in production and deterioration in business confidence. Despite this sharp slowdown, inflation continued to remain high, partly due to regulated price increases and import restrictions that lowered domestic supply.

Review of performance

Our operations in Latin America reported a profit before tax of US$2.4bn in 2012, 3% higher than in 2011 and an increase of 16% on a constant currency basis. This included a gain of US$102m following the completion of the sale of our general insurance manufacturing business in Argentina, a loss of US$62m on the sale of our operations in Costa Rica, Honduras and El Salvador and a loss of US$96m recognised following the reclassification of our non-strategic businesses in Colombia, Peru, and Paraguay to Assets held for sale.

On an underlying basis, pre-tax profits rose by 19%, primarily due to increased revenues across all global businesses, partly offset by higher loan impairment charges. In RBWM, the revenue increase reflected growth in average lending balances in Argentina and a higher yielding portfolio mix in Brazil while, in CMB, it resulted from continued balance sheet growth in Brazil which was driven by a strong demand for trade-related lending and higher balances of Payment and Cash Management current accounts in Argentina. In addition, there were higher Balance Sheet Management revenues in Brazil following a downward movement in interest rates which lowered

the cost of funding. In Brazil, loan impairment charges rose, primarily as a result of increased delinquency rates in RBWM and CMB, particularly in the Business Banking portfolio, reflecting lower economic growth in 2012. Loan impairment charges improved during the second half of 2012, mainly due to lower collective portfolio provisions in Brazil.

We made significant progress in reducing the fragmentation in our Latin American businesses through disposals in our non-strategic markets. In May 2012, we announced the sale of our businesses in Colombia, Peru, Uruguay and Paraguay, with completion expected in 2013. We will continue to offer full branch services to our customers during transition. In the second half of 2012, we completed the sale of our businesses in Costa Rica, El Salvador and Honduras. In addition, we completed the sale of our general insurance manufacturing business in Argentina and announced the agreement to sell a portfolio of general insurance assets and liabilities in Mexico with completion expected in 2013. Under the terms of these agreements, the purchasers will provide general insurance products to HSBC to sell to our retail customers in the two countries. This long-term collaboration will broaden and strengthen the suite of general insurance products available to our customers. In February 2013, we announced an agreement to sell our operations in Panama. The transaction is subject to regulatory approvals and other conditions and is expected to complete by the third quarter of 2013.

In our RBWM business, we made good progress in developing a wealth management service that addresses our customers needs and we strengthened our sales force capabilities to capture wealth creation in the region. Wealth Management revenues increased by over US$275m or 36%. This included the favourable effect of the recognition of a PVIF asset in Brazil. Excluding this gain, Wealth Management revenues rose by 17%, mainly from insurance and mutual funds.

In CMB, we worked closely with GB&M to ensure our clients had access to appropriate products. In addition, our relationships with CMB payroll customers enabled us to increase personal lending to their employees, who became our RBWM customers. We were able to provide support to companies as they grow internationally through our Global Trade and Receivables Finance products, and used our international expertise to capture trade and capital flows, notably in the Brazil-China trade corridors. We continued to strengthen our service to international SMEs by increasing the number of specialist International Relationship Managers in Brazil.

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

In GB&M, we continued to target international corporate customers throughout Latin America. We were awarded First place in International Debt Capital Markets by the Brazilian Financial and Capital Markets Association and Best Project Finance House in Latin America from *Euromoney*. We also maintained a strong presence in the foreign exchange and derivatives markets.

Across the region, we continued to implement measures to improve operational efficiency, incurring US$167m of restructuring costs in 2012. We achieved a 14% net reduction of almost 7,500 FTEs, including more than 4,000 employees transferred with the disposals described earlier, and approximately US$285m of additional sustainable savings.

The following commentary is on a constant currency basis.

Net interest income increased by 12% compared with 2011, with growth across all global businesses.

In RBWM, net interest income rose due to higher average lending volumes, mainly in personal loans and credit cards in Argentina as a result of successful marketing and sales campaigns. We also benefited from a change in the composition of the lending book in Brazil as we increased our balances of higher yielding assets. Net interest income from deposits also increased due to higher balances in current accounts in Mexico and savings accounts in Argentina supported by marketing campaigns.

In CMB, higher net interest income reflected a rise in average loans and advances to customers in Brazil, driven by strong demand for trade-related lending and our focus on corporate relationships and sectors with potential for international expansion. Net interest income also rose in Argentina, mainly in Payments and Cash Management current accounts, reflecting higher balances which were supported by successful marketing campaigns, and wider spreads driven by a rise in interest rates.

In GB&M, net interest income increased, notably in Balance Sheet Management in Brazil, as we benefited from the downward movements in interest rates which lowered the cost of funding assets in this portfolio.

Net fee income increased by 8% to US$1.7bn, mainly due to higher Payments and Cash Management revenues, which benefited from mandates from new customers and repricing initiatives in Argentina and Brazil. Fee income was also higher as a result of the sale of the general insurance business as fee expense associated with

this business was no longer incurred.

Net trading income of US$971m was 19% lower than in 2011, primarily due to lower reverse repos driven by positions in GB&M in Brazil that had matured but had not been renewed, and lower income related to government debt securities. This was partly offset by gains in the Rates business as a result of favourable rate movements.

Net income from financial instruments designated at fair value increased by 39%, or US$187m, mainly in Brazil, reflecting higher investment gains arising from favourable equity and debt market movements and growth in policyholder assets from higher sales of unit-linked pension products. To the extent that these investment gains were attributed to policyholders there was a corresponding increase in *Net insurance claims incurred and movement in liabilities to policyholders*.

Gains less losses from financial investments of US$227m were 80% or US$100m higher than in 2011, primarily in Brazil due to gains on sale of shares in non-strategic investments and disposals of government debt securities in GB&M in 2012, partly offset by the non-recurrence of a gain in GB&M on the sale of shares in a Mexican listed company in 2011.

Net earned insurance premiums increased by 5% to US$2.5bn, driven by increased sales in Brazil of unit-linked pension products and term life insurance products. Premiums also rose in Mexico, mainly due to growth in sales of an endowment product. In Argentina, premiums were lower, following the sale of the general insurance business in 2012.

Other operating income decreased by 8% to US$253m, driven by a loss of US$62m on the sale of our operations in Costa Rica, Honduras and El Salvador, and a loss of US$96m recognised following the reclassification of our non-strategic businesses in Colombia, Peru, and Paraguay to held for sale. In addition, in 2011, we reported a gain on sale of the Mexican pension administration business, HSBC Afore, of US$83m and a gain on the sale and leaseback of branches of US$53m. These factors were partly offset by the favourable effect of the recognition of a PVIF asset in Brazil of US$119m relating to unit-linked pensions, together with an increase in the value of new term life business in Brazil, as well as the gain on sale of the general insurance business in Argentina of US$102m.

Net insurance claims incurred and movement in liabilities to policyholders increased by 15%, driven

Report of the Directors: Financial Review (continued)

by higher net investment gains on the fair value of the assets held to support policyholder contracts. In addition, liabilities to policyholders were established for new business, reflecting the increase in premiums in Brazil, though this was partly offset by the disposal of the general insurance business in Argentina in 2012.

Loan impairment charges and other credit risk provisions increased by 29%. This was mainly in Brazil, driven by increased delinquency rates in RBWM and CMB, particularly in Business Banking, reflecting lower economic growth in 2012. We took a number of steps to reposition our portfolios in RBWM and CMB including reducing third-party originations and lowering credit limits where appropriate. We also improved our collections capabilities. Loan impairment charges improved during the second half of the year in Brazil.

Operating expenses decreased by US$83m compared with 2011. Restructuring costs declined by US$137m as 2011 included costs associated with the consolidation of the branch network and the reorganisation of regional and country support functions. These restructuring initiatives and our continued efforts to exercise strict cost control and progress with our organisational effectiveness programmes resulted in approximately US$285m of additional sustainable cost savings and a net 7% reduction in average FTEs of around 4,000 in 2012. These savings were partly offset by inflationary pressures, union-agreed wage increases in Brazil and Argentina and a payment of fines and penalties of US$29m in connection with non-compliance with anti-money laundering systems and controls including requirements to report unusual transactions, in Mexico.

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Reconciliation of reported and constant currency profit/(loss) before tax Latin America

	2011 as reported US$m	Currency translation adjustment[1] US$m	2011 at 2012 exchange rates US$m	2012 as reported US$m	Reported change[2] %	Constant currency change[2] %
Net interest income	6,956	(709)	6,247	6,984		12
Net fee income	1,781	(174)	1,607	1,735	(3)	8
Other income[7]	2,716	(333)	2,383	2,232	(18)	(6)
Net operating income[4]	11,453	(1,216)	10,237	10,951	(4)	7
LICs[42]	(1,883)	221	(1,662)	(2,137)	(13)	(29)
Net operating income	9,570	(995)	8,575	8,814	(8)	3
Operating expenses	(7,255)	742	(6,513)	(6,430)	11	1
Operating profit	2,315	(253)	2,062	2,384	3	16
Income from associates[43]						
Profit before tax	2,315	(253)	2,062	2,384	3	16

For footnotes, see page 132.

Reconciliation of reported and underlying items Latin America

	Year ended 31 December 2012 US$m	2011 US$m	Change[2] %
Revenue[4]			
Reported	10,951	11,453	(4)
Currency translation adjustment[1]		(1,216)	
Acquisitions, disposals and dilutions	(343)	(492)	
Underlying	10,608	9,745	9
LICs[42]			
Reported	(2,137)	(1,883)	(13)
Currency translation adjustment[1]		221	
Acquisitions, disposals and dilutions	16	16	
Underlying	(2,121)	(1,646)	(29)
Operating expenses			
Reported	(6,430)	(7,255)	11
Currency translation adjustment[1]		742	

Acquisitions, disposals and dilutions	183	295	
Underlying	(6,247)	(6,218)	
Underlying cost efficiency ratio	58.9%	63.8%	
Profit before tax			
Reported	2,384	2,315	3
Currency translation adjustment[1]		(253)	
Acquisitions, disposals and dilutions	(144)	(181)	
Underlying	2,240	1,881	19

For footnotes, see page 132.

127f

Report of the Directors: Financial Review (continued)

Profit/(loss) before tax and balance sheet data Latin America

	2013						
	Retail Banking and Wealth Management US$m	Commercial Banking US$m	Global Banking and Markets US$m	Global Private Banking US$m	Other US$m	Inter-segment elimination[49] US$m	Total US$m
Profit/(loss) before tax							
Net interest income/(expense)	3,776	1,828	775	24	(12)	(205)	6,186
Net fee income	952	548	168	32	1		1,701
Trading income/(expense) excluding net interest income	138	117	456	4	(4)		711
Net interest income on trading activities			20			205	225
Net trading income/(expense)[44]	138	117	476	4	(4)	205	936
Changes in fair value of long- term debt issued and related derivatives							
Net income from other financial instruments designated at fair value	264	61	1				326
Net income from financial instruments designated at fair value	264	61	1				326
Gains less losses from financial investments		1	81				82
Dividend income	5	3	1				9
Net earned insurance premiums	1,464	360	6				1,830
Other operating income	312	485	310	1	196	(189)	1,115
Total operating income	6,911	3,403	1,818	61	181	(189)	12,185
Net insurance claims[50]	(1,323)	(291)	(3)				(1,617)
Net operating income[4]	5,588	3,112	1,815	61	181	(189)	10,568
Loan impairment charges and other credit risk provisions	(1,552)	(1,062)	(52)				(2,666)
Net operating income	4,036	2,050	1,763	61	181	(189)	7,902
Total operating expenses	(3,610)	(1,586)	(596)	(60)	(267)	189	(5,930)
Operating profit/(loss)	426	464	1,167	1	(86)		1,972
Share of profit in associates and joint ventures							
Profit/(loss) before tax	426	464	1,167	1	(86)		1,972
	%	%	%	%	%		%
Share of HSBC s profit before tax	1.9	2.0	5.2		(0.4)		8.7
Cost efficiency ratio	64.6	51.0	32.8	98.4	147.5		56.1
Balance sheet data[40]							
	US$m	US$m	US$m	US$m	US$m		US$m

Loans and advances to customers (net)	**13,616**	**19,923**	**10,306**	**75**			**43,920**
Total assets	**30,584**	**30,001**	**52,977**	**337**	**634**	**(534)**	**113,999**
Customer accounts	**23,943**	**16,593**	**11,804**	**1,859**			**54,199**

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

	2012						
	Retail Banking and Wealth Management US$m	Commercial Banking US$m	Global Banking and Markets US$m	Global Private Banking US$m	Other US$m	Inter-segment elimination[49] US$m	Total US$m
Profit/(loss) before tax							
Net interest income/(expense)	4,145	2,173	993	30	(2)	(355)	6,984
Net fee income	873	622	207	33			1,735
Trading income excluding net interest income	85	99	398	3	1		586
Net interest income on trading activities			29		1	355	385
Net trading income[44]	85	99	427	3	2	355	971
Changes in fair value of long- term debt issued and related derivatives							
Net income from other financial instruments designated at fair value	503	163	1				667
Net income from financial instruments designated at fair value	503	163	1				667
Gains less losses from financial investments	75	21	131				227
Dividend income	9	5	1				15
Net earned insurance premiums	1,985	450	17				2,452
Other operating income/(expense)	309	(9)	6	3	134	(190)	253
Total operating income	7,984	3,524	1,783	69	134	(190)	13,304
Net insurance claims[50]	(1,875)	(469)	(9)				(2,353)
Net operating income[4]	6,109	3,055	1,774	69	134	(190)	10,951
Loan impairment charges and other credit risk provisions	(1,541)	(581)	(13)	(2)			(2,137)
Net operating income	4,568	2,474	1,761	67	134	(190)	8,814
Total operating expenses	(3,960)	(1,723)	(608)	(47)	(282)	190	(6,430)
Operating profit/(loss)	608	751	1,153	20	(148)		2,384
Share of profit in associates and joint ventures							
Profit/(loss) before tax	608	751	1,153	20	(148)		2,384
	%	%	%	%	%		%
Share of HSBC s profit before tax	2.9	3.6	5.6	0.1	(0.7)		11.6
Cost efficiency ratio	64.8	56.4	34.3	68.1	210.4		58.7
Balance sheet data[40]							
	US$m	US$m	US$m	US$m	US$m		US$m
Loans and advances to customers (net)	17,236	25,379	10,903	91			53,609
Total assets	36,141	35,507	58,272	570	1,110	(323)	131,277
Customer accounts	28,688	20,834	12,604	4,430			66,556

For footnotes, see page 132.

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

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

	2011						
	Retail Banking and Wealth Management US$m	Commercial Banking US$m	Global Banking and Markets US$m	Global Private Banking US$m	Other US$m	Inter-segment elimination[49] US$m	Total US$m
Profit/(loss) before tax							
Net interest income/(expense)	4,519	2,229	882	25	(7)	(692)	6,956
Net fee income	939	610	196	36			1,781
Trading income/(expense) excluding net interest income	68	106	372	5	(7)		544
Net interest income on trading activities			134		8	692	834
Net trading income[44]	68	106	506	5	1	692	1,378
Changes in fair value of long- term debt issued and related derivatives							
Net income from other financial instruments designated at fair value	424	124	2				550
Net income from financial instruments designated at fair value	424	124	2				550
Gains less losses from financial investments	11	1	124	1			137
Dividend income	10	3	1				14
Net earned insurance premiums	2,068	551	34				2,653
Other operating income	265	57	32	2	222	(250)	328
Total operating income	8,304	3,681	1,777	69	216	(250)	13,797
Net insurance claims[50]	(1,850)	(478)	(16)				(2,344)
Net operating income[4]	6,454	3,203	1,761	69	216	(250)	11,453
Loan impairment charges and other credit risk provisions	(1,369)	(501)	(12)		(1)		(1,883)
Net operating income	5,085	2,702	1,749	69	215	(250)	9,570
Total operating expenses	(4,382)	(1,835)	(700)	(49)	(539)	250	(7,255)
Operating profit/(loss)	703	867	1,049	20	(324)		2,315
Share of profit in associates and joint ventures							
Profit/(loss) before tax	703	867	1,049	20	(324)		2,315
	%	%	%	%	%		%
Share of HSBC s profit before tax	3.2	4.0	4.8	0.1	(1.5)		10.6
Cost efficiency ratio	67.9	57.3	39.8	71.0	249.5		63.3

Balance sheet data[40]

	US$m	US$m	US$m	US$m	US$m		US$m
Loans and advances to customers (net)	19,025	25,834	11,011	62	6		55,938
Total assets	39,231	38,410	66,241	1,660	417	(1,070)	144,889
Customer accounts	28,629	24,050	18,940	7,079	62		78,760

For footnotes, see page 132.

Report of the Directors: Financial Review (continued)

Other information

Funds under management and assets held in custody[54]

Funds under management

	2013 US$bn	2012 US$bn
Funds under management		
At 1 January	**910**	847
Net new money	**(18)**	5
Value change	**34**	49
Exchange and other	**(5)**	9
At 31 December	**921**	910

	At 31 December 2013 US$bn	2012 US$bn
Funds under management by business		
Global Asset Management	**420**	425
Global Private Banking	**282**	288
Affiliates	**5**	3
Other	**214**	194
	921	910

For footnote, see page 132.

Funds under management (FuM) at 31 December 2013 amounted to US$921bn, marginally higher than at 31 December 2012, reflecting favourable market movements which were largely offset by net outflows and adverse foreign exchange movements.

Global Asset Management funds of US$420bn at 31 December 2013 were marginally down on 31 December 2012 due to net outflows from liquidity funds, notably in the US and Europe as a result of continued low interest rate; adverse foreign exchange movements reflecting the strengthening of the US dollar against emerging market currencies; and other movements, including the amortisation and maturity of assets in an asset-backed securities mandate managed on behalf of GB&M. These factors were partly offset by strong inflows in fixed income products from our customers in Europe and Rest of Asia-Pacific and favourable movements in developed equity markets.

GPB funds decreased by 2% compared with 31 December 2012 to US$282bn. This was mainly due to negative net new money in Europe, which was driven by actions taken to refocus our client base towards higher net worth relationships, the adoption of new compliance and tax transparency standards and a large number of client withdrawals, particularly in Switzerland. These factors were partly offset by favourable market movements, notably in Europe, and positive net new money in Asia.

Other FuM increased by 10% to US$214bn, primarily due to favourable equity market movements.

Assets held in custody and under administration

Custody is the safekeeping and servicing of securities and other financial assets on behalf of clients. At 31 December 2013, we held assets as custodian of US$6.2 trillion, 3% higher than the US$6.0 trillion held at 31 December 2012. This was mainly driven by increased new business and favourable market movements, partly offset by adverse foreign exchange movements.

Our assets under administration business, which includes the provision of bond and loan administration services as well as the valuation of portfolios of securities and other financial assets on behalf of clients, complements the custody business. At 31 December 2013, the value of assets held under administration by the Group amounted to US$3.1 trillion, which was 6% higher than at 31 December 2012. This was mainly driven by increased new business and favourable market movements.

Property

At 31 December 2013, we operated from some 8,230 operational properties worldwide, of which approximately 2,110 were located in Europe, 2,515 in Hong Kong and Rest of Asia-Pacific, 500 in North America, 2,770 in Latin America and 335 in the Middle East and North Africa. These properties had an area of approximately 56.6m square feet (2012: 59.7m square feet).

Our freehold and long leasehold properties, together with all our leasehold land in Hong Kong, were valued in 2013. The value of these properties was US$10.3bn (2012: US$9.7bn) in excess of their carrying amount in the consolidated balance sheet on a historical cost based measure. In addition, properties with a net book value of US$1.9bn (2012: US$1.3bn) were held for investment purposes.

Our operational properties are stated at cost, being historical cost or fair value at the date of transition to IFRSs (their deemed cost) less any impairment losses, and are depreciated on a basis calculated to write off the assets over their estimated useful lives. Properties owned as a consequence of an acquisition are recognised initially at fair value.

Further details are included in Note 23 on the Financial Statements.

Report of the Directors: Financial Review (continued)

Detailed list of disclosures in this report arising from EDTF recommendations

Type of risk	Recommendation	Disclosure	Page
General	1	The risks to which the business is exposed.	135 to 139
	2	Our risk appetite and stress testing.	139 to 141
	3	Top and emerging risks, and the changes during the reporting period.	141 to 147
	4	Discussion of future regulatory developments affecting our business model and Group profitability, and its implementation in Europe.	142 and 309 to 317
Risk governance, risk management and business model	5	Group Risk Committee, and their activities.	352 to 358
	6	Risk culture and risk governance and ownership.	134
	7	Diagram of the risk exposure by global business segment.	37
	8	Stress testing and the underlying assumptions.	139 to 141
Capital adequacy and risk-weighted assets	9	Pillar 1 capital requirements.	320 to 322
		For calculation of Pillar 1 capital requirements, see pages 10 to 14 of *Pillar 3 Disclosures 2012*.	
	10	Reconciliation of the accounting balance sheet to the regulatory balance sheet.	307

	11	Flow statement of the movements in regulatory capital since the previous reporting period, including changes in core tier 1, tier 1 and tier 2 capital.	304
	12	Discussion of targeted level of capital, and the plans on how to establish this.	299 and 314 to 320
	13	Analysis of risk-weighted assets by risk type, global business and geographical region, and market risk RWAs.	299 to 300
	14	For analysis of the capital requirements for each Basel asset class, see pages 10 to 14, 23, 58 and 61 of *Pillar 3 Disclosures 2012*.	
	15	For analysis of credit risk for each Basel asset class, see pages 23 to 28 and 32 to 38 of *Pillar 3 Disclosures 2012*.	
	16	Flow statements reconciling the movements in risk-weighted assets for each risk-weighted asset type.	302 to 303
	17	For discussion of Basel credit risk model performance, see pages 39 to 41 of the *Pillar 3 Disclosures 2012* document.	
Liquidity	18	Analysis of the Group s liquid asset buffer.	215 to 216
Funding	19	Encumbered and unencumbered assets analysed by balance sheet category.	224 to 226
	20	Consolidated total assets, liabilities and off-balance sheet commitments analysed by remaining contractual maturity at the balance sheet date.	533 to 541
	21	Analysis of the Group s sources of funding and a description of our funding strategy.	219 to 211
Market risk	22	Relationship between the market risk measures for trading and non-trading portfolios and the balance sheet, by business segment.	236 to 237
	23	Discussion of significant trading and non-trading market risk factors.	232 to 235
	24	VaR assumptions, limitations and validation.	282 to 284
	25	Discussion of stress tests, reverse stress tests and stressed VaR.	284
Credit risk	26	Analysis of the aggregate credit risk exposures, including details of both personal and wholesale lending.	152 to 154
	27	Discussion of the policies for identifying impaired loans, defining impairments and renegotiated loans, and explaining loan forbearance policies.	185 and 268 to 273
	28	Reconciliations of the opening and closing balances of impaired loans and impairment allowances during the year.	186 and 191
	29	Analysis of counterparty credit risk that arises from derivative transactions.	158
	30	Discussion of credit risk mitigation, including collateral held for all sources of credit risk.	179 to 184
Other risks	31	Quantified measures of the management of operational risk.	245 to 248
	32	Discussion of publicly known risk events.	141 to 147

The 32 recommendations listed above were made in the report Enhancing the Risk Disclosures of Banks issued by the Enhanced Disclosure Task Force of the Financial Stability Board in October 2012.

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Disclosure controls

The Group Chief Executive and Group Finance Director, with the assistance of other members of management, carried out an evaluation of the effectiveness of the design and operation of HSBC Holdings disclosure controls and procedures as at 31 December 2013. Based upon that evaluation, the Group Chief Executive and Group Finance Director concluded that our disclosure controls and procedures as at 31 December 2013 were effective to provide reasonable assurance that information required to be disclosed in the reports which the company files and submits under the US Securities Exchange Act of 1934, as amended, is recorded, processed, summarised and reported as and when required. There are inherent limitations to the effectiveness of any system of disclosure controls and procedures, including the possibility of human error and the circumvention or overriding of the controls and procedures. Accordingly, even effective disclosure controls and procedures can only provide reasonable assurance of achieving their control objectives.

There has been no change in HSBC Holdings internal controls over financial reporting during the year ended 31 December 2013 that has materially affected, or is reasonably likely to materially affect, HSBC Holdings internal controls over financial reporting.

Management s assessment of internal controls over financial reporting

Management is responsible for establishing and maintaining an adequate internal control structure and procedures for financial reporting, and has completed an assessment of the effectiveness of the Group s internal controls over financial reporting for the year ended 31 December 2013. In making the assessment, management used the framework for internal control evaluation contained within the Financial Reporting Council s Internal Control Revised Guidance for Directors, as well as the criteria established by the Committee of Sponsoring Organisations of the Treadway Commission (COSO) in Internal Control-Integrated Framework (1992) .

Based on the assessment performed, management concluded that as at 31 December 2013, the Group s internal controls over financial reporting were effective.

KPMG Audit Plc, which has audited the consolidated financial statements of the Group for the year ended 31 December 2013, 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 page 410.

In May 2013, the Committee of Sponsoring Organisations of the Treadway Commission (COSO) issued the 2013 Internal Control Integrated Framework (Framework). HSBC plan to use the 2013 Framework for the assessment for the year ending 31 December 2014. HSBC continued to evaluate its internal control over financial reporting under the original 1992 Framework for the year ended 31 December 2013.

Report of the Directors: Financial Review (continued)

Footnotes to pages 47 to 131

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

1 *Currency translation adjustment is the effect of translating the results of subsidiaries and associates for the previous year at the average rates of exchange applicable in the current year.*
2 *Positive numbers are favourable: negative numbers are unfavourable.*
3 *Changes in fair value due to movements in own credit spread on long-term debt issued. This does not include the fair value changes due to own credit risk in respect of trading liabilities or derivative liabilities.*
4 *Net operating income before loan impairment charges and other credit risk provisions, also referred to as revenue.*
5 *The operating results of these disposals were removed from underlying results in addition to disposal gains and losses.*
6 *The operating results of these disposals and acquisitions were not removed from underlying results as they were not significant.*
7 *Other income in this context comprises where applicable net trading income, net income/(expense) from other financial instruments designated at fair value, gains less losses from financial investments, dividend income, net earned insurance premiums and other operating income less net insurance claims incurred and movement in liabilities to policyholders.*

Financial summary

8 *The effect of the bonus element of the rights issue in 2009 has been included within the basic and diluted earnings per share.*
9 *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. For further information, see footnote 3 on page 46.*
10 *Dividends per ordinary share expressed as a percentage of basic earnings per share.*
11 *The accounting for the disposal of our interest in Ping An is described on page 521. In the first half of 2013, we recognised a net gain on the completion of the Ping An disposal of US$553m which offset the US$553m loss on the contingent forward sale contract recognised in the second half of 2012. The gain of US$553m represented the net effect of the US$1,235m gain on derecognition of the Ping An equity securities classified as available-for-sale investments and recorded in Gains less losses from financial investments , offset by the US$682m adverse change in fair value of the contingent forward sale contract in the period to the point of delivery of the equity securities recorded in Net trading income .*
12 *Net interest income includes the cost of internally funding trading assets, while the related external revenues are reported in Trading income . In our global business results, the cost of funding trading assets is included with Global Banking and Market s net trading income as interest expense.*
13 *Gross interest yield is the average annualised interest rate earned on average interest-earning assets (AIEA).*
14 *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.*
15 *Net interest margin is net interest income expressed as an annualised percentage of AIEA.*
16 *Interest income on trading assets is reported as Net trading income in the consolidated income statement.*
17 *Interest income on financial assets designated at fair value is reported as Net income from financial instruments designated at fair value in the consolidated income statement.*
18 *Including interest-bearing bank deposits only.*
19 *Interest expense on financial liabilities designated at fair value is reported as Net income on financial instruments designated at fair value in the consolidated income statement, other than interest on own debt which is reported in Interest expense .*
20 *Including interest-bearing customer accounts only.*
21 *Trading income also includes movements on non-qualifying hedges. These hedges are derivatives entered into as part of a documented interest rate management strategy for which hedge accounting was not, nor could be, applied. They are principally cross-currency and interest rate swaps used to economically hedge fixed rate debt issued by HSBC Holdings and floating rate debt issued by HSBC Finance. The size and direction of the changes in the fair value of non-qualifying hedges that are recognised in the income statement can be volatile from year-to-year, but do not alter the cash flows expected as part of the documented interest rate management strategy for both the instruments and the underlying economically hedged assets and liabilities if the derivative is held to maturity.*
22 *Net trading income includes an unfavourable movement of US$66m (2012: unfavourable movement of US$629m; 2011: favourable movement of US$458m), associated with changes in the fair value of issued structured notes and other hybrid instrument liabilities arising from movements in HSBC issuance spreads.*
23

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

24 *Discretionary participation features.*

25 *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 incurred 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.*

26 *The cost efficiency ratio is defined as total operating expenses divided by net operating income before loan impairment charges and other credit risk provisions.*

Consolidated balance sheet

27 *Net of impairment allowances.*

28 *The calculation of capital resources, capital ratios and risk-weighted assets on a Basel 2.5 basis.*

29 *Capital resources are total regulatory capital, the calculation of which is set out on page 305.*

30 *Including perpetual preferred securities, details of which can be found in Note 32 on the Financial Statements.*

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

31 *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.*
32 *Currency translation adjustment is the effect of translating the assets and liabilities of subsidiaries and associates for the previous year-end at the rates of exchange applicable at the current year-end.*
33 *Balance included in disposal groups, per note 25 on the Financial Statements.*
34 *In 2013, GB&M changed the way it manages repo and reverse repo activities in the Credit and Rates businesses as set out on page 68. This led to an increase in the amount of reverse repo and repo agreements classified as Loans and advances to customers at amortised cost and Customer accounts at amortised cost in the balance sheet, respectively. The increase in amortised cost balances primarily occurred in Europe and North America, specifically in the UK and the US and the Global Banking and Markets global business.*
35 *France primarily comprises the domestic operations of HSBC France, HSBC Assurances Vie and the Paris branch of HSBC Bank plc.*

Reconciliation of RoRWA measures

36 *Risk-weighted assets (RWA s) and pre-tax return on average risk-weighted assets (RoRWA).*
37 *Underlying RoRWA is calculated using underlying pre-tax return and reported average RWAs at constant currency and adjusted for the effects of business disposals.*
38 *Other includes treasury services related to the US Consumer and Mortgage Lending business and commercial operations in run-off. US CML includes loan portfolios within the run-off business that are designated held for sale.*

Global businesses and geographical regions

39 *The main items reported under Other are the results of HSBC s holding company and financing operations, which includes net interest earned on free capital held centrally, operating costs incurred by the head office operations in providing stewardship and central management services to HSBC, along with the costs incurred by the Group Service Centres and Shared Service Organisations and associated recoveries. The results also include fines and penalties as part of the settlement of investigations into past inadequate compliance with anti-money laundering and sanctions laws, the UK bank levy together with unallocated investment activities, centrally held investment companies, gains arising from the dilution of interests in associates and joint ventures and certain property transactions. In addition, Other also includes part of the movement in the fair value of long-term debt designated at fair value (the remainder of the Group s movement on own debt is included in GB&M).*
40 *Assets by geographical region and global businesses include intra-HSBC items. These items are eliminated, where appropriate, under the heading Intra-HSBC items or inter-segment elimination , as appropriate.*
41 *For divested businesses, this includes the gain or loss on disposal and material results of operations as described on page 47.*
42 *Loan impairment charges and other credit risk provisions.*
43 *Share of profit in associates and joint ventures.*
44 *In the analysis of global businesses, net trading income/(expense) comprises all gains and losses from changes in the fair value of financial assets and financial liabilities classified as held for trading, related external and internal interest income and interest expense, and dividends received; in the statutory presentation internal interest income and expense are eliminated.*
45 *In 2013, funding costs that had previously been reported within Other were allocated to their respective business lines. For comparative purposes, 2012 data have been re-presented to reflect this change.*
46 *In 2013, Markets included an adverse fair value movement of US$66m on the widening of credit spreads on structured liabilities (2012: adverse fair value movement of US$629m; 2011: favourable fair value movement of US$458m).*
47 *Other in GB&M includes net interest earned on free capital held in the global business not assigned to products, allocated funding costs and gains resulting from business disposals. Within the management view of total operating income, notional tax credits are allocated to the businesses to reflect the economic benefit generated by certain activities which is not reflected within operating income, for example notional credits on income earned from tax-exempt investments where the economic benefit of the activity is reflected in tax expense. In order to reflect the total operating income on an IFRS basis, the offset to these tax credits are included within Other .*
48 *Client assets are translated at the rates of exchange applicable for their respective period-ends, with the effects of currency translation reported separately. The main components of client assets are funds under management, which are not reported on the Group s balance sheet, and customer deposits, which are reported on the Group s balance sheet.*
49 *Inter-segment elimination comprises (i) the costs of shared services and Group Service Centres included within Other which are recovered from global businesses, and (ii) the intra-segment funding costs of trading activities undertaken within GB&M. HSBC s Balance Sheet Management business, reported*

within GB&M, provides funding to the trading businesses. To report GB&M s Net trading income on a fully funded basis, Net interest income and Net interest income/(expense) on trading activities are grossed up to reflect internal funding transactions prior to their elimination in the inter-segment column.

50 *Net insurance claims incurred and movement in liabilities to policyholders.*

51 *Employee expenses comprise costs directly incurred by each global business. The reallocation and recharging of employee and other expenses directly incurred in the Other category are shown in Other operating expenses .*

52 *RWAs are non-additive across geographical regions due to market risk diversification effects within the Group.*

53 *In 2012 CMB results include US$128m of net operating income and US$43m of profit before tax, related to low income housing tax credit investments in the US which are offset within the Other segment.*

54 *Funds under management and assets held in custody are not reported on the Group s balance sheet, except where it is deemed that we are acting as principal rather than agent in our role as investment manager, and these assets are consolidated as Structured entities (see Note 42 on the Financial Statements).*

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Average balance sheet

55 *Interest income on trading assets is reported as Net trading income in the consolidated income statement.*
56 *Interest income on financial assets designated at fair value is reported as Net income from financial instruments designated at fair value in the consolidated income statement.*
57 *Brazilian operations comprise HSBC Bank Brasil S.A.-Banco Múltiplo and subsidiaries, plus HSBC Serviços e Participações Limitada.*
58 *This includes interest-bearing bank deposits only. See page 69(m) for an analysis of all bank deposits.*
59 *Interest expense on financial liabilities designated at fair value is reported as Net income on financial instruments designated at fair value in the consolidated income statement, other than interest on own debt which is reported in Interest Expense .*
60 *This includes interest-bearing customer accounts only. See page 69(n) for an analysis of all customer accounts.*
61 *Net interest margin is calculated as net interest income divided by average interest earning assets.*

Ratio of earnings to fixed charges

62 *For the purpose of calculating the ratios, earnings consist of income from continuing operations before taxation and non-controlling interests, plus fixed charges, and after deduction of the unremitted pre-tax income of associated undertakings. Fixed charges consist of total interest expense, including or excluding interest on deposits, as appropriate, dividends on preference shares and other equity instruments, as applicable, and the proportion of rental expense deemed representative of the interest factor.*
63 *Ratios previously disclosed from 2009 to 2012 excluded interest expense on certain debt instruments in addition to interest on deposits. Ratios presented for these periods have been re-presented to exclude interest on deposits only.*

Balance sheet data significant to Global Banking and Markets

64 *Trading assets and financial investments held by GB&M in North America include financial assets which may be repledged or resold by counterparties.*
65 *Derivative assets and derivative liabilities of GB&M include derivative transactions between different regions of GB&M.*

133a

Report of the Directors: Financial Review (continued)

Legal proceedings and regulatory matters

HSBC is party to legal proceedings and regulatory matters in a number of jurisdictions arising out of its normal business operations. The recognition of provisions is determined in accordance with the accounting policies set out in Note 2. Apart from the matters described below, HSBC considers that none of these matters are material, either individually or in the aggregate. Where an individual provision is material, the fact that a provision has been made is stated and quantified. Any provision recognised does not constitute an admission of wrongdoing or legal liability. While the outcome of these matters is inherently uncertain, management believes that, based on the information available to it, appropriate provisions have been made in respect of legal proceedings and regulatory matters as at 31 December 2013 (see Note 31). It is not practicable to provide an aggregate estimate of potential liability for our legal proceedings and regulatory matters as a class of contingent liabilities.

Securities litigation

As a result of an August 2002 restatement of previously reported consolidated financial statements and other corporate events, including the 2002 settlement with 46 states and the District of Columbia relating to real estate lending practices, Household International and certain former officers were named as defendants in a class action lawsuit, *Jaffe v. Household International, Inc., et al.* (N.D. Ill. No. 02 C5893), filed 19 August 2002 in the US District Court for the Northern District of Illinois (District Court). The complaint asserted claims under § 10 and § 20 of the Securities Exchange Act of 1934 and alleged that the defendants knowingly or recklessly made false and misleading statements of material fact relating to Household International s Consumer Lending operations, including collections, sales and lending practices, some of which ultimately led to the 2002 state settlement agreement, and facts relating to accounting practices evidenced by the restatement. Ultimately, a class was certified on behalf of all persons who acquired and disposed of Household International common stock between 30 July 1999 and 11 October 2002.

A jury trial concluded in April 2009, which was decided partly in favour of the plaintiffs. Various legal challenges to the verdict were raised in post-trial briefing.

In December 2011, following the submission of claim forms by class members, the Court-appointed claims administrator to the District Court reported that the total number of claims that generated an

allowed loss was 45,921, and that the aggregate amount of these claims was approximately US$2.2bn. The defendants filed legal challenges regarding the presumption of reliance as to the class and compliance with the claims form requirements, which the District Court in September 2012 rejected for the most part. The District Court directed further proceedings before a court-appointed Special Master to address certain claim submission issues.

On 4 October 2013, the District Court denied the defendants additional post-trial motions for judgement as a matter of law or, in the alternative, for a new trial, and granted plaintiffs motions for a partial final judgement and awarded pre-judgement interest at the Prime rate, compounded annually. Subsequently, on 17 October 2013, the District Court entered a partial final judgement against the defendants in the amount of approximately US$2.46bn. In addition to the partial judgement that has been entered, there also remain approximately US$527m in claims, prior to imposition of prejudgement interest, that still are subject to objections that have not yet been ruled upon by the District Court.

The defendants have filed a Notice of Appeal of the partial final judgement. The defendants have also filed a Supersedeas Bond in the approximate amount of the judgement (US$2.46bn) in order to stay execution on the judgement pending appeal. Despite the jury verdict, the various rulings of the District Court, and the partial final judgement, we continue to believe that we have meritorious grounds for appeal. The timing and outcome of the ultimate resolution of this matter is uncertain.

Given the complexity and uncertainties associated with the actual determination of damages, including the outcome of any appeals, there is a wide range of possible damages. We believe we have meritorious grounds for appeal on matters of both liability and damages, and will argue on appeal that damages should be zero or a relatively insignificant amount. If the Appeals Court rejects or only partially accepts our arguments, the amount of damages, based upon the claims submitted and the application of pre-judgement interest at the Prime rate as ordered by the District Court, may lie in a range from a relatively insignificant amount to an amount up to or exceeding US$3.5bn. Once a judgement is entered (such as the approximately US$2.46bn partial final judgement entered on 17 October 2013), post-judgement interest accrues on the judgement at a rate equal to the weekly average of the 1-year constant maturity treasury yield as published by the Federal Reserve System. A provision has been made based on management s best estimate of probable outflows.

133b

Report of the Directors: Financial Review (continued)

Bernard L. Madoff Investment Securities LLC

In December 2008, Bernard L. Madoff (Madoff) was arrested for running a Ponzi scheme and a trustee was appointed for the liquidation of his firm, Bernard L. Madoff Investment Securities LLC (Madoff Securities), an SEC-registered broker-dealer and investment adviser. Since his appointment, the trustee has been recovering assets and processing claims of Madoff Securities customers. Madoff subsequently pleaded guilty to various charges and is serving a 150 year prison sentence. He has acknowledged, in essence, that while purporting to invest his customers money in securities and, upon request, return their profits and principal, he in fact never invested in securities and used other customers money to fulfil requests for the return of profits and principal. The relevant US authorities are continuing their investigations into his fraud, and have brought charges against others, including certain former employees and the former auditor of Madoff Securities. Madoff was sentenced in June 2009.

Various non-US HSBC companies provided custodial, administration and similar services to a number of funds incorporated outside the US whose assets were invested with Madoff Securities. Based on information provided by Madoff Securities, as at 30 November 2008, the purported aggregate value of these funds was US$8.4bn, an amount that includes fictitious profits reported by Madoff. Based on information available to HSBC to date, we estimate that the funds actual transfers to Madoff Securities minus their actual withdrawals from Madoff Securities during the time that HSBC serviced the funds totalled approximately US$4bn.

Plaintiffs (including funds, fund investors, and the Madoff Securities trustee) have commenced Madoff-related proceedings against numerous defendants in a multitude of jurisdictions. Various HSBC companies have been named as defendants in suits in the US, Ireland, Luxembourg and other jurisdictions. Certain suits (which include US putative class actions) allege that the HSBC defendants knew or should have known of Madoff s fraud and breached various duties to the funds and fund investors.

In December 2011, claims against HSBC and other defendants by fund investors in three related putative class actions pending in the US District Court for the Southern District of New York were dismissed on grounds of *forum non conveniens*. In September 2013, the US Court of Appeals for the Second Circuit affirmed the dismissal of the claims. The plaintiffs have requested a rehearing of their

appeal, and that request remains pending.

In July and December 2013, settlements were reached in respect of the claim by Thema International Fund plc and AA (Alternative Advantage) Plc respectively against HSBC Institutional Trust Services (Ireland) Limited in the Irish High Court.

The Madoff Securities Trustee has commenced suits against various HSBC companies in the US Bankruptcy Court and in the English High Court. The US action (which also names certain funds, investment managers, and other entities and individuals) sought US$9bn in damages and additional recoveries from HSBC and the various co-defendants and alleged that HSBC aided and abetted Madoff s fraud and breach of fiduciary duty. In July 2011, the US District Court for the Southern District of New York dismissed the trustee s various common law claims on the grounds that the trustee lacks standing to assert them, and that dismissal was affirmed in a decision issued by the Second Circuit in June 2013. On 9 October 2013, the Trustee filed a petition for *writ of certiorari* to review the Second Circuit s decision with the US Supreme Court. The HSBC defendants filed their response to the petition for *writ of certiorari* on 16 December 2013. The Supreme Court has issued an order inviting the US Solicitor General to file a brief in the case expressing the views of the US government on the petition. The Trustee s remaining US claims seek, pursuant to US bankruptcy law, recovery of unspecified amounts received by HSBC from funds invested with Madoff, including amounts that HSBC received when it redeemed units HSBC held in the various funds in connection with financing transactions HSBC had entered into with various clients, as well as fees earned by HSBC for providing custodial, administration and similar services to the funds. These claims remain pending.

The trustee s English action seeks recovery of unspecified transfers of money from Madoff Securities to or through HSBC, on the ground that the HSBC defendants actually or constructively knew of Madoff s fraud. HSBC has not been served with the trustee s English action.

Between October 2009 and April 2012, Fairfield Sentry Limited, Fairfield Sigma Limited and Fairfield Lambda Limited (Fairfield), funds whose assets were directly or indirectly invested with Madoff Securities, commenced multiple suits in the British Virgin Islands (BVI) and the US against numerous fund shareholders, including various HSBC companies that acted as nominees for clients of HSBC s private banking business and other

133c

Report of the Directors: Financial Review (continued)

clients who invested in the Fairfield funds. The Fairfield actions seek restitution of amounts paid to the defendants in connection with share redemptions, on the ground that such payments were made by mistake, based on inflated values resulting from Madoff s fraud, and some actions also seek recovery of the share redemptions under BVI insolvency law. The actions in the US are currently stayed in the Bankruptcy Court pending developments in related appellate litigation in the BVI.

There are many factors which may affect the range of possible outcomes, and the resulting financial impact, of the various Madoff-related proceedings, including but not limited to the circumstances of the fraud, the multiple jurisdictions in which the proceedings have been brought and the number of different plaintiffs and defendants in such proceedings. For these reasons, among others, it is not practicable at this time for HSBC to estimate reliably the aggregate liabilities, or ranges of liabilities, that might arise as a result of all such claims but they could be significant. In any event, HSBC considers that it has good defences to these claims and will continue to defend them vigorously.

US mortgage-related investigations

In April 2011, HSBC Bank USA entered into a consent cease and desist order with the Office of the Comptroller of the Currency (OCC) and HSBC Finance and HSBC North America Holdings Inc. (HNAH) entered into a similar consent order with the Federal Reserve Board (together with the OCC, the Servicing Consent Orders) following completion of a broad horizontal review of industry residential mortgage foreclosure practices. These consent orders require prescribed actions to address the deficiencies noted in the joint examination and described in the consent orders. HSBC Bank USA, HSBC Finance and HNAH continue to work with the OCC and the Federal Reserve Board to align their processes with the requirements of the consent orders and are implementing operational changes as required.

The Servicing Consent Orders required an independent review of foreclosures (the Independent Foreclosure Review) pending or completed between January 2009 and December 2010 to determine if any borrower was financially injured as a result of an error in the foreclosure process. As required by the Servicing Consent Orders, an independent consultant was retained to conduct that review.

On 28 February 2013, HSBC Bank USA entered into an agreement with the OCC, and HSBC Finance

and HNAH entered into an agreement with the Federal Reserve Board, (together the IFR Settlement Agreements), pursuant to which the Independent Foreclosure Review has ceased and been replaced by a broader framework under which we and 12 other participating servicers will, in the aggregate, provide in excess of US$9.3bn in cash payments and other assistance to help eligible borrowers. Pursuant to the IFR Settlement Agreements, HNAH has made a cash payment of US$96m into a fund used to make payments to borrowers that were in active foreclosure during 2009 and 2010, and in addition, will provide other assistance (e.g. loan modifications) to help eligible borrowers. Borrowers who receive compensation will not be required to execute a release or waiver of rights and will not be precluded from pursuing litigation concerning foreclosure or other mortgage servicing practices. For participating servicers, including HSBC Bank USA and HSBC Finance, fulfilment of the terms of the IFR Settlement Agreements will satisfy the Independent Foreclosure Review requirements of the Servicing Consent Orders, including the wind down of the Independent Foreclosure Review.

The Servicing Consent Orders do not preclude additional enforcement actions against HSBC Bank USA, HSBC Finance or HNAH by bank regulatory, governmental or law enforcement agencies, such as the US Department of Justice (DoJ) or State Attorneys General, which could include the imposition of civil money penalties and other sanctions relating to the activities that are the subject of the Servicing Consent Orders. Pursuant to the IFR Settlement Agreement with the OCC, however, the OCC has agreed that it will not assess civil money penalties or initiate any further enforcement action with respect to past mortgage servicing and foreclosure-related practices addressed in the Servicing Consent Orders, provided the terms of the IFR Settlement Agreement are fulfilled. The OCC s agreement not to assess civil money penalties is further conditioned on HNAH making payments or providing borrower assistance pursuant to any agreement that may be entered into with the DoJ in connection with the servicing of residential mortgage loans within two years. The Federal Reserve Board has agreed that any assessment of civil money penalties by the Federal Reserve Board will reflect a number of adjustments, including amounts expended in consumer relief and payments made pursuant to any agreement that may be entered into with the DoJ in connection with the servicing of residential mortgage loans. In addition, the IFR Settlement Agreements do not preclude private litigation concerning these practices.

Report of the Directors: Financial Review (continued)

Separate from the Servicing Consent Orders and the settlement related to the Independent Foreclosure Review discussed above, in February 2012 five of the largest US mortgage servicers (not including HSBC companies) reached a settlement with the DoJ, the US Department of Housing and Urban Development and State Attorneys General of 49 states with respect to foreclosure and other mortgage servicing practices. Following this settlement, these government agencies initiated discussions with mortgage industry servicers. HNAH, HSBC Bank USA and HSBC Finance have had discussions with US bank regulators and other governmental agencies regarding a potential resolution, although the timing of any settlement is not currently known. HSBC has recognised a provision to reflect the estimated liability associated with a proposed settlement of this matter. Any such settlement, however, may not completely preclude other enforcement actions by state or federal agencies, regulators or law enforcement bodies related to foreclosure and other mortgage servicing practices, including, but not limited to matters relating to the securitisation of mortgages for investors. These practices have in the past resulted in private litigation and such a settlement would not preclude further private litigation concerning these practices.

US mortgage securitisation activity and litigation

HSBC Bank USA has been involved as a sponsor/seller of loans used to facilitate whole loan securitisations underwritten by HSBC Securities (USA) Inc. (HSI). During 2005-2007, HSBC Bank USA purchased and sold US$24bn of such loans to HSI which were subsequently securitised and sold by HSI to third parties. The outstanding principal balance on these loans was approximately US$6.4bn and US$7.4bn at 31 December 2013 and 31 December 2012, respectively.

Participants in the US mortgage securitisation market that purchased and repackaged whole loans have been the subject of lawsuits and governmental and regulatory investigations and inquiries, which have been directed at groups within the US mortgage market, such as servicers, originators, underwriters, trustees or sponsors of securitisations, and at particular participants within these groups. As the industry s residential mortgage foreclosure issues continue, HSBC Bank USA has taken title to an increasing number of foreclosed homes as trustee on behalf of various securitisation trusts. As nominal record owner of these properties, HSBC Bank USA has been sued by municipalities and tenants alleging various violations of law, including laws regarding

property upkeep and tenants rights. While HSBC believes and continues to maintain that the obligations at issue and the related liability are properly those of the servicer of each trust, HSBC continues to receive significant and adverse publicity in connection with these and similar matters, including foreclosures that are serviced by others in the name of HSBC, as trustee .

Various HSBC companies have been named as defendants in a number of actions in connection with residential mortgage-backed securities (RMBS) offerings, which generally allege that the offering documents for securities issued by securitisation trusts contained material misstatements and omissions, including statements regarding the underwriting standards governing the underlying mortgage loans. These include an action filed in September 2011 by the Federal Housing Finance Agency (FHFA), acting in its capacity as conservator for the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) in the US District Court for the Southern District of New York (the District Court) against HSBC Bank USA, HSBC North America Holdings Inc. (HNAH), HSI and HSI Asset Securitization (HASCO) and five former and current officers and directors of HASCO, seeking damages or rescission of mortgage-backed securities purchased by Fannie Mae and Freddie Mac that were either underwritten or sponsored by HSBC companies. The aggregate unpaid principal balance of the securities was approximately US$1.6bn at 31 December 2013. This action, captioned *Federal Housing Finance Agency, as Conservator for the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation v. HSBC North America Holdings Inc., et al.* (S.D.N.Y. No. CV 11-6189-LAK), is one of a series of similar actions filed against 17 financial institutions alleging violations of federal and state securities laws in connection with the sale of private-label RMBS purchased by Fannie Mae and Freddie Mac, primarily from 2005 to 2008. These actions were transferred to a single judge, who directed the defendant in the first-filed matter, UBS, to file a motion to dismiss. In May 2012, the District Court filed its decision denying the motion to dismiss FHFA s securities law claims and granting the motion to dismiss FHFA s negligent misrepresentation claims. The District Court s ruling formed the basis for rulings on the other matters, including the action filed against HSBC Bank USA and its affiliates. On 5 April 2013, the Second Circuit Court of Appeals affirmed the ruling of the District Court. In January 2013, the FHFA parties met with the Magistrate Judge to discuss how to

structure mediation. Since that time, a number of the FHFA defendants have resolved their lawsuits.

Discovery in HSBC s case continues. Factual discovery closed in December 2013. Expert discovery is scheduled to continue through the end of July 2014, with the summary judgement motion scheduled to be fully briefed by the end of July 2014. These dates are subject to change by the court.

The timing and outcome of this matter is uncertain. It is possible that HSBC could be found liable to pay damages. Based upon the information currently available, it is possible that these damages could be as high as US$1.6bn.

HSBC Bank USA, HSBC Finance and Decision One Mortgage Company LLC (a subsidiary of HSBC Finance) have been named as defendants in a number of mortgage loan repurchase actions brought by trustees of securitisation trusts. These actions include (i) Deutsche Bank National Trust Company, as Trustee of HASCO 2007-NC1 v. HSBC Bank USA; (ii) Deutsche Bank, as Trustee of MSAC 2007-HE6 v. Decision One and HSBC Finance Corp., and (iii) Deutsche Bank, as Trustee of HASCO 2007-HE2 v. Decision One, HSBC Finance and HSBC Bank USA. In the aggregate, these actions seek to have the HSBC defendants repurchase mortgage loans, or pay compensatory damages in lieu of repurchase, totalling at least US$1bn. On 13 January 2014 HSBC Bank USA filed a motion to dismiss the Deutsche Bank National Trust Company, as Trustee of HASCO 2007-NC1 v. HSBC Bank USA matter. HSBC Finance was dismissed, on motion, as a defendant in Deutsche Bank, as Trustee of MSAC 2007-HE6 v. Decision One and HSBC Finance Corp., but the case remains pending against Decision One Mortgage Company LLC. One other mortgage loan repurchase action against Decision One, Seagull Point LLC, individually and on behalf of the MSAC 2007-HE5 Trust v. Decision One Mortgage Company LLC, et al. was dismissed voluntarily in January 2014.

In December 2010 and February 2011, HSBC Bank USA received subpoenas from the SEC seeking production of documents and information relating to its involvement and the involvement of its affiliates in specified private-label RMBS transactions as an issuer, sponsor, underwriter, depositor, trustee, custodian or servicer. HSBC Bank USA has also had preliminary contacts with other government authorities exploring the role of trustees in private-label RMBS transactions. In February 2011, HSBC Bank USA also received a subpoena from the US Attorney s Office, Southern District of New York seeking production of documents and

information relating to loss mitigation efforts with respect to residential mortgages in the State of New York. In January 2012, HSI was served with a Civil Investigative Demand from the Massachusetts State Attorney General seeking documents, information and testimony related to the sale of RMBS to public and private customers in the State of Massachusetts from January 2005 to the present.

HSBC expects this level of focus will continue. As a result, HSBC companies may be subject to additional claims, litigation and governmental and regulatory scrutiny related to its participation in the US mortgage securitisation market, either individually or as a member of a group.

The timing and outcome of the ultimate resolution of these matters, and the amount of any possible obligations, is highly uncertain.

Anti-money laundering and sanctions-related

In October 2010, HSBC Bank USA entered into a consent cease and desist order with the OCC and the indirect parent of that company, HNAH, entered into a consent cease and desist order with the Federal Reserve Board (the Orders). These Orders required improvements to establish an effective compliance risk management programme across HSBC s US businesses, including various issues relating to US Bank Secrecy Act (BSA) and anti-money laundering (AML) compliance. Steps continue to be taken to address the requirements of the Orders to ensure compliance, and that effective policies and procedures are maintained.

In addition, in December 2012, HSBC Holdings, HNAH and HSBC Bank USA entered into agreements with US and UK government agencies regarding past inadequate compliance with the BSA and AML and sanctions laws. Among those agreements, HSBC Holdings and HSBC Bank USA entered into a five-year deferred prosecution agreement with the DoJ, the US Attorney s Office for the Eastern District of New York, and the US Attorney s Office for the Northern District of West Virginia (the US DPA), HSBC Holdings entered into a two-year deferred prosecution agreement with the New York County District Attorney (the DANY DPA), and HSBC Holdings consented to a cease and desist order and HSBC Holdings and HNAH consented to a monetary penalty order with the Federal Reserve Board (FRB). In addition, HSBC Bank USA entered into a monetary penalty consent order with FinCEN and a separate monetary penalty order with the OCC. HSBC Holdings also entered into an agreement with the Office of Foreign Assets

133f

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Control (OFAC) regarding historical transactions involving parties subject to OFAC sanctions and an undertaking with the UK Financial Services Authority, now a Financial Conduct Authority (FCA) Direction, to comply with certain forward-looking AML- and sanctions-related obligations.

Under these agreements, HSBC Holdings and HSBC Bank USA made payments totalling US$1,921m to US authorities and are continuing to comply with ongoing obligations. On 1 July 2013, the US District Court for the Eastern District of New York approved the US DPA and retained authority to oversee implementation of the same. Under the agreements with the DoJ, FCA, and the FRB, an independent monitor (who is, for FCA purposes, a skilled person under Section 166 of the Financial Services and Markets Act) will evaluate and regularly assess the effectiveness of HSBC s AML and sanctions compliance function and HSBC s progress in implementing its remedial obligations under the agreements. The monitorship, which began on 22 July 2013, is proceeding as anticipated.

If HSBC Holdings and HSBC Bank USA fulfil all of the requirements imposed by the US DPA, the DoJ charges against those entities will be dismissed at the end of the five-year period of that agreement. Similarly, if HSBC Holdings fulfils all of the requirements imposed by the DANY DPA, DANY s charges against it will be dismissed at the end of the two-year period of that agreement. The DoJ may prosecute HSBC Holdings or HSBC Bank USA in relation to the matters which are the subject of the US DPA if HSBC Holdings or HSBC Bank USA breaches the terms of the US DPA, and DANY may prosecute HSBC Holdings in relation to the matters which are subject of the DANY DPA if HSBC Holdings violates the terms of the DANY DPA.

HSBC Bank USA also entered into a separate consent order with the OCC requiring it to correct the circumstances and conditions as noted in the OCC s then most recent report of examination and imposing certain restrictions on HSBC Bank USA directly or indirectly acquiring control of, or holding an interest in, any new financial subsidiary, or commencing a new activity in its existing financial subsidiary, unless it receives prior approval from the OCC. HSBC Bank USA also entered into a separate consent order with the OCC requiring it to adopt an enterprise wide compliance programme.

The settlement with US and UK authorities does not preclude private litigation relating to, among other things, HSBC s compliance with applicable AML, BSA and sanctions laws or other regulatory or law enforcement actions for AML/BSA or sanctions

matters not covered by the various agreements.

US tax and broker-dealer investigations

HSBC continues to cooperate in ongoing investigations by the DoJ and the US Internal Revenue Service regarding whether certain HSBC companies and employees acted appropriately in relation to certain customers who had US tax reporting requirements. In connection with these investigations, HSBC Private Bank Suisse SA, with due regard for Swiss law, has produced records and other documents to the DoJ and is cooperating with the investigation. In August 2013, the DoJ informed HSBC Private Bank Suisse SA that it is not eligible for the Program for Non-Prosecution Agreements or Non-Target Letters for Swiss Banks since a formal investigation had been authorised. The DoJ also requested additional information from HSBC Private Bank Suisse SA and other Swiss banks regarding the transfer of assets to and from US person related accounts and employees who serviced those accounts. It is preparing this data, in a manner consistent with Swiss law.

Other HSBC companies are also cooperating with the relevant US authorities, including with respect to US-based clients of an HSBC company in India.

In April 2011, HSBC Bank USA received a summons from the US Internal Revenue Service directing HSBC Bank USA to produce records with respect to US-based clients of an HSBC company in India. HSBC Bank USA has cooperated fully by providing responsive documents in its possession in the US to the US Internal Revenue Service.

Also in April 2011, HSBC Bank USA received a subpoena from the SEC directing HSBC Bank USA to produce records in the US related to, among other things, HSBC Private Bank Suisse SA s cross-border policies and procedures and adherence to US broker-dealer and investment adviser rules and regulations when dealing with US resident clients. HSBC Bank USA continues to cooperate with the SEC. HSBC Private Bank Suisse SA has also produced records and other documents to the SEC and is cooperating with the SEC s investigation.

Based on the facts currently known in respect of each of these investigations, there is a high degree of uncertainty as to the terms on which the ongoing investigations will be resolved and the timing of such resolution, including the amounts of fines and/or penalties. As matters progress, it is possible that fines and/or penalties could be significant.

Report of the Directors: Financial Review (continued)

London interbank offered rates, European interbank offered rates and other benchmark interest and foreign exchange rate investigations and litigation

Various regulators and competition and enforcement authorities around the world including in the UK, the US, the EU, Switzerland, Hong Kong, Thailand, South Korea and elsewhere are conducting investigations and reviews related to certain past submissions made by panel banks and the processes for making submissions in connection with the setting of London interbank offered rates (Libor), European interbank offered rates (Euribor) and other benchmark interest and foreign exchange rates. As certain HSBC companies are members of such panels, HSBC has been the subject of regulatory demands for information and is cooperating with those investigations and reviews.

On 14 June 2013, in conjunction with the completion of its review, the Monetary Authority of Singapore (MAS) censured The Hongkong and Shanghai Banking Corporation Ltd (HBAP) for deficiencies in governance, risk management, internal controls and surveillance systems in connection with its participation on the contributing panel with respect to certain foreign exchange spot benchmarks that are commonly used to settle non-deliverable forward foreign exchange contracts. At the same time, HBAP was directed to adopt measures to address the identified deficiencies, to appoint a party to ensure the robustness of its remedial measures, and to maintain additional statutory reserves with the MAS at zero interest for a period of one year. HBAP was one of twenty banks subjected to supervisory action by the MAS as a result of its review.

On 4 December 2013, the European Commission (Commission) announced that it had imposed fines on eight financial institutions under its cartel settlement procedure for their participation in illegal activity related to Euro interest rate derivatives and/or yen interest rate derivatives. Although HSBC was not one of the financial institutions fined, the Commission announced that it had opened proceedings against HSBC in connection with its Euribor-related investigation of Euro interest rate derivatives only. This investigation will continue under the standard Commission cartel procedure.

On 3 January 2014, the Canadian Competition Bureau (CCB) notified HSBC that it was discontinuing its investigation into alleged collusive conduct in the setting of Japanese yen Libor on the basis that the evidence collected was insufficient to

justify prosecution under applicable law.

As for ongoing regulatory investigations, reviews and proceedings, based on the facts currently known in respect of each of these, there is a high degree of uncertainty as to the terms on which the ongoing investigations, reviews or proceedings will be resolved and the timing of such resolutions, including the amounts of fines and/or penalties. As matters progress, it is possible that fines and/or penalties could be significant.

The Financial Conduct Authority is also conducting investigations alongside several other law enforcement and/or regulatory agencies in various countries into a number of firms, including HSBC, related to trading on the foreign exchange market. We are cooperating with the investigations which are ongoing. It is not practicable at this stage for HSBC to estimate reliably any possible liability that might arise.

In addition, HSBC and other panel banks have been named as defendants in a number of private lawsuits filed in the US with respect to the setting of US dollar Libor. These lawsuits include individual and putative class actions, most of which have been transferred and/or consolidated for pre-trial purposes before the US District Court for the Southern District of New York. The complaints in those actions assert claims against HSBC and other US dollar Libor panel banks under various US laws including US antitrust and racketeering laws, the US Commodity Exchange Act (CEA), and state law.

In March 2013, the US District Court Judge overseeing the consolidated proceeding that encompasses a number of pending actions related to US dollar Libor issued an opinion and order in the six oldest actions dismissing the plaintiffs federal and state antitrust claims, racketeering claims, and unjust enrichment claims in their entirety, but allowing certain of their CEA claims that were not barred by the applicable statute of limitations to proceed. Some of those plaintiffs have appealed the dismissal opinion and order to the US Court of Appeals for the Second Circuit. The Court of Appeals has dismissed those appeals on the grounds that they are premature and plaintiffs subsequent motion for reconsideration was denied. Other plaintiffs have filed amended complaints in the District Court to assert additional allegations, and the defendants have filed motions to dismiss the amended complaints. The District Court held oral argument on the motions to dismiss in February 2014, and it has stayed proceedings with respect to all other actions in the consolidated proceeding pending its decision on the motions to dismiss.

Report of the Directors: Financial Review (continued)

Separately, HSBC and other panel banks have also been named as defendants in a putative class action filed in the US on behalf of persons and entities who transacted in euroyen futures and options contracts related to the euroyen Tokyo interbank offered rate (Tibor). The complaint alleges, amongst other things, misconduct related to euroyen Tibor, although HSBC is not a member of the Japanese Bankers Association s euroyen Tibor panel, as well as Japanese yen Libor, in violation of US antitrust laws, the US CEA, and state law. In April 2013, the plaintiff filed a second amended complaint which the defendants moved to dismiss in June 2013. Oral argument on the motion to dismiss is scheduled for March 2014.

In November 2013, HSBC and other panel banks were also named as defendants in a putative class action filed in the US on behalf of persons who transacted in futures contracts and other financial instruments related to Euribor. The complaint alleges, amongst other things, misconduct related to Euribor in violation of US antitrust laws, the US CEA, and state law. HSBC has not yet responded to the complaint and an amended complaint is expected by the end of March 2014. HSBC expects to file a motion to dismiss thereafter.

In late 2013 and early 2014, HSBC and a number of other banks were named as defendants in various putative class actions filed in the US on behalf of persons who executed foreign currency trades that settled on the basis of foreign exchange rates published by WM/Reuters or that otherwise occurred during the time periods when the WM/Reuters rates were being set. The complaints allege, amongst other things, that the defendants conspired to manipulate the WM/Reuters foreign exchange rates in violation of US antitrust laws. In February 2014, the US District Court Judge appointed interim lead class counsel and ordered the plaintiffs to file a consolidated amended complaint. HSBC has not yet responded, but intends to do so at the appropriate time set by the court.

Based on the facts currently known, it is not practicable at this time for HSBC to predict the resolution of these private lawsuits, including the timing and potential impact on HSBC.

Credit default swap regulatory investigation and litigation

In July 2013, HSBC received a Statement of Objections from the European Commission relating to its ongoing investigation of alleged anti-competitive activity by a number of market participants in the credit derivatives market between

2006 and 2009. The Statement of Objections sets out the European Commission s preliminary views and does not prejudge the final outcome of its investigation. HSBC has submitted a response to the European Commission. Based on the facts currently known, it is not practicable at this time for HSBC to predict the resolution of the European Commission s investigation, including the timing or impact on HSBC.

HSBC Bank USA, HSBC Holdings and HSBC Bank have been named as defendants, among others, in numerous putative class actions filed in federal courts located in New York and Chicago. These class actions allege that the defendants, which include ISDA, Markit and several financial institutions, conspired to restrain trade in violation of the federal anti-trust laws by, among other things, restricting access to credit default swap pricing exchanges and blocking new entrants into the exchange market, with the purpose and effect of artificially inflating the bid/ask spread paid to buy and sell credit default swaps in the US. The plaintiffs in these suits purport to represent a class of all persons who purchased credit default swaps from or sold credit default swaps to defendants primarily in the US. On 16 October 2013, the Judicial Panel on Multi-district Litigation ordered that all cases be consolidated in the Southern District of New York as *In re Credit Default Swaps Antitrust* Litigation, MDL No. 2476. On 5 December 2013, the District Court held its Initial Pretrial Conference, at which time it selected Lead Interim Class Counsel and set a schedule for the filing of an amended, consolidated complaint and motions to dismiss that complaint. The amended, consolidated complaint was filed on 31 January 2014 and names HSBC Bank USA and HSBC Bank, but not HSBC Holdings, as defendants, among others. Based on the facts currently known, it is not practicable at this time for HSBC to predict the resolution of these lawsuits, including the timing and potential impact on HSBC.

Economic plans: HSBC Bank Brasil S.A.

Economic plans were introduced in the mid 1980 s and early 1990 s by the government of Brazil to reduce escalating inflation. The implementation of certain of these plans adversely impacted savings account holders, thousands of which consequently commenced legal proceedings against financial institutions in Brazil, including HSBC Bank Brasil S.A. (HSBC Brazil), alleging, inter alia, that savings account balances were adjusted by a different price index than that contractually agreed, which caused them a loss of income. Certain of these cases have reached the Brazilian Supreme Court

Report of the Directors: Financial Review (continued)

(Supreme Court). The proceedings in the Supreme Court are currently due to commence in February 2014. The Supreme Court has suspended all cases pending before lower courts until it delivers a final judgement on the constitutionality of the changes resulting from the economic plans. It is anticipated that the outcome of the Supreme Court s final judgement will set a precedent for all cases pending before the lower courts. Separately, the Brazilian Superior Civil Court (Superior Civil Court) is considering matters relating to, among other things, contractual and punitive interest rates to be applied to calculate any loss of income.

There is a high degree of uncertainty as to the terms on which the proceedings in the Supreme Court and Superior Civil Court will be resolved and the timing of such resolution including the amount of losses HSBC Brazil may be liable to pay in the event of an unfavourable judgement. Such losses may lie in a range from a relatively insignificant amount to an amount up to US$600m, although the upper end of this range is considered unlikely.

Report of the Directors: Financial Review (continued)

Regulation and supervision

With listings of its ordinary shares in London, Hong Kong, New York, Paris and Bermuda, HSBC Holdings complies with the relevant requirements for listing and trading on each of these exchanges. In the UK, these are the Listing Rules of the Financial Conduct Authority (FCA) in its role as the UK Listing Authority; in Hong Kong, The Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited (HKSE); in the US, where the shares are traded in the form of ADSs, HSBC Holdings shares are registered with the US Securities and Exchange Commission (SEC). As a consequence of its US listing, HSBC Holdings is also subject to the reporting and other requirements of the US Securities Act of 1933, as amended, the Securities Exchange Act of 1934, as amended, and the New York Stock Exchange s (NYSE) Listed Company Manual, in each case as applied to foreign private issuers. In France and Bermuda, HSBC Holdings is subject to the listing rules of Euronext, Paris and the Bermuda Stock Exchange respectively, applicable to companies with secondary listings.

A statement of our compliance with the provisions of the UK Corporate Governance Code issued by the Financial Reporting Council and with the Hong Kong Corporate Governance Code (formerly the Code on Corporate Governance Practice in Appendix 14 to the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited) is set out in the Report of the Directors: Corporate Governance on page 329.

Our operations throughout the world are regulated and supervised by over 400 different central banks and other regulatory authorities in those jurisdictions in which we have offices, branches or subsidiaries. These authorities impose a variety of requirements and controls designed to provide financial stability, transparency in financial markets and a contribution to economic growth. These regulations and controls cover, *inter alia*, capital adequacy, depositor protection, market liquidity, governance standards, customer protection (for example, fair lending practices, product design and marketing and documentation standards), and financial crime and other obligations (for example, anti-money laundering, anti-bribery and corruption, and anti-terrorist financing measures). In addition, a number of countries in which we operate impose rules that affect, or place limitations on, foreign or foreign-owned or controlled banks and financial institutions. The rules include restrictions on the opening of local offices, branches or subsidiaries and the types of banking and non-banking activities that

may be conducted by those local offices, branches or subsidiaries; restrictions on the acquisition of local banks or regulations requiring a specified percentage of local ownership; and restrictions on investment and other financial flows entering or leaving the country. Country supervisory and regulatory regimes will determine to some degree our ability to expand into new markets, the services and products that we will be able to offer in those markets and how we structure specific operations. As a result of government interventions in response to global economic conditions, there has been (and it is expected that there will continue to be) a substantial increase in government regulation and supervision of the financial services industry, including the imposition of higher capital and liquidity requirements, heightened disclosure standards and restrictions on certain types of products or transaction structures.

The Prudential Regulation Authority (PRA) acts as the HSBC Group s consolidated lead regulator. The other UK regulator, the FCA, supervises 13 HSBC regulated entities in the UK including 8 where the PRA is responsible for prudential supervision. The FCA also supervises the Group globally in relation to financial crime matters. Additionally, both the PRA and FCA have certain limited direct supervisory powers over our unregulated qualifying parent company HSBC Holdings plc, including (in the FCA s case) pursuant to Directions issued by the FCA on 2 April 2013 in connection with HSBC Holdings plc and HSBC North America Holdings, Inc. having entered into agreements as part of a global settlement with a number of US authorities in relation to the Group s failure to comply with anti-money laundering rules, US sanctions requirements and related matters. In addition, each operating bank, finance company or insurance operation within HSBC is regulated by local supervisors. The primary regulatory authorities are those in the UK, Hong Kong and the US, our principal jurisdictions of operation. However, and in addition, the European Banking Authority, the European Insurance and Occupational Pensions Authority and the European Securities and Markets Authority, as the three European supervisory authorities, are also likely to have greater influence on the supervisory agenda and regulatory approach across the EU. With the EU Banking Union legislation in progress and the Single Supervisory Mechanism being adopted by 17 EU member states the European Central Bank (ECB) will become the single EU supervisor. The ECB will also take direct responsibility for systemically relevant banks in the eurozone from November 2014, which will include certain HSBC Group companies such as

133k

Report of the Directors: Financial Review (continued)

HSBC France and HSBC Malta. Developments in the EU will lead to changes in how the Group is regulated and supervised on a day-to-day basis as each of these authorities develops its powers having regard to some of the regulatory initiatives highlighted in this report.

UK regulation and supervision

The UK financial services regulatory structure has undergone substantial reform following the abolition of the Financial Services Authority (FSA) and establishment of three new regulatory bodies on 1 April 2013. These three bodies comprise the Financial Policy Committee (FPC), a committee of the Bank of England (BoE), the PRA, a subsidiary of the BoE and the FCA.

The FPC is responsible for macro-prudential supervision, focussing on systemic risk that may affect the UK s financial stability. The PRA and the FCA are micro-prudential supervisors inheriting the majority of the FSA s functions. Some Group subsidiaries such as HSBC Bank plc will be dual-regulated firms, subject to prudential regulation by the PRA and to conduct regulation by the FCA. Other UK subsidiaries are solo regulated by the FCA. As a result of these reforms, the new regulatory bodies gained additional powers. For example, under certain circumstances, the PRA and FCA are empowered to issue directions to unregulated qualifying parent undertakings such as HSBC Holdings.

UK banking and financial services institutions are subject to multiple regulations. The primary UK statute in this context is the Financial Services and Markets Act 2000 (FSMA) as amended by subsequent legislation.

Other UK financial services legislation includes that derived from EU directives and regulations relating to banking, securities, insurance, investments and sales of personal financial services.

The FCA in conjunction with the PRA is responsible for authorising and supervising all our operating businesses in the UK which require authorisation under FSMA. These include deposit-taking, retail banking, life and general insurance, pensions, investments, mortgages, custody and share-dealing businesses and treasury and capital markets activity. HSBC Bank plc is our principal authorised institution in the UK.

PRA and FCA rules establish the minimum criteria for the authorisation of banks and financial services businesses in the UK and the PRA and FCA have the right to object, on prudential grounds, to

persons who hold, or intend to hold, 10% or more of the voting power or shares of a financial institution that it regulates, or of its parent undertaking. PRA rules also set out reporting (and, as applicable, consent) requirements with regard to large individual exposures and large exposures to related borrowers. In its capacity as our supervisor on a consolidated basis, the PRA receives information on the capital adequacy of, and sets requirements for, the Group as a whole. Individual banking subsidiaries in the Group are directly regulated by their local banking supervisors, who set and monitor, *inter alia*, their capital adequacy requirements.

We calculate capital at a Group level using the Basel II framework of the Basel Committee on Banking Supervision. However, local regulators are at different stages of implementation of this framework and also of the updated Basel III requirements and as such, local reporting may differ. In most jurisdictions, non-banking financial subsidiaries are also subject to the supervision and capital requirements of local regulatory authorities.

Basel II is structured around three pillars : minimum capital requirements, supervisory review process and market discipline. The Capital Requirements Directive (CRD) implemented Basel II in the EU and the FSA, then gave effect to the CRD by including the EU s requirements in its own rulebooks. The latest iteration of this legislation, CRD IV, was formally published in the Official Journal of the EU on 27 June 2013 and the majority of the rules contained in the legislation will apply from 1 January 2014. CRD IV broadly implements the provisions of Basel III in Europe, albeit subject to amendments agreed by the EU legislative process and where certain provisions permits, national discretion by EU member states.

In December 2013, the PRA published its final rules on implementing CRD IV in Policy Statement 7/13. From 1 January 2014, major UK banks and building societies, including HSBC, are required to meet a 3% CRD IV end point tier 1 leverage ratio and to hold capital resources equivalent to at least 7% of their risk-weighted assets, using a CRD IV definition of common equity tier 1 (CET1) but after taking account of any adjustments set by the PRA. This follows the FPC s 2013 capital shortfall exercise which included an assessment of expected future losses, future costs of conduct redress and adjusting for a more prudent calculation of risk weights.

Despite final PRA rules there remains continued uncertainty as to the on-going amount of capital that banks will be required to hold under CRD IV. This

Report of the Directors: Financial Review (continued)

relates to the quantification and interaction of CRD IV capital buffers and Pillar 2, where further PRA consultations are due in 2014. Furthermore, there are a significant number of draft and unpublished EBA technical standards due in 2014 which will potentially impact our capital position and risk-weighted assets. Further information on developments relevant to our prudential regulatory framework is set out in the Capital section on page 314 of our *Annual Report and Accounts 2013*.

The PRA and FCA monitor authorised institutions through ongoing supervision and the review of routine and *ad hoc* reports relating to financial, prudential and conduct of business matters. They may also obtain independent reports from a skilled person on the adequacy of procedures and systems covering internal control and governing records and accounting. The PRA meet regularly with the Group s senior executives to discuss our adherence to the PRA s prudential guidelines. In addition, both the PRA and FCA regularly discuss fundamental matters relating to our business in the UK and internationally, including areas such as strategic and operating plans, risk control, loan portfolio composition and organisational changes, including succession planning and recovery and resolution arrangements. During the year, we also participated in and satisfied various regulator-required stress tests. With the rapid pace of regulatory change and market conditions, we continue to experience a high level of ongoing interaction with both the PRA and the FCA.

The FPC has been granted powers to give directions to the FCA or the PRA on the exercise of their supervisory powers, and may make recommendations within the BoE, to HM Treasury, to the FCA or the PRA or to other persons . From 2014 the FPC is also responsible for decisions on the countercyclical capital buffer (CCB), a CRD IV requirement, to be applied to certain financial institutions. The CCB is a macro-prudential tool at the disposal of national authorities that can be deployed when the FPC judges that threats to financial stability have arisen in the UK increasing system-wide risk, and to protect the banking sector from future potential losses. Should a CCB be required, it is expected that the additional capital required would be in the range of 0-2.5% of risk-weighted assets, although national supervisors have powers under CRD IV to increase this.

In addition, the FPC has been granted direction power, under the new legislation, over sectoral capital requirements (SCR s). The SCR tool would allow the FPC to change capital requirements above minimum regulatory standards on exposures held by

all UK banks to three broad sectors judged to pose a risk to the system as a whole (residential property, including mortgages; commercial property; and exposures to the financial sector), as well as more granular sub-sectors (for example, to mortgages with high loan-to-value or loan-to-income ratios at origination). This will include both banking book and trading book exposures and be irrespective of the domicile of the ultimate borrower.

The CCB and SCR tools are stated as broad powers designed to reduce the likelihood and severity of financial crises, their primary purpose being to tackle cyclical risks. Both tools provide the FPC with means to increase the amount of capital that banks must have when threats to financial stability are judged to be emerging.

The Financial Services Act 2010 (amongst other things) empowered the UK regulators to make rules about remuneration requiring all authorised firms to operate a remuneration policy which is consistent with the effective management of risks and the Financial Stability Board s (FSB) Implementation Standards for Principles for Sound Compensation Practices . In 2011, the FSA implemented the requirements of CRD III, which requires certain financial institutions, including banks and investment firms, to have in place remuneration policies that are consistent with effective risk management. These requirements will be updated following the agreement of CRD IV and the EBA has set out proposed rules. However, the timetable for finalisation and implementation of these rules is uncertain. In addition to the rules required by the PRA and FCA for the Group, individual legal entities may also be subject to their own local requirements.

There are a substantial number of other on-going regulatory initiatives affecting the Group driven by or from the UK. These include the UK bank levy, ongoing rule making regarding recovery and resolution plans (RRP) and the implementation of the recommendations of the UK Independent Commission on Banking (ICB) and the Parliamentary Commission on Banking Standards (PCBS).

Legislation in respect of the UK bank levy was substantively created in July 2011, in the form of the Finance Act 2011 and the levy has been applied since January 2011. HSBC is a UK banking group for these purposes and the UK levy is chargeable on the Group s consolidated balance sheet at the year end. A charge of US$904m for the UK bank levy on the 2013 balance sheet has been recognised of which US$484m does not relate to UK banking activity.

133m

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

The Financial Services Act 2010 also empowered the FSA (and now the PRA) to make rules requiring authorised firms to prepare and keep up-to-date RRP. During 2012, the FSA set out the rules for the RRP for HSBC on a Group basis, with additional requirements specific to HSBC Bank plc. These rules may be amended by the European Recovery and Resolution Directive, a draft of which was published in June 2012, but which is not yet finalised. In addition to the rules required by the FSA for the Group, individual legal entities may also be subject to their own local requirements.

The ICB published its final report in September 2011 and the UK Government expressed broad approval for the principle of establishing a ring-fenced bank for retail banking activities and greater loss absorbing capacity. In December 2013, the UK s Financial Services (Banking Reform) Act 2013 received Royal Assent, becoming primary legislation. It implements the recommendations of the ICB and of the Parliamentary Commission on Banking Standards, which *inter alia* establish a framework for ring-fencing the UK retail banking from trading activities, and sets out requirements for loss absorbency in the form of equity capital and loss absorbing debt. The PRA, subject to the approval of Her Majesty s Treasury, is empowered to require banking groups to restructure their operations if it considers that the operation of the ring-fence in a group is proving to be ineffective. The exercise of these powers may lead to groups being required to split their retail and investment banking operations into separate corporate groups. A consultation has also taken place on draft secondary legislation setting out further details but the underlying rules from supervisory authorities are not yet available.

The UK Financial Services (Banking Reform) Act 2013 also creates a bail-in mechanism as an additional resolution tool alongside existing options to transfer all or part of the bank to a private sector purchaser, to transfer parts of the bank to a new bridge bank which is later sold or to take the bank into temporary public sector ownership. In a bail-in , shareholders and creditors in the bank have their investments written down in value or converted into new interests (such as new shares) without the bank being placed in liquidation. This allows the bank to continue to provide its core banking services without interruption and ensures that the solvency of the bank is addressed without taxpayer support, while also allowing the Bank of England to provide temporary funding to this newly solvent bank. Certain liabilities such as deposits protected by the Financial Services Compensation Scheme are

excluded from bail-in. It is intended that these bail-in provisions will be consistent with the European Recovery and Resolution Directive once it comes into force.

The UK government intends to complete the legislative process by the end of this Parliament in May 2015 and to have reforms in place by 2019.

At a national level in the UK, other relevant regulatory initiatives include the FCA s Mortgage Market Reviews, transfer of consumer credit regulation to the FCA and an ever greater focus on conduct risk including attention to sales processes and incentives, product and investment suitability, employee activities in relation to benchmark, index and other rate setting processes. Uncertainty remains about the details and timing of some of the resulting reforms and the effect they will ultimately have on HSBC.

The FCA is making increasing use of existing and new powers of intervention and enforcement, including powers to consider past business undertaken and implement customer compensation and redress schemes or other, potentially significant remedial work. Additionally, the FCA and other regulators may increasingly take actions in response to customer complaints either specific to an institution or, more generally, in relation to a particular product. We have seen recent examples of this approach across the financial services sector in the UK, for example in the context of the mis-selling of payment protection insurance, interest rate derivative products to SMEs and wealth management products.

The UK and other regulators may identify future industry-wide mis-selling, market conduct or other issues that could affect the Group. This may lead from time to time to: (i) significant direct costs or liabilities; and (ii) changes in the practices of such businesses. Further, decisions taken in the UK by the Financial Ombudsman Service in relation to customer complaints (or any overseas equivalent that has jurisdiction) could, if applied to a wider class or grouping of customers, have a material adverse effect on the operating results, financial condition and prospects of the Group.

The FCA also continues to apply close scrutiny to the Group s financial crime control framework both generally in conjunction with the exercise of its wider powers under FSMA and more specifically under the Directions issued by the FCA against HSBC Holdings plc in April 2013 as described above. This includes ongoing consideration of the Group s progress in meeting its obligations under

133n

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

the Deferred Prosecution Agreement and other commitments outlined below.

Hong Kong regulation and supervision

Banking in Hong Kong is subject to the provisions of the Banking Ordinance and to the powers, functions and duties ascribed by the Banking Ordinance to the Hong Kong Monetary Authority (the HKMA). The principal function of the HKMA is to promote the general stability and effective working of the banking system in Hong Kong. The HKMA is responsible for supervising compliance with the provisions of the Banking Ordinance. The Banking Ordinance gives power to the Chief Executive of Hong Kong to give directions to the HKMA and the Financial Secretary with respect to the exercise of their respective functions under the Banking Ordinance.

The HKMA has responsibility for authorising banks, and has discretion to attach conditions to its authorisation. The HKMA requires that banks or their holding companies file regular prudential returns, and holds regular discussions with the management of the banks to review their operations. The HKMA may also conduct on-site examinations of banks and, in the case of banks incorporated in Hong Kong, of any local and overseas branches and subsidiaries. The HKMA requires all authorised institutions to have adequate systems of internal control and requires the institutions external auditors, upon request, to report on those systems and other matters such as the accuracy of information provided to the HKMA. In addition, the HKMA may from time to time conduct tripartite discussions with banks and their external auditors.

The HKMA has the power to serve a notice of objection on persons if they are no longer deemed to be fit and proper to be controllers of the bank, if they may otherwise threaten the interests of depositors or potential depositors, or if they have contravened any conditions specified by the HKMA. The HKMA may revoke authorisation in the event of an institution s non-compliance with the provisions of the Banking Ordinance. These provisions require, among other things, the furnishing of accurate reports. The HKMA has implemented Basel II for all authorised institutions incorporated in Hong Kong and subsequently adopted Basel III from 1 January 2013, implementing in accordance with the Basel Committee on Banking Supervision s timetable, including transitional arrangements.

The marketing of, dealing in and provision of advice and asset management services in relation to securities and futures in Hong Kong are subject to

the provisions of the Securities and Futures Ordinance of Hong Kong. Entities engaging in activities regulated by the Ordinance are required to be licensed. The HKMA is the primary regulator for banks involved in the securities business, while the Securities and Futures Commission (SFC) is the regulator for securities and futures markets. Amongst other functions, the Securities and Futures Ordinance vested the SFC with powers to set and enforce market regulations, including investigating breaches of rules and market misconduct and taking appropriate enforcement action. The SFC is responsible for licensing and supervising intermediaries seeking to conduct SFC regulated activities, for example investment advisors, fund managers and brokers. Additionally the SFC authorises investment products and offering documents prior to their distribution to retail investors.

US regulation and supervision

The Group is subject to extensive federal and state supervision and regulation in the US. Banking laws and regulations of the Board of Governors of the Federal Reserve System (the Federal Reserve Board), the Office of the Comptroller of the Currency (the OCC) and the Federal Deposit Insurance Corporation (the FDIC) govern many aspects of our US business. Furthermore, since we have substantial operations outside the US which conduct many of their day-to-day transactions in US dollars which are ultimately cleared and settled in the US, HSBC entities operations outside the US are also subject to the extra-territorial effects of US regulation in many respects. The requirements of the Deferred Prosecution Agreement entered into by HSBC in December 2012 and described in this section under Anti-money laundering and related regulation should also be noted in this context.

In July 2010, the US enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), which provides a broad framework for significant regulatory changes that will extend to almost every area of US financial regulation. The implementation of

Dodd-Frank requires further detailed rulemaking over several years by different US regulators, including the Department of the Treasury, the Federal Reserve Board, the FDIC, the SEC, the Commodity Futures Trading Commission (CFTC), the Financial Stability Oversight Council (FSOC) and the Consumer Financial Protection Bureau (Consumer Bureau). Notwithstanding the time that has passed since Dodd-Frank was enacted, substantial uncertainty remains about many of the final details, timing and impact of the rules.

133o

Report of the Directors: Financial Review (continued)

The Federal Reserve Board, in consultation with the FSOC may take certain actions, including precluding mergers, restricting financial products offered, restricting or terminating activities, imposing conditions on activities or requiring the sale or transfer of assets, against any bank holding company with assets greater than US$50bn that is found to pose a grave threat to financial stability. The FSOC is supported by the Office of Financial Research (OFR) which may impose data reporting requirements on financial institutions. The cost of operating both the FSOC and OFR is paid for through an assessment on large bank holding companies.

Over a transition period from 2013 to 2019, the Federal Reserve Board will apply more stringent capital and risk management requirements on bank holding companies such as HSBC North America Holdings Inc. (HNAH), which will require a minimum supplementary leverage ratio of 3% and an effective minimum total risk-based capital ratio of 10.5%. The 10.5% ratio includes the capital conservation buffer which is not a minimum requirement, per se, but rather a necessary condition to capital distributions. Additionally, failure to maintain minimum regulatory ratios in simulated stress conditions will restrict HNAH from engaging in capital distributions such as dividends or share repurchases. In addition, large bank holding companies such as HNAH (or their parent companies) are now required to file resolution plans identifying material subsidiaries and core business lines domiciled in the US, describing what strategy would be followed in the event of significant financial distress and including identifying how insured bank subsidiaries are adequately protected from risk created by other affiliates. The failure to cure deficiencies in a resolution plan would enable the US regulators to impose more stringent capital, leverage and liquidity requirements, restrict the growth, activities or operations of the company or, if such failure persists, require the company to divest assets or operations. The Federal Reserve Board has also recently adopted final rules requiring a series of increased supervisory standards to be followed by large bank holding companies, and certain foreign banking organisations that meet particular thresholds including stress testing requirements and risk management standards. These rules also authorise the Federal Reserve proposed to impose a 15-to-1 debt-to-equity ratio limit on non-bank financial companies, bank holding companies and the US operations of foreign banking organisations that the FSOC determines to pose a grave threat to the

financial stability of the US. Under the proposed rule requiring remediation in the event of failure to meet capital requirements, the Federal Reserve Board would also be able to restrict the size and growth of systemically significant non-bank financial companies and large interconnected bank holding companies. In addition, the final rules require certain foreign banking organisations to restructure their US operations. Because of the current structure of our US operations, we do not expect this requirement to have a significant impact on those operations.

In October 2012, the Federal Reserve Board published a final rule setting out stress testing requirements for bank holding companies with US$50bn or more in total consolidated assets. HNAH became subject to the rule from October 2013 and was required to comply with the Federal Reserve Board s Comprehensive Capital Analysis and Review (CCAR) programme for its capital plan submission in January 2014.

Under the CCAR process, the Federal Reserve Board will consider a bank holding company s overall financial condition, risk profile and capital adequacy over a nine-quarter forward-looking planning horizon. The Federal Reserve Board will assess a bank holding company s ability to meet qualitative aspects of capital planning and risk management, as well as maintaining minimum regulatory ratios including a 5% tier 1 common equity ratio, for each quarter of the planning horizon under baseline, adverse and severely adverse economic scenarios. The Federal Reserve Board will also take into account a bank holding company s planned capital actions (such as dividends or share repurchases) over the planning horizon when assessing capital adequacy. If, based on such assessment, the Federal Reserve Board were to issue an objection to a bank holding company s capital plan or planned capital actions, the bank holding company would be required to submit a revised capital plan, and generally would not be able to undertake planned capital actions until approved by the Federal Reserve Board. The Federal Reserve Board will publicly release a summary of its CCAR assessments in March of each year and bank holding companies are also required to publicly release a summary of their stress test results under the supervisory severely adverse scenario. Bank holding companies subject to these stress test rules are also required to conduct a mid-year company-run stress test, submit the results to the Federal Reserve Board and publicly disclose a summary of these mid-year stress test results in September of each year.

133p

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

HSBC and its US operations are subject to supervision, regulation and examination by the Federal Reserve Board because HSBC is a bank holding company under the US Bank Holding Company Act of 1956 (BHCA), as a result of its control of HSBC Bank USA, N.A., McLean, Virginia (HSBC Bank USA); and HSBC Trust Company (Delaware), N.A., Wilmington, Delaware (HTCD). HNAH is also a bank holding company . Both HSBC and HNAH have elected to be financial holding companies (FHC s) pursuant to the provisions of the Gramm-Leach Bliley Act (the GLB Act) and, accordingly, may affiliate with securities firms and insurance companies and engage in other activities that are financial in nature or incidental or complementary to activities that are financial in nature.

Under regulations implemented by the Federal Reserve Board, if any financial holding company, or any depository institution controlled by a financial holding company, ceases to meet certain capital or management standards, the Federal Reserve Board may impose corrective capital and/or managerial requirements on the financial holding company and place limitations on its ability to conduct the broader financial activities permissible for financial holding companies. In addition, the Federal Reserve Board may require divestiture of the holding company s depository institutions or its affiliates engaged in broader financial activities in reliance on financial holding company status under the GLB Act if the deficiencies persist. The regulations also provide that if any depository institution controlled by a financial holding company fails to maintain a satisfactory rating under the Community Reinvestment Act of 1977, the Federal Reserve Board must prohibit the financial holding company and its subsidiaries from engaging in any additional activities other than those permissible for bank holding companies that are not financial holding companies.

As reflected in the agreement entered into with the OCC on December 11, 2012 (the GLBA Agreement), the OCC has determined that HSBC Bank USA is not in compliance with the requirements set forth in 12 U.S.C. § 24a(a)(2)(c) and 12 C.F.R. § 5.39(g)(1), which provide that a national bank and each depository institution affiliate of the national bank must be both well capitalised and well managed in order to own or control a financial subsidiary. As a result, HSBC Bank USA and its parent holding companies, including HSBC Holdings plc no longer meet the qualification requirements for financial holding company status, and may not engage in any new types of financial activities without the prior approval of the Federal

Reserve Board. In addition, HSBC Bank USA may not directly or indirectly acquire control of, or hold an interest in, any new financial subsidiary, nor commence a new activity in its existing financial subsidiary, unless it receives prior approval from the OCC. If all of our affiliate US depositary institutions are not in compliance with these requirements within the time periods specified in the GLBA Agreement, as they may be extended, HSBC could be required either to divest HSBC Bank USA or to divest or terminate any financial activities conducted in reliance on financial holding company status under the GLB Act. Similar consequences could result for financial subsidiaries of HSBC Bank USA that engage in activities in reliance on expanded powers provided for in the GLB Act. The GLBA Agreement requires HSBC Bank USA to take all steps necessary to correct the circumstances and conditions resulting in HSBC Bank USA s noncompliance with the requirements referred to above. We are taking steps to satisfy the requirements of the GLBA Agreement.

The two US banks, HSBC Bank USA and HTCD, are subject to regulation and examination primarily by the OCC. HSBC Bank USA and HTCD are subject to additional regulation and supervision, secondly by the FDIC, and by the Federal Reserve Board and the Consumer Bureau. Banking laws and regulations restrict many aspects of their operations and administration, including the establishment and maintenance of branch offices, capital and reserve requirements, deposits and borrowings, investment and lending activities, payment of dividends and numerous other matters. In addition, the FDIC requires FDIC-insured banks with US$50bn or more in total assets (such as HSBC Bank USA) to submit resolution plans that should enable the FDIC to resolve the bank in a manner that ensures that depositors receive access to their insured deposits within one business day of the institution s failure (two business days if the failure occurs on a day other than Friday), maximises the value from the sale or disposition of its assets and minimises the amount of any loss to be realised by the institution s creditors. Joint initial resolution plans for HNAH and HSBC Bank USA were filed with the Federal Reserve Board and the FDIC in June 2013.

Large bank holding companies, including HNAH, became subject to the US rules adopted in 2007 that provided for the implementation of Basel II advanced approaches in the US. The US Basel II implementation timetable originally consisted of a parallel calculation period under the current regulatory capital regime (Basel I), followed by a three-year transitional floor period, during which Basel II advance approaches risk-based

Report of the Directors: Financial Review (continued)

capital requirements could not fall below certain floors based on Basel I regulations.

In June 2011, the US banking agencies adopted final regulations to implement the capital floor provision of the so-called Collins Amendment of Dodd-Frank. These regulations, as subsequently modified by the Basel III final rule (defined below), eliminated the three-year transitional floor period in favour of a permanent floor based on the generally applicable risk-based capital rules (currently Basel I although switching to the standardised approach beginning in 2015). Pursuant to these regulations, a banking organisation that has formally implemented the Basel II advanced approaches must calculate its capital requirements under Basel I and the Basel II advanced approaches (as revised by the Basel III final rule from 1 January 2014), compare the two results, and then use the lower of such ratios for purposes of determining compliance with its minimum common equity tier 1, tier 1 capital and total risk-based capital requirements. HNAH is required successfully to complete a parallel run by measuring regulatory capital under both the new regulatory capital rules and the existing Basel I general risk-based rules (and the Standardised Approach described below beginning in 2015) for a period of at least four quarters. Successful completion of the parallel run period requires the approval of US regulators. HNAH began the parallel run period, which encompasses enhancements to a number of risk policies, processes and systems to align HSBC Bank USA with the Basel III final rule requirements, in January 2010. The timing of receipt of US regulatory approval is uncertain.

In July 2013, the US banking agencies adopted a final rule that (i) implements the Basel III capital framework in the United States; (ii) replaces the current generally applicable risk-based capital rules (Basel I) with a modified version of the Basel II standardised approach; and (iii) removes from both the generally applicable risk-based rules and the Basel II advanced approaches rules all references to and reliance upon external credit ratings, as required under Dodd-Frank (the Basel III final rule). The Basel III final rule establishes an integrated regulatory capital framework to improve the quality and quantity of regulatory capital and introduces the Standardised Approach for risk weighted assets, which will replace the Basel I risk-based guidance for determining risk-weighted assets as of 1 January 2015. For the largest banking organisations, such as HNAH, the final rule is largely unchanged from the proposed rules and took effect on 1 January 2014 with a number of the provisions being phased in through to 2019. The final rule is also largely

consistent with regard to the Standardised Approach, although it did not adopt modifications from the Basel I standards to the calculation of risk-weighting for mortgages as proposed.

In June 2012, the US banking agencies issued a final rule to amend the market risk capital rule to implement Basel 2.5 to better capture positions for which the market risk capital rules are appropriate, reduce procyclicality, enhance the sensitivity to risk not adequately captured under existing methodologies and increase transparency through enhanced disclosures. The final rule also implemented the prohibition in Dodd-Frank on references to and reliance upon the use of external credit ratings in the US banking agencies regulations. The final market risk rule published in August 2012 sets forth alternative methodologies to external credit ratings that must be used to determine the capital requirements applicable to certain debt and securitisation positions subject to the market risk capital rule. The final Basel 2.5 rule became effective on 1 January 2013.

HSBC Bank USA and HTCD are subject to risk-based assessments from the FDIC, which insures deposits generally to a maximum of US$250,000 per depositor for domestic deposits. Dodd-Frank changes the FDIC s risk-based deposit insurance assessment framework primarily by basing assessments on an FDIC-insured institution s total assets less tangible equity rather than US domestic deposits, which is expected to shift a greater portion of the aggregate assessments to large FDIC-insured institutions. The new large bank pricing system will result in higher assessment rates for banks with high-risk asset concentrations, less stable balance sheet liquidity, or potentially higher loss severity in the event of failure.

With effect from 1 October 2013, Dodd-Frank and the applicable regulations of the OCC required that the lending limits applicable to HSBC Bank USA and HTCD with respect to credit extensions to third parties take into account credit exposure from derivative transactions, securities borrowing and lending transactions, and repurchase and reverse repurchase agreements.

HSBC s US consumer finance operations are subject to extensive state-by-state regulation in the US, and to laws relating to consumer protection (both in general, and in respect of sub-prime lending operations, which have been subject to enhanced regulatory scrutiny); discrimination in extending credit; use of credit reports; privacy matters; disclosure of credit terms; and correction of billing

Report of the Directors: Financial Review (continued)

errors. They also are subject to regulations and legislation that limit operations in certain jurisdictions.

On 10 December 2013, US regulators issued final regulations implementing the Volcker Rule. The Volcker Rule will limit the ability of companies related to a US bank (including HSBC group companies outside the US) to sponsor or invest in private equity or hedge funds or to engage in certain types of proprietary trading in the US. The final rule extended the conformance period for all banking entities until 21 July 2015 (with the possibility of two one-year extensions under certain circumstances and for certain activities), by which time financial institutions subject to the rule must bring their activities and investments into compliance with the rule. The Group continues to update its existing conformance plans and to finalise adjustments necessary to its businesses both in the US and elsewhere to comply with these final rules.

Dodd-Frank also provides regulators with tools to provide greater capital, leverage and liquidity requirements and other prudential standards, particularly for financial institutions that pose significant systemic risk. However, in imposing heightened capital, leverage, liquidity and other prudential standards on non-US banks, the Federal Reserve Board is directed to take into account the principle of national treatment and equality of competitive opportunity, and the extent to which the foreign bank is subject to comparable home country standards. As noted above, the Federal Reserve Board has recently adopted certain enhanced supervisory standards that would apply to HSBC. Certain other enhanced supervisory standards proposed by the Federal Reserve Board have not yet been finalised. The cumulative effect of the rules and proposals on HSBC is unclear.

Furthermore, Dodd-Frank provides for an extensive framework for the regulation of over-the-counter (OTC) derivatives, including mandatory clearing, exchange trading and transaction reporting of certain OTC derivatives, as well as rules regarding the registration of swap dealers and major swap participants, and related capital, margin, business conduct, record keeping and other requirements applicable to such entities. These rules became effective in October 2012 and HSBC Bank USA and HSBC Bank plc are provisionally registered as Swap Dealers with the Commodity Futures Trading Commission. On January 16, 2014, the CFTC confirmed the de-registration of The Hongkong and Shanghai Banking Corporation Limited, and as of such date it is no longer a Swap Dealer for purposes of Dodd-Frank. We continue to assess how compliance

with these new rules will affect our business.

Dodd-Frank grants the SEC discretionary rule-making authority to modify the standard of care that applies to brokers, dealers and investment advisers when providing personalised investment advice to retail customers and to harmonise other rules applying to these regulated entities. Dodd-Frank also expands the extraterritorial jurisdiction of US courts over actions brought by the SEC or the US with respect to violations of the anti-fraud provisions in the Securities Act, the Securities Exchange Act of 1934 and the Investment Advisers Act of 1940. In addition, regulations which the FSOC, the Consumer Bureau or other regulators may adopt could affect the nature of the activities which our FDIC-insured depository institution subsidiaries may conduct, and may impose restrictions and limitations on the conduct of such activities.

The ongoing implementation of Dodd-Frank and related final regulations could result in additional costs or limit or restrict the way we conduct our business, both in relation to our US operations and our non-US operations, although uncertainty remains about many of the details, impact and timing of these reforms and the ultimate effect they will have on HSBC.

Global and regional prudential and other regulatory developments

The Group is subject to regulation and supervision by a large number of regulatory bodies and other agencies. In addition to changes being pursued at a country level, changes are also being pursued globally through the actions of bodies such as the G-20, the FSB and Basel Committee, as well as regionally through the EU and similar. Key areas include the work of the FSB on global systemically important banks (G-SIBs), the Basel Committee s Basel III capital requirements, the EU s measures to implement Basel III (referred to as CRD IV), and the EU s proposed recovery and resolution framework.

Recovery and resolution

The FSB has been designated by the G-20 as the body responsible for coordinating the delivery of a global reform programme following the financial crisis, a key element of which is that no firm should be too big or too complicated to fail, and that taxpayers should not bear the cost of resolution. HSBC has been classified by the FSB as a G-SIB and therefore will be subject to what the FSB refers to as a multi-pronged and integrated set of policies . These include proposals that would place an

133s

Report of the Directors: Financial Review (continued)

additional capital buffer on the Group and require enhanced reporting.

The FSB also determined that recovery and resolution strategies should be developed for all G-SIBs. Recovery plans set out the actions which management may take during a period of stress to avoid the failure of the firm. Resolution plans are prepared by the authorities based on information provided by firms and set out the actions which may be taken if the firm reaches the point of non-viability. This work is led by the PRA and the BoE for the consolidated Group in conjunction with the regulators of HSBC s largest operating entities which together make up the Crisis Management Group (CMG) of regulators for HSBC.

In accordance with guidance from the FSB and UK requirements, HSBC has produced recovery plans for the Group, drawing together many of the actions contained in stress testing and scenario planning exercises conducted within the Group. The recovery plans identify a series of early warning signals indicative of developing financial stress and establishes triggers which, if breached, would precipitate pre-planned but urgent action from the Group. The plans also contain a series of recovery options to raise additional capital or funding for the Group or individual entities as appropriate. These options would be reviewed for applicability and feasibility once the cause and magnitude of the financial stress was evident. These Group recovery plans have been submitted to the PRA and the BoE in the UK and through them discussed with the CMG.

HSBC has also provided the PRA, the BoE and the CMG with information for them to determine a resolution strategy for the HSBC Group

European regulation

Through the UK s membership of the EU, HSBC is both directly and indirectly subject to European financial services regulation.

In December 2010, the Basel Committee issued two documents: A global regulatory framework for more resilient banks and banking systems and International framework for liquidity risk measurement, standards and monitoring , which together are commonly referred to as Basel III . These will be given effect across the EU through new Capital Requirement Regulations and Directives, collectively known as CRD IV. This was published in June 2013 and the majority of the rules contained in the legislation apply from 1 January 2014. The key requirements of CRD IV include:

- *Quality of capital:* a further strengthening and harmonisation of the criteria for eligibility of capital instruments with an emphasis on common equity as the principal component of tier 1 capital;

- *Capital buffers:* this includes a capital conservation buffer of 2.5% of RWAs to be built up during periods of economic growth, aimed at ensuring the capacity to absorb losses in stressed periods that may span a number of years; a countercyclical capital buffer to be built up when threats to stability emerge, a systemic risk buffer to mitigate structural macroprudential risk and an additional capital surcharge for sytemically important institutions;

- *Derivatives and central counterparty clearing:* higher capital requirements to be imposed for bilateral (uncleared) transactions, to incentivise the use of central clearing;

- *Counterparty credit risk:* requirements for managing and capitalising counterparty credit risk are to be strengthened. In particular, an additional capital charge for potential losses associated with the deterioration in the creditworthiness of individual counterparties (credit valuation adjustment or CVA) will be introduced; and

Liquidity and funding: a new minimum standard, the Liquidity Coverage Ratio, designed to improve the short-term resilience of a bank s liquidity risk profile, will be introduced after an observation and review period in 2015. In January 2013, the Basel Committee issued revisions to the later document significantly revising the liquidity coverage ratio, which requires banking organisations to hold high quality liquid assets that can be quickly and easily monetised to cover their liquidity needs over a 30-day liquidity stress scenario.

A description of the estimated effect of adopting Basel III can be found in Basel III on page 309.

Additionally, the EU is progressing its Banking Union legislation to achieve increased integration in the eurozone banking system. The first stage will be the introduction of a Single Supervisory Mechanism that gives ultimate responsibility for bank supervisory tasks for larger banks to the European Central Bank. This will apply initially only to systemic banks in 17 EU member states, with other EU member states having the option to opt in . Additional related initiatives being progressed include proposals for a:

Single European Rulebook;

Report of the Directors: Financial Review (continued)

European Deposit Insurance Scheme; and

European Resolution Scheme funded by bank contributions.

The UK has indicated that it will not join the Banking Union.

A number of European governments have considered structural reforms of banks to separate or prohibit certain activities. France and Germany now have laws which, when implemented, will prohibit a limited range of trading activities within banks.

In February 2012, the European Commission appointed a High Level Expert Group under the Governor of the Bank of Finland, Erkki Liikanen, to consider potential structural changes in banks within the EU. The group recommended, *inter alia*, the ring-fencing of certain market-making and trading activities from the deposit-taking and retail payments activities of major banks and possible amendments to the use of bail-in instruments as a resolution tool, as well as a number of other comments.

In January 2014, following a consultation period, the European Commission published its own legislative proposals on the structural reform of the European banking sector which would prohibit proprietary trading in financial instruments and commodities, and enable supervisors to require trading activities such as market-making, complex derivatives and securitisation operations to be undertaken in a separate subsidiary from deposit taking activities.

The ring-fenced deposit taking entity would be subject to separation from the trading entity including capital and management structures, issuance of own debt and arms-length transactions between entities.

The proposals allow for derogation from these requirements for super-equivalent national regimes. On the current basis, it is understood that non-EU subsidiaries of the Group which could be separately resolved without a threat to the financial stability of the EU would be excluded from the proposals.

The proposals will now be subject to discussion in the European Parliament and the Council of Ministers (representing the EU member states) and are not expected to be finalised in 2014. The implementation date for any separation under the final rules would depend upon the date on which the final legislation is agreed.

In December 2013, political agreement was reached at EU level on the text of a Recovery and Resolution Directive (formerly the Crisis

Management Directive) (RRD). This is intended to provide a harmonised framework for the resolution of credit institutions across the EU. While setting out a general framework, the proposals delegated much of the detailed application to local supervisors. The proposals remain subject to negotiation between EU bodies with an implementation date of 1 January 2015. See page 133(s) for more detail on the Group s current approach to recovery and resolution.

The EU also continues to pursue the development of markets, and conduct-related EU regulations such as the Short Selling Regulation and the European Markets Infrastructure Regulation, some or all parts of which have been or are now being implemented. A number of other EU regulations are in the legislative process. For example, in 2014 it is expected that the Markets in Financial Instrument Directive/Regulation and the Market Abuse Directive/Regulation will be finalised and will move into the implementation phase.

Anti-money laundering and related regulation

HSBC places a high priority on its obligations to deter money laundering and terrorist financing. The European Commission has proposed a Fourth Directive on the prevention of the use of the financial system for the purpose of money laundering and terrorist financing (known as the

Fourth Money Laundering Directive). Political agreement is expected in 2014, meaning that the new regime is likely to come into force in 2016. HSBC policy requires that all Group companies should adhere to the letter and spirit of all applicable laws and regulations and we have policies, procedures and training intended to ensure that our employees know and understand our criteria for deciding when a client relationship or business should be evaluated as higher risk.

Risk mitigation measures aimed at deterring money laundering, terrorist and proliferation (weapons) financing (collectively referred to as AML) have been focused in three key areas:

- meeting HSBC s regulatory obligations;
- transitioning to a new operating infrastructure and Global Standards governance; and
- managing risk.

HSBC met all obligations due in 2013 under the Deferred Prosecution Agreement with the US Department of Justice.

An AML plan setting out the key dates and

133u

Report of the Directors: Financial Review (continued)

actions to move to a new operating infrastructure was designed with the support of the Global Standards Programme Office and approved by the Board in July 2013.

An AML Compliance organisational blueprint was designed and signed off during 2013 for all countries outside the US (where it is under review by the recently appointed Head of Financial Crime Compliance).

A human capital plan is in place to develop the AML team and the supporting infrastructure. A number of experienced subject matter experts were recruited during 2013 pursuant to this plan. Among the senior roles filled were:

- Global Head of AML Compliance;
- Global Head of Financial Intelligence Unit; and
- Global Head of Correspondent Banking Financial Crime Compliance.

An AML Risk Analytics team was established in 2013 and will be expanded throughout 2014.

To maximise information sharing across the Group, two key units were formed: the Financial Intelligence Unit and AML Investigations. These teams are priority areas for expansion in 2014.

A Financial Crime Risk Appetite Statement was approved by the Board in October 2013.

A financial crime-based component has been embedded in Group Strategy determining what business HSBC does, with whom and in what markets.

An enhanced global AML policy, incorporating risk appetite, was approved by the Board in January 2014. The policy adopts and enforces the highest or most effective standards globally, including a globally consistent approach to knowing and retaining our customers.

The AML policy is being implemented in phases by developing and applying global minimum standards of procedure to manage AML compliance. The overriding policy objective is for every HBSC employee to conduct the right kind of business , which will be a recurring theme across all pillars of the AML programme and engagement campaign.

Enhanced minimum standards for customer due diligence procedures covering the majority of HSBC s customer types have already been completed and approved in 2013. Conducting customer due diligence is one of the fundamental ways in which we understand and manage financial crime risk.

The AML programme is being better aligned to the three lines of defence model (described on page 39) with roles and accountability across all three lines clearly set out and embedded through employee awareness initiatives.

As part of our continuing evaluation of AML and sanctions risk, we also monitor activities relating to the countries subject to US economic sanctions programmes administered by OFAC, as well as those subject to United Nations, UK and EU sanctions. HSBC Group Policy requires all Group companies to comply to the extent applicable with US law and regulation, including the country and individual sanctions promulgated by OFAC sanctions. This means that not only must US subsidiaries and US nationals comply with OFAC regulations, but that HSBC subsidiaries outside the US which are not US persons must not participate in US dollar business that would, if conducted by a US person, contravene the OFAC sanctions. We do not consider that our business activities with counterparties in, or directly relating to, these countries are material to our business, and such activities represented a very small part of the Group s total assets at 31 December 2013 and total revenues for the year ended 31 December 2013.

Other

HSBC Bank USA entered into a Consent Cease and Desist Order with the OCC, and HNAH entered into a Consent Cease and Desist Order with the Federal Reserve Board in October 2010. These Orders require improvement of our Compliance Risk Management Programme including AML controls across our US businesses. Steps continue to be taken to address the requirements of these Orders and to ensure that compliance and effective policies and procedures are maintained.

Disclosures pursuant to Section 13(r) of the Securities Exchange Act

Section 13(r) of the Securities Exchange Act, requires each issuer registered with the SEC to disclose in its annual or quarterly reports whether it or any of its affiliates have knowingly engaged in specified activities or transactions with persons or entities targeted by US sanctions programmes relating to Iran, terrorism, or the proliferation of weapons of mass destruction, even if those activities are not prohibited by US law and are conducted outside the US by non-US affiliates in compliance with local laws and regulations.

In order to comply with this new requirement, HSBC Holdings Plc (together with its affiliates,

Report of the Directors: Financial Review (continued)

HSBC) has requested relevant information from its affiliates globally. The following activities are disclosed in response to Section 13(r).

Loans in repayment

Between 2001 and 2005, the Project and Export Finance (PEF) division of HSBC arranged or participated in a portfolio of loans to Iranian energy companies and banks. All of these loans were guaranteed by European and Asian export credit agencies, and they have varied maturity dates with final maturity in 2018. For those loans that remain outstanding, we continue to seek repayment in accordance with our obligations to the supporting export credit agencies and, in all cases, with appropriate regulatory approvals. Details of these loans follow.

We have 13 loans outstanding to an Iranian petrochemical and energy company. These loans are supported by the official Export Credit Agencies of the following countries: the United Kingdom, France, Germany, Spain, The Netherlands, South Korea and Japan. We continue to seek repayments from the company under the existing loans in accordance with the original maturity profiles. All repayments made by the Iranian company have received a licence or an authorisation from relevant authorities. Two repayments have been received under each loan in 2013.

Bank Melli and Bank Saderat acted as sub-participants in three of the aforementioned loans. The repayments due to these banks under the loan agreements were paid into frozen accounts under licences or authorisations from relevant European governments.

In 2002, we provided a loan to Bank Tejarat with a guarantee from the Government of Iran to fund the construction of a petrochemical plant undertaken by a UK contractor. This loan was supported by the UK Export Credit Agency and is administered under licence from the relevant European Government. No repayments have been received directly from Bank Tejarat in 2013 and claims have been settled by the supporting Export Credit Agency.

We also maintain sub-participations in four loans provided by other international banks to Bank Tejarat and Bank Mellat with guarantees from the Government of Iran. These sub-participations were supported by the Export Credit Agencies of Italy, The Netherlands and Spain. The repayments due under the sub-participations were not received during 2013 and claims are being processed and settled by the relevant European Export Credit Agencies. Licences and relevant authorisations have been obtained from the

competent authorities of the European Union in respect of the transactions.

Estimated gross revenue generated by these loans in repayment for 2013, which includes interest and fees, was approximately US$2.2m. Estimated net profit during 2013 was approximately US$1.3m. While we intend to continue to seek repayment, we do not intend to extend any new loans.

Legacy contractual obligations related to guarantees

Between 1996 and 2007, HSBC provided guarantees to a number of its non-Iranian customers in Europe and the Middle East for various business activities in Iran. In a number of cases, HSBC issued counter indemnities in support of guarantees issued by Iranian banks as the Iranian beneficiaries of the guarantees required that they be backed directly by Iranian banks. The Iranian banks to which HSBC provided counter indemnities included Bank Tejarat, Bank Melli, and the Bank of Industry and Mine.

We have worked with relevant regulatory authorities to obtain licences where required and ensure compliance with laws and regulations while seeking to cancel the guarantees and counter indemnities. Several were cancelled during 2013, and approximately 20 remain outstanding.

Estimated gross revenue for 2013, which includes fees and/or commissions, was US$10,000. We do not allocate direct costs to fees and commissions and therefore have not disclosed a separate profits measure. We are seeking to cancel all relevant guarantees and do not intend to provide any new guarantees involving Iran.

Cheque clearing

Certain Iranian banks sanctioned by the United States continue to participate in official clearing systems in the UAE, Bahrain, Oman, Lebanon, Qatar, and Turkey. We have a presence in these countries and, as such, participate in the clearing systems. The Iranian banks participating in the clearing systems vary by location and include Bank Saderat, Bank Melli, Future Bank, and Bank Mellat. We have implemented automated and manual controls in order to preclude settling cheque transactions with these institutions. There was no measurable gross revenue or net profit generated by this activity in 2013.

Other relationships with Iranian banks

Activity related to US-sanctioned Iranian banks not covered elsewhere in this disclosure includes the following:

Report of the Directors: Financial Review (continued)

We maintain a frozen account in the UK for an Iranian-owned, UK-regulated financial institution. In April 2007, the UK government issued a licence to allow us to handle certain transactions (operational payments and settlement of pre-sanction transactions) for this institution. In December 2013, the UK government issued a new licence to allow HSBC to deposit certain cheque payments. There was some licensed activity in 2013.

We act as the trustee and administrator for pension schemes involving three employees of a US-sanctioned Iranian bank in Hong Kong. Under the rules of these schemes, we accept contributions from the Iranian bank each month and allocate the funds into the pension accounts of the three Iranian bank employees. We run and operate these pension schemes in accordance with Hong Kong laws and regulations.

In 2010, we closed our representative office in Iran. We maintain a local account with a US-sanctioned Iranian bank in Tehran in order to facilitate residual activity related to the closure. During 2013 we used this account to pay tax equivalent to approximately US$20,000 to Iran s social security organisation. We have been authorised by the US Government (and by relevant non-US regulators) to make these types of payments in connection with the liquidation and deregistration of the representative office in Tehran, and anticipate making the last of such payments in 2014.

Estimated gross revenue for 2013 for all Iranian bank-related activity described in this section, which includes fees and/or commissions, was US$109,013. We do not allocate direct costs to fees and commissions and therefore have not disclosed a separate profits measure. We intend to continue to wind down this Iranian bank-related activity and not enter into any new such activity.

Iranian embassy related activity

We held a bank account in London for the Iranian embassy in London, which was used to support Iranian students studying in the UK and in which there was minimal activity during 2013. The account was closed in 2013, and the funds were moved into unclaimed balances.

Activity related to US Executive Order 13224

We maintained a frozen personal account for an individual sanctioned under Executive Order 13224

and by the UK and the UN Security Council. Activity on this account in 2013 was permitted by a licence issued by the UK. There was no measurable gross revenue or net profits generated in 2013.

We held personal and business accounts in the UK for two individuals sanctioned by the US under Executive Order 13224. UK and UN Security Council sanctions against these individuals were lifted in 2012. All the accounts were closed during 2013. The account balances were returned to the relevant individuals. There was no measurable gross revenue or net profits generated in the second or third quarters of 2013.

We hold a frozen personal account in the United Arab Emirates for an individual who was designated under Executive Order 13224 during 2013. Subsequent to designation and prior to the freezing of the account in the second quarter, there were several transactions. Estimated gross revenue in 2013 was approximately US$250. There has been no activity and no measurable gross revenue or net profit generated since the second quarter of 2013. A second personal account held in Hong Kong for the same individual was closed in the third quarter of 2013 and the balance moved into unclaimed balances. There has been no activity and no measurable gross revenue or net profit generated on the account in 2013 since designation.

We held an account and had an outstanding loan for a partnership that included one individual sanctioned under Executive Order 13224. The account has been closed, and the sanctioned individual has been removed from the loan account. There was no measurable gross revenue or net profits recognised in 2013 for this activity.

Activity related to US Executive Order 13382

We held an account for a customer in the United Arab Emirates that was sanctioned under Executive Order 13382 in 2013. The account was closed in 2013, and the funds were moved into unclaimed balances. The estimated gross revenue or net profits generated in 2013 was US$37.

Frozen accounts and transactions

We maintain several accounts that are frozen under relevant sanctions programmes and on which no activity, other than the posting of nominal amounts of interest, took place during 2013. In 2013, we also froze payments where required under relevant sanctions programmes. There was no gross revenue or net profit to HSBC.

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Risk

1 *Appendix to Risk risk policies and practices.*

2 *Unaudited.* 3 *Audited.* 4 *Audited where indicated.*

For details of HSBC s policies and practices regarding risk management and governance see the Appendix to Risk on page 266.

Risk profile

(Unaudited)

Managing our risk profile

A strong balance sheet remains core to our philosophy.

Our portfolios continue to be aligned to our risk appetite and strategy.

Our risk management framework is supported by strong forward-looking risk identification.

Maintaining capital strength and strong liquidity position

Our core tier 1 and common equity tier 1 capital ratios remain strong at 13.6% and 10.9%.

We have sustained our strong liquidity position throughout 2013.

The ratio of customer advances to deposits remains significantly below 90%.

Strong governance

Robust risk governance and accountability is embedded across the Group.

The Board, advised by the Group Risk Committee, approves our risk appetite.

The Compliance function has been restructured into the Financial Crime Compliance and Regulatory Compliance functions to provide more in-depth focus on these areas.

Our global risk operating model supports adherence to globally consistent standards and risk management policies across the Group.

Our top and emerging risks

Macroeconomic and geopolitical risk.

Macro-prudential, regulatory and legal risks to our business model.

Risks related to our business operations, governance and internal control systems.

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Risk Factors

(Unaudited)

Macroeconomic and geopolitical risk

Current economic and market conditions may adversely affect our results

Our earnings are affected by global and local economic and market conditions. Following the global financial crisis in 2007, despite signs that economies are beginning to improve, a difficult economic climate remains with continued pressures on household, financial institutions and government finances. During 2013, world economic growth remained muted and growth is expected to remain well below its past long-term potential in 2014. Expectations of a reduction in the scale of government repurchase schemes and quantitative easing measures resulted in more volatile market conditions during the year.

Mature economies continue to deleverage and implement austerity and structural reforms that are restricting economic activity in the short term. Growth in a number of emerging markets decelerated during 2013, affected by lower world demand and cautious official policies. In addition, capital flows were volatile, particularly during the second half of the year, and in several cases lead to a tightening of monetary policy to counter capital outflows. Mainland China has experienced a slowdown in economic growth in recent years, which may be aggravated by difficulties in non-bank financial institutions. While current economic growth appears to be in line with its government s expectations, a sharper than expected slowdown could take place with consequences for all other emerging markets.

The uncertain economic conditions continue to create a challenging operating environment for financial services companies such as HSBC. In particular, we may face the following challenges to our operations and operating model in connection with these factors:

- the demand for borrowing from creditworthy customers may diminish if economic activity slows or remains subdued;

- as capital flows are increasingly disrupted, some emerging markets could be tempted to impose protectionist measures that could affect financial institutions and their clients;

- European banks may come under renewed stress as a result of the interdependencies between economic conditions, the sovereign financial situation in the eurozone and the impact of the
pending European Central Bank (ECB) Asset Quality Review;

- geopolitical risks might grow in different regions of the world, affecting directly the economies of these countries and their economic policies. Continuing political instability and unrest in the Middle East may affect the ability of our customers to meet their contractual commitments to HSBC;

- a scaling back of quantitative easing (QE) or just the expectation of a scaling back could have an adverse impact on global equity and bond prices, and create turbulence in global currency (foreign exchange) markets. The pace and timing of QE cessation could also heighten market instability;

- a prolonged period of modest interest rates will constrain, for example, through margin compression and low returns on assets, the net interest income we earn from investing our excess deposits;

- our ability to borrow from other financial institutions or to engage in funding transactions may be adversely affected by market disruption, for example, in the event of contagion from stress in the eurozone sovereign and financial sectors; and

- market developments may depress consumer and business confidence beyond expected levels. If economic growth remains subdued, for example, asset prices and payment patterns may be adversely affected, leading to greater than expected increases in our delinquencies, default rates, write-offs and loan impairment charges. However, if growth is too rapid, new asset valuation bubbles could appear especially in the real estate sector with potentially negative consequences for banks.

The occurrence of any of these events or circumstances could have a material adverse effect on our business, our financial condition, our prospects, our customers and their operations and/or results of our operations.

We have exposure to the ongoing economic crisis in the eurozone

The risk of a split of the eurozone has receded, both as a result of the support given by the ECB and of the implementation of structural reforms and austerity measures in most countries. Confidence has returned in the eurozone as a whole and the fall in yields has also eased the situation for the sovereigns. These restructuring efforts strongly

134a

Report of the Directors: Financial Review (continued)

affected growth in 2012 but have had positive effects in 2013 in several countries where growth is resuming.

Throughout 2013, core eurozone countries such as Germany and the Netherlands have demonstrated an improvement in economic fundamentals and the risk of contagion leading to a broadly based failure of the euro has abated considerably. Should a peripheral eurozone country need to leave the euro it is now expected to be on a managed basis that is less likely to present a risk to the eurozone itself. For a further description of our exposures to selected eurozone countries, eurozone banks and other financial institutions and corporates see Areas of special interest on page 147.

We are subject to political and economic risks in the countries in which we operate, including the risk of government intervention

We operate through an international network of subsidiaries and affiliates in 75 countries and territories around the world. Our results are, therefore, subject to the risk of loss from unfavourable political developments, currency fluctuations, social instability and changes in government policies on such matters as expropriation, authorisations, international ownership, interest-rate caps, limits on dividend flows and tax in the jurisdictions in which we operate. For example, in the Middle East, continued violence and unrest in Egypt and the civil war in Syria have intensified strategic risks to regional security and global energy prices. The recent agreement with Iran on its nuclear programme diffuses the short-term risk of military intervention, but increases risk in the medium-term should Iran not comply with requirements. In East Asia, tensions over maritime sovereignty disputes involving mainland China and Japan may lead to further military escalation and have had an effect on bilateral trade. Civil unrest and demonstrations in a number of emerging markets, including Turkey and Brazil, have been driven by political grievances and concerns over prevailing economic policies and may resume if growth remains subdued.

Changes in foreign currency exchange rates may affect our results

We prepare our accounts in US dollars, but because a substantial portion of our assets, liabilities, assets under management, revenues and expenses are denominated in other currencies, changes in foreign exchange rates have an effect on our reported income, cash flows and shareholders equity and

may have a material adverse effect on our business, prospects, financial condition and/or results of operations.

Macro-prudential, regulatory and legal risks to our business model

Failure to implement our obligations under the deferred prosecution agreements could have a material adverse effect on our results and operations.

In December 2012, HSBC Holdings, HSBC North America Holdings, Inc (HNAH), and HSBC Bank USA N.A. (HSBC Bank USA) entered into agreements with US and UK authorities in relation to investigations regarding past inadequate compliance with anti-money laundering and sanctions laws. Among other agreements, HSBC Holdings and HSBC Bank USA entered into a five-year Deferred Prosecution Agreement (US DPA) with the US Department of Justice (DoJ) and HSBC Holdings entered into a two-year Deferred Prosecution Agreement with the New York County District Attorney (the DANY DPA). HSBC Holdings also entered into an undertaking with the FSA (revised as the FCA Direction) to comply with certain forward-looking obligations with respect to anti-money laundering and sanctions requirements.

Under the settlement agreements, HSBC Holdings, HNAH and HSBC Bank USA made payments totalling US$1.9bn to US authorities and undertook to take further action to strengthen our compliance policies and procedures. The agreements with the DoJ and the US Federal Reserve Board (FRB) and the FCA Direction require us to retain an independent Monitor (who will, for FCA purposes, be a skilled person under section 166 of the Financial Services and Markets Act (FSMA)) to evaluate our progress in fully implementing our obligations and produce regular assessments of the effectiveness of our Compliance function.

Michael Cherkasky began his work as the Monitor on 22 July 2013. His work is proceeding as anticipated, consistent with the timelines and requirements set forth in the relevant agreements.

Breach of the US DPA at any time during its term may allow the DoJ to prosecute HSBC Holdings or HSBC Bank USA in relation to the matters which are the subject of the US DPA. Breach of the DANY DPA may allow the New York County District Attorney s Office to prosecute HSBC Holdings in relation to the matters which are the subject of that DPA. There can be no assurance that the steps taken to address the requirements of the DPAs will be completely effective or that HSBC will

Report of the Directors: Financial Review (continued)

not have to take additional remedial measures in the future to comply with the terms of the DPAs or the FCA Direction. Any such breach of the DPAs or the FCA Direction leading to further enforcement action, including the prosecution of HSBC would have a material adverse effect on our business, financial condition, results of operations and prospects, including the potential significant loss of business and withdrawal of funding.

Failure to comply with certain regulatory requirements would have a material adverse effect on our results and operations.

As reflected in the agreement entered into with the Office of the Comptroller of the Currency (OCC) in December 2012 (the Gramm-Leach-Bliley Act (GLBA) Agreement), the OCC has determined that HSBC Bank USA is not in compliance with the requirements set forth in 12 U.S.C. § 24a(a)(2)(c) and 12 C.F.R. § 5.39(g)(1), which provide that a national bank and each depository institution affiliate of the national bank must be both well capitalised and well managed in order to own or control a financial subsidiary. As a result, HSBC Bank USA and its parent holding companies, including HSBC Holdings, no longer meet the qualification requirements for financial holding company status, and may not engage in any new types of financial activities without the prior approval of the FRB. In addition, HSBC Bank USA may not directly or indirectly acquire control of, or hold an interest in, any new financial subsidiary, nor commence a new activity in its existing financial subsidiary, unless it receives prior approval from the OCC. If all of our affiliate depositary institutions are not in compliance with these requirements within the time periods specified in the GLBA Agreement, as they may be extended, HSBC could be required either to divest HSBC Bank USA or to divest or terminate any financial activities conducted in reliance on financial holding company status under the GLBA. Similar consequences could result for financial subsidiaries of HSBC Bank USA that engage in activities in reliance on expanded powers provided for in the GLBA. Any such divestiture or termination of activities would have a material adverse effect on our business, prospects, financial condition and results of operation.

Failure to meet the requirements of regulatory stress tests could have a material adverse effect on our capital plan, operations, results and future prospects

Supervisory stress test requirements are increasing in frequency and in the granularity of information

required. The Group is subject to supervisory stress testing in many jurisdictions. These exercises include the programmes of the PRA, the FRB, the European Banking Authority (EBA), the ECB and the Hong Kong Monetary Authority, as well as stress tests undertaken in many other jurisdictions.

The Group is taking part in the Bank of England concurrent stress test exercise in 2014. This programme will include common base and stress scenarios applied across all major UK banks. The exercise will be supported by a complementary programme of data provision to the Bank of England under its Firm Data Submission Framework. The PRA is considering a range of disclosure options related to the stress test exercise.

In October 2013, the BoE published a discussion paper A framework for stress testing the UK banking system . The proposed framework will replace the current stress-testing for the Capital Planning Buffer and the results will inform the setting of the PRA Buffer, Countercyclical Capital Buffer, Sectoral Capital Requirements and other FPC recommendations to the PRA. The PRA is expected to consult on the transition to the PRA Buffer and the relationship between the PRA Buffer and the proposed stress testing exercise in 2014. These buffers are described on page 314.

HNAH is subject to the FRB s Comprehensive Capital Analysis and Review (CCAR). In addition, both HNAH and HSBC Bank USA are subject to the Dodd-Frank Stress Testing programme. HNAH and HSBC Bank USA made submissions under these programmes on 6 January 2014. There are significant consequences if minimum requirements are not met. Under the CCAR process, the FRB will consider a bank holding company s overall financial condition, risk profile and capital adequacy including its ability to maintain a 5% tier 1 common equity ratio for each quarter of the forward looking nine-quarter planning horizon under baseline, adverse and severely adverse economic scenarios. The FRB will assess a bank holding company s ability to meet qualitative aspects of capital planning and risk management. It will also take into account a bank holding company s planned capital actions (such as dividends or share repurchases) over the planning horizon when assessing capital adequacy.

If, based on such assessment, the FRB were to issue an objection to a bank holding company s capital plan, the bank holding company would be required to submit a revised capital plan, and generally would not be able to undertake planned capital actions until approved by the FRB. The FRB will publicly release a summary of its CCAR assessments in March of each year and bank holding companies are

134c

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

also required to publicly release a summary of their Dodd-Frank stress test results under the supervisory severely adverse scenario. Bank holding companies subject to these stress test rules are also required to conduct a mid-year company-run stress test, submit the results to the FRB and publicly disclose a summary of these mid-year stress test results in September of each year.

HSBC will be included in the next round of European stress test exercises, scheduled for 2014. HSBC France and HSBC Bank Malta P.l.c. will participate in the ECB s Asset Quality review, run as part of the ECB s comprehensive assessment prior to inception of the Single Supervisory Mechanism. They will then be subject to the ECB s stress testing process. The Group will take part in the related exercise run by the EBA. Disclosures of the results of these exercises are planned in late 2014. The EBA have announced capital thresholds of 8% common equity tier 1 (CET1) for the baseline scenario and 5.5% CET1 for the stress scenario. Regulators may set higher hurdle rates and formally commit to take specific actions on the basis of those higher requirements.

Failure to meet requirements of regulatory stress tests, or the failure by regulators to approve our stress results and capital plans, could have a material adverse effect on our operations, results and future prospects.

We are subject to a number of legal and regulatory actions and investigations, the outcomes of which are inherently difficult to predict, but unfavourable outcomes could have a material adverse effect on our operating results and brand

We face significant legal and regulatory risks in our business. The volume and amount of damages claimed in litigation, regulatory proceedings and other adversarial proceedings against financial institutions are increasing for many reasons, including a substantial increase in the number of regulatory changes taking place globally and higher expectations from regulators and the public.

Additionally, we continue to be subject to a number of material legal proceedings, regulatory actions and investigations as described in Note 43 on the Financial Statements. It is inherently difficult to predict the outcome of many of the legal, regulatory and other adversarial proceedings involving our businesses, particularly those cases in which the matters are brought on behalf of various classes of claimants, seek damages of unspecified or indeterminate amounts or involve novel legal claims.

An unfavourable result in one or more of these proceedings could have a material adverse effect on our business, prospects, financial condition, reputation and/or results of operations.

Unfavourable legislative or regulatory developments, or changes in the policy of regulators or governments, could generate model risk and could have a material adverse effect on our operations, financial condition and prospects

Our businesses are subject to ongoing regulation and associated regulatory risks, including the effects of changes in the laws, regulations, policies, voluntary codes of practice and interpretations in the UK, the US, Hong Kong, the EU and the other markets where we operate. This is particularly so in the current environment, where we expect government and regulatory intervention in the banking sector to continue to increase for the foreseeable future. Additionally, many of these changes increasingly have an impact beyond the country in which they are effected as regulators either deliberately enact regulation with extra-territorial impact or our operations mean that the Group is obliged to give effect to local laws and regulations on a wider basis.

Since 2008, regulators and governments have focused on reforming both the prudential regulation of the financial services industry, to improve financial stability, and the ways in which business is conducted. Measures include enhanced capital, liquidity and funding requirements, the separation or prohibition of certain activities by banks, changes in the capital regime and the operation of capital markets activities, the introduction of tax levies and transaction taxes, changes in compensation practices and adjustments to how business is conducted. The US Government, the UK Government, our regulators in the UK, US, Hong Kong, the EU or elsewhere may intervene further in relation to areas of industry risk already identified, or in new areas, which could adversely affect us.

Changes in laws, rules or regulations, or in their interpretation or enforcement, or in how new laws, rules or regulations are implemented may adversely affect our business, prospects, financial condition and/or results of operations. Further, uncertainty and lack of international regulatory coordination as enhanced supervisory standards are developed and implemented may adversely affect our ability to engage in effective business, capital and risk management planning.

Report of the Directors: Financial Review (continued)

More stringent regulatory requirements, including enhanced capital, liquidity and funding requirements and those governing the development of parameters applied and controls around models used for measuring risk can give rise to changes that may adversely affect our business, including increases in capital requirements.

We may fail to comply with all applicable regulations, particularly in areas where applicable regulations may be unclear or where regulators revise existing guidance or courts overturn previous rulings. Authorities in many jurisdictions have the power to bring administrative or judicial proceedings against us which could result in, among other things, the suspension or revocation of our licenses, cease and desist orders, fines, civil penalties, criminal penalties or other disciplinary action which could have a material adverse effect on our business, prospects, financial condition, reputation and/or results of operations and seriously harm our reputation.

Areas where changes could have an adverse effect on our business, prospects, financial condition or results of operations include, but are not limited to:

- general changes in government, central bank or regulatory policy, or changes in regulatory regimes that may influence investor decisions in particular markets in which we operate;

- proposed changes in and the implementation of regulations for derivatives and central counterparties; the UK s planned framework for the ring-fencing of retail banking, other structural separation proposals or regimes, including the Volcker Rule issued under the Dodd-Frank Act, proposals in France, Germany and the European Commission s own proposals for the ring-fencing of certain activities; the EU s Recovery and Resolution Directive and similar country specific measures; and the US Foreign Account Tax Compliance Act (FATCA), any or all of which may change the structure of those markets and the products offered or may increase the costs of doing business in those markets;

- external bodies applying or interpreting standards or laws differently to us;

- further requirements relating to financial reporting, corporate governance, conduct of business and employee compensation; and

- expropriation, nationalisation, confiscation of assets and changes in legislation or regulations relating to foreign ownership.

HSBC is supervised on a consolidated basis in the UK. On 1 April 2013, three new regulatory bodies were established: the Financial Policy Committee (FPC), the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA). The FPC will not directly supervise firms, being responsible for macro-prudential regulation and considering systemic risk affecting economic and financial stability. The PRA and the FCA have inherited the majority of the FSA s previous functions as the micro-prudential supervisors. Some Group subsidiaries such as HSBC Bank plc (HSBC Bank) will be dual-regulated firms, subject to prudential regulation by the PRA and to conduct regulation by the FCA. Other UK subsidiaries are solo regulated by the FCA. The new regulatory bodies also have additional powers. For example, under certain circumstances, the PRA and the FCA are able to issue directions to unregulated qualifying parent undertakings such as HSBC Holdings. The FPC has powers to give a direction to the FCA or the PRA, and it may make recommendations within the Bank of England to the Treasury, to the FCA or the PRA or to other persons . In addition, European supervisory authorities, the EBA, the European Insurance and Occupational Pensions Authority (EIOPA) and the European Securities and Markets Authority (ESMA) are likely to exert greater influence on regulatory issues across the EU and with the EU Banking Union legislation in progress and the Single Supervisory Mechanism being adopted by 17 EU member states, the ECB will become the single EU supervisor, taking direct responsibility for systematically relevant banks in the eurozone from November 2014, which may include certain HSBC Group companies. These developments are expected to continue to change the way in which we are regulated and supervised and could affect our business, capital requirements or results of operations.

Since 2009, the Basel Committee has approved significant changes to the regulation of banking institutions capital and liquidity, involving a substantial strengthening of the minimum requirements. Implementation at the national level remains ongoing.

HSBC has been classified by the Financial Stability Board (FSB) as a Global Systemically Important Bank (G-SIB) and therefore will be subject to what the FSB refers to as a multi-pronged and integrated set of policies . These include proposals that would place an additional capital buffer on the Group and require enhanced reporting.

Report of the Directors: Financial Review (continued)

The ongoing implementation of Dodd-Frank and related final regulations in the US could result in additional costs or limit or restrict the way we conduct our business. Uncertainty remains about the details, impact and timing of some of these reforms and the effect they will ultimately have on HSBC. Within Dodd-Frank, the Volcker Rule is intended to prohibit deposit-taking banks and their affiliates from engaging in proprietary trading and investing in or sponsoring hedge funds or private equity funds. The Volcker Rule came into force in July 2012, subject to a two-year conformance period. On 10 December 2013, US regulators released final version regulations to implement the Volcker Rule. The final Rule extended the conformance period for all banking entities until 21 July 2015 (with the possibility of two one-year extensions under certain circumstances and for certain activities), by which time financial institutions subject to the Rule must bring their activities and investments into compliance with it. We continue to update our existing conformance plans and to finalise adjustments necessary to our businesses both in the US and elsewhere to comply with these final rules. In addition, in February 2014, the FRB adopted final rules to apply certain enhanced supervisory standards to large foreign banking organisations such as HSBC. Certain proposals that would apply other enhanced supervisory standards to large foreign banking organisation have not yet been finalised.

There are also a number of ongoing regulatory initiatives at the EU and at a national level in the UK in various stages of development which could result in additional costs or limit or restrict the way we conduct business. At an EU level, initiatives include the ongoing implementation of the EU s version of the Basel III proposals (CRD IV), the European Markets Infrastructure Regulation (EMIR), the revised Markets in Financial Instruments Directive/Regulation (MiFID2) and the Market Abuse Regulation.

In June 2013, the European Commission published the final Regulation and Directive, known collectively as CRD IV, to give effect to the Basel III framework in the EU. This came into effect on 1 January 2014.

In December 2013, the PRA published its final rules on implementing CRD IV in Policy Statement 7/13. From 1 January 2014, major UK banks and building societies, including HSBC, are required to meet a 3% CRD IV end point tier 1 leverage ratio and to hold capital resources equivalent to at least 7% of their risk-weighted assets, using a CRD IV definition of CET1 but after taking account of any

adjustments set by the PRA. This follows the FPC s 2013 capital shortfall exercise which included an assessment of expected future losses, future costs of conduct redress and adjusting for a more prudent calculation of risk weights.

Despite final PRA rules there remains continued uncertainty as to the on-going amount of capital that banks will be required to hold under CRD IV. This relates to the quantification and interaction of CRD IV capital buffers and Pillar 2, where further PRA consultations are due in 2014. Furthermore, there are a significant number of draft and unpublished EBA technical standards due in 2014 which will potentially impact our capital position and risk-weighted assets.

In our capital section on page 309 of the *2013 Annual Report and Accounts* we quantify the capital and RWA effects of CRD IV as at 31 December 2013 based on our interpretation of the final CRD IV regulation and final rules issued by the PRA, as supplemented by regulatory guidance. The effects of draft EBA Standards are not captured in our numbers. Consequently, there could be additional, potentially significant, impacts on our capital position and RWAs.

Other relevant regulatory initiatives in the UK include the FCA s Mortgage Market Review, changes to the consumer credit regime in the UK and an ever greater focus by our regulators on conduct risk including attention to sales processes and incentives, product and investment suitability and conduct of business concerns more generally. Uncertainty remains about the details and timing of some of these reforms and the effect they will ultimately have on HSBC.

These measures are concerned principally, but not exclusively, with the conduct of business with retail customers and, in conjunction with this focus, the UK regulators are making increasing use of existing and new powers of intervention and enforcement, including powers to consider past business undertaken and implement customer compensation and redress schemes or other, potentially significant remedial work. Additionally, the UK and other regulators may increasingly take actions in response to customer complaints either specific to an institution or more generally in relation to a particular product. We have seen recent examples of this approach in the context of the possible mis-selling of payment protection insurance, of interest rate derivative products to SME and wealth management products. Further, regulators in the UK and elsewhere are increasingly pursuing investigations in relation to employee

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

activities in relation to benchmark, index and other rate setting and the operation of other (non-retail) markets, including foreign exchange markets. Whilst these investigations are generally focused on the wholesale sector, regulators may not only exercise powers in relation to relevant market participants in that sector, but may also consider the wider effects of such activities for customers more generally and impose appropriate measures, including, for example, customer redress or compensation schemes as well as fines and/or other actions against involved companies and relevant individuals.

Accordingly, there are significant risks that the UK and other regulators may identify future industry-wide mis-selling, market misconduct or other issues that could affect the Group. This may lead from time to time to: (i) significant direct costs or liabilities (including in relation to mis-selling or improper activities); and (ii) changes in the practices of such businesses which benefit customers at a cost to shareholders. Further, decisions taken in the UK by the Financial Ombudsman Service in relation to customer complaints (or any overseas equivalent that has jurisdiction) could, if applied to a wider class or grouping of customers, have a material adverse effect on the business, operating results, financial condition and prospects of the Group.

The UK Government has passed legislation to implement banking reforms based on the recommendations of the Independent Commission on Banking. Additional banking reform proposals are being considered in France, Germany and the EU and any resulting structural changes could have a material adverse effect on us

The Independent Commission on Banking (ICB) published its final report in September 2011 and the UK Government expressed broad approval for the principle of establishing a ring-fenced bank for retail banking activities and greater loss absorbing capacity.

In December 2013, the UK s Financial Services (Banking Reform) Act 2013 received Royal Assent, becoming primary legislation. It implements the recommendations of the ICB and of the Parliamentary Commission on Banking Standards, which *inter alia* establish a framework for ring-fencing the UK retail banking from trading activities and sets out requirements for loss absorbency in the form of equity capital and loss absorbing debt. The PRA, subject to the approval of Her Majesty s Treasury, is empowered to require banking groups to restructure their operations if it considers that the operation of the ring-fence in a

group is proving to be ineffective. The exercise of these powers may lead to groups being required to split their retail and investment banking operations into separate corporate groups. A consultation has also taken place on draft secondary legislation setting out further details but the underlying rules from supervisory authorities are not yet available.

The UK Financial Services (Banking Reform) Act 2013 also creates a bail-in mechanism as an additional resolution tool alongside existing options to transfer all or part of the bank to a private sector purchaser, to transfer parts of the bank to a new bridge bank which is later sold or to take the bank into temporary public sector ownership. In a bail-in , shareholders and creditors in the bank have their investments written down in value or converted into new interests (such as new shares) without the bank being placed in liquidation. This allows the bank to continue to provide its core banking services without interruption and ensures that the solvency of the bank is addressed without taxpayer support, while also allowing the Bank of England to provide temporary funding to this newly solvent bank. Certain liabilities such as deposits protected by the Financial Services Compensation Scheme are excluded from bail-in. It is intended that these bail- in provisions will be consistent with the European Recovery and Resolution Directive once it comes into force.

The UK government intends to complete the legislative process by the end of this Parliament in May 2015 and to have reforms in place by 2019.

In February 2012, the European Commission appointed a High Level Expert Group under the Governor of the Bank of Finland, Erkki Liikanen, to consider potential structural changes in banks within the EU. The group recommended, *inter alia*, the ring-fencing of certain market-making and trading activities from the deposit-taking and retail payments activities of major banks and possible amendments to the use of bail-in instruments as a resolution tool, as well as a number of other comments.

In January 2014, following a consultation period, the European Commission published its own legislative proposals on the structural reform of the European banking sector which would prohibit proprietary trading in financial instruments and commodities, and enable supervisors to require trading activities such as market-making, complex derivatives and securitisation operations to be undertaken in a separate subsidiary from deposit taking activities.

Report of the Directors: Financial Review (continued)

The ring-fenced deposit taking entity would be subject to separation from the trading entity including capital and management structures, issuance of own debt and arms-length transactions between entities.

The proposals allow for derogation from these requirements for super-equivalent national regimes. On the current basis of the proposals, it is understood that non-EU subsidiaries of the Group which could be separately resolved without a threat to the financial stability of the EU would be excluded from the proposals.

The proposals will now be subject to discussion in the European Parliament and the Council of Ministers (representing the EU member states) and are not expected to be finalised in 2014. The implementation date for any separation under the final rules would depend upon the date on which the final legislation is agreed. The relationship between the UK, French, German and any EU proposals has still to be clarified (as does the interactivity between any of these proposals and the US Volcker Rule), although the G20 has asked the FSB, in collaboration with the IMF and OECD, to assess the cross-border consistency and global financial stability implications of structural measures, to be completed by the end of 2014.

We are subject to tax-related risks in the countries in which we operate which could have a material adverse effect on our operating results

HSBC is subject to the substance and interpretation of tax laws in all countries in which we operate and is subject to routine review and audit by tax authorities in relation thereto. We provide for potential tax liabilities that may arise on the basis of the amounts expected to be paid to the tax authorities. The amounts ultimately paid may differ materially from the amounts provided depending on the ultimate resolution of such matters. Changes to tax law, tax rates and penalties for failure to comply could have a material adverse effect on our business, financial condition and/or results of operations.

Risks related to our business operations, governance and internal control systems

Our risk management measures may not be successful

The management of risk is an integral part of all our activities. Risk constitutes our exposure to uncertainty and the consequent variability of return. Specifically, risk equates to the adverse effect on profitability or financial condition arising from

different sources of uncertainty including retail and wholesale credit risk, market risk, operational risk, non-traded market risk, insurance risk, concentration risk, liquidity and funding risk, litigation risk, reputational risk, strategic risk, pension obligation risk and regulatory risk. We seek to monitor and manage our risk exposure through a variety of separate but complementary control and reporting systems such as financial, credit, market, operational, compliance and legal. While we employ a broad and diversified set of risk monitoring and risk mitigation techniques, such techniques and the judgements that accompany their application cannot anticipate every unfavourable event or the specifics and timing of every outcome. Failure to manage risks appropriately could have a significant effect on our business prospects, financial condition and/or results of operations.

Operational risks are inherent in our business

We are exposed to many types of operational risk, that are inherent in banking operations including fraudulent and other criminal activities (both internal and external), breakdowns in processes or procedures and systems failure or non-availability. These risks apply equally when we rely on outside suppliers or vendors to provide services to us and our customers. These operational risks could have a material adverse effect on our business, prospects, financial condition and results of operation.

Our operations are subject to the threat of fraudulent activity

Fraudsters may target any of our products, services and delivery channels including lending, internet banking, payments, cards services and account takeover. This may result in financial loss to the bank, an adverse customer experience, reputational damage and potential regulatory action depending on the circumstances of the event.

Our operations are subject to disruption from the external environment

HSBC operates in many geographical locations, which are subject to events which are outside our control. These events may be acts of God such as natural disasters and epidemics, geopolitical risks including acts of terrorism and social unrest and infrastructure issues such as transport or power failure. These risk events may give rise to disruption to our services, result in physical damage and/or loss of life, and could have a material adverse effect on our business, prospects, financial condition and results of operation.

Report of the Directors: Financial Review (continued)

Our operations utilise third-party suppliers

HSBC also utilises third-party firms for the supply of certain of its goods and services. The inadequate management of our significant third-party supplies of goods and services could lead to a failure to meet our operational and business requirements which, in turn, may involve regulatory breaches, civil or monetary penalties or damage both to shareholder value and to our reputation/brand image.

Our operations are highly dependent on our information technology systems

The reliability and security of our information and technology infrastructure and our customer databases are crucial to maintaining the service availability of banking applications and processes and to protecting the HSBC brand. The proper functioning of our payment systems, financial control, risk management, credit analysis and reporting, accounting, customer service and other information technology systems, as well as the communication networks between our branches and main data processing centres, are critical to our operations.

Critical system failure, any prolonged loss of service availability or any material breach of data security, particularly involving confidential customer data, could cause serious damage to our ability to service our clients, could breach regulations under which we operate and could cause long-term damage to our business and brand that could have a material adverse effect on our business, prospects, financial condition, reputation and/or results of operations. This includes the operation of our key payments services.

The threat from cyber attacks is a concern for our organisation and failure to protect our operations from internet crime or cyber attacks may result in financial loss and loss of customer data or other sensitive information which could undermine our reputation and our ability to attract and keep customers. This could have a material adverse effect on our business, financial condition and/or results of our operations. We face various cyber risks in line with other multinational organisations. During 2013, we were subjected to 20 denial of service attacks on our external facing websites across the Group. A denial of service attack is the attempt to intentionally disrupt, paralyse and potentially extract data from a computer network by flooding it with data sent simultaneously from many individual computers.

We experienced a major global attack in July 2013. During this incident, we were attacked numerous individual times over a three-hour period.

Each attack lasted 15-20 minutes and utilised a different attack profile for each phase. During the active attacks, customers were intermittently unable to access our websites. There were three times when access to HSBC websites was unavailable.

Although most cyber attacks in 2013 had a negligible effect on our customers, services or firm, future cyber attacks could have a material adverse effect on our business, financial condition and/or results of operations.

We may not be able to meet regulatory requests for data

New regulatory requirements necessitate more frequent reporting, which requires accurate, consistent and timely management information and analysis to be produced. In addition, we are required to meet the FSB data obligations by the end of 2015. Inadequate management information systems or processes could lead to a failure to meet our regulatory reporting obligations or other internal or external information demands.

Our operations have inherent reputational risk

Reputational risk is the risk that illegal, unethical or inappropriate behaviour by the Group itself, members of staff, representatives of the Group or its clients act in a way that will damage HSBC s reputation leading, potentially, to a loss of business, fines or penalties. Reputational risk could arise from negative public opinion about the actual, or perceived, manner in which we conduct our business activities, our financial performance, and actual or perceived practices in banking and the financial services industry generally.

Modern technologies, in particular online social networks and other broadcast tools which facilitate communication with large audiences in short time frames and with minimal costs, may significantly enhance and accelerate the impact of damaging information and allegations. Negative public opinion may adversely affect our ability to keep and attract customers and, in particular, corporate and retail depositors and could have a material adverse effect on our business, prospects, financial condition, reputation and/or results of operations.

We may suffer losses due to employee misconduct

Our businesses are exposed to risk from potential non-compliance with policies, employee misconduct or negligence and fraud, which could result in regulatory sanctions and serious reputational or

Report of the Directors: Financial Review (continued)

financial harm. In recent years, a number of multinational financial institutions have suffered material losses due to the actions of rogue traders or other employees. It is not always possible to deter employee misconduct and the precautions we take to prevent and detect this activity may not always be effective.

We rely on recruiting, retaining and developing appropriate senior management and skilled personnel

Our continued success depends in part on the continued service of key members of our management team. The ability to continue to attract, train, motivate and retain highly qualified professionals is a key element of our strategy. The successful implementation of our growth strategy depends on the availability of skilled management, both at our head office and at each of our business units. If one of our business units or other functions fails to staff its operations appropriately, or loses one or more of its key senior executives, and fails to replace them in a satisfactory and timely manner, or fails to implement successfully the organisational changes required to support the Group s strategy, our business prospects, financial condition and/or results of operations, including control and operational risks, may be materially adversely affected. Likewise, if we fail to attract and appropriately train, motivate and retain qualified professionals, our business may be adversely affected.

Our financial statements are based in part on judgements, estimates and assumptions which are subject to uncertainty

The preparation of financial statements requires management to make judgements, estimates and assumptions that affect the reported amounts of assets, liabilities, income and expenses. Due to the inherent uncertainty in making estimates, actual results reported in future periods may be based upon amounts which differ from those estimates. Estimates, judgements, assumptions and models are continually evaluated and are based on historical experience and other factors, including expectations of future events that are believed to be reasonable under the circumstances. Revisions to accounting estimates are recognised in the period in which the estimate is revised and in any future periods affected. The accounting policies deemed critical to our results and financial position, based upon materiality and significant judgements and estimates, include impairment of loans and advances, goodwill impairment, valuation of financial instruments,

deferred tax assets, provisions and interests in associates, which are discussed in detail in Critical accounting policies on page 72.

The valuation of financial instruments measured at fair value can be subjective, in particular where models are used which include unobservable inputs. Given the uncertainty and subjectivity associated with valuing such instruments, future outcomes may differ materially from those assumed using information available at the reporting date. The effect of these differences on the future results of operations and the future financial position of the Group may be material. For further details, see Critical accounting policies on page 72.

If the judgement, estimates and assumptions we use in preparing our consolidated financial statements are subsequently found to be materially different from those assumed using information available at the reporting date, this could affect our business, financial conditions, prospects, and/or results of operations and have a corresponding effect on our funding requirements and capital ratios.

Third parties may use us as a conduit for illegal activities without our knowledge, which could have a material adverse effect on us

We are required to comply with applicable anti-money laundering laws and regulations and have adopted various policies and procedures, including internal control and know your customer procedures, aimed at preventing use of HSBC products and services for the purpose of committing or concealing financial crime. A major focus of US and UK governmental policy relating to financial institutions in recent years has been combating money laundering and enforcing compliance with US and EU economic sanctions, and this prioritisation is evidenced by our agreements with US and UK authorities relating to various investigations regarding past inadequate compliance with anti-money laundering and sanctions law including DPAs with the US DoJ, the FCA and others. Certain US subsidiaries of HSBC Holdings have entered into a consent cease and desist order with the OCC and a similar consent order with the FRB which requires the implementation of improvements to compliance procedures regarding obligations under the US Bank Secrecy Act (the BSA), FCA Direction and anti-money laundering (AML) rules. These consent orders do not preclude additional enforcement actions by bank regulatory, governmental or law enforcement agencies or private litigation.

Report of the Directors: Financial Review (continued)

In relevant situations, and where permitted by regulation, we may rely upon certain counterparties to maintain and properly apply their own appropriate AML procedures. While permitted by regulation, such reliance may not be completely effective in preventing third parties from using us (and our relevant counterparties) as a conduit for money laundering including illegal cash operations without our knowledge (and that of our relevant counterparties). Becoming a party to money laundering, association with, or even accusations of being associated with money laundering will damage our reputation and could make us subject to fines, sanctions and/or legal enforcement (including being added to blacklists that would prohibit certain parties from engaging in transactions with us). Any one of these outcomes could have a material adverse effect on our business, prospects, financial condition and/or results of operations.

A number of the remedial actions taken or being taken as a result of the matters to which the DPAs relate are intended to ensure that the Group s businesses are better protected in respect of these risks. These actions are listed in the DPAs. It will, however, take time to complete these remedial actions. Breach of the DPAs at any time during their terms may allow the DoJ or the New York County District Attorney s Office to prosecute HSBC in relation to the matters which are the subject of the respective DPAs.

We may not achieve all the expected benefits of our strategic initiatives

The Group s strategy (see page 11), is built around two trends, the continued growth of international trade and capital flows, and wealth creation, particularly in faster-growing markets. We have analysed those trends, and have developed criteria to help us better deploy capital in response. We have also launched an initiative to reduce costs, part of which includes the disposal of non-core businesses. The development and implementation of our strategy requires difficult, subjective and complex judgements, including forecasts of economic conditions in various parts of the world. We may fail to correctly identify the trends we seek to exploit and the relevant factors in making decisions as to capital deployment and cost reduction. Our ability to execute our strategy may also be limited by our operational capacity and the increasing complexity of the regulatory environment in which we operate. For example, the complexities of separating disposed of assets from continuing operations, including transitional arrangements, could increase operational

and reputational risks and threaten successful execution of an announced disposal. In addition, factors beyond our control, including but not limited to the market and economic conditions and other challenges discussed in detail above, could limit our ability to achieve all of the expected benefits of these initiatives.

Risks related to our business

We have significant exposure to counterparty risk within the financial sector and to other risk concentrations

We have exposure to virtually all major industries and counterparties, and we routinely execute transactions with counterparties in financial services, including brokers and dealers, commercial banks, investment banks, mutual and hedge funds, and other institutional clients. Many of these transactions expose us to credit risk in the event of default by our counterparty or client. Our ability to engage in routine transactions to fund our operations and manage our risks could be materially adversely affected by the actions and commercial soundness of other financial services institutions. Financial institutions are necessarily interdependent because of trading, clearing, counterparty or other relationships. As a consequence, a default by, or decline in market confidence in, individual institutions, or anxiety about the financial services industry generally, can lead to further individual and/or systemic difficulties, defaults and losses.

Mandatory central clearing brings new risks to HSBC. As a clearing member we will be required to underwrite losses incurred at Central Counterparty (CCP) by the default of other clearing members and their clients. Hence central clearing brings with it a new element of interconnectedness between clearing members and clients which we believe may increase rather than reduce our exposure to systemic risk. At the same time, our ability to manage such risk ourselves will be reduced because control has been largely outsourced to CCPs and it is unclear at present how, at a time of stress, regulators and resolution authorities will intervene.

Where bilateral counterparty risk has been mitigated by taking collateral, our credit risk may remain high if the collateral we hold cannot be realised or has to be liquidated at prices which are insufficient to recover the full amount of our loan or derivative exposure. There is a risk that collateral cannot be realised, including situations where this arises by change of law that may influence our ability to foreclose on collateral or otherwise enforce contractual rights.

134k

Report of the Directors: Financial Review (continued)

The Group also has credit exposure arising from mitigants such as credit default swaps (CDS s), and other credit derivatives, each of which is carried at fair value. The risk of default by counterparties to CDSs and other credit derivatives used as mitigants affects the fair value of these instruments depending on the valuation and the perceived credit risk of the underlying instrument against which protection has been purchased. Any such adjustments or fair value changes may have a material adverse effect on our financial condition and results of operations.

Market fluctuations may reduce our income or the value of our portfolios

Our businesses are inherently subject to risks in financial markets and in the wider economy, including changes in, and increased volatility of, interest rates, inflation rates, credit spreads, foreign exchange rates, commodity, equity, bond and property prices and the risk that our customers act in a manner inconsistent with our business, pricing and hedging assumptions.

Market movements will continue to significantly affect us in a number of key areas. For example, our pension scheme assets include equity and debt securities, the cash flows of which change as equity prices and interest rates vary. Banking and trading activities are subject to interest rate risk, foreign exchange risk, inflation risk and credit spread risk. Changes in interest rate levels, interbank spreads over official rates, yield curves and spreads affect the interest rate spread realised between lending and borrowing costs. The potential for future volatility and margin changes remains. Competitive pressures on fixed rates or product terms in existing loans and deposits sometimes restrict our ability to change interest rates applying to customers in response to changes in official and wholesale market rates.

Our insurance businesses are exposed to the risk that market fluctuations will cause mismatches to occur between product liabilities and the investment assets which back them. Market risks can affect our insurance products in a number of ways depending upon the product and associated contract. For example, mismatches between assets and liability yields and maturities give rise to interest rate risk. Some of these risks are borne directly by the customer and some are borne by the insurance businesses themselves, with their excess capital invested in the markets. Some insurance contracts involve guarantees and options that increase in value in adverse investment markets. There is a risk that the insurance businesses will bear some of the cost of such guarantees and options. The performance of the investment markets will thus have a direct effect

upon the value embedded in the insurance and investment contracts and our operating results, financial condition and prospects.

It is difficult to predict with any accuracy changes in market conditions, and such changes may have a material adverse effect on our business, operating results, financial condition and prospects.

Liquidity, or ready access to funds, is essential to our businesses

Our ability to borrow on a secured or unsecured basis and the cost of so doing can be affected by increases in interest rates or credit spreads, the availability of credit, regulatory requirements relating to liquidity or the market perceptions of risk relating to us or the banking sector, including our perceived or actual creditworthiness.

Current accounts and savings deposits payable on demand or at short notice form a significant part of our funding, and we place considerable importance on maintaining their stability. For deposits, stability depends upon preserving investor confidence in our capital strength and liquidity, and on comparable and transparent pricing. Although deposits have been, over time, a stable source of funding, this may not continue.

We also access wholesale markets in order to provide funding for entities that do not accept deposits, to align asset and liability maturities and currencies and to maintain a presence in local markets. In 2013, we issued the equivalent of US$15.6bn of term debt securities in the public capital markets in a range of currencies and maturities from a number of Group entities. Included within overall public issuance was 1.5bn of subordinated securities issued by HSBC Holdings. An inability to obtain financing in the unsecured long-term or short-term debt capital markets, or to access the secured lending markets, could have a substantial adverse effect on our liquidity. Unfavourable macroeconomic developments, market disruptions or regulatory developments may increase our funding costs or challenge our ability to raise funds to support or expand our businesses, materially adversely affecting our business, prospects, financial condition and/or results of operations.

If we are unable to raise funds through deposits and/or in the capital markets, our liquidity position could be adversely affected and we might be unable to meet deposit withdrawals on demand or at their contractual maturity, to repay borrowings as they mature, to meet our obligations under committed financing facilities and insurance contracts, or to fund new loans, investments and businesses. We

Report of the Directors: Financial Review (continued)

may need to liquidate unencumbered assets to meet our liabilities. In a time of reduced liquidity, we may be unable to sell some of our assets, or we may need to sell assets at depressed prices, which in either case could materially adversely affect our business, prospects, results of operations and/or financial condition.

Any reduction in the credit rating assigned to HSBC Holdings, any subsidiaries of HSBC Holdings or any of their respective debt securities could increase the cost or decrease the availability of our funding and adversely affect our liquidity position and interest margins

Credit ratings affect the cost and other terms upon which we are able to obtain market funding. Rating agencies regularly evaluate HSBC Holdings and certain of its subsidiaries, as well as their respective debt securities. Their ratings are based on a number of factors, including their assessment of the relative financial strength of HSBC or of the relevant entity, as well as conditions affecting the financial services industry generally. There can be no assurance that the rating agencies will maintain HSBC s or the relevant entity s current ratings or outlook, especially in light of the difficulties in the financial services industry and the financial markets. Although at the end of 2013, HSBC Holdings long-term debt rating outlook by Fitch was stable, Moody s and Standard & Poor s ratings outlook are negative. Any reductions in these ratings and outlook could increase the cost of our funding, limit access to capital markets and require additional collateral to be placed and, consequently, materially adversely affect our interest margins and/or our liquidity position.

Under the terms of our current collateral obligations under derivative contracts, we could be required to post additional collateral as a result of a one or two notch downgrade in HSBC s credit rating as described on page 226.

Risks concerning borrower credit quality are inherent in our businesses

Risks arising from changes in credit quality and the recoverability of loans and amounts due from borrowers and counterparties (e.g. reinsurers and counterparties in derivative transactions) are inherent in a wide range of our businesses. Adverse changes in the credit quality of our borrowers and counterparties arising from a general deterioration in economic conditions or systemic risks in the financial systems could reduce the recoverability

and value of our assets and require an increase in our loan impairment charges.

We estimate and recognise impairment allowances for credit losses inherent in our credit exposure. This process, which is critical to our results and financial condition, requires difficult, subjective and complex judgements, including forecasts of how these economic conditions might impair the ability of our borrowers to repay their loans and the ability of other counterparties to meet their obligations. As is the case with any such assessments, we may fail to estimate accurately the effect of factors that we identify or fail to identify relevant factors. Further, the information we use to assess the creditworthiness of our counterparties may be inaccurate or incorrect. Any failure by us to accurately estimate the ability of our counterparties to meet their obligations may have a material adverse effect on our business, prospects, financial conditions and/or results of operations.

Our insurance businesses are subject to risks relating to insurance claim rates and changes in insurance customer behaviour

We provide various insurance products for customers with whom we have a banking relationship, including several types of life insurance products. The cost of claims and benefits can be influenced by many factors, including mortality and morbidity rates, lapse and surrender rates and, if the policy has a savings element, the performance of assets to support the liabilities. Adverse developments in any of these factors may materially adversely affect our financial condition and results of operations.

HSBC Holdings is a holding company and as a result, is dependent on loan payments and dividends from its subsidiaries to meet its obligations, including obligations with respect to its debt securities, and to provide profits for payment of future dividends to shareholders

HSBC Holdings is a non-operating holding company and as such the principal sources of its income are from operating subsidiaries which hold the principal assets of HSBC. As a separate legal entity, HSBC Holdings relies on remittance of its subsidiaries loan payments and dividends in order to be able to pay obligations to debt holders as they fall due and to pay dividends to its shareholders. The ability of HSBC Holdings subsidiaries and affiliates to pay dividends could be restricted by changes in regulation, exchange controls and other requirements.

134m

Table of Contents

Report of the Directors: Financial Review (continued)

We may be required to make substantial contributions to our pension plans

We operate a number of pension plans throughout the world, including defined benefit plans. Pension scheme obligations fluctuate with changes in long-term interest rates, inflation, salary levels and the longevity of scheme members. The level of contributions we make to our pension plans has a direct effect on our cash flow. To the extent plan assets are insufficient to cover existing liabilities, higher levels of contributions will be required. As a result, deficits in those pension plans may have a material adverse effect on our business, prospects, financial condition and/or results of operations.

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Managing risk

(Unaudited)

As a provider of banking and financial services, we actively manage risk as a core part of our day-to-day activities.

Our risk management and risk governance frameworks, which are employed at all levels of the organisation, are described on page 39.

The growth in our business during 2013 was achieved while risks were assumed in a measured manner in line with our risk appetite and risks, particularly reputational and operational, were mitigated when they exceeded our risk appetite.

On a reported basis, total assets decreased by 1% while our credit risk-weighted assets (RWA s) decreased by 4% during the year.

We continue to maintain a very strong liquidity position and are well positioned for the changing regulatory landscape.

Risks faced by HSBC

All of our activities involve, to varying degrees, the analysis, evaluation, acceptance and management of risks or combinations of risks.

Risk factors

We have identified a comprehensive suite of risk factors which covers the broad range of risks our businesses are exposed to.

A number of the risk factors have the potential to affect the results of our operations or financial condition, but may not necessarily be deemed as top or emerging risks. They inform the ongoing assessment of our top and emerging risks which may result in our risk appetite being revised. The risk factors are:

Macroeconomic and geopolitical risk

- Current economic and market conditions may adversely affect our results.
- We have exposure to the ongoing economic crisis in the eurozone.
- We are subject to political and economic risks in the countries in which we operate, including the risk of government intervention.
- Changes in foreign currency exchange rates may affect our results.

Macro-prudential, regulatory and legal risks to our business model

Failure to implement our obligations under the deferred prosecution agreements could have a material adverse effect on our results and operations.

Failure to comply with certain regulatory requirements would have a material adverse effect on our results and operations.

Failure to meet the requirements of regulatory stress tests could have a material adverse effect on our capital plan, operations, results and future prospects.

We are subject to a number of legal and regulatory actions and investigations, the outcomes of which are inherently difficult to predict, but unfavourable outcomes could have a material adverse effect on our operating results and brand.

Unfavourable legislative or regulatory developments, or changes in the policy of regulators or governments, could generate model risk and could have a material adverse effect on our operations, financial condition and prospects.

The UK Government has passed legislation to implement banking reforms based on the recommendations of the Independent Commission on Banking (ICB). Additional banking reform proposals are being considered in France, Germany and the EU and any resulting structural changes could have a material adverse effect on us.

We are subject to tax-related risks in the countries in which we operate which could have a material adverse effect on our operating results.

Risks related to our business operations, governance and internal control systems

Our risk management measures may not be successful.

Operational risks are inherent in our business.

Our operations are subject to the threat of fraudulent activity.

Our operations are subject to disruption from the external environment.

Our operations utilise third-party suppliers.

Our operations are highly dependent on our information technology systems.

We may not be able to meet regulatory requests for data.

Report of the Directors: Financial Review (continued)

Our operations have inherent reputational risk.

We may suffer losses due to employee misconduct.

We rely on recruiting, retaining and developing appropriate senior management and skilled personnel.

Our financial statements are based in part on judgements, estimates and assumptions which are subject to uncertainty.

Third parties may use us as a conduit for illegal activities without our knowledge, which could have a material adverse effect on us.

We may not achieve all the expected benefits of our strategic initiatives.

We have significant exposure to counterparty risk within the financial sector and to other risk concentrations.

Market fluctuations may reduce our income or the value of our portfolios.

Liquidity, or ready access to funds, is essential to our businesses.
Any reduction in the credit rating assigned to HSBC Holdings, any subsidiaries of HSBC Holdings or any of their respective debt securities could increase the cost or decrease the availability of our funding and adversely affect our liquidity position and interest margins.

Risks concerning borrower credit quality are inherent in our businesses.

Our insurance business is subject to risks relating to insurance claim rates and changes in insurance customer behaviour.

HSBC Holdings is a holding company and, as a result, is dependent on loan payments and dividends from its subsidiaries to meet its obligations, including obligations with respect to its debt securities, and to provide profits for payment of future dividends to shareholders.

We may be required to make substantial contributions to our pension plans.

Risks managed by HSBC

The principal risks associated with our banking and insurance manufacturing operations are described in the tables below.

Description of risks banking operations

Risks	Arising from	Measurement, monitoring and management of risk
Credit risk (page 150) *The risk of financial loss if a customer or counterparty fails to meet an obligation under a contract.*	Credit risk arises principally from direct lending, trade finance and leasing business, but also from certain other products such as guarantees and derivatives.	Credit risk is: **measured** as the amount which could be lost if a customer or counterparty fails to make repayments. In the case of derivatives, the measurement of exposure takes into account the current mark-to-market value to HSBC of the contract and the expected potential change in that value over time caused by movements in market rates; **monitored** within limits, approved by individuals within a framework of delegated authorities. These limits represent the peak exposure or loss to which HSBC could be subjected should the customer or counterparty fail to perform its contractual obligations; and **managed** through a robust risk control framework which outlines clear and consistent policies, principles and guidance for risk managers.
Liquidity and funding risk (page 213) *The risk that we do not have sufficient financial resources to meet our obligations as they fall due or that we can only do so at excessive cost.*	Liquidity risk arises from mismatches in the timing of cash flows. Funding risk arises when the liquidity needed to fund illiquid asset positions cannot be obtained at the expected terms and when required.	Liquidity and funding risk is: **measured** using internal metrics including stressed operational cash flow projections, coverage ratio and advances to core funding ratios; **monitored** against the Group s liquidity and funding risk framework and overseen by regional Asset and Liability Management Committees (ALCO s), Group ALCO and the Risk Management Meeting; and **managed** on a stand-alone basis with no reliance on any Group entity (unless pre-committed) or central bank unless this represents routine established business as usual market practice.

Report of the Directors: Financial Review (continued)

Risks	Arising from	Measurement, monitoring and management of risk
Market risk (page 230) *The risk that movements in market factors, including foreign exchange rates and commodity prices, interest rates, credit spreads and equity prices, will reduce our income or the value of our portfolios.*	Exposure to market risk is separated into two portfolios: trading portfolios comprise positions arising from market-making and warehousing of customer-derived positions. non-trading portfolios comprise positions that primarily arise from the interest rate management of our retail and commercial banking assets and liabilities, financial investments designated as available for sale and held to maturity, and exposures arising from our insurance operations (page 258).	Market risk is: **measured** in terms of value at risk, which is used to estimate potential losses on risk positions as a result of movements in market rates and prices over a specified time horizon and to a given level of confidence, augmented with stress testing to evaluate the potential impact on portfolio values of more extreme, though plausible, events or movements in a set of financial variables; **monitored** using measures including the sensitivity of net interest income and the sensitivity of structural foreign exchange which are applied to the market risk positions within each risk type; and **managed** using risk limits approved by the GMB for HSBC Holdings and our various global businesses. These units are allocated across business lines and to the Group s legal entities.
Operational risk (page 244) *The risk of loss resulting from inadequate or failed internal processes, people and systems or from external events, including legal risk (along with accounting, tax, security and fraud, people, systems, projects, operations and organisational change risk).*	Operational risk arises from day to day operations or external events, and is relevant to every aspect of our business. Compliance risk and fiduciary risk are discussed below. Other operational risks are covered in the Appendix to Risk (page 266).	Operational risk is: **measured** using both the top risk analysis process and the risk and control assessment process, which assess the level of risk and effectiveness of controls; **monitored** using key indicators and other internal control activities; and **managed** primarily by global business and functional managers. They identify and assess risks, implement controls to manage them and monitor the effectiveness of these controls utilising the operational risk management framework. Global Operational Risk is responsible for the framework and for overseeing the management of operational risks within businesses and functions.
Compliance risk (page 247)		Compliance risk is:

The risk that we fail to observe the letter and spirit of all relevant laws, codes, rules, regulations and standards of good market practice, and incur fines and penalties and suffer damage to our business as a consequence.	Compliance risk is part of operational risk, and arises from rules, regulations, other standards and Group policies, including those relating to anti-money laundering, anti-bribery and corruption, counter-terrorist and proliferation financing, sanctions compliance, conduct of business and market conduct.	**measured** by reference to identified metrics, incident assessments (whether affecting HSBC or the wider industry), regulatory feedback and the judgement and assessment of the managers of our global businesses and functions; **monitored** against our compliance risk assessments and metrics, the results of the monitoring and control activities of the second line of defence functions, including the Financial Crime Compliance and Regulatory Compliance functions, and the results of internal and external audits and regulatory inspections; and
	The DPA is discussed in Top and Emerging Risks on page 144 and the Monitor on page 24.	**managed** by establishing and communicating appropriate policies and procedures, training employees in them, and monitoring activity to assure their observance. Proactive risk control and/or remediation work is undertaken where required.
Fiduciary risk (page 248) *The risk of breaching our fiduciary duties.*	Fiduciary risk is part of operational risk, and arises from our business activities where we act in a fiduciary capacity as Trustee, Investment Manager or as mandated by law or regulation.	Fiduciary risk is: **measured** by monitoring against risk appetite; **monitored** through the use of key indicators; and **managed** within the designated businesses via a comprehensive policy framework.

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Description of risks banking operations (continued)

Risks	Arising from	Measurement, monitoring and management of risk
Other material risks		
Reputational risk (page 260) *The risk that illegal, unethical or inappropriate behaviour by the Group itself, members of staff or clients or representatives of the Group will damage HSBC s reputation, leading potentially to a loss of business, fines or penalties.*	Reputational risk encompasses negative reaction not only to activities which may be illegal or against regulations, but also to activities that may be counter to societal standards, values and expectations. It arises from a wide variety of causes, including how we conduct our business and the way in which clients to whom we provide financial services, and bodies who represent HSBC, conduct themselves.	Reputational risk is: **measured** by reference to our reputation as indicated by our dealings with all relevant stakeholders, including media, regulators, customers and employees; **monitored** through a reputational risk management framework, taking into account the results of the compliance risk monitoring activity outlined above; and **managed** by every member of staff and is covered by a number of policies and guidelines. There is a clear structure of committees and individuals charged with mitigating reputational risk, including the Group Reputational Risk Policy Committee and regional/business equivalents.
Pension risk (page 260) *The risk that contributions from Group companies and members fail to generate sufficient funds to meet the cost of accruing benefits for the future service of active members, and the risk that the performance of assets held in pension funds is insufficient to cover existing pension liabilities.*	Pension risk arises from investments delivering an inadequate return, economic conditions leading to corporate failures, adverse changes in interest rates or inflation, or members living longer than expected (longevity risk). Pension risk includes operational risks listed above.	Pension risk is: **measured** in terms of the schemes ability to generate sufficient funds to meet the cost of their accrued benefits; **monitored** through the specific risk appetite that has been developed at both Group and regional levels; and **managed** locally through the appropriate pension risk governance structure and globally through the Risk Management Meeting.
Sustainability risk (page 263) *The risk that the environmental and social effects of providing financial services outweigh the*	Sustainability risk arises from the provision of financial services to companies or	Sustainability risk is:

economic benefits.	projects which run counter to the needs of sustainable development.	**measured** by assessing the potential sustainability effect of a customer s activities and assigning a Sustainability Risk Rating to all high risk transactions; **monitored** quarterly by the Risk Management Meeting and monthly by Group Sustainability Risk management; and **managed** using sustainability risk policies covering project finance lending and sector-based sustainability polices for sectors with high environmental or social impacts.

Our insurance manufacturing subsidiaries are separately regulated from our banking operations. Risks in the insurance entities are managed using methodologies and processes appropriate to insurance activities, but remain subject to oversight

at Group level. Our insurance operations are also subject to the operational risks and the other material risks presented above in relation to the banking operations, and these are covered by the Group s risk management processes.

Report of the Directors: Financial Review (continued)

Description of risks insurance manufacturing operations

Risks	Arising from	Measurement, monitoring and management of risk
Financial risks (page 253) *Our ability to effectively match the liabilities arising under insurance contracts with the asset portfolios that back them are contingent on the management of financial risks such as market, credit and liquidity risks, and the extent to which these risks are borne by the policyholders.* *Liabilities to policyholders under unit-linked contracts move in line with the value of the underlying assets, and as such the policyholder bears the majority of the financial risks.* *Contracts with DPF share the performance of the underlying assets between policyholders and the shareholder in line with the type of contract and the specific contract terms.*	Exposure to financial risks arises from: market risk of changes in the fair values of financial assets or their future cash flows from fluctuations in variables such as interest rates, foreign exchange rates and equity prices; credit risk and the potential for financial loss following the default of third parties in meeting their obligations; and liquidity risk of entities not being able to make payments to policyholders as they fall due as there are insufficient assets that can be realised as cash.	Financial risks are: **measured** separately for each type of risk: market risk is measured in terms of exposure to fluctuations in key financial variables; credit risk is measured as the amount which could be lost if a customer or counterparty fails to make repayments; and liquidity risk is measured using internal metrics including stressed operational cash flow projections. **monitored** within limits approved by individuals within a framework of delegated authorities; and **managed** through a robust risk control framework which outlines clear and consistent policies, principles and guidance for risk managers. Subsidiaries manufacturing products with guarantees are usually exposed to falls in market interest rates and equity prices to the extent that the market exposure cannot be managed by utilising any discretionary participation (or bonus) features within the policy contracts they issue.
Insurance risk (page 258) *The risk that, over time, the cost of acquiring and administering a contract, claims and benefits may exceed the aggregate amount of premiums received and investment income.*	The cost of claims and benefits can be influenced by many factors, including mortality and morbidity experience, lapse and surrender rates and, if the policy has a savings element,	Insurance risk is: **measured** in terms of life insurance liabilities;

	the performance of the assets held to support the liabilities.	**monitored** by the RBWM Risk Management Committee, which checks the risk profile of the insurance operations against a risk appetite for insurance business agreed by the GMB; and
		managed both centrally and locally using product design, underwriting, reinsurance and claims-handling procedures.

Stress testing

Our stress testing and scenario analysis programme examines the sensitivities of our capital plans and demand for regulatory capital under a number of scenarios and ensures that top and emerging risks have been appropriately considered. The governance and management of enterprise-wide stress testing, including model development, validation and use, is overseen by the Group Risk Committee.

The development of macroeconomic scenarios is a critical part of the process. Potential scenarios are defined and generated by an expert panel comprising Global Risk, Global Finance and external economic advisers. Variables and assumptions underpinning the scenarios, including economic indicators such as yield curves, exchange rates and volatilities, are tested through internal and external research and circulated to our businesses, along with instructions and methodologies for specific risk types.

Stress test results are subject to a review and challenge process at regional and Group levels and action plans are developed to mitigate identified risks.

The extent to which those action plans are implemented will depend on senior management s evaluation of the risks and their potential consequences, taking into account HSBC s risk appetite.

During 2013, the results of a number of macroeconomic stress scenarios were presented to senior management. These included an assessment of the 2013 annual operating plan under two macroeconomic scenarios: a worsening eurozone crisis and a US fiscal cliff scenario. We also ran a PRA core programme stress testing exercise based on a global slow growth scenario, which factored in a China hard landing scenario specified by the PRA based on a pronounced economic slowdown in mainland China and Hong Kong. The slow growth component was developed internally and stipulated a period of reduced inflation across the world. The results of these stress tests demonstrated that HSBC would remain satisfactorily capitalised after taking account of assumed management actions to mitigate the results.

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

The macroeconomic stress scenarios are described below.

Stress scenario assumptions 2013 annual operating plan

Scenario	Worsening eurozone crisis scenario	US fiscal cliff scenario
Assumptions	Greece, Ireland, Portugal, Spain and Italy exit the eurozone in the first quarter of 2013;	Tightening of fiscal policy;
	debt is re-denominated in new national currencies, which depreciate sharply (from 15% to 50%);	effective federal corporate and personal tax rates are increased back towards their 2001 levels;
	equity prices fall by around 50% in the exiting countries and initially by 30% elsewhere in the eurozone;	federal spending reduces by around US$95bn;
	exiting countries experience large-scale capital outflows, rising inflation and interest rates;	US dollar depreciates by around 5% as economic prospects for the US deteriorate;
	government bond spreads rise significantly in exiting countries (from 700 to 1,200bps);	Federal Reserve supports the economy with additional quantitative easing, boosting its balance sheet by another US$500bn (around 3% of GDP) and maintaining that level for one year before beginning to unwind;
	banking sectors in both the exiting countries and the eurozone suffer significant losses and credit standards tighten dramatically; and	government spending cuts and tax increases lead to lower consumer spending and business investment;
	the residual euro exchange rate initially depreciates by around 15% against the US dollar.	US GDP falls by around 7% below the pre-crisis baseline; and

lower US demand dampens exports from the rest of the world, leading to a slowdown in global GDP growth.

Stress scenario assumptions 2013 PRA core programme

Scenario	Global slow growth scenario
Assumptions	Mainland China suffers a 50% reduction in property prices as an intitial modest price decline becomes self-reinforcing through a deterioration in investor sentiment; mainland China equity prices fall by around 25% and unemployment doubles to 7%; mainland China GDP growth averages 3% per annum in the two years following the crisis; the tightening of monetary policy in mainland China to prevent capital flight leads to liquidity issues; Hong Kong exports to mainland China decline rapidly and significantly; Hong Kong GDP contracts by around 4% in 2013 and 2014 and unemployment rises to 10%; Hong Kong property and equity prices fall by about 50%; weak macro-economic outlook currently facing major advanced economies persists over the next five years; substantial fall in commodity prices triggered by continued slow growth, leading to a reduction in inflation, domestic demand and economic growth across commodity exporting countries; deflation, or 0% inflation, in advanced economies as energy prices decline; and reduction in exports from advanced economies due to reduced demand from emerging markets.

In addition to the Group-wide risk scenarios, each major HSBC subsidiary conducts regular macroeconomic and event-driven scenario analyses specific to their region. They may also participate in local regulatory stress testing programmes.

We also examined the effect on our businesses and our capital position of other macroeconomic and geopolitical events at Group or major subsidiary levels. These included a possible US default, renminbi internationalisation, the conflict in Syria and tensions between mainland China and Japan.

Stress testing is used across risk categories such as market risk, liquidity and funding risk and credit risk to evaluate the potential effect of stress scenarios

on portfolio values, structural long-term funding positions, income or capital.

We also conduct reverse stress testing, which is a process of working backwards from the event of non-viability of the business model to the identification of a range of occurrences that could bring that event about. Non-viability might occur before the bank s capital is depleted, and could result from a variety of events. These include idiosyncratic or systemic events or combinations thereof, and/or could imply failure of the Group s holding company or one of its major subsidiaries. They would not necessarily mean the simultaneous failure of all the major subsidiaries. We use reverse stress testing to strengthen resilience by helping to inform early-warning triggers, management actions and contingency plans to mitigate against

Report of the Directors: Financial Review (continued)

potential stresses and vulnerabilities which the Group might face.

HSBC participate, where appropriate, in scenario analyses requested by regulatory bodies.

The Group is taking part in the Bank of England concurrent stress test exercise in 2014. This programme will include common base and stress scenarios applied across all major UK banks. The exercise will be supported by a complementary programme of data provision to the Bank of England under its Firm Data Submission Framework (FDSF). The PRA is considering a range of disclosure options related to the stress test exercise.

HSBC North America Holdings Inc. (HNAH) and HSBC Bank USA NA (HBUS) are subject to the CCAR and Dodd-Frank Stress Testing programmes of the Federal Reserve and the Office of the Comptroller of the Currency. HNAH and HBUS made submissions under these programmes on 6 January 2014. Disclosure by the Federal Reserve and by HNAH and HBUS of the results of these exercises will be made in March 2014.

HSBC will be included in the next round of European stress test exercises, scheduled for 2014. HSBC France and HSBC Malta will participate in the ECB s Asset Quality Review, run as part of the ECB s comprehensive assessment prior to inception of the Single Supervisory Mechanism. They will then be subject to the ECB s stress testing process. The Group will take part in the related exercise run by European Banking Authority (EBA). Disclosures of the results of these exercises are planned in late 2014.

Top and emerging risks /

(Unaudited)

Our approach to identifying and monitoring top and emerging risks is described on page 38.

During 2013, senior management paid particular attention to a number of top and emerging risks, and our current ones are as follows:

Macroeconomic and geopolitical risks

Emerging markets slowdown.

Increased geopolitical risk.

Emerging markets slowdown

Growth in a number of emerging markets decelerated during 2013. Weak demand for commodities and raw materials due to subdued economic growth and limited investment activity in mature markets and in mainland China affected all exporting countries. Emerging markets continued to face the risks of fiscal decline and increasing financing requirements. In addition, capital flows were volatile, particularly during the second half of the year, and in several cases lead to a tightening of monetary policy to counter capital outflows. Any consequent rise in interest rates, however, could put growth at risk and increase the risk of a liquidity crisis.

Mature economies are depending on stronger trade growth with emerging markets to help them through difficult economic times domestically. A number of them have implemented austerity measures in order to reduce their deficits and public debt. While austerity is expected to help resolve the sovereign and banking crisis in the medium term, it is limiting growth, increasing unemployment and restricting taxation revenues severely in the short term. This, in turn, is affecting the rest of the world through lower trade.

Potential impact on HSBC

Global trade and capital flows may contract as a result of weaker economic growth in some emerging markets, banks deleveraging, expectations of tapering of quantitative easing, the introduction of protectionist measures in certain markets, the emergence of geopolitical risks or increasing redenomination risk. The contraction might curtail our profitability.

While growth in emerging markets as a whole has been constrained by lower world demand and commodity prices, some countries are struggling with domestic issues and could trigger a new crisis of confidence with the potential for increased volatility. In Egypt, an uncertain future is affecting the economy and the country s ability to attract the necessary financial support. In Brazil, middle class protests have highlighted concerns regarding the political and economic choices made by the authorities, while in Turkey the situation has been aggravated by internal conflict in the ruling

141

Report of the Directors: Financial Review (continued)

party. In Argentina, the unresolved dispute with hold out bondholders is fuelling the risk of new defaults. Emerging markets have been supported during the last two years by significant capital inflows from advanced economies but a reverse of these capital flows, as happened in mid-2013, would create difficulties for all countries having to finance current account deficits, government debt or both. Finally, while economic growth in mainland China appears to be in line with its government s expectations, structural issues remain and a sharper than expected slowdown could occur with implications for all other emerging markets. We closely watch developments in all markets to ensure insights are shared and appropriate mitigating action is taken as circumstances evolve.

Increased geopolitical risk

Our operations are exposed to risks arising from political instability and civil unrest in a number of countries which may have a wider effect on regional stability and regional and global economies.

Geopolitical risk remains high in the Middle East as a result of the continued violence and unrest in Egypt and the civil war in Syria, which may spill over into neighbouring countries. Tensions between Israel and Iran add to the risks in the region, although diplomatic contacts with Iran s new administration may engender an improvement in relations.

In Asia, continued tensions over maritime sovereignty disputes involving mainland China and Japan may escalate to include military action, while actions by the government of the Democratic People s Republic of Korea risk destabilising the region.

In other emerging markets such as Turkey and Brazil, demonstrations have taken place as the population has become increasingly critical of prevailing economic policies. In Turkey, there is significant political uncertainty and the government is struggling to maintain a credible policy in order to maintain creditors confidence.

Potential impact on HSBC

Our results are subject to the risk of loss from unfavourable political developments, currency fluctuations, social instability and changes in government policies on matters such as expropriation, authorisations, international ownership, interest-rate caps, foreign exchange transferability and tax in the jurisdictions in
which we operate. Actual conflict could put our staff in harm s way and bring physical damage to our assets.

We have increased our monitoring of the geopolitical and economic outlook, in particular in countries where we have material exposures and a physical presence. Our internal credit risk rating of sovereign counterparties takes these factors into account and drives our appetite for conducting business in those countries. Where necessary, we adjust our country limits and exposures to reflect our appetite and mitigate these risks as appropriate.

Macro-prudential, regulatory and legal risks to our business model

Regulatory developments affecting our business model and Group profitability

Regulatory investigations, fines, sanctions, commitments and consent orders and requirements relating to conduct of business and financial crime negatively affecting our results and brand.

Dispute risk.

Financial service providers face increasingly stringent and costly regulatory and supervisory requirements, particularly in the areas of capital and liquidity management, conduct of business, operational structures and the integrity of financial services delivery. Increased government intervention and control over financial institutions, together with measures to reduce systemic risk, may significantly alter the competitive landscape. These measures may be introduced as formal requirements in a supra-equivalent manner and to variable timetables by different regulatory regimes.

Regulatory developments affecting our business model and Group profitability

Several regulatory changes are likely to affect our activities, both of the Group as a whole and of some or all of our principal subsidiaries. These changes include:

the publication on 27 June 2013 of CRD IV, which introduced in the EU the Basel III measures that came into effect on 1 January 2014, together with the publication by the PRA on 19 December 2013 of its final rules on implementing CRD IV which apply to firms regulated by the PRA in the UK;

Report of the Directors: Financial Review (continued)

the introduction of new regulatory bodies and powers in Europe comprising, in the UK, the FPC, the PRA and the FCA; and, in the eurozone, the granting to the European Central Bank (ECB) of supervisory powers from November 2014;

the designation of the Group by the Financial Stability Board as a global systemically important bank and resultant application of higher loss absorbency and other requirements;

finalisation of the Financial Services (Banking Reform) Act 2013 in the UK to give effect to the recommendations of the Independent Commission on Banking (ICB) in relation to the future ring-fencing of our UK retail banking business from wholesale banking activities, the structural separation of certain activities envisaged in legislation and rules adopted in the US (including the final Volcker Rule adopted in December 2013 under the Dodd-Frank Act) and potential legislative changes across the EU;

changes in the regime for the operation of capital markets with increasing standardisation, central clearing, reporting and margin requirements through a number of regulatory initiatives including European Market Infrastructure Regulation, Dodd Frank and the revised Markets in Financial Instruments Directive/Regulation (MiFID2);

requirements flowing from arrangements for the recovery and resolution of the Group and its main operating entities;

continued changes in the manner and standards for the conduct of business, including the effects of the recommendations made by the Parliamentary Commission on Banking Standards (which will be given effect through Part 4 of the Financial Services (Banking Reform) Act 2013);

the forthcoming ECB Asset Quality Review (AQR), which may reveal that substantial recapitalisation is needed among eurozone banks;

the tightening of credit controls by regulators in a number of countries on mortgage lending and unsecured portfolios; and

the continued risk of further changes to regulation relating to remuneration and other taxes.

Potential impact on HSBC

Proposed changes in regulation relating to capital and liquidity requirements, remuneration and/or taxes could increase our cost of doing business, reducing future profitability.

Proposed changes in and the implementation of regulations for derivatives including mandatory central clearing, the ICB ring-fencing proposals, recovery and resolution plans, the Volcker Rule and the Foreign Account Tax Compliance Act (known as FATCA) may affect the manner in which we conduct our activities and how the Group is structured. These measures have the potential to increase our cost of doing business and curtail the types of business we can carry out, with the consequent risk of decreased profitability. Because the development and implementation of many of these various regulations are in their early stages, it is not possible to estimate the effect on our operations.

Mandatory central clearing of derivatives also brings new risks to HSBC in our role as a clearing member, as we will be required to underwrite losses incurred by central clearing counterparties from the default of other clearing members and their clients. Hence central clearing brings with it a new element of interconnectedness between clearing members and clients which we believe may increase rather than reduce our exposure to systemic risk.

Potential market disruption as a result of the AQR, including a possible re-emergence of the eurozone crisis, may affect us directly through our exposure to eurozone banks and sovereigns, and indirectly should there be any diminution in economic activity in the eurozone.

While the tightening by regulators of credit controls limits consumer indebtedness and will benefit credit markets and our portfolios in the longer term, it may reduce our growth prospects and affect our business strategy in certain countries.

We are closely engaged with governments and regulators in the countries in which we operate to help ensure that the new requirements are properly considered and can be implemented in an effective manner. We are also ensuring that our capital and liquidity plans take into account the potential effects of the changes. Capital allocation and liquidity management disciplines have been expanded to incorporate future

Report of the Directors: Financial Review (continued)

increased capital and liquidity requirements and drive appropriate risk management and mitigating actions

Regulatory investigations, fines, sanctions, commitments and consent orders and requirements relating to conduct of business and financial crime negatively affecting our results and brand

Financial service providers are at risk of regulatory sanctions or fines related to conduct of business and financial crime. The incidence of regulatory proceedings and other adversarial proceedings against financial service firms is increasing.

Regulatory commitments and consent orders

In December 2012, HSBC Holdings, HNAH and HSBC Bank USA, N.A. (HSBC Bank USA) entered into agreements with US and UK authorities in relation to investigations regarding past inadequate compliance with anti-money laundering and sanctions laws. Among these agreements, HSBC Holdings and HSBC Bank USA entered into a five-year deferred prosecution agreement (US DPA) with the US Department of Justice (DoJ) and HSBC Holdings entered into a two-year DPA with the New York County District Attorney (the DANY DPA). HSBC Holdings also entered into an undertaking with the FSA (revised as the FCA Direction) to comply with certain forward-looking obligations with respect to anti-money laundering and sanctions requirements.

Under the settlement agreements, HSBC Holdings, HNAH and HSBC Bank USA made payments totalling US$1.9bn to US authorities and undertook to continue cooperating fully with US and UK regulatory and law enforcement authorities and take further action to strengthen our compliance policies and procedures. The agreements with the DoJ and the US Federal Reserve Board and the FCA Direction require us to retain an independent monitor (who is, for FCA purposes, a skilled person under section 166 of the Financial Services and Markets Act) to evaluate our progress in fully implementing our obligations and produce regular assessments of the effectiveness of our Compliance function.

On 1 July 2013, the US District Court for the Eastern District of New York approved the US DPA and retained authority to oversee implementation of the same. Michael Cherkasky began his work as Monitor on 22 July 2013, charged with evaluating and reporting upon, the effectiveness of the Group s internal controls, policies and procedures as they

relate to ongoing compliance with applicable anti-money laundering and sanctions laws. His work is proceeding as anticipated consistent with the timelines and requirements set forth in relevant agreements.

As reflected in the agreement entered into with the OCC in December 2012 (the the Gramm-Leach-Bliley Act (GLBA) Agreement), the OCC has determined that HSBC Bank USA is not in compliance with the requirements which provide that a national bank and each depository institution affiliate of the national bank must be both well-capitalised and well-managed in order to own or control a financial subsidiary. As a result, HSBC Bank USA and its parent holding companies, including HSBC, no longer meet the qualification requirements for financial holding company status, and may not engage in any new types of financial activities without the prior approval of the Federal Reserve Board. In addition, HSBC Bank USA may not directly or indirectly acquire control of or hold an interest in any new financial subsidiary, nor commence a new activity in its existing financial subsidiary, unless it receives prior approval from the OCC.

Potential impact on HSBC

It is difficult to predict the outcome of the regulatory proceedings involving our businesses. Unfavourable outcomes may have a material adverse effect on our reputation, brand and results, including loss of business and withdrawal of funding.

Our significant involvement in facilitating international capital flows and trade exposes the Group to the risk of financial crime or inadvertently breaching restrictions and sanctions imposed by OFAC and other regulators. Through our Global Standards programme, we are implementing consistent procedures and controls to detect, deter and protect against financial crime.

In relation to the DPAs, HSBC Holdings and HSBC Bank USA have committed to take or continue to adhere to a number of remedial measures. Breach of the US DPA at any time during its term may allow the DoJ to prosecute HSBC Holdings or HSBC Bank USA in relation to the matters which are the subject of the US DPA. Breach of the DANY DPA may allow the New York County District Attorney s Office to prosecute HSBC Holdings in relation to the matters which are the subject of that DPA.

Report of the Directors: Financial Review (continued)

In relation to the GLBA Agreement, if all of our affiliate depositary institutions are not in compliance with these requirements within the time periods specified in the GLBA Agreement, HSBC could be required either to divest HSBC Bank USA or to divest or terminate any financial activities conducted in reliance on the GLBA. Similar consequences under the GLBA Agreement could result for subsidiaries of HSBC Bank USA that engage in financial activities in reliance on expanded powers provided for in the GLBA. Any such divestiture or termination of activities would have a material adverse effect on the consolidated results and operation of HSBC. The GLBA Agreement requires HSBC Bank USA to take all steps necessary to correct the circumstances and conditions resulting from non-compliance with the requirements referred to above. We have initiated steps to satisfy the requirements of the GLBA Agreement.

Steps to address many of the requirements of the DPAs, the FCA Direction and the GLBA Agreement have either already been taken or are under way. These include simplifying the Group s control structure, strengthening the governance structure with new leadership appointments, revising key policies and establishing bodies to implement single Global Standards shaped by the highest or most effective standards available in any location where the Group operates, as well as substantially increasing spending and staffing in the anti-money laundering and regulatory compliance areas in the past few years. There can be no assurance that these steps will be effective or that HSBC will not have to take additional remedial measures in the future to comply with the terms of the DPAs, the FCA Direction or the GLBA Agreement.

Conduct of business

Regulators in the UK and other countries have continued to increase their focus on conduct risk including paying attention to sales processes and incentives, product and investment suitability and more general conduct of business concerns. In the UK, the FCA is making increasing use of existing and new powers of intervention and enforcement, including powers to consider past business undertaken and implement customer compensation and redress schemes or other, potentially significant, remedial work. Additionally, the FCA and other regulators increasingly take actions in response to customer complaints which may be amplified through customers use of social media channels, either specific to an institution or more generally

in relation to a particular product. There have been recent examples of this approach by regulators in the context of the possible mis-selling of payment protection insurance (PPI), of interest rate hedging products to SMEs and of wealth management products.

The Group also remains subject to a number of other regulatory proceedings involving investigations and reviews by various national regulatory, competition and enforcement authorities including in the UK, the US, Canada, the EU, Switzerland and Asia that are conducting investigations and reviews relating to certain past submissions made by panel banks and the process for making submissions in connection with the setting of London interbank offered rates (Libor), European interbank offered rates (Euribor) and other benchmark interest rates. In addition, regulators in the UK, the US, Hong Kong and certain other jurisdictions are conducting investigations relating to trading on foreign exchange markets. As certain HSBC entities are members of these panels and participate in the foreign exchange market, HSBC and/or its subsidiaries have been the subject of regulatory demands for information and are cooperating with those investigations and reviews.

In addition, HSBC Holdings, HSBC Bank plc, HSBC Bank USA and other panel banks have been named as defendants in private lawsuits filed in the US with respect to the setting of Libor, including putative class action lawsuits which have been consolidated before the US District Court for the Southern District of New York. HSBC and other panel banks have also been named as defendants in putative class action lawsuits in New York and Chicago relating to credit default swap pricing. The complainants in those actions assert claims against HSBC and other panel banks under various US laws including US antitrust laws, the US Commodities Exchange Act and state law (see Note 43 on the Financial Statements for further information).

Potential impact on HSBC

Regulators in the UK and other countries may identify future industry-wide mis-selling, market conduct or other issues that could affect the Group. This may lead from time to time to: (i) significant direct costs or liabilities; and (ii) changes in the practices of such businesses. Also, decisions taken in the UK by the Financial Ombudsman Service in relation to customer complaints (or any overseas equivalent with jurisdiction) could, if applied to a wider class or grouping of customers, have a material

145

Report of the Directors: Financial Review (continued)

adverse effect on the operating results, financial condition and prospects of the Group.

Dispute risk

The current economic environment has increased the Group s exposure to actual and potential litigation. Further details are provided in Note 43 on the Financial Statements.

Potential impact on HSBC

Dispute risk gives rise to potential financial loss and significant reputational damage which could adversely affect customer and investor confidence.

Risks related to our business operations, governance and internal control systems

Heightened execution risk.

Internet crime and fraud.

Information security risk.

Data management.

Model risk.

Heightened execution risk

There are a number of factors which may affect the successful delivery of our strategy. These include the increasing regulatory pressures and demands and the challenging macroeconomic environment, which may affect our ability to achieve planned earnings growth. The implementation of our strategy to simplify our business, which involves withdrawing from certain markets, presents disposal risks which must be carefully managed. Implementing organisational changes to support the Group s strategy, including the restructuring of our Compliance function into two distinct sub-functions: Financial Crime Compliance and Regulatory Compliance, also requires close management oversight.

Potential impact on HSBC

Our annual planning and stress testing processes consider the effect of potential risks from the external environment on our earnings and capital position and actions by management to mitigate them.

The potential risks of disposals include regulatory breaches, industrial action, loss of key personnel and interruption to systems and processes during business transformation.
They can have both financial and reputational implications.

The size and scope of the change to our Compliance function could generate heightened execution and people risk (including significant resourcing demands) and are subject to close management oversight.

Internet crime and fraud

With the ever-growing acceptance of and demand for internet and mobile services by customers, HSBC is increasingly exposed to fraudulent and criminal activities via these channels. Internet crime could result in financial loss and/or customer data and sensitive information being compromised. Along with internet fraud, the overall threat of external fraud may increase during adverse economic conditions, particularly in retail and commercial banking.

We also face the risk of breakdowns in processes or procedures and systems failure or unavailability, and our business is subject to disruption from events that are wholly or partially beyond our control, such as internet crime and acts of terrorism.

Potential impact on HSBC

Internet crime and fraud may give rise to losses in service to customers and/or economic loss to HSBC. These threats also exist when we rely on external suppliers or vendors for services provided to the Group and our customers.

We have increased our defences through enhanced monitoring and have implemented additional controls such as two-factor authentication to reduce the possibility of losses from fraud. We continually assess the threats from internet crime and fraud as they evolve and adapt our controls to mitigate them.

Information security risk

The security of our information and technology infrastructure is crucial for maintaining our banking applications and processes while protecting our customers and the HSBC brand.

Potential impact on HSBC

Information security risk gives rise to potential financial loss and reputational damage which could adversely affect customer and investor confidence. Loss of customer data would also trigger regulatory breaches which could result in fines and penalties being incurred.

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

We have invested significantly in addressing this risk through increased training to raise staff awareness of the requirements and enhanced multi-layered controls protecting our information and technical infrastructure.

Data management

We have received feedback from external stakeholders that we need a clear data strategy to meet the volume, granularity, frequency and scale of regulatory reporting requirements as well as other internal and external information demands. In addition, we are required to comply with the principles for effective risk data aggregation and risk reporting as set out by the Basel Committee on Banking Supervision (BCBS) by the end of 2015.

Potential impact on HSBC

Financial institutions that fail to meet their BCBS data obligations by the required deadline may face supervisory measures. Senior management recognise the importance of data management and therefore established a Data Strategy Board in 2012 to define our data strategy and ensure consistent data aggregation, reporting and mananagement across the Group. Key initiatives and projects to deliver our strategy and work towards meeting our data obligations are now in progress.

Regulators are evaluating the industry on its ability to provide accurate information and may use the industry-developed data maturity model to assess financial services firms.

Model risk

Increasingly stringent regulatory requirements governing the development of parameters applied to models used for measuring risk and controls over the models can have implications for the modelled outcomes, including increases in capital requirements. This risk extends more broadly to the use of models across HSBC, for example those used in financial reporting, stress testing or pricing. The evolving external economic and legislative environment and changes in customer behaviour can lead also to the assumptions in our models becoming invalid.

Potential impact on HSBC

These model risks have the potential to increase our capital requirement and/or make our capital requirement more volatile

We continue to address these risks through enhanced model development, independent review and model oversight to ensure our models remain fit for purpose.

Areas of special interest

(Unaudited)

Financial crime compliance and regulatory compliance

In recent years, we have experienced increasing levels of compliance risk as regulators and other agencies pursued investigations into historical activities and we continued to work with them in relation to existing issues. This has included the matters giving rise to the DPAs reached with US authorities in relation to investigations regarding inadequate compliance with anti-money laundering and sanctions law, and the related undertaking with the FSA (revised as the FCA Direction following the UK regulatory restructuring in April 2013). The work of the Monitor, who has been appointed to assess our progress against our various obligations, including the DPAs, is discussed on page 24.

We have also responded to a number of investigations by the FCA into the possible mis-selling in the UK of certain products, including PPI and interest rate hedging products sold to SMEs. In addition, we have been involved in investigations and reviews by various regulators and competition enforcement authorities relating to certain past submissions made by panel banks and the process for making submissions in connection with the setting of Libor, Euribor and other benchmark interest and foreign exchange rates.

It is clear from both our own and wider industry experience that the level of activity among regulators and law enforcement agencies in investigating possible breaches of regulations has increased, and that the direct and indirect costs of such breaches can be significant. Coupled with a substantial rise in the volume of new regulation, much of which has some element of extra-territorial reach, and the geographical spread of our businesses, we believe that the level of inherent compliance risk that we face as a Group will continue to remain high for the foreseeable future.

Commercial real estate

Details of our exposure to commercial real estate lending are set out on page 168.

Report of the Directors: Financial Review (continued)

Eurozone crisis

Eurozone countries are members of the EU and part of the euro single currency bloc. The peripheral eurozone countries are those which exhibited levels of market volatility that exceeded other eurozone countries, demonstrating persistent fiscal or political uncertainty in 2013. In spite of austerity measures and structural reform throughout 2012 and 2013, the peripheral eurozone countries of Greece, Ireland, Italy, Portugal, Spain and Cyprus continued to exhibit a high ratio of sovereign debt to GDP or short to medium-term maturity concentration of their liabilities. However, some of these peripheral eurozone countries showed improvements with Ireland able to access the long-term bond markets and Spain experiencing lower borrowing costs. In March 2013, Cyprus sought assistance from the Troika (the European Commission, European Central Bank and International Monetary Fund), which ultimately agreed a bailout under conditions requiring a consolidation of banking assets and the bail-in of larger depositors monies. Capital controls led to some minor disruption of payments from Cyprus. However, HSBC has limited exposure to the country and no impairments were recorded.

The European Central Bank brought interest rates to record low levels in order to support growth in the eurozone but the very low level of inflation in the region is limiting the impact of such measures. These measures are putting additional stress on the profitability of the European banking sector.

Net exposure

At 31 December 2013, our net exposure to the peripheral eurozone countries was US$37.5bn (2012: US$38.8bn), including net exposure to sovereign borrowers, agencies and banks of US$10.1bn (2012: US$11.6bn).

Our businesses in peripheral eurozone countries are funded from a mix of local deposits, local wholesale sources and intra-Group loans extended from HSBC operations with surplus funds. Intra-Group funding carries the risk that a member country might exit the eurozone and redenominate its national currency, which could result in a significant currency devaluation. A description of redenomination risk in the event of the exit of a eurozone member is provided on page 211.

Our exposure to eurozone countries is analysed in the table on page 210.

Risk management and contingency planning

We have a well-developed framework for dealing with counterparty and systemic crisis situations, both regionally and globally, which is complemented by regular specific and enterprise-wide stress testing and scenario planning. The framework functions before, during and after crises and ensures that we have detailed and evolving operational plans in the event of an adverse situation materialising. It was applied throughout 2013 to ensure that pre-crisis preparation remained apposite and robust. A Cyprus Major Incident Group was effective in dealing with the Group s response to the Cyprus sovereign debt crisis.

Exposures to Egypt

Since the onset of the Arab Spring we have actively managed our exposure within Egypt. During 2013, our systemic crisis management processes were reinstigated in response to the unfolding constitutional crisis, and we continued to monitor developments closely. The most material risk to our overall portfolio in Egypt is the economic instability that could be caused by a further significant deterioration in the security situation.

At 31 December 2013, our total net lending exposure to Egypt was US$10.9bn. Just under half of our exposure was to other financial institutions and corporates (US$5.4bn), almost all of which was onshore lending by HSBC in Egypt to corporate entities. Of this exposure, US$3.4bn was off-balance sheet, principally undrawn committed facilities. This corporate exposure was diversified with nearly half spread across a broad range of manufacturing activities and the remainder covering a range of other industry sectors.

The sovereign and agencies exposure, including exposure to the central bank, was US$4.1bn. This exposure was almost wholly in the form of local currency denominated treasury bills and central bank deposits.

Exposure to banks was US$0.4bn, largely comprising off-balance sheet commitments consisting of trade lines to Egyptian banks for the confirmation of their letters of credit.

Personal lending US lending

Economic conditions in the US continued to improve in 2013, supported by improvements in the housing sector and increases in consumer spending. The unemployment rate declined during the year amid signs that the labour market is becoming more stable.

Report of the Directors: Financial Review (continued)

We remained focused on managing the run-off of balances in our HSBC Finance portfolio and completed the sale within our CML portfolio of US$3.7bn of personal unsecured loans and US$5.7bn of real estate loans. We transferred a further US$0.1bn of real estate loans to Assets held for sale during 2013. The sale of these assets will accelerate portfolio wind-down, reduce risk, and alleviate some of the operational burden given that these receivables are demanding to service and subject to foreclosure delays.

Total lending balances within HSBC Finance were US$30bn at 31 December 2013 including loans held for sale, a decline of US$13bn compared with the end of 2012. The rate at which balances in the

CML portfolio are declining continues to be affected by the lack of refinancing opportunities available to customers. By 31 December 2013, we had resumed processing suspended foreclosure activities in substantially all states and had referred the majority of the backlog of loans for foreclosure. We also began initiating new foreclosure activities in all states. Our loan modification programmes, which are designed to improve cash collections and avoid foreclosures, continued to slow the rate of repayment.

Total mortgage lending in the US was US$47bn at 31 December 2013, a decline of 15% compared with the end of 2012, mainly due to the continued run-off of the CML portfolio.

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Credit risk

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

1 *Appendix to Risk risk policies and practices.*

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Credit risk is the risk of financial loss if a customer or counterparty fails to meet an obligation under a contract. It arises principally from direct lending, trade finance and leasing business, but also from other products such as guarantees and credit derivatives and from holding assets in the form of debt securities.

There were no material changes to our policies and practices for the management of credit risk in 2013.

A summary of our current policies and practices regarding credit risk is provided in the Appendix to Risk on page 266.

Summary of credit risk in 2013

(Unaudited)

Maximum exposure to credit risk

	At 31 December 2013	2012
	US$m	US$m
Trading assets	**239,301**	367,177
other trading assets	**229,181**	248,496
reverse repos	**10,120**	118,681
Financial assets designated at fair value	**12,719**	12,714
Derivatives	**282,265**	357,450
Loans and advances to banks	**211,521**	152,546
loans and other receivables	**120,046**	117,085
reverse repos	**91,475**	35,461
Loans and advances to customers	**1,080,304**	997,623
loans and other receivables	**992,089**	962,972
reverse repos	**88,215**	34,651
Financial investments	**416,785**	415,312
Assets held for sale	**3,306**	9,292
Other assets	**231,858**	203,561
Off-balance sheet exposures	**633,903**	624,462
financial guarantees and similar contracts	**46,300**	44,993
loan and other credit-related commitments	**587,603**	579,469
	3,111,962	3,140,137

Total exposure to credit risk remained broadly unchanged in 2013 with loans and advances remaining the largest element. While the total exposure to credit risk remained broadly stable, there was an increase in the amount of reverse repos classified as Loans and advances to banks and Loans and advances to customers , with a corresponding reduction in the amount classified as Trading assets . This followed a change in the way GB&M manages reverse repo activities during the year, as set out on page 220.

For a detailed analysis of our maximum exposure to credit risk, see page 157.

In 2013, we successfully weathered the imposition of capital controls in Cyprus and we continued to monitor events in the eurozone. We also continued to monitor our portfolio in Egypt as the constitutional crisis unfolded.

More details of the specific political and macroeconomic risks associated with these countries, and our management response, are provided on page 148.

Loans and advances excluding held for sale: total exposure, impairment allowances and charges

(Unaudited)

	2013 US$bn	2012 US$bn
At 31 December		
Total gross loans and advances (A)	**1,307.0**	1,166.3
Impairment allowances (a)	**15.2**	16.2
(a) as a percentage of A	**1.16%**	1.39%
Loans and advances net of impairment allowances	**1,291.8**	1,150.2
Year ended 31 December		
Impairment charges	**6.0**	8.2

After excluding reverse repo balances, (a) as a percentage of A was 1.35% at 31 December 2013 (2012: 1.47%).

Impairment allowances as a percentage of gross loans and advances decreased to 1.16% in 2013 from 1.39% in 2012. This reduction was mainly in North America due to the run-off and loan sales in our CML portfolio.

For further details on our loan impairment allowances, see page 188.

Report of the Directors: Financial Review (continued)

Personal lending

(Unaudited)

	Europe US$m	Hong Kong US$m	Rest of Asia-Pacific US$m	MENA US$m	North America US$m	Latin America US$m	Total US$m
2013							
First lien residential mortgages							
Gross amount (A)	**140,474**	**53,762**	**38,285**	**2,451**	**60,955**	**3,948**	**299,875**
Impairment allowances	**439**		**57**	**124**	**2,886**	**32**	**3,538**
as a percentage of A	**0.3%**		**0.1%**	**5.1%**	**4.7%**	**0.8%**	**1.2%**
Other personal lending[1]							
Gross amount (B)	**51,633**	**19,794**	**12,688**	**4,033**	**11,735**	**10,970**	**110,853**
Impairment allowances	**959**	**78**	**144**	**169**	**532**	**1,182**	**3,064**
as a percentage of B	**1.9%**	**0.4%**	**1.1%**	**4.2%**	**4.5%**	**10.8%**	**2.8%**
Total personal lending							
Gross amount (C)	**192,107**	**73,556**	**50,973**	**6,484**	**72,690**	**14,918**	**410,728**
Impairment allowances	**1,398**	**78**	**201**	**293**	**3,418**	**1,214**	**6,602**
as a percentage of C	**0.7%**	**0.1%**	**0.4%**	**4.5%**	**4.7%**	**8.1%**	**1.6%**
2012							
First lien residential mortgages							
Gross amount (D)	135,172	52,296	36,906	2,144	70,133	5,211	301,862
Impairment allowances	489	4	66	136	4,163	47	4,905
as a percentage of D	0.4%	0.0%	0.2%	6.3%	5.9%	0.9%	1.6%
Other personal lending[1]							
Gross amount (E)	51,102	18,045	12,399	4,088	14,221	13,376	113,231
Impairment allowances	977	57	143	189	684	1,257	3,307
as a percentage of E	1.9%	0.3%	1.2%	4.6%	4.8%	9.4%	2.9%
Total personal lending							
Gross amount (F)	186,274	70,341	49,305	6,232	84,354	18,587	415,093
Impairment allowances	1,466	61	209	325	4,847	1,304	8,212
as a percentage of F	0.8%	0.1%	0.4%	5.2%	5.7%	7.0%	2.0%

For footnote, see page 263.

The following commentary is on a constant currency basis.

Total personal lending of US$411bn at 31 December 2013 was broadly in line with 2012. Balances decreased in North America from the continued run-off and loan sales in our CML portfolio, including the disposal of our non-real estate loan portfolio and several tranches of real estate loan balances. In addition, in Latin America, we disposed of our operations in Panama. These reductions were broadly offset by increases in residential mortgage balances in Rest of Asia-Pacific, the UK and Hong Kong.

Impairment allowances declined by 18% to US$7bn at 31 December 2013 from US$8bn at the end of 2012, primarily in North America

reflecting the continued run-off and loan sales in our CML portfolio and an improvement in the housing market. In Hong Kong and Rest of Asia-Pacific, impairment allowances remained at low levels throughout 2013. Impairment allowances as a percentage of total personal lending reduced to 1.6% from 2.0% in 2012. This was driven by North America for the reasons noted above. In Europe, they declined as a percentage of gross personal lending balances to 0.7% compared with 0.8% in 2012.

During the year we reviewed the impairment allowance methodology used for retail banking across the Group (see page 72).

For a more detailed analysis of our personal lending, see page 160.

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Wholesale lending

(Unaudited)

	Europe US$m	Hong Kong US$m	Rest of Asia-Pacific US$m	MENA US$m	North America US$m	Latin America US$m	Total US$m
2013							
Corporate and commercial							
Gross amount (A)	**242,107**	**114,832**	**89,066**	**19,760**	**50,585**	**30,188**	**546,538**
Impairment allowances	**3,821**	**361**	**557**	**1,212**	**769**	**1,339**	**8,059**
as a percentage of A	**1.58%**	**0.31%**	**0.63%**	**6.13%**	**1.52%**	**4.44%**	**1.47%**
Financial[2]							
Gross amount (B)	**149,454**	**42,760**	**59,159**	**8,975**	**72,755**	**16,657**	**349,760**
Impairment allowances	**379**	**10**	**7**	**78**	**55**	**11**	**540**
as a percentage of B	**0.25%**	**0.02%**	**0.01%**	**0.87%**	**0.08%**	**0.07%**	**0.15%**
2012							
Corporate and commercial							
Gross amount (C)	226,755	99,199	85,305	22,452	48,083	35,590	517,384
Impairment allowances	3,537	383	526	1,312	732	856	7,346
as a percentage of C	1.56%	0.39%	0.62%	5.84%	1.52%	2.41%	1.42%
Financial[2]							
Gross amount (D)	101,052	28,046	48,847	10,394	27,400	18,122	233,861
Impairment allowances	358	29	11	174	37	2	611
as a percentage of D	0.35%	0.10%	0.02%	1.67%	0.14%	0.01%	0.26%

For footnote, see page 263.

Total wholesale lending increased to US$896bn at 31 December 2013 from US$747bn at the end of 2012 due to increased reverse repo loans to banks and customers resulting from the change in the way GB&M manages these activities (see page 220). Total reverse repos to customers increased by US$53bn and to banks by US$56bn.

Excluding reverse repos, total balances rose due to higher international trade and services lending, mainly in Hong Kong and, to a lesser extent, in Rest of Asia-Pacific as we capitalised on trade and capital flows. Commercial real estate and other property related balances increased, mainly in Hong Kong as a result of demand for financing in the property investment and development sectors. Other commercial balances increased, notably in GB&M in the UK, on corporate overdraft balances which did not meet the netting criteria. In addition, loans and advances to banks rose as a result of increased trade re-finance and central bank lending in Hong Kong.

This was partly offset by a decline in Latin America following the disposal of our operations in Panama.

Impairment allowances increased to US$9bn at 31 December 2013 from US$8bn at the end of 2012. In Latin America, they rose as a proportion of gross corporate and commercial lending to 4.44% (2012: 2.33%). This was principally in Mexico from higher individually assessed impairments in CMB relating to homebuilders resulting from a change in public housing policy. In Brazil, there were increases in CMB due to model changes and assumption revisions on restructured loan account portfolios, which were partly offset by an improvement in the quality of the portfolio. In addition there were higher specific impairments across a number of corporate exposures. In the Middle East and North Africa, impairment allowances as a proportion of gross financial lending fell from 1.70% to 0.87%, mainly due to a release on an individually assessed impairment in 2013.

For a more detailed analysis of our wholesale lending, see page 165.

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Credit quality of gross loans and advances

(Unaudited)

	Europe US$m	Hong Kong US$m	Rest of Asia-Pacific US$m	MENA US$m	North America US$m	Latin America US$m	Total US$m
2013							
Neither past due nor impaired	**568,040**	**229,202**	**195,299**	**32,194**	**174,455**	**55,862**	**1,255,052**
of which renegotiated	**2,534**	**248**	**172**	**1,021**	**4,882**	**543**	**9,400**
Past due but not impaired	**2,399**	**1,499**	**2,723**	**757**	**6,453**	**1,640**	**15,471**
of which renegotiated	**748**	**9**	**31**	**146**	**3,002**	**11**	**3,947**
Impaired	**13,228**	**445**	**1,178**	**2,285**	**15,123**	**4,244**	**36,503**
of which renegotiated	**6,474**	**86**	**221**	**927**	**10,905**	**2,215**	**20,828**
2012							
Neither past due nor impaired	500,599	200,110	179,337	35,628	127,457	65,520	1,108,651
of which renegotiated	3,871	275	199	1,300	6,061	1,109	12,815
Past due but not impaired	2,339	1,311	2,974	975	7,721	3,591	18,911
of which renegotiated	371	8	35	168	3,104	133	3,819
Impaired	11,145	477	1,147	2,474	20,345	3,188	38,776
of which renegotiated	5,732	109	318	921	16,997	1,516	25,593

On a reported basis at 31 December 2013, US$1,255bn of gross loans and advances were classified as neither past due nor impaired, an increase of 13% on the end of 2012, mainly in Europe and North America, resulting from higher reverse repo balances due to the change in the way GB&M manages these activities (see page 220).

At 31 December 2013, US$15bn of gross loans and advances were classified as past due but not impaired compared with US$19bn at the end of 2012, a reduction of 18%. The largest concentration of these balances was in HSBC Finance. The decrease was mainly in Latin America where we repositioned our portfolio in Brazil and disposed of our operations in Panama, and in North America, due to the continued run-off and loan sales in the CML portfolio.

Gross loans and advances classified as impaired decreased by 6% to US$37bn, mainly in North America due to the continued run-off and loan sales in the CML portfolio.

Renegotiated loans totalled US$34bn at 31 December 2013 compared with US$42bn at the end of 2012. The reduction was primarily due to the continued run-off and loan sales in the CML portfolio. North America accounted for the largest

volume of renegotiated loans, at US$19bn or 55% of the total at 31 December 2013 (2012: US$26bn or 62%), most of which were first lien residential mortgages held by HSBC Finance. US$11bn of the renegotiated loans in North America were impaired at 31 December 2013 (2012:

US$17bn).

For a more detailed analysis of the credit quality of financial instruments, see page 169.

Impairment of loans and advances

(Unaudited)

Loan impairment charges by geographical region

Loan impairment charges by industry

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Loan impairment charges in 2013 decreased to US$6.0bn from US$8.2bn in 2012 on a reported basis. On a constant currency basis they were 24% lower. The reduction was primarily in RBWM in North America, due to improvements in housing market conditions and lower delinquency levels, along with the continued run-off and loan disposals in the CML portfolio and the sale of the CRS business in 2012. This decline was partly offset by increases in Latin America, principally in Mexico, where there were higher specific impairments in CMB which primarily related to homebuilders due to a change in public housing policy, and collective impairment provisions in RBWM. In Brazil, loan impairment charges increased, reflecting impairment model changes and assumption revisions for restructured loan account portfolios in RBWM and CMB and higher specific impairments across a number of corporate exposures. This rise was partly offset by improvements in the quality of the portfolio in Brazil as the modification of credit strategies in previous years helped to mitigate rising delinquency rates.

For a more detailed analysis of the impairment of loans and advances, see page 187.

Assets held for sale

During 2013, the growth in gross loans and advances was affected by a reclassification of certain lending balances to Assets held for sale . Disclosures relating to assets held for sale are provided in the following credit risk management tables, primarily where the disclosure is relevant to the measurement of these financial assets:

- Maximum exposure to credit risk (page 159);
- Distribution of financial instruments by credit quality (page 170); and
- Ageing analysis of days past due but not impaired gross financial instruments (page 173).

Although gross loans and advances held for sale and related impairment allowances are reclassified from Loans and advances to customers and Loans and advances to banks in the balance sheet, there is no equivalent income statement reclassification. As a result, charges for loan impairment losses shown in the credit risk disclosures include loan impairment charges relating to financial assets classified as Assets held for sale .

Loans and advances to customers and banks measured at amortised cost

(Audited)

	At 31 December 2013		At 31 December 2012	
	Gross loans and advances US$m	**Impairment allowances**	Gross loans and advances US$m	Impairment allowances

			on loans and advances US$m		on loans and advances US$m
Reported in	Loans and advances to customers and banks	**1,307,026**	**15,201**	1,166,338	16,169
Reported in	Assets held for sale	**1,970**	**111**	7,350	718
		1,308,996	**15,312**	1,173,688	16,887

The lending balances in Assets held for sale at the end of 2013 included balances associated with the disposal of our operations in Colombia, Uruguay and Jordan, net of impairment allowances.

We continue to measure lending balances held for sale at amortised cost less allowances for impairment; such carrying amounts may differ from fair value. Any difference between the carrying amount and the sales price, which is the fair value at the time of sale, would be recognised as a gain or a loss.

The table below analyses the amount of loan impairment charges and other credit risk provisions (LIC s) arising from assets held for sale.

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Loan impairment charges and other credit risk provisions

(Unaudited)

	2013 US$m
LICs arising from:	
disposals and assets held for sale	197
assets not held for sale	5,652
	5,849

See Note 16 on the Financial Statements for the carrying amount and the fair value at 31 December 2013 of loans and advances to banks and customers classified as held for sale.

Credit exposure

Maximum exposure to credit risk

(Audited)

The table on page 159 provides information on balance sheet items, offsets and loan and other credit-related commitments. Commentary on balance sheet movements is provided on page 66.

Maximum exposure to credit risk table (page 159)

The table presents our maximum exposure to credit risk from balance sheet and off-balance sheet financial instruments before taking account of any collateral held or other credit enhancements (unless such enhancements meet accounting offsetting requirements). For financial assets recognised on the balance sheet, the maximum exposure to credit risk equals their carrying amount; for financial guarantees and similar contracts granted, it is the maximum amount that we would have to pay if the guarantees were called upon. For loan commitments and other credit-related commitments that are irrevocable over the life of the respective facilities, it is generally the full amount of the committed facilities.

Loans and advances

For details of our maximum exposure to loans and advances, see Personal lending on page 160 (unaudited); Wholesale lending on page 165 (unaudited); Credit quality of financial instruments on page 169; and Concentration of exposure on page 197 (unaudited).

The loans and advances offset in the table on page 159 relates to customer loans and deposits and balances where there is a legally enforceable right of offset in the event of counterparty default and where, as a result, there is a net exposure for credit risk purposes. However, as there is no intention to settle these balances on a net basis under normal circumstances, they do not qualify for net presentation for accounting purposes.

Derivatives

Our maximum exposure to derivatives decreased, primarily reflecting a reduction in the fair value of interest rate derivative contracts in Europe due to upward movements in yield curves in major currencies. Over half of all trades were exchange traded or otherwise settled centrally, the majority of these being interest rate derivatives.

The derivatives offset amount in the table on page 159 relates to exposures where the counterparty has an offsetting derivative exposure with HSBC, a master netting arrangement is in place and the credit risk exposure is managed on a net basis, or the position is specifically collateralised, normally in the form of cash.

At 31 December 2013, the total amount of such offsets was US$252bn (2012: US$311bn), of which US$209bn (2012: US$270bn) were offsets under a master netting arrangement, US$36bn (2012: US$39bn) was collateral received in cash and US$7bn (2012: US$1.8bn) was other collateral. The decline in the total offset reflects the reduction in the fair value of derivative contracts in the year resulting from an upward shift in major yield curves. These amounts do not qualify for offset for accounting purposes as either there is no legally enforceable right to offset or it is not intended for settlement to be on a net basis.

Loan and other credit-related commitments

Loan and other credit-related commitments largely consist of corporate and commercial off-balance sheet commitments including term and trade-related lending balances and overdrafts, and retail off-balance sheet commitments including overdrafts, residential mortgages, personal loans and credit card balances. They remained well diversified across geographical regions.

At 31 December 2013, loan and other credit-related commitments rose to US$588bn (2012: US$579bn), driven by increased undrawn corporate facilities in Europe, mainly in France, the UK and Germany, and in North America reflecting our focus on growing in target commercial segments in the US. These increases were partly offset by a decline in Latin America following the disposal of our operations in Panama.

For details of our loans and other credit-related commitments, see page 160 (unaudited).

Report of the Directors: Financial Review (continued)

Other credit risk mitigants

While not disclosed as an offset in the Maximum exposure to credit risk table, other arrangements are in place which reduce our maximum exposure to credit risk. These include short positions in securities and financial assets held as part of linked insurance/investment contracts where the risk is predominantly

borne by the policyholder. In addition, we hold collateral in the form of financial instruments that are not recognised on the balance sheet.

See page 178 and Note 34 on the Financial Statements for further details on collateral in respect of certain loans and advances.

Counterparty analysis of notional contract amounts of derivatives by product type

(Unaudited)

		Traded over the counter		
	Traded on recognised exchanges US$m	Settled by central counterparties US$m	Not settled by central counterparties US$m	Total US$m
At 31 December 2013				
HSBC				
Foreign exchange	**41,384**	**16,869**	**5,232,750**	**5,291,003**
Interest rate	**857,562**	**18,753,836**	**7,736,520**	**27,347,918**
Equity	**274,880**		**315,023**	**589,903**
Credit		**104,532**	**573,724**	**678,256**
Commodity and other	**6,531**		**71,311**	**77,842**
	1,180,357	**18,875,237**	**13,929,328**	**33,984,922**
At 31 December 2012				
HSBC				
Foreign exchange	27,869	11,156	4,413,532	4,452,557
Interest rate	837,604	12,316,673	8,459,665	21,613,942
Equity	225,452		270,216	495,668
Credit		73,281	828,226	901,507
Commodity and other	19,006		61,213	80,219
	1,109,931	12,401,110	14,032,852	27,543,893

The purposes for which HSBC uses derivatives are described in Note 18 on the Financial Statements.

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Maximum exposure to credit risk

(Audited)

	At 31 December 2013			At 31 December 2012		
	Maximum exposure US$m	Offset US$m	Net US$m	Maximum exposure US$m	Offset US$m	Net US$m
Cash and balances at central banks	166,599		166,599	141,532		141,532
Items in the course of collection from other banks	6,021		6,021	7,303		7,303
Hong Kong Government certificates of indebtedness	25,220		25,220	22,743		22,743
Trading assets	239,301	(1,777)	237,524	367,177	(19,700)	347,477
Treasury and other eligible bills	21,584		21,584	26,282		26,282
Debt securities	141,644		141,644	144,677		144,677
Loans and advances to banks	27,885		27,885	78,271		78,271
Loans and advances to customers	48,188	(1,777)	46,411	117,947	(19,700)	98,247
Financial assets designated at fair value	12,719		12,719	12,714		12,714
Treasury and other eligible bills	50		50	54		54
Debt securities	12,589		12,589	12,551		12,551
Loans and advances to banks	76		76	55		55
Loans and advances to customers	4		4	54		54
Derivatives	282,265	(252,344)	29,921	357,450	(310,859)	46,591
Loans and advances to customers held at amortised cost[3]	1,080,304	(116,677)	963,627	997,623	(91,846)	905,777
personal	404,126	(1,348)	402,778	406,881	(1,604)	405,277
corporate and commercial	538,479	(90,215)	448,264	510,038	(78,650)	431,388
financial (non-bank financial institutions)	137,699	(25,114)	112,585	80,704	(11,592)	69,112
Loans and advances to banks held at amortised cost[3]	211,521	(2,903)	208,618	152,546	(3,732)	148,814
Financial investments	416,785		416,785	415,312		415,312
Treasury and other similar bills	78,111		78,111	87,550		87,550
Debt securities	338,674		338,674	327,762		327,762
Assets held for sale	3,306	(22)	3,284	9,292	(164)	9,128
disposal groups	2,647	(22)	2,625	5,359	(164)	5,195
non-current assets held for sale	659		659	3,933		3,933
Other assets	34,018		34,018	31,983		31,983
Endorsements and acceptances	11,624		11,624	12,032		12,032
Other	22,394		22,394	19,951		19,951
Financial guarantees and similar contracts	46,300		46,300	44,993		44,993
Loan and other credit-related commitments[4]	587,603		587,603	579,469		579,469
	3,111,962	(373,723)	2,738,239	3,140,137	(426,301)	2,713,836

For footnotes, see page 263.

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Loan and other credit-related commitments

(Unaudited)

	Europe US$m	Hong Kong US$m	Rest of Asia-Pacific US$m	MENA US$m	North America US$m	Latin America US$m	Total US$m
At 31 December 2013							
Personal	**92,148**	**50,306**	**24,139**	**2,940**	**15,647**	**9,774**	**194,954**
Corporate and commercial	**91,895**	**50,128**	**69,956**	**19,045**	**92,837**	**21,956**	**345,817**
Financial	**18,930**	**4,517**	**3,960**	**705**	**17,478**	**1,242**	**46,832**
	202,973	**104,951**	**98,055**	**22,690**	**125,962**	**32,972**	**587,603**
At 31 December 2012							
Personal	80,596	47,617	26,133	5,271	17,424	14,142	191,183
Corporate and commercial	91,957	58,082	64,618	17,197	87,631	22,770	342,255
Financial	15,080	2,958	6,919	453	18,099	2,522	46,031
	187,633	108,657	97,670	22,921	123,154	39,434	579,469

Personal lending

(Unaudited)

We provide a broad range of secured and unsecured personal lending products to meet customer needs. Given the diversity of the markets in which we operate, the range is not standard across all countries but is tailored to meet the demands of individual markets.

Personal lending includes advances to customers for asset purchases such as residential property, where the loans are typically secured by the assets being acquired. We also offer loans secured on existing assets, such as first and second liens on residential property and unsecured lending products such as overdrafts, credit cards and payroll loans.

Total personal lending

(Unaudited)

	UK US$m	Rest of Europe US$m	Hong Kong US$m	US[5] US$m	Rest of North America US$m	Other regions[6] US$m	Total US$m
At 31 December 2013							
First lien residential mortgages (A)	132,174	8,300	53,762	42,317	18,638	44,684	299,875
Other personal lending (B)	22,913	28,720	19,794	6,257	5,478	27,691	110,853
motor vehicle finance		11			20	2,662	2,693
credit cards	11,480	3,016	6,428	734	411	8,287	30,356
second lien residential mortgages				5,010	251	93	5,354
other	11,433	25,693	13,366	513	4,796	16,649	72,450
Total personal lending (C)	155,087	37,020	73,556	48,574	24,116	72,375	410,728
Impairment allowances on personal lending							
First lien residential mortgages (a)	368	71		2,834	52	213	3,538
Other personal lending (b)	450	509	78	470	62	1,495	3,064
motor vehicle finance		3				90	93
credit cards	132	271	40	39	8	365	855
second lien residential mortgages				421	5		426
other	318	235	38	10	49	1,040	1,690
Total (c)	818	580	78	3,304	114	1,708	6,602
(a) as a percentage of A	0.3%	0.9%		6.7%	0.3%	0.5%	1.2%
(b) as a percentage of B	2.0%	1.8%	0.4%	7.5%	1.1%	5.4%	2.8%
(c) as a percentage of C	0.5%	1.6%	0.1%	6.8%	0.5%	2.4%	1.6%

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

	UK US$m	Rest of Europe US$m	Hong Kong US$m	US[5] US$m	Rest of North America US$m	Other regions[6] US$m	Total US$m
At 31 December 2012							
First lien residential mortgages (E)	127,024	8,148	52,296	49,417	20,716	44,261	301,862
Other personal lending (F)	23,446	27,656	18,045	7,382	6,839	29,863	113,231
motor vehicle finance		24			20	3,871	3,915
credit cards	11,369	3,060	5,930	821	735	8,881	30,796
second lien residential mortgages	508			5,959	363	131	6,961
other	11,569	24,572	12,115	602	5,721	16,980	71,559
Total personal lending (G)	150,470	35,804	70,341	56,799	27,555	74,124	415,093
Impairment allowances on personal lending							
First lien residential mortgages (e)	425	64	4	4,133	30	249	4,905
Other personal lending (f)	576	401	57	590	94	1,589	3,307
motor vehicle finance		4			1	144	149
credit cards	150	184	28	40	14	385	801
second lien residential mortgages	44			542	6		592
other	382	213	29	8	73	1,060	1,765
Total (g)	1,001	465	61	4,723	124	1,838	8,212
(e) as a percentage of E	0.3%	0.8%		8.4%	0.1%	0.6%	1.6%
(f) as a percentage of F	2.5%	1.4%	0.3%	8.0%	1.4%	5.3%	2.9%
(g) as a percentage of G	0.7%	1.3%	0.1%	8.3%	0.5%	2.5%	2.0%

For footnotes, see page 263.

Total personal lending was US$411bn at 31 December 2013, down from US$415bn at the end of 2012 (US$412bn on a constant currency basis). The decrease on a constant currency basis reflected the continued run-off and loan sales in the CML portfolio in the US and the disposal of our operations in Panama. This was mostly offset by an increase in mortgage lending in Rest of Asia-Pacific, the UK and Hong Kong.

For further analysis of the impairment of loans and allowances, see page 187.

Mortgage lending

(Unaudited)

We offer a wide range of mortgage products designed to meet customer needs, including capital repayment, interest-only, affordability and offset mortgages.

Group credit policy prescribes the range of acceptable residential property loan-to-value (LTV) thresholds with the maximum upper limit for new loans set between 75% and 95%. Specific

LTV thresholds and debt-to-income ratios are managed at regional and country levels and, although the parameters must comply with Group policy, strategy and risk appetite, they differ in the various locations in which we operate to reflect the local economic and housing market conditions, regulations, portfolio performance, pricing and other product features.

The commentary that follows is on a constant currency basis.

At 31 December 2013, total mortgage lending was US$305bn, a reduction of US$3bn on 2012. Balances declined in North America due to the continued run-off and loan sales in the CML portfolio, and in Latin America following the disposal of our operations in Panama. This was largely offset by increases in Rest of Asia-Pacific and Hong Kong which reflected our focus on secured lending, although the rate of growth in the latter began to slow as transaction volumes in the property market declined in 2013. Balances also grew in the UK due to our competitive offering.

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Mortgage lending products

(Unaudited)

	UK US$m	Rest of Europe US$m	Hong Kong US$m	US[5] US$m	Rest of North America US$m	Other regions[6] US$m	Total US$m
At 31 December 2013							
First lien residential mortgages	**132,174**	**8,300**	**53,762**	**42,317**	**18,638**	**44,684**	**299,875**
Second lien residential mortgages				**5,010**	**251**	**93**	**5,354**
Total mortgage lending (A)	**132,174**	**8,300**	**53,762**	**47,327**	**18,889**	**44,777**	**305,229**
Second lien as a percentage of A				**10.6%**	**1.3%**	**0.2%**	**1.8%**
Impairment allowances on mortgage lending	**368**	**71**		**3,255**	**57**	**213**	**3,964**
First lien residential mortgages	**368**	**71**		**2,834**	**52**	**213**	**3,538**
Second lien residential mortgages				**421**	**5**		**426**
Interest-only (including offset) mortgages	**48,907**	**553**	**6**		**352**	**1,109**	**50,927**
Affordability mortgages, including adjustable-rate mortgages	**2**	**506**	**12**	**16,274**		**5,581**	**22,375**
Other	**95**					**159**	**254**
Total interest-only, affordability mortgages and other (a)	**49,004**	**1,059**	**18**	**16,274**	**352**	**6,849**	**73,556**
(a) as a percentage of A	**37.1%**	**12.8%**		**34.4%**	**1.9%**	**15.3%**	**24.1%**
At 31 December 2012							
First lien residential mortgages	127,024	8,148	52,296	49,417	20,716	44,261	301,862
Second lien residential mortgages	508			5,959	363	131	6,961
Total mortgage lending (B)	127,532	8,148	52,296	55,376	21,079	44,392	308,823
Second lien as a percentage of B	0.4%			10.8%	1.7%	0.3%	2.3%
Impairment allowances on mortgage lending	469	64	4	4,675	36	249	5,497
First lien residential mortgages	425	64	4	4,133	30	249	4,905
Second lien residential mortgages	44			542	6		592
Interest-only (including offset) mortgages	49,650	372	30		531	1,146	51,729
Affordability mortgages, including adjustable-rate mortgages	6	532	19	18,456		5,135	24,148
Other	99					204	303
Total interest-only, affordability mortgages and other (b)	49,755	904	49	18,456	531	6,485	76,180
(b) as a percentage of B	39.0%	11.1%	0.1%	33.3%	2.5%	14.6%	24.7%

For footnotes, see page 263.

Mortgage lending in the US

(Unaudited)

In the US, total mortgage lending balances were US$47bn at 31 December 2013, a decrease of 15% compared with the end of 2012. Overall, US mortgage lending comprised 12% of our total personal lending and 16% of our total mortgage lending.

Mortgage lending balances at 31 December 2013 in HSBC Finance were US$30bn, a decrease of 22% compared with the end of 2012 due to the continued run-off and loan sales in the CML portfolio. In HSBC Bank USA, mortgage lending balances were US$18bn at 31 December 2013, broadly in line with 2012.

HSBC Finance

The CML portfolio continued to be affected by economic conditions in the US, where the housing market improved but unemployment remained high despite levels declining during 2013. In addition, liquidation rates continued to be affected by declines in loan prepayment rates as fewer refinancing opportunities for our customers existed.

Report of the Directors: Financial Review (continued)

HSBC Finance US Consumer and Mortgage Lending[7] *residential mortgages*

(Unaudited)

	At 31 December 2013 US$m	2012 US$m
Residential mortgages		
First lien	**27,305**	35,092
Second lien	**3,014**	3,651
Total (A)	**30,319**	38,743
Impairment allowances	**3,028**	4,480
as a percentage of A	**10.0%**	11.6%

For footnote, see page 263.

For first lien residential mortgages in our CML portfolio, two months and over delinquent balances were US$4.6bn at 31 December 2013 compared with US$7.6bn at 31 December 2012. The decline in delinquent balances mainly reflected the continued portfolio run-off and loan sales as well as the improved conditions in the housing market.

Second lien residential mortgage balances in our CML portfolio two months and over delinquent declined by 21% to US$276m at 31 December 2013, as a result of the continued run-off and loan sales in the CML portfolio.

HSBC Bank USA

In HSBC Bank USA we continued to sell a portion of new originations to the secondary market as a means of managing our interest rate risk and improving structural liquidity and focused on our strategy to grow the HSBC Premier customer base. First lien residential mortgage balances two months and over delinquent, rose in 2013 to US$1.3bn as they continued to be affected by a lengthy foreclosure process which has resulted in higher balances remaining delinquent. The delinquency ratio fell over the same period.

Second lien mortgages in the US

The majority of second lien residential mortgages are taken up by customers who hold a first lien mortgage issued by a third party. Second lien residential mortgage loans have a risk profile characterised by higher LTV ratios, because in the majority of cases the loans were taken out to complete the refinancing of properties. Loss severity on default of second liens has typically approached 100% of the amount outstanding, as any equity in the property is consumed through the repayment of the first lien loan.

Impairment allowances for these loans are determined by applying a roll-rate migration analysis which captures the propensity of these loans to default based on past experience. Once we believe that a second lien residential mortgage loan is likely to progress to write-off, the loss severity assumed in establishing our impairment allowance is close to 100% in the CML portfolios, and more than 80% in HSBC Bank USA.

Trends in two months and over contractual delinquency in the US

(Unaudited)

	At 31 December		
	2013	2012	2011
	US$m	US$m	US$m
In personal lending in the US			
First lien residential mortgages	**5,931**	8,926	9,065
Consumer and Mortgage Lending	**4,595**	7,629	7,922
other mortgage lending	**1,336**	1,297	1,143
Second lien residential mortgages	**406**	477	674
Consumer and Mortgage Lending	**276**	350	501
other mortgage lending	**130**	127	173
Credit card	**25**	27	714
Private label			316
Personal non-credit card	**25**	335	513
Total	**6,387**	9,765	11,282
	%	%	%
As a percentage of the relevant loans and receivables balances			
First lien residential mortgages	**14.0**	18.1	17.1
Second lien residential mortgages	**8.1**	8.0	8.5
Credit card	**3.4**	3.3	3.8
Private label			2.5
Personal non-credit card	**4.9**	7.4	8.3
Total	**13.1**	16.1	11.4

Report of the Directors: Financial Review (continued)

HSBC Finance: foreclosed properties in the US

(Unaudited)

	Year ended 31 December	
	2013	2012
Number of foreclosed properties at end of period	**4,254**	2,973
Number of properties added to foreclosed inventory in the period	**9,752**	6,827
Average loss on sale of foreclosed properties[8]	**1%**	6%
Average total loss on foreclosed properties[9]	**51%**	54%
Average time to sell foreclosed properties (days)	**154**	172

For footnotes, see page 263.

Credit quality of personal lending in the US

(Unaudited)

The increase in foreclosed residential properties was due to the suspension of foreclosure activities at the end of 2011 and during the first half of 2012. We have resumed processing suspended foreclosure actions in all states and have referred the majority of the backlog of loans for foreclosure. We also began initiating new foreclosure activities in all states. As a consequence, although the number of foreclosed properties sold increased and the time to sell these properties accelerated, the number of new properties added to the foreclosed inventory at HSBC Finance in 2013 increased to 9,752. This number will continue to be affected by refinements to our foreclosure processes. The number of real estate owned properties adding to inventory during 2014 will be affected by our receivable sale programme. We expect many of the properties currently in foreclosure to be sold prior to taking title.

Valuation of foreclosed properties in the US

We obtain real estate by foreclosing on the collateral pledged as security for residential mortgages. Prior to foreclosure, carrying amounts of the loans in excess of fair value less costs to sell are written down to the discounted cash flows expected to be recovered, including from the sale of the property.

Broker price opinions are obtained and updated every 180 days and real estate price trends are reviewed quarterly to reflect any improvement or additional deterioration. Our methodology is regularly validated by comparing the discounted cash flows expected to be recovered based on current market conditions (including estimated cash flows from the sale of the property) to the updated broker price opinion, adjusted for the estimated historical difference between interior and exterior appraisals. The fair values of foreclosed properties are initially determined on the basis of broker price opinions. Within 90 days of foreclosure, a more detailed property valuation is performed reflecting information obtained from a physical interior inspection of the property and additional allowances or write-downs are recorded as appropriate. Updates to the valuation are performed no less than once every 45 days until the property is sold, with declines or increases recognised through changes to allowances.

The significant backlog of foreclosures and additional delays in the processing of foreclosures could have an adverse effect on housing prices, which in turn may result in higher loss severities while foreclosures are delayed. The number of foreclosed properties at 31 December 2013 increased to 4,254 from 2,973 at the end of December 2012, reflecting the higher volume of properties added to the foreclosed inventory. The average total loss and the average loss on sale of foreclosed properties improved during 2013, reflecting improvements in home prices during the year.

For further information on renegotiated loans in North America, see page 174.

Non-US mortgage lending

(Unaudited)

The commentary that follows is on a constant currency basis.

Total non-US mortgage lending was US$258bn at 31 December 2013, an increase of US$5bn on 2012. Our most significant concentrations of mortgage lending were in the UK and Hong Kong.

The Group s largest concentration of mortgage exposure was in the UK. At 31 December 2013 it was US$132bn, up by 1% on the end of 2012. The credit performance of our UK mortgage portfolio was stable, reflecting actions taken in previous years which included restrictions on lending to purchase residential property for the purpose of rental. Impairment allowances on first lien mortgages as a proportion of total first lien mortgage loan balances remained low. Almost all lending was originated through our own sales force, and the self-certification of income was not permitted. The majority of our mortgage lending in the UK was to existing customers who held current or savings accounts with HSBC. The average LTV ratio for new business was 60% during 2013 (2012: 59%). Loan impairment charges and delinquency levels in our UK mortgage book declined, aided by the low interest rate environment.

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Interest-only mortgage products in the UK totalled US$49bn or 37% of the UK mortgage portfolio, down marginally on 2012. All interest-only lending is assessed for affordability on a capital repayment basis and, since March 2013, is only available to Premier customers. Offset mortgage products in the UK totalled US$22bn or 17% of the UK mortgage portfolio. The offset mortgage product, originated only by First Direct, is assessed for affordability on a capital repayment basis. Offset mortgage customers may make regular or one-off capital repayments but are able to redraw additional funds up to an agreed limit.

The underwriting criteria for interest-only products are consistent with those for equivalent capital repayment mortgages, and such products are typically originated at more conservative LTV ratios. We monitor specific risk characteristics within the interest-only portfolio, such as LTV ratio, age at expiry, current income levels and credit bureau scores. There are currently no concentrations of higher risk characteristics that cause the interest-only portfolio to be considered as carrying unduly high credit risk, and delinquency and impairment charges remain low, demonstrating similar performance characteristics to our capital repayment products. We run contact programmes to ensure we build an informed relationship with customers so that they receive appropriate support in meeting the final repayment of principal and understand the alternative repayment options available.

Mortgage lending in Hong Kong was US$54bn, an increase of 3% on the end of 2012, although the rate of growth began to slow as transaction volumes in the property market declined in 2013. The quality of our mortgage book remained high with no new impairment allowances in 2013. The average LTV ratio on new mortgage lending was 44% compared with an estimated 32% for the overall portfolio.

Mortgage lending in Rest of North America fell by 5% to US$19bn. This included a reduction of US$857m in Canada due to tightened regulatory lending guidelines.

Mortgage lending in other regions rose by 7% to US$45bn at 31 December 2013. Balances grew in

Rest of Asia-Pacific, resulting from our focus on secured lending and supported by marketing campaigns, mainly in mainland China and Australia. This was partly offset by a reduction in Latin America due to the disposal of our operations in Panama.

Other personal lending

(Unaudited)

Credit cards

Total credit card lending of US$30bn at 31 December 2013 was 2% higher than at the end of 2012, mainly in Hong Kong from marketing campaigns and in Turkey from business expansion. This was partly offset by the sale of the private label credit card portfolio in Canada in 2013.

Other personal non-credit card lending

Other personal non-credit card lending balances remained broadly in line with 2012 at US$80bn at 31 December 2013. There were reductions in North America in the US on second lien mortgages as noted above and in Canada, mainly due to client deleveraging, high credit standards and tightened regulatory lending guidelines. In Latin America, there was a decline due to the disposal of our operations in Panama, our focus on growing secured lending and our more restrictive lending criteria in Brazil. This was largely offset by increases in term lending in France, second lien mortgages in Singapore and personal loans in Mexico.

Wholesale lending

(Unaudited)

Wholesale lending covers the range of credit facilities granted to sovereign borrowers, banks, non-bank financial institutions, corporate entities and commercial borrowers. Our wholesale portfolios are well diversified across geographical and industry sectors, with certain exposures subject to specific portfolio controls.

During the year GB&M made a change to the way it manages reverse repo activities (see page 220), materially affecting loans and advances to banks and financial (non-bank) balances.

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Total wholesale lending

(Unaudited)

	Europe US$m	Hong Kong US$m	Rest of Asia-Pacific US$m	MENA US$m	North America US$m	Latin America US$m	Total US$m
At 31 December 2013							
Corporate and commercial (A)	**239,529**	**114,832**	**89,066**	**19,760**	**50,447**	**30,188**	**543,822**
manufacturing	**55,920**	**11,582**	**19,176**	**3,180**	**11,853**	**12,214**	**113,925**
international trade and services	**77,113**	**43,041**	**36,327**	**8,629**	**11,676**	**8,295**	**185,081**
commercial real estate	**31,326**	**25,358**	**9,202**	**639**	**5,900**	**2,421**	**74,846**
other property-related	**7,308**	**19,546**	**7,601**	**1,333**	**8,716**	**328**	**44,832**
government	**3,340**	**739**	**282**	**1,443**	**564**	**974**	**7,342**
other commercial[1]	**64,522**	**14,566**	**16,478**	**4,536**	**11,738**	**5,956**	**117,796**
Financial (non-bank financial institutions) (B)	**75,550**	**7,610**	**8,522**	**2,532**	**42,591**	**1,376**	**138,181**
Asset-backed securities reclassified	**2,578**				**138**		**2,716**
Loans and advances to banks (C)	**73,904**	**35,150**	**50,637**	**6,443**	**30,164**	**15,281**	**211,579**
Total wholesale lending (D)	**391,561**	**157,592**	**148,225**	**28,735**	**123,340**	**46,845**	**896,298**
Of which:							
reverse repos to customers	**48,091**	**1,991**	**4,457**		**33,676**		**88,215**
reverse repos to banks	**49,631**	**2,473**	**10,500**	**24**	**23,744**	**5,103**	**91,475**
Impairment allowances on wholesale lending							
Corporate and commercial (a)	**3,821**	**361**	**557**	**1,212**	**769**	**1,339**	**8,059**
manufacturing	**618**	**85**	**161**	**182**	**89**	**384**	**1,519**
international trade and services	**1,216**	**236**	**192**	**502**	**188**	**349**	**2,683**
commercial real estate	**1,116**	**5**	**17**	**153**	**202**	**396**	**1,889**
other property-related	**269**	**16**	**86**	**236**	**93**	**8**	**708**
government	**3**			**10**	**1**		**14**
other commercial	**599**	**19**	**101**	**129**	**196**	**202**	**1,246**
Financial (non-bank financial institutions) (b)	**344**	**10**	**7**	**60**	**50**	**11**	**482**
Loans and advances to banks (c)	**35**			**18**	**5**		**58**
Total (d)	**4,200**	**371**	**564**	**1,290**	**824**	**1,350**	**8,599**
(a) as a percentage of A	**1.60%**	**0.31%**	**0.63%**	**6.13%**	**1.52%**	**4.44%**	**1.48%**
(b) as a percentage of B	**0.46%**	**0.13%**	**0.08%**	**2.37%**	**0.12%**	**0.80%**	**0.35%**
(c) as a percentage of C	**0.05%**			**0.28%**	**0.02%**		**0.03%**
(d) as a percentage of D	**1.07%**	**0.24%**	**0.38%**	**4.49%**	**0.67%**	**2.88%**	**0.96%**

Report of the Directors: Financial Review (continued)

	Europe US$m	Hong Kong US$m	Rest of Asia-Pacific US$m	MENA US$m	North America US$m	Latin America US$m	Total US$m
At 31 December 2012							
Corporate and commercial (E)	223,061	99,199	85,305	22,452	47,886	35,590	513,493
manufacturing	56,690	10,354	19,213	3,373	9,731	12,788	112,149
international trade and services	70,954	33,832	32,317	9,115	13,419	9,752	169,389
commercial real estate	33,279	23,384	9,286	865	6,572	3,374	76,760
other property-related	7,402	16,399	6,641	2,103	7,607	380	40,532
government	2,393	2,838	1,136	1,662	774	1,982	10,785
other commercial[1]	52,343	12,392	16,712	5,334	9,783	7,314	103,878
Financial (non-bank financial institutions) (F)	55,732	4,546	4,255	1,196	13,935	1,594	81,258
Asset-backed securities reclassified	3,694				197		3,891
Loans and advances to banks (G)	45,320	23,500	44,592	9,198	13,465	16,528	152,603
Total wholesale lending (H)	327,807	127,245	134,152	32,846	75,483	53,712	751,245
Of which:							
reverse repos to customers	27,299	760	307		6,281	4	34,651
reverse repos to banks	22,301	1,918	6,239	500	811	3,692	35,461
Impairment allowances on wholesale lending							
Corporate and commercial (e)	3,537	383	526	1,312	732	856	7,346
manufacturing	611	86	129	210	84	287	1,407
international trade and services	992	233	185	360	189	329	2,288
commercial real estate	1,011	5	62	156	214	103	1,551
other property-related	164	20	81	241	102	13	621
government	15			42	2		59
other commercial	744	39	69	303	141	124	1,420
Financial (non-bank financial institutions) (f)	318	29	11	157	37	2	554
Loans and advances to banks (g)	40			17			57
Total (h)	3,895	412	537	1,486	769	858	7,957
(e) as a percentage of E	1.59%	0.39%	0.62%	5.84%	1.53%	2.41%	1.43%
(f) as a percentage of F	0.57%	0.64%	0.26%	13.13%	0.27%	0.13%	0.68%
(g) as a percentage of G	0.09%			0.18%			0.04%
(h) as a percentage of H	1.19%	0.32%	0.40%	4.52%	1.02%	1.60%	1.06%

For footnote, see page 263.

After excluding reverse repo balances, (d) as a percentage of D was 1.43% for Europe, 1.24% for North America and 1.2% in total at 31 December 2013. After excluding reverse repo balances, (h) as a percentage of H was 1.4% for Europe, 1.12% for North America and 1.17% in total at 31 December 2012.

On a reported basis, total wholesale lending increased by US$145bn to US$896bn at 31 December 2013. On a constant currency basis balances grew by US$149bn, of which reverse repo balances to customers increased by US$53bn and to banks by US$56bn, driven by the change in the way GB&M manages these activities (see page 220). Excluding reverse repos, total balances rose due to higher international trade and services lending, mainly in Hong Kong and, to a lesser extent, in Rest of Asia-Pacific, as we capitalised on trade and capital flows. Other commercial balances increased, notably in GB&M in the UK, on corporate overdraft balances which did not meet the netting criteria. In addition, loans and advances to banks rose as a result of increased trade re-finance and central bank lending in Hong Kong. This was partly offset by a decline in Latin America following the disposal of our operations in Panama.

For more detail on impairment allowances see page 187.

The commentary that follows is on a constant currency basis.

Financial (non-bank)

Financial (non-bank) lending increased from US$82bn at 31 December 2012 to US$138bn at 31 December 2013. This was mainly in Europe and North America due to increased reverse repo balances, as discussed above.

Loans and advances to banks

Loans and advances to banks increased from US$150bn at 31 December 2012 to US$212bn at 31 December 2013. This was driven by higher reverse repo balances due to the change in the way GB&M manages these activities, mainly affecting Europe and North America. In addition, there was a rise in placements with financial institutions in Hong Kong and Rest of Asia-Pacific.

Report of the Directors: Financial Review (continued)

Corporate and commercial

Corporate and commercial lending increased by US$33bn to US$544bn at 31 December 2013. This was driven by a rise in international trade and services lending balances, mainly in Hong Kong and, to a lesser extent, Rest of Asia-Pacific as we capitalised on trade and capital flows. Other commercial balances increased, notably in GB&M in the UK, on corporate overdraft balances which did not meet the netting criteria, and in North America from growth in lending to corporate customers, reflecting our focus on target segments in the US. This was partly offset in Latin America as a result of the disposal of our operations in Panama and tightened lending criteria across most of the region coupled with a reduction of government loans in Hong Kong following repayments in the year.

Total commercial real estate and other property-related lending was US$120bn at 31 December 2013, marginally higher compared with 2012. Loan balances grew in Hong Kong as a result of demand for financing in the property investment and development sectors. This was partly offset by lower demand for lending in the UK and the disposal of our operations in Panama.

Commercial real estate

Our exposure to commercial real estate lending continued to be concentrated in Hong Kong, the UK, Rest of Asia-Pacific and North America. The markets in Hong Kong and Rest of Asia-Pacific remained relatively strong throughout 2013 despite cooling measures and the prospect of an end to tapering in the US. In the UK, the commercial property market steadily improved as demand for commercial tenancies rose amid signs that the benefits of the economic recovery were beginning to filter to regional markets beyond London and the South East, which had remained relatively strong throughout the downturn. In North America, the US market showed the benefits of a return to economic growth with trends reflecting the recovery, particularly in larger metropolitan markets, where both commercial and residential demand improved. In Canada, broader concerns regarding overheating in the real estate markets did not affect the commercial property market.

Refinance risk in commercial real estate

It is not untypical for commercial real estate lending to require the repayment of a significant proportion

of the principal at maturity. Typically, a customer will arrange repayment through the acquisition of a new loan to settle the existing debt. Refinance risk is the risk that a customer, being unable to repay their debt on maturity, is unable to refinance the debt at commercial rates. Refinance risk is described in more detail on page 272. This risk is subject to close scrutiny in key commercial real estate markets because it can arise, in particular, when a loan is serviced exclusively by the property to which it relates, i.e. when the bank does not, or is not able to, place principal reliance on other cash flows available to the borrower. We monitor our commercial real estate portfolio closely, assessing those drivers that may indicate potential issues with refinancing. The principal driver is the vintage of the loan, when origination reflected previous market norms which no longer apply in the current market. Examples might be higher LTV ratios and/or lower interest cover ratios. The range of refinancing sources in the local market is also an important consideration, with risk increasing when lenders are restricted to banks and when bank liquidity is limited. In addition, underlying fundamentals such as the reliability of tenants, the ability to let and the condition of the property are important, as they influence property values.

For the Group s commercial real estate portfolios as a whole, the behaviour of markets and the quality of assets did not cause undue concern in 2013. While the commercial real estate market in the UK has taken some time to recover, the drivers described above are not currently causing sufficient concern regarding our sensitivity to the risk of refinancing to warrant enhanced management attention. Stronger liquidity in 2013, as a wider range of international financiers returned to the market, significantly eased pressure on the options for refinance.

At 31 December 2013, we had US$22bn of commercial real estate loans in the UK of which US$7bn were due to be refinanced within the next 12 months. Of these balances, cases subject to close monitoring in our Loan Management unit amounted to US$2bn. US$2bn were disclosed as impaired with impairment allowances of US$650m. Where these loans are not considered impaired it is because there is sufficient evidence to indicate that the associated contractual cash flows will be recovered or that the loans will not need to be refinanced on terms we would consider below market norms.

Report of the Directors: Financial Review (continued)

Credit quality of financial instruments

(Audited)

A summary of our current policies and practices regarding the credit quality of financial instruments is provided in the Appendix to Risk on page 267.

The five classifications describing the credit quality of our lending, debt securities portfolios and derivatives are defined on page 267 (unaudited). Additional credit quality information in respect of our consolidated holdings of ABSs is provided on page 275.

For the purpose of the following disclosure, retail loans which are past due up to 89 days and are not otherwise classified as impaired in accordance with our disclosure convention (see page 267 (unaudited)), are not disclosed within the expected loss (EL) grade to which they relate, but are separately classified as past due but not impaired.

2013 compared with 2012

(Unaudited)

We assess credit quality on all financial instruments which are subject to credit risk, as shown in the table on page 170.

On a reported basis, the balance of financial instruments bearing credit risk at 31 December 2013 was US$2,478bn, of which US$1,650bn or 67% was classified as strong (31 December 2012: 67%). The proportion of financial instruments classified as good and satisfactory remained broadly stable at 17% and 13%, respectively. The proportion of sub-standard financial instruments remained low at 2% at 31 December 2013.

Loans and advances held at amortised cost increased to US$1,292bn from US$1,150bn at 31 December 2012. At 31 December 2013, 77%

of these balances were classified as either strong or good , broadly in line with the end of 2012.

The majority of the Group s exposure to financial investments was in the form of available-for-sale debt securities issued by governments and government agencies classified as strong . This proportion was broadly unchanged in 2013 at 87%.

Trading assets on which credit quality has been assessed decreased by 35% from 31 December 2012 to US$239bn due to lower reverse repo balances following a change to the way GB&M manages these activities. The proportion of balances classified as strong rose marginally from 65% at 31 December 2012 to 68% at 31 December 2013. This was due to the reduction in reverse repo balances as noted above, with most of these balances previously being spread across the strong , good and satisfactory classifications. In addition, there was a reduction in our holdings of government bonds in Hong Kong and Rest of Asia-Pacific.

The proportion of derivative assets classified as strong fell marginally from 79% at the end of 2012 to 78% at 31 December 2013 as a result of a decrease in the fair value of interest rate derivatives classified as strong in Europe. The proportion of satisfactory balances fell to 5% from 7% for the same reason.

Cash and balances at central banks rose by 18% to US$167bn, mainly in Europe due to the placement of surplus funds from deposit growth exceeding lending growth and, to a lesser extent in North America. Substantially all of the Group s cash and balances at central banks were classified as strong , with the most significant concentrations in Europe and North America.

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Distribution of financial instruments by credit quality

(Audited)

	Neither past due nor impaired				Past due		Impair-ment	
	Strong US$m	Good US$m	Satisfactory US$m	Sub-standard US$m	but not impaired US$m	Impaired US$m	allowances[11] US$m	Total US$m
At 31 December 2013								
Cash and balances at central banks	162,017	2,877	265	1,440				166,599
Items in the course of collection from other banks	5,590	66	286	79				6,021
Hong Kong Government certificates of indebtedness	25,220							25,220
Trading assets[12]	163,444	39,475	34,868	1,514				239,301
treasury and other eligible bills	17,235	3,585	758	6				21,584
debt securities	107,831	16,498	16,167	1,148				141,644
loans and advances:								
to banks	15,804	5,546	6,342	193				27,885
to customers	22,574	13,846	11,601	167				48,188
Financial assets designated at fair value[12]	6,608	5,183	671	257				12,719
treasury and other eligible bills	50							50
debt securities	6,490	5,179	664	256				12,589
loans and advances:								
to banks	68		7	1				76
to customers		4						4
Derivatives[12]	220,711	47,004	13,425	1,125				282,265
Loans and advances to customers held at amortised cost[13]	535,947	262,698	220,970	23,944	15,460	36,428	(15,143)	1,080,304
personal	326,269	39,024	14,882	1,580	10,175	18,798	(6,602)	404,126
corporate and commercial	133,355	194,970	175,046	21,281	5,009	16,877	(8,059)	538,479
financial (non-bank financial institutions)	76,323	28,704	31,042	1,083	276	753	(482)	137,699
of which:								
reverse repos	47,443	19,621	21,149	2				88,215
Loans and advances to banks held at amortised cost	155,598	39,388	13,382	3,125	11	75	(58)	211,521
of which:								
reverse repos	64,100	18,257	7,116	2,002				91,475
Financial investments	362,799	27,833	17,556	6,089		2,508		416,785
treasury and other similar bills	69,364	5,595	1,856	1,296				78,111

debt securities	**293,435**	**22,238**	**15,700**	**4,793**		**2,508**		**338,674**
Assets held for sale	**1,129**	**642**	**1,050**	**351**	**89**	**156**	**(111)**	**3,306**
disposal groups	**1,093**	**642**	**496**	**351**	**86**	**90**	**(111)**	**2,647**
non-current assets held for sale	**36**		**554**		**3**	**66**		**659**
Other assets	**11,372**	**7,386**	**13,798**	**808**	**218**	**436**		**34,018**
endorsements and acceptances	**1,976**	**4,824**	**4,562**	**225**	**19**	**18**		**11,624**
accrued income and other	**9,396**	**2,562**	**9,236**	**583**	**199**	**418**		**22,394**
	1,650,435	**432,552**	**316,271**	**38,732**	**15,778**	**39,603**	**(15,312)**	**2,478,059**

170

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

	Neither past due nor impaired				Past due		Impair-	
				Sub-	but not		ment	
	Strong US$m	Good US$m	Satisfactory US$m	standard US$m	impaired US$m	Impaired US$m	allowances[11] US$m	Total US$m
At 31 December 2012								
Cash and balances at central banks	138,124	3,235	147	26				141,532
Items in the course of collection from other banks	6,661	203	439					7,303
Hong Kong Government certificates of indebtedness	22,743							22,743
Trading assets[12]	237,078	60,100	66,537	3,462				367,177
treasury and other eligible bills	20,793	4,108	1,340	41				26,282
debt securities	106,453	16,685	20,931	608				144,677
loans and advances:								
to banks	49,133	21,018	7,418	702				78,271
to customers	60,699	18,289	36,848	2,111				117,947
Financial assets designated at fair value[12]	6,186	5,884	401	243				12,714
treasury and other eligible bills	54							54
debt securities	6,089	5,830	391	241				12,551
loans and advances:								
to banks	43		10	2				55
to customers		54						54
Derivatives[12]	284,115	46,214	24,877	2,244				357,450
Loans and advances to customers held at amortised cost[13]	507,871	222,402	202,666	23,224	18,901	38,671	(16,112)	997,623
personal	321,887	39,533	16,225	1,430	12,267	23,751	(8,212)	406,881
corporate and commercial	137,139	166,338	172,457	20,920	6,437	14,093	(7,346)	510,038
financial (non-bank financial institutions)	48,845	16,531	13,984	874	197	827	(554)	80,704
of which:								
reverse repos	29,324	4,944	381	2				34,651
Loans and advances to banks held at amortised cost	117,220	23,921	10,575	772	10	105	(57)	152,546
of which:								
reverse repos	29,483	3,509	2,467	2				35,461
Financial investments	357,452	27,428	21,143	6,759		2,530		415,312
treasury and other similar bills	80,320	3,818	1,957	1,455				87,550
debt securities	277,132	23,610	19,186	5,304		2,530		327,762
Assets held for sale	2,425	3,287	2,311	314	387	1,286	(718)	9,292
disposal groups	2,033	1,118	1,789	268	118	82	(49)	5,359
non-current assets held for sale	392	2,169	522	46	269	1,204	(669)	3,933
Other assets	9,679	6,007	13,845	1,759	231	462		31,983
endorsements and acceptances	1,995	4,344	5,195	483	7	8		12,032
accrued income and other	7,684	1,663	8,650	1,276	224	454		19,951

	1,689,554	398,681	342,941	38,803	19,529	43,054	(16,887)	2,515,675

For footnotes, see page 263.

Report of the Directors: Financial Review (continued)

Past due but not impaired gross financial instruments

(Audited)

Past due but not impaired loans are those in respect of which the customer is in the early stages of delinquency and has failed to make a payment or a partial payment in accordance with the contractual terms of the loan agreement. This is typically when a loan is less than 90 days past due and there are no other indicators of impairment.

Further examples of exposures past due but not impaired include individually assessed mortgages that are in arrears more than 90 days for which there are no other indicators of impairment and the value of collateral is sufficient to repay both the principal debt and all potential interest for at least one year, or short-term trade facilities past due more than

90 days for technical reasons such as delays in documentation but there is no concern over the creditworthiness of the counterparty. When groups of loans are collectively assessed for impairment, collective impairment allowances are recognised for loans classified as past due but not impaired.

At 31 December 2013, US$15.5bn of loans and advances held at amortised cost were classified as past due but not impaired (2012: US$18.9bn). The largest concentration of these balances was in HSBC Finance, where they decreased by 13% compared with the end of 2012 due to the continued run-off and loan sales in the CML portfolio. In Latin America, balances decreased by 54% to US$1.6bn, primarily in Brazil as we reposition our portfolio. In addition, we disposed of our operations in Panama.

Past due but not impaired loans and advances to customers and banks by geographical region

(Audited)

	Europe US$m	Hong Kong US$m	Rest of Asia-Pacific US$m	MENA US$m	North America US$m	Latin America US$m	Total US$m
31 December 2013							
Banks		**11**					**11**
Customers	**2,399**	**1,488**	**2,723**	**757**	**6,453**	**1,640**	**15,460**
personal	**1,287**	**882**	**1,882**	**174**	**4,817**	**1,133**	**10,175**
corporate and commercial	**1,092**	**410**	**787**	**580**	**1,635**	**505**	**5,009**
financial (non-bank financial institutions)	**20**	**196**	**54**	**3**	**1**	**2**	**276**
	2,399	**1,499**	**2,723**	**757**	**6,453**	**1,640**	**15,471**
31 December 2012							

Banks			10				10
Customers	2,339	1,311	2,964	975	7,721	3,591	18,901
personal	1,416	638	1,961	248	5,806	2,198	12,267
corporate and commercial	909	579	953	726	1,910	1,360	6,437
financial (non-bank financial institutions)	14	94	50	1	5	33	197
	2,339	1,311	2,974	975	7,721	3,591	18,911

172

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Ageing analysis of days for past due but not impaired gross financial instruments

(Audited)

	Up to 29 days US$m	30-59 days US$m	60-89 days US$m	90-179 days US$m	180 days and over US$m	Total US$m
At 31 December 2013						
Loans and advances to customers held at amortised cost	**11,689**	**2,587**	**1,057**	**76**	**51**	**15,460**
personal	**7,170**	**2,124**	**865**	**16**		**10,175**
corporate and commercial	**4,290**	**418**	**190**	**60**	**51**	**5,009**
financial (non-bank financial institutions)	**229**	**45**	**2**			**276**
Loans and advances to banks held at amortised cost	**11**					**11**
Loans and advances	**11,700**	**2,587**	**1,057**	**76**	**51**	**15,471**
Assets held for sale	**61**	**12**	**8**	**6**	**2**	**89**
disposal groups	**61**	**11**	**8**	**5**	**1**	**86**
non-current assets held for sale		**1**		**1**	**1**	**3**
Other assets	**142**	**43**	**18**	**6**	**9**	**218**
endorsements and acceptances	**13**	**3**		**1**	**2**	**19**
other	**129**	**40**	**18**	**5**	**7**	**199**
	11,903	**2,642**	**1,083**	**88**	**62**	**15,778**
At 31 December 2012						
Loans and advances to customers held at amortised cost	14,226	3,189	1,262	200	24	18,901
personal	8,718	2,441	1,058	42	8	12,267
corporate and commercial	5,384	675	204	158	16	6,437
financial (non-bank financial institutions)	124	73				197
Loans and advances to banks held at amortised cost	10					10
Loans and advances	14,236	3,189	1,262	200	24	18,911
Assets held for sale	251	84	48	2	2	387
disposal groups	87	17	11	1	2	118
non-current assets held for sale	164	67	37	1		269
Other assets	122	37	24	12	36	231
endorsements and acceptances	6	1				7
other	116	36	24	12	36	224
	14,609	3,310	1,334	214	62	19,529

Renegotiated loans and forbearance

(Audited)

Current policies and procedures regarding renegotiated loans and forbearance are described in the Appendix to Risk on page 268.

The contractual terms of a loan may be modified for a number of reasons, including changes in market conditions, customer retention and other factors not related to the current or potential credit deterioration of a customer. Forbearance describes concessions made on the contractual terms of a loan in response to an obligor s financial difficulties. We classify and report loans on which concessions have been granted under conditions of credit distress as renegotiated loans when their contractual payment terms have been modified, because we have significant concerns about the borrowers ability to meet contractual payments when due. Concessions on loans made to customers which do not affect the

payment structure or basis of repayment, such as waivers of financial or security covenants, do not directly provide concessionary relief to customers in terms of their ability to service obligations as they fall due and are therefore not included in this classification.

There were no material changes to our group standard policies and procedures regarding renegotiated loans in 2013. In Brazil, we realigned local practices to meet Group standard policy and reviewed the impairment allowance methodology used for our retail banking and Business Banking mass portfolios to ensure that it better reflected the level of restructuring that is taking place and the performance of these restructured accounts.

The following tables show the gross carrying amounts of the Group s holdings of renegotiated loans and advances to customers by industry sector, geography and credit quality classification.

Report of the Directors: Financial Review (continued)

Renegotiated loans and advances to customers

(Audited)

	At 31 December 2013				At 31 December 2012			
	Neither past due nor impaired US$m	**Past due but not impaired US$m**	**Impaired US$m**	**Total US$m**	Neither past due nor impaired US$m	Past due but not impaired US$m	Impaired US$m	Total US$m
Personal	**5,895**	**3,585**	**12,092**	**21,572**	7,952	3,524	18,279	29,755
first lien residential mortgages	**4,881**	**3,219**	**10,857**	**18,957**	5,861	2,828	15,459	24,148
other personal[1]	**1,014**	**366**	**1,235**	**2,615**	2,091	696	2,820	5,607
Corporate and commercial	**3,147**	**362**	**8,493**	**12,002**	4,608	295	6,892	11,795
manufacturing and international trade services	**1,529**	**163**	**4,178**	**5,870**	2,381	154	3,012	5,547
commercial real estate and other property-related	**1,050**	**113**	**3,385**	**4,548**	1,796	10	3,484	5,290
governments	**274**		**43**	**317**	177			177
other commercial[10]	**294**	**86**	**887**	**1,267**	254	131	396	781
Financial	**358**		**243**	**601**	255		422	677
	9,400	**3,947**	**20,828**	**34,175**	12,815	3,819	25,593	42,227
Total renegotiated loans and advances to customers as a percentage of total gross loans and advances to customers				**3.1%**				4.2%

For footnotes, see page 263.

Renegotiated loans and advances to customers by geographical region

(Audited)

	Europe US$m	**Hong Kong US$m**	**Rest of Asia-Pacific US$m**	**MENA US$m**	**North America US$m**	**Latin America US$m**	**Total US$m**
31 December 2013							
Personal	**2,251**	**218**	**217**	**149**	**18,130**	**607**	**21,572**
first lien residential mortgages	**1,820**	**52**	**65**	**91**	**16,853**	**76**	**18,957**
other personal[1]	**431**	**166**	**152**	**58**	**1,277**	**531**	**2,615**
Corporate and commercial	**7,270**	**125**	**205**	**1,583**	**658**	**2,161**	**12,002**
manufacturing and international trade services	**3,709**	**18**	**85**	**489**	**198**	**1,371**	**5,870**
commercial real estate and other property-related	**2,940**	**3**	**36**	**662**	**446**	**461**	**4,548**
governments				**137**		**180**	**317**

other commercial[10]	**621**	**104**	**84**	**295**	**14**	**149**	**1,267**
Financial	**235**		**2**	**362**	**1**	**1**	**601**
	9,756	**343**	**424**	**2,094**	**18,789**	**2,769**	**34,175**
Total impairment allowances on renegotiated loans	**1,867**	**13**	**88**	**460**	**2,285**	**1,014**	**5,727**
individually assessed	**1,821**	**12**	**66**	**460**	**98**	**464**	**2,921**
collectively assessed	**46**	**1**	**22**		**2,187**	**550**	**2,806**

Report of the Directors: Financial Review (continued)

	Europe US$m	Hong Kong US$m	Rest of Asia-Pacific US$m	MENA US$m	North America US$m	Latin America US$m	Total US$m
31 December 2012							
Personal	2,817	245	248	190	25,474	781	29,755
first lien residential mortgages	1,896	68	78	112	21,896	98	24,148
other personal[1]	921	177	170	78	3,578	683	5,607
Corporate and commercial	6,829	147	300	1,859	685	1,975	11,795
manufacturing and international trade services	3,002	22	193	659	191	1,480	5,547
commercial real estate and other property-related	3,641	25	37	899	486	202	5,290
governments				2		175	177
other commercial[10]	186	100	70	299	8	118	781
Financial	328		4	340	3	2	677
	9,974	392	552	2,389	26,162	2,758	42,227
Total impairment allowances on renegotiated loans	1,547	16	96	546	3,864	485	6,554
individually assessed	1,545	15	63	543	39	213	2,418
collectively assessed	2	1	33	3	3,825	272	4,136

For footnotes, see page 263.

Movement in renegotiated loans by geographical region

(Unaudited)

	Europe US$m	**Hong Kong US$m**	**Rest of Asia-Pacific US$m**	**MENA US$m**	**North America US$m**	**Latin America US$m**	**Total US$m**
Renegotiated loans at 1 January 2013	**9,974**	**392**	**552**	**2,389**	**26,162**	**2,758**	**42,227**
personal	**2,817**	**245**	**248**	**190**	**25,474**	**781**	**29,755**
corporate and commercial	**6,829**	**147**	**300**	**1,859**	**685**	**1,975**	**11,795**
financial	**328**		**4**	**340**	**3**	**2**	**677**
Loans renegotiated in the year without derecognition	**2,807**		**49**	**101**	**1,727**	**1,311**	**5,995**
personal	**264**		**8**	**16**	**1,335**	**507**	**2,130**
corporate and commercial	**2,541**		**41**	**85**	**391**	**803**	**3,861**
financial	**2**				**1**	**1**	**4**
Loans renegotiated in the year resulting in recognition of a new loan	**105**	**47**	**66**	**14**		**62**	**294**
personal	**17**	**46**	**30**	**14**		**25**	**132**
corporate and commercial	**88**	**1**	**36**			**37**	**162**
financial							
Repayments	**(2,139)**	**(99)**	**(134)**	**(541)**	**(1,759)**	**(707)**	**(5,379)**
personal	**(489)**	**(71)**	**(40)**	**(64)**	**(1,387)**	**(353)**	**(2,404)**
corporate and commercial	**(1,574)**	**(28)**	**(93)**	**(477)**	**(370)**	**(354)**	**(2,896)**
financial	**(76)**		**(1)**		**(2)**		**(79)**

Amounts written off	**(426)**	**(2)**	**(23)**	**(38)**	**(1,035)**	**(409)**	**(1,933)**
personal	**(99)**	**(2)**	**(18)**	**(9)**	**(995)**	**(233)**	**(1,356)**
corporate and commercial	**(303)**		**(5)**	**(29)**	**(40)**	**(175)**	**(552)**
financial	**(24)**					**(1)**	**(25)**
Other	**(565)**	**5**	**(86)**	**169**	**(6,306)**	**(246)**	**(7,029)**
personal	**(259)**		**(11)**	**2**	**(6,297)**	**(120)**	**(6,685)**
corporate and commercial	**(311)**	**5**	**(74)**	**145**	**(8)**	**(125)**	**(368)**
financial	**5**		**(1)**	**22**	**(1)**	**(1)**	**24**
At 31 December 2013	**9,756**	**343**	**424**	**2,094**	**18,789**	**2,769**	**34,175**
personal	**2,251**	**218**	**217**	**149**	**18,130**	**607**	**21,572**
corporate and commercial	**7,270**	**125**	**205**	**1,583**	**658**	**2,161**	**12,002**
financial	**235**		**2**	**362**	**1**	**1**	**601**

For footnote, see page 263.

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

The above table shows the movement in renegotiated loans for the year. During the year there were US$6.3bn of new loans classified as renegotiated, of which US$294m resulted in the derecognition of the original loan and recognition of a new loan. The majority of the movement during the year was in Other , which included a reduction in North America of US$5.6bn due to loan sales in the CML portfolio and transfers to other assets upon foreclosure and repossession of the real estate collateral of US$668m. In addition, there were refinements in data collection to personal and corporate and commercial, which resulted in improved renegotiated loan identification and led to a decrease in Turkey of US$523m.

See page 270 for further details on the types of restructures that may result in derecognition accounting.

2013 compared with 2012

(Unaudited)

The following commentary is on a reported basis.

Renegotiated loans totalled US$34.2bn at 31 December 2013 (2012: US$42.2bn). The most significant portfolio remained in North America at US$18.8bn or 55% of the total at 31 December 2013 (2012: US$26.2bn or 62%), substantially all of which were retail loans held by HSBC Finance

Further commentary is provided below for retail and corporate and commercial renegotiated loans.

Retail renegotiated loans

(Unaudited)

The following commentary is on a reported basis.

Renegotiated loans to retail customers totalled US$21.6bn at 31 December 2013, a reduction of US$8.2bn compared with the end of 2012. This was due to the continued run-off and loan sales in the CML portfolio. The most significant portfolio of renegotiated retail loans remained in North America and amounted to US$18.1bn or 84% of the Group s total, substantially all of which were retail loans held by HSBC Finance.

The next largest portfolio of renegotiated retail loans was in Europe and amounted to US$2.3bn, a reduction of US$566m compared with the end of 2012. The decrease was mainly due to repayments and write-offs on renegotiated loans in the UK.

In Latin America, renegotiated retail loans decreased by US$174m to US$607m, mainly resulting from more restrictive conditions being required for the approval of renegotiations.

Renegotiated retail loans in Hong Kong, Rest of Asia-Pacific and the Middle East and North Africa remained low.

HSBC Finance loan modifications and re-age programmes

HSBC Finance maintains loan modification and re-age (loan renegotiation) programmes in order to manage customer relationships, improve collection opportunities and, if possible, avoid foreclosure.

Since 2006, HSBC Finance has implemented an extensive loan renegotiation programme, and a significant portion of its loan portfolio has been subject to renegotiation at some stage in the life of the customer relationship as a consequence of the economic conditions in the US and the nature of HSBC Finance s customer base.

The volume of loans that qualify for modification has reduced significantly in recent years. We expect this trend to continue as HSBC Finance believes the percentage of its customers with unmodified loans who would benefit from loan modification in a way that would avoid non-payment of future cash flows is decreasing. In addition, volumes of new loan modifications are expected to decrease due to gradual improvements in economic conditions, the cessation of new real estate secured and personal non-credit card receivables originations, and the continued run-off and loan sales in the CML portfolio.

Qualifying criteria

For an account to qualify for renegotiation it must meet certain criteria. However, HSBC Finance retains the right to decline a renegotiation. The extent to which HSBC Finance renegotiates accounts that are eligible under its existing policies varies according to its view of prevailing economic conditions and other factors which may change from year to year. In addition, exceptions to policies and practices may be made in specific situations in response to legal or regulatory agreements or orders.

Renegotiated real estate secured and personal lending receivables are not eligible for a subsequent renegotiation for twelve and six months, respectively, with a maximum of five renegotiations permitted within a five-year period. Borrowers must be approved for a modification and generally make two minimum qualifying monthly payments within 60 days to activate a modification. In certain circumstances where the debt has been restructured in bankruptcy proceedings, fewer or no payments may be required. Accounts whose borrowers are subject to a Chapter 13 plan filed with a bankruptcy court generally may be re-aged upon receipt of one

Report of the Directors: Financial Review (continued)

qualifying payment, while accounts whose borrowers have filed for Chapter 7 bankruptcy protection may be re-aged upon receipt of a signed reaffirmation agreement. In addition, for some products accounts may be re-aged without receipt of a payment in certain special circumstances (e.g. in the event of a natural disaster or a hardship programme).

Types of loan renegotiation programme in HSBC Finance

A temporary modification is a change to the contractual terms of a loan that results in HSBC Finance giving up a right to contractual cash flows over a pre-defined period. With a temporary modification the loan is expected to revert back to the original contractual terms, including the interest rate charged, after the modification period. An example is reduced interest payments.

A substantial number of HSBC Finance modifications involve interest rate reductions, which lower the amount of interest income HSBC Finance is contractually entitled to receive in future periods. Historically, modifications have generally been for six months, although extended modification periods are now more common.

Loans that have been re-aged are classified as impaired with the exception of first-time loan re-ages that were less than 60 days past due at the time of re-age. These remain classified as impaired until they have demonstrated a history of payment performance against their original contracted terms for at least 12 months.

A permanent modification is a change to the contractual terms of a loan that results in HSBC Finance giving up a right to contractual cash flows over the life of the loan. An example is a permanent reduction in the interest rate charged.

Permanent or long-term modifications which are due to an underlying hardship event remain classified as impaired for their full life.

The term re-age describes a renegotiation by which the contractual delinquency status of a loan is reset to current after demonstrating payment performance. The overdue principal and/or interest is deferred and paid at a later date. Loan re-ageing enables customers who have been unable to make a small number of payments to have their loan delinquency status reset to current so that their credit score is not affected by the overdue balances.

Loans that have been re-aged remain classified as impaired until they have demonstrated a history of payment performance against the original contractual terms for at least 12 months.

A temporary or permanent modification may also lead to a re-ageing of a loan although a loan may be re-aged without any modification to its original terms and conditions.

Where loans have been granted multiple concessions, subject to the qualifying criteria discussed above, the concession is deemed to have been made due to concern regarding the borrower s ability to pay, and the loan is disclosed as impaired. The loan remains disclosed as impaired from that date forward until the borrower has demonstrated a history of repayment performance for the period of time required for either modifications or re-ages, as described above.

2013 compared with 2012

At 31 December 2013, renegotiated real estate secured accounts in HSBC Finance represented 91% (2012: 86%) of North America s total renegotiated loans. US$10bn (2012: US$14bn) of renegotiated real estate secured loans were classified as impaired. A significant portion of HSBC Finance s renegotiated portfolio has received multiple renegotiations. Consequently, a significant proportion of loans included in the table below have undergone multiple re-ages or modifications. In this regard, multiple modifications have remained consistent at 75% to 80% of total modifications.

During 2013, the aggregate number of renegotiated loans reduced, due to the run-off and loan sales in the CML portfolio, despite renegotiation activity continuing. Within the constraints of our Group credit policy, HSBC Finance s policies allow for multiple renegotiations under certain circumstances, and a significant number of accounts received second or subsequent renegotiations during the year which do not appear in the statistics presented. These statistics treat a loan as an addition to the volume of renegotiated loans on its first renegotiation only. At 31 December 2013, renegotiated loans were 57% (2012: 58%) of the total portfolio of HSBC Finance s real estate secured accounts.

Report of the Directors: Financial Review (continued)

Gross loan portfolio of HSBC Finance real estate secured balances

(Unaudited)

	Re-aged[14] US$m	Modified and re-aged US$m	Modified US$m	Total re-negotiated loans US$m	Total non-renegotiated loans US$m	Total gross loans US$m	Total impairment allowances US$m	Impairment allowances/ gross loans %
At 31 December 2013	**8,167**	**8,213**	**768**	**17,148**	**13,171**	**30,319**	**3,028**	**10**
At 31 December 2012	9,640	11,660	1,121	22,421	16,261	38,743	4,481	12

For footnote, see page 263.

Movement in HSBC Finance renegotiated real estate balances

(Unaudited)

	2013 US$m	2012 US$m
At 1 January	**22,421**	24,588
Additions	**967**	1,221
Payments	**(1,540)**	(1,133)
Write-offs	**(1,122)**	(1,796)
Transfer to Assets held for sale and Other assets	**(3,578)**	(459)
At 31 December	**17,148**	22,421

Number of renegotiated real estate secured accounts remaining in HSBC Finance s portfolio

(Unaudited)

	Number of renegotiated loans (000s) Re-aged	Modified and re-aged	Modified	Total	Total number of loans (000s)
At 31 December 2013	**102**	**78**	**8**	**188**	**352**
At 31 December 2012	117	107	11	235	427

Corporate and commercial renegotiated loans

(Unaudited)

For the current policies and procedures regarding renegotiated loans in the corporate and commercial sector, see the Appendix to Risk on page 271.

On a reported basis, there was a US$207m increase in renegotiated loans in the corporate and commercial sector in 2013 to US$12bn. Higher balances in Europe US$441m and Latin America US$186m, were partly offset by reductions across the other regions.

In Europe, there were higher balances in manufacturing and international trade services of US$707m, mainly in the UK due to a small number of significant individual restructurings, and in other commercial balances of US$435m, principally in Spain. This was partly offset by lower balances in the commercial real estate and other property-related sector of US$701m, mainly in the UK due to net loan repayments.

In the Middle East and North Africa, the majority of the fall of US$276m was due to loan repayments in both manufacturing and international

trade services and commercial real estate and other property-related sectors, mainly in the UAE.

In Rest of Asia-Pacific, the majority of the US$95m reduction in renegotiated loan balances was in the manufacturing and international trade services sector as well as the commercial real estate and other property-related sector.

Renegotiated balances in Latin America increased by US$186m compared with the end of 2012, primarily due to a small number of large renegotiations in the commercial real estate and other property-related sector in Mexico, related to homebuilders resulting from a change in public housing policy.

Collateral

Collateral and other credit enhancements held

(Audited)

Loans and advances held at amortised cost

It is the Group s practice to lend on the basis of customers ability to meet their obligations out of cash flow resources rather than rely on the value of security offered. Depending on a customer s standing and the type of product, facilities may

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

be provided without security. For other lending, a charge over collateral is obtained and considered in determining the credit decision and pricing. In the event of default, the bank may utilise the collateral as a source of repayment. Depending on its form, collateral can have a significant financial effect in mitigating our exposure to credit risk.

The tables below provide a quantification of the value of fixed charges we hold over borrowers specific assets where we have a history of enforcing, and are able to enforce, collateral in satisfying a debt in the event of the borrower failing to meet its contractual obligations, and where the collateral is cash or can be realised by sale in an established market. The collateral valuation in the tables below excludes any adjustments for obtaining and selling the collateral.

We may also manage our risk by employing other types of collateral and credit risk enhancements such as second charges, other liens and unsupported guarantees, but the valuation of such mitigants is less certain and their financial effect has not been quantified. In particular, loans shown in the tables below as not collateralised or

partially collateralised may benefit from such credit mitigants.

Certain credit mitigants are used strategically in portfolio management activities. While single name concentrations arise in portfolios managed by GB&M and CMB, it is only in the former that their size requires the use of portfolio level credit mitigants. Across GB&M risk limits and utilisations, maturity profiles and risk quality are monitored and managed pro-actively. This process is key to determining our risk appetite for these larger, more complex, geographically distributed customer groups. While the principal form of risk management continues to be at the point of exposure origination through the lending decision-making process, GB&M also utilises loan sales and credit default swap (CDS) hedges to manage concentrations and reduce risk. These transactions are the responsibility of a dedicated GB&M portfolio management team. Hedging activity is carried out within agreed credit parameters, and is subject to market risk limits and a robust governance structure. CDS mitigants are held at portfolio level and are not reported in the presentation below.

Personal lending

Residential mortgage loans including loan commitments by level of collateral

(Audited)

	Europe US$m	Hong Kong US$m	Rest of Asia-Pacific US$m	MENA US$m	North America US$m	Latin America US$m	Total US$m
At 31 December 2013							
Non-impaired loans and advances							
Fully collateralised	**146,326**	**54,432**	**43,900**	**2,235**	**44,125**	**3,749**	**294,767**
Loan to value (LTV) ratio:							
less than 25%	**11,438**	**8,496**	**4,270**	**149**	**3,339**	**219**	**27,911**
25% to 50%	**43,590**	**29,508**	**13,205**	**600**	**9,833**	**1,118**	**97,854**
51% to 75%	**66,452**	**13,726**	**20,644**	**1,095**	**20,751**	**1,715**	**124,383**

76% to 90%	**21,603**	**1,887**	**4,949**	**348**	**6,933**	**606**	**36,326**
91% to 100%	**3,243**	**815**	**832**	**43**	**3,269**	**91**	**8,293**
Partially collateralised:							
greater than 100% LTV (A)	**1,410**	**14**	**348**	**42**	**4,150**	**59**	**6,023**
collateral value on A	**852**	**14**	**293**	**37**	**3,681**	**49**	**4,926**
	147,736	**54,446**	**44,248**	**2,277**	**48,275**	**3,808**	**300,790**
Impaired loans and advances							
Fully collateralised	**1,369**	**33**	**221**	**90**	**10,128**	**160**	**12,001**
LTV ratio:							
less than 25%	**47**	**15**	**17**	**2**	**128**	**4**	**213**
25% to 50%	**197**	**11**	**57**	**13**	**1,265**	**93**	**1,636**
51% to 75%	**452**	**7**	**89**	**31**	**4,250**	**47**	**4,876**
76% to 90%	**320**		**49**	**34**	**2,809**	**13**	**3,225**
91% to 100%	**353**		**9**	**10**	**1,676**	**3**	**2,051**
Partially collateralised:							
greater than 100% LTV (B)	**104**		**17**	**6**	**2,548**	**8**	**2,683**
collateral value on B	**91**		**4**	**6**	**2,272**	**4**	**2,377**
	1,473	**33**	**238**	**96**	**12,676**	**168**	**14,684**
	149,209	**54,479**	**44,486**	**2,373**	**60,951**	**3,976**	**315,474**

179

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Residential mortgage loans including loan commitments by level of collateral (continued)

(Audited)

	Europe US$m	Hong Kong US$m	Rest of Asia-Pacific US$m	MENA US$m	North America US$m	Latin America US$m	Total US$m
At 31 December 2012							
Non-impaired loans and advances							
Fully collateralised	139,769	53,431	43,399	1,955	46,312	5,035	289,901
LTV ratio:							
less than 25%	11,569	8,076	4,419	117	3,546	308	28,035
25% to 50%	35,557	30,132	12,665	579	9,365	1,468	89,766
51% to 75%	59,702	12,760	19,534	929	20,755	2,222	115,902
76% to 90%	26,768	1,931	6,144	172	8,437	855	44,307
91% to 100%	6,173	532	637	158	4,209	182	11,891
Partially collateralised:							
greater than 100% LTV (C)	2,748	2	366	72	6,330	15	9,533
collateral value on C	2,445	1	315	64	5,514	11	8,350
	142,517	53,433	43,765	2,027	52,642	5,050	299,434
Impaired loans and advances							
Fully collateralised	1,904	47	263	151	13,487	158	16,010
LTV ratio:							
less than 25%	164	14	19	8	157	11	373
25% to 50%	481	23	87	44	1,569	54	2,258
51% to 75%	693	10	91	72	5,827	73	6,766
76% to 90%	350		51	17	3,870	16	4,304
91% to 100%	216		15	10	2,064	4	2,309
Partially collateralised:							
greater than 100% LTV (D)	219		10	13	3,880	1	4,123
collateral value on D	120		8	12	3,170	1	3,311
	2,123	47	273	164	17,367	159	20,133
	144,640	53,480	44,038	2,191	70,009	5,209	319,567

The above table shows residential mortgage lending including off-balance sheet loan commitments by level of collateral. Off-balance sheet commitments include loans that have been approved but which the customer has not yet drawn, and the undrawn portion of loans that have a flexible drawdown facility such as the offset mortgage product. The collateral included in the table above consists of first charges on real estate.

The LTV ratio is calculated as the gross on-balance sheet carrying amount of the loan and any off-balance sheet loan commitment at the balance sheet date divided by the value of collateral. The methodologies for obtaining residential property collateral values vary throughout the Group, but are typically determined by using a combination of professional appraisals, house price indices and statistical analysis. Valuations must be updated on a regular basis and, as a minimum, at intervals of every three years. They are conducted more frequently when market conditions or portfolio performance are subject to significant change or when a loan is identified and assessed as impaired.

The LTV ratio bandings are consistent with our internal risk management reporting. While we do have mortgages in the higher LTV bands, our

appetite for such lending is restricted and the larger portion of our portfolio is concentrated in the lower risk LTV bandings of 75% and below.

Other personal lending

Other personal lending consists primarily of overdrafts, credit cards and second lien mortgage portfolios. Second lien lending is supported by collateral but the claim on the collateral is subordinate to the first lien charge. The majority of our second lien portfolios were originated in North America where loss experience on defaulted second lien loans has typically approached 100%; consequently, we do not generally attach any significant financial value to this type of collateral. Credit cards and overdrafts are usually unsecured.

Corporate, commercial and financial (non-bank) lending

Collateral held is analysed separately below for commercial real estate and for other corporate, commercial and financial (non-bank) lending. This reflects the difference in collateral held on the portfolios. In each case, the analysis includes off-balance sheet loan commitments, primarily undrawn credit lines.

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Commercial real estate loans and advances including loan commitments by level of collateral

(Audited)

	Europe US$m	Hong Kong US$m	Rest of Asia-Pacific US$m	MENA US$m	North America US$m	Latin America US$m	Total US$m
At 31 December 2013							
Rated CRR/EL 1 to 7							
Not collateralised	**4,865**	**10,186**	**3,978**	**192**	**137**	**935**	**20,293**
Fully collateralised	**24,154**	**18,895**	**6,422**	**21**	**8,627**	**1,728**	**59,847**
Partially collateralised (A)	**2,664**	**1,552**	**825**	**139**	**704**	**484**	**6,368**
collateral value on A	**1,827**	**1,278**	**410**	**24**	**303**	**292**	**4,134**
	31,683	**30,633**	**11,225**	**352**	**9,468**	**3,147**	**86,508**
Rated CRR/EL 8							
Not collateralised	**109**		**10**		**1**	**3**	**123**
Fully collateralised	**793**			**72**	**68**	**1**	**934**
LTV ratio:							
less than 25%	**13**				**4**		**17**
25% to 50%	**126**				**11**		**137**
51% to 75%	**367**			**72**	**49**	**1**	**489**
76% to 90%	**173**				**4**		**177**
91% to 100%	**114**						**114**
Partially collateralised (B)	**360**		**2**		**13**		**375**
collateral value on B	**281**		**1**		**11**		**293**
	1,262		**12**	**72**	**82**	**4**	**1,432**
Rated CRR/EL 9 to 10							
Not collateralised	**564**			**7**	**4**	**521**	**1,096**
Fully collateralised	**1,079**	**6**	**6**	**31**	**233**	**286**	**1,641**
LTV ratio:							
less than 25%	**46**				**1**	**5**	**52**
25% to 50%	**229**	**2**		**7**	**38**	**27**	**303**
51% to 75%	**436**	**3**	**3**	**7**	**110**	**57**	**616**
76% to 90%	**209**	**1**	**2**	**17**	**62**	**62**	**353**
91% to 100%	**159**		**1**		**22**	**135**	**317**
Partially collateralised (C)	**1,815**		**5**	**181**	**240**	**56**	**2,297**
collateral value on C	**1,284**		**5**	**89**	**115**	**34**	**1,527**
	3,458	**6**	**11**	**219**	**477**	**863**	**5,034**

	36,403	**30,639**	**11,248**	**643**	**10,027**	**4,014**	**92,974**
At 31 December 2012							
Rated CRR/EL 1 to 7							
Not collateralised	7,068	10,790	3,647	569	181	2,083	24,338
Fully collateralised	23,450	17,355	6,106	92	9,054	1,846	57,903
Partially collateralised (A)	3,088	1,476	1,150	33	1,063	903	7,713
collateral value on A	2,780	1,179	464	29	401	423	5,276
	33,606	29,621	10,903	694	10,298	4,832	89,954
Rated CRR/EL 8 to 10							
Not collateralised	418			14	34	105	571
Fully collateralised	1,261	2	60	8	408	141	1,880
LTV ratio:							
less than 25%	34		1		25	10	70
25% to 50%	119	1	55	7	86	8	276
51% to 75%	437		2		69	28	536
76% to 90%	501		1		58	63	623
91% to 100%	170	1	1	1	170	32	375
Partially collateralised (B)	1,585		51	204	377	24	2,241
collateral value on B	938		15	111	265	13	1,342
	3,264	2	111	226	819	270	4,692
	36,870	29,623	11,014	920	11,117	5,102	94,646

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

The collateral used in the assessment of the above lending consists of fixed first charges on real estate and charges over cash for commercial real estate. These facilities are disclosed as not collateralised if they are unsecured or benefit from credit risk mitigation from guarantees, which are not quantified for the purposes of this disclosure. In Hong Kong, market practice is typically for lending to major property companies to be secured by guarantees or unsecured. In Europe, facilities of a working capital nature are generally not secured by a first fixed charge and are therefore disclosed as not collateralised.

The value of commercial real estate collateral is determined by using a combination of professional and internal valuations and physical inspections. Due to the complexity of valuing collateral for commercial real estate, local valuation policies determine the frequency of review on the basis of local market conditions. Revaluations are sought with greater frequency when, as part of the regular

credit assessment of the obligor, material concerns arise in relation to the transaction which may affect the underlying performance of the collateral, or the obligor s credit quality declines sufficiently to raise questions over whether the principal source of payment can fully meet the obligation (i.e. the obligor s credit quality classification indicates it is at the lower end, that is sub-standard, or approaching impaired). Where such concerns exist the revaluation method selected will depend upon the LTV relationship, the direction in which the local commercial real estate market has moved since the last valuation and, most importantly, the specific characteristics of the underlying commercial real estate which is of concern. Collateral values held for customers rated CRR 9 to 10 (i.e. classified as impaired) are separately disclosed above, starting with 2013.

For further details on cross-collateralisation and LTV calculations for commercial real estate and other corporate and commercial, see page 183.

Other corporate, commercial and financial (non-bank) loans and advances including loan commitments by level of collateral rated CRR/EL 8 to 10 only

(Audited)

	Europe US$m	Hong Kong US$m	Rest of Asia-Pacific US$m	MENA US$m	North America US$m	Latin America US$m	Total US$m
At 31 December 2013							
Rated CRR/EL 8							
Not collateralised	**2,411**	**5**	**180**	**37**	**328**	**456**	**3,417**
Fully collateralised	**259**	**16**	**35**	**1**	**227**	**70**	**608**
LTV ratio:							
less than 25%	**15**	**1**	**15**		**7**	**7**	**45**
25% to 50%	**50**	**15**	**7**	**1**	**77**	**4**	**154**
51% to 75%	**103**		**4**		**47**	**10**	**164**
76% to 90%	**25**		**8**		**31**	**5**	**69**
91% to 100%	**66**		**1**		**65**	**44**	**176**
Partially collateralised (A)	**435**	**14**	**9**	**528**	**345**	**73**	**1,404**
collateral value on A	**17**	**3**	**2**	**398**	**89**	**18**	**527**

	3,105	**35**	**224**	**566**	**900**	**599**	**5,429**
Rated CRR/EL 9 to 10							
Not collateralised	**1,467**	**229**	**456**	**1,089**	**26**	**1,615**	**4,882**
Fully collateralised	**1,121**	**47**	**114**	**49**	**309**	**266**	**1,906**
LTV ratio:							
less than 25%	**36**	**1**	**6**	**2**	**7**	**42**	**94**
25% to 50%	**88**	**7**	**43**		**17**	**117**	**272**
51% to 75%	**161**	**10**	**11**	**47**	**29**	**49**	**307**
76% to 90%	**156**	**24**	**29**		**46**	**43**	**298**
91% to 100%	**680**	**5**	**25**		**210**	**15**	**935**
Partially collateralised (B)	**1,192**	**53**	**251**	**770**	**359**	**290**	**2,915**
collateral value on B	**606**	**33**	**117**	**102**	**149**	**131**	**1,138**
	3,780	**329**	**821**	**1,908**	**694**	**2,171**	**9,703**
	6,885	**364**	**1,045**	**2,474**	**1,594**	**2,770**	**15,132**

182

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

	Europe US$m	Hong Kong US$m	Rest of Asia-Pacific US$m	MENA US$m	North America US$m	Latin America US$m	Total US$m
At 31 December 2012							
Rated CRR/EL 8 to 10							
Not collateralised	5,110	260	572	1,186	533	1,023	8,684
Fully collateralised	1,463	82	146	132	478	284	2,585
LTV ratio:							
less than 25%	77	3	11		11	68	170
25% to 50%	192	4	62	6	49	84	397
51% to 75%	290	39	31	33	131	61	585
76% to 90%	196	24	11	18	96	17	362
91% to 100%	708	12	31	75	191	54	1,071
Partially collateralised (A)	1,106	84	251	828	753	273	3,295
collateral value on A	628	41	89	124	359	108	1,349
	7,679	426	969	2,146	1,764	1,580	14,564

The collateral used in the assessment of the above lending primarily includes first legal charges over real estate and charges over cash in the commercial and industrial sector, and charges over cash and marketable financial instruments in the financial (non-bank) sector. Government sector lending is generally unsecured.

It should be noted that the above table excludes other types of collateral which are commonly taken for corporate and commercial lending such as unsupported guarantees and floating charges over the assets of a customer s business. While such mitigants have value, often providing rights in insolvency, their assignable value is not sufficiently certain and they are assigned no value for disclosure purposes.

As with commercial real estate, the value of real estate collateral included in the table above is generally determined by using a combination of professional and internal valuations and physical inspections. The frequency of revaluation is similar to commercial real estate loans and advances; however, for financing activities in corporate and commercial lending that are not predominantly commercial real estate-oriented, collateral value is not as strongly correlated to principal repayment performance. Collateral values are generally refreshed when an obligor s general credit performance deteriorates and we have to assess the likely performance of secondary sources of repayment should it prove necessary to rely on them. For this reason, the table above reports values only for customers with CRR 8 to 10, recognising that these loans and advances generally have valuations which are comparatively recent. Starting with 2013, collateral values held for customers rated CRR 9 to 10 (i.e. classified as impaired) are separately disclosed. For the above table, cash is valued at its nominal value and marketable securities at their

fair value. The LTV ratios presented are calculated by directly associating loans and advances with the collateral that individually and uniquely supports each facility. Where collateral assets are shared by multiple loans and advances, whether specifically or, more generally, by way of an all monies charge, the collateral value is pro-rated across the loans and advances protected by the collateral.

In both the commercial real estate and other corporate and commercial collateral tables the difference between the collateral value and the value of partially collateralised lending cannot be directly compared with any impairment allowances recognised in respect of impaired loans, as the loans may be performing in accordance with their contractual terms. When loans are not performing in accordance with their contractual terms, the recovery of cash flows may be affected by other cash resources of the customer, or other credit risk enhancements not quantified for the tables above. The values in the tables represent the expected market value on an open market basis; no adjustment has been made to the collateral for any expected costs of recovery. When a loan is considered for impairment, the value used in the impairment allowance calculation takes such costs into consideration and might also reflect any deviation from an open market value arising from the expected conditions for sale, such as a forced sale within a specified timetable. While the values reported are therefore expected to be closely aligned to the values used in impairment assessment, they will not be the same. The existence or otherwise of specific collateral is not taken into account in the modeling of wholesale impairment allowances for loss events which are incurred but not reported. These models operate on portfolio level observations of current loss in each portfolio to which they are applied as described on page 272. As current loss estimates are

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

derived from adjusted historical observations, the contribution of collateral is indirectly reflected in the loss history.

Our policy for determining impairment allowances, including the effect of collateral on these impairment allowances, is described on page 272.

Loans and advances to banks

The following table shows loans and advances to banks, including off-balance sheet loan commitments by level of collateral.

Loans and advances to banks including loan commitments by level of collateral

(Audited)

	Europe US$m	Hong Kong US$m	Rest of Asia-Pacific US$m	MENA US$m	North America US$m	Latin America US$m	Total US$m
At 31 December 2013							
Rated CRR/EL 1 to 8							
Not collateralised	**22,356**	**31,462**	**41,524**	**6,374**	**7,211**	**10,481**	**119,408**
Fully collateralised	**52,114**	**2,260**	**8,168**	**24**	**23,744**	**4,724**	**91,034**
Partially collateralised (A)	**68**	**1,866**	**2,616**				**4,550**
collateral value on A	**3**	**1,696**	**2,516**				**4,215**
	74,538	**35,588**	**52,308**	**6,398**	**30,955**	**15,205**	**214,992**
Rated CRR/EL 9 to 10							
Not collateralised	**153**			**312**	**14**		**479**
	74,691	**35,588**	**52,308**	**6,710**	**30,969**	**15,205**	**215,471**
At 31 December 2012							
Rated CRR/EL 1 to 10							
Not collateralised	36,043	24,622	40,694	7,290	9,050	12,838	130,537
Fully collateralised	25,496	2,294	5,667		811	3,691	37,959
Partially collateralised (C)	62	1,459	1,207				2,728
collateral value on C	61	1,452	1,135				2,648
	61,601	28,375	47,568	7,290	9,861	16,529	171,224

The collateral used in the assessment of the above lending relates primarily to cash and marketable securities. Loans and advances to banks are typically unsecured. Certain products such as reverse repos and stock borrowing are effectively collateralised and have been included in the above as fully or partly collateralised. The fully collateralised loans and advances to banks in Europe consist primarily of reverse repo agreements and stock borrowing. Collateral values held for customers rated CRR 9 to 10 (i.e. classified as impaired) are separately disclosed above, starting with 2013.

Derivatives

The International Swaps and Derivatives Association (ISDA) Master Agreement is our preferred agreement for documenting derivatives activity. It provides the contractual framework within which dealing activity across a full range of over-the-counter (OTC) products is conducted, and contractually binds both parties to apply close-out netting across all outstanding transactions covered by an agreement if either party defaults or another pre-agreed termination event occurs. It is common, and our preferred practice, for the parties to execute

a Credit Support Annex (CSA) in conjunction with the ISDA Master Agreement. Under a CSA, collateral is passed between the parties to mitigate the counterparty risk inherent in outstanding positions. The majority of our CSAs are with financial institutional clients.

We manage the counterparty exposure arising from market risk on our OTC derivative contracts by using collateral agreements with counterparties and netting agreements. Currently, we do not actively manage our general OTC derivative counterparty exposure in the credit markets, although we may manage individual exposures in certain circumstances.

For a description of how the derivative offset amount in the Maximum exposure to credit risk table is derived, see page 159.

Other credit risk exposures

In addition to collateralised lending, other credit enhancements are employed and methods used to mitigate credit risk arising from financial assets. These are described in more detail below:

some securities issued by governments, banks and other financial institutions benefit from

Report of the Directors: Financial Review (continued)

additional credit enhancement provided by government guarantees that cover the assets.

Details of government guarantees are included in Notes 6, 10 and 12 on the Financial Statements.

debt securities issued by corporates are primarily unsecured;

debt securities issued by banks and financial institutions include ABSs and similar instruments which are supported by underlying pools of financial assets. Credit risk associated with ABSs is reduced through the purchase of CDS protection.

Disclosure of the Group s holdings of ABSs and associated CDS protection is provided on page 204.

trading assets include loans and advances held with trading intent. These mainly consist of cash collateral posted to satisfy margin requirements on derivatives, settlement accounts, reverse repos and stock borrowing. There is limited credit risk on cash collateral posted since in the event of default of the counterparty these would be set off against the related liability. Reverse repos and stock borrowing are by their nature collateralised.

Collateral accepted as security that the Group is permitted to sell or repledge under these arrangements is described in Note 36 on the Financial Statements.

The Group s maximum exposure to credit risk includes financial guarantees and similar arrangements that we issue or enter into, and loan commitments that we are irrevocably committed to. Depending on the terms of the arrangement, we may have recourse to additional credit mitigation in the event that a guarantee is called upon or a loan commitment is drawn and subsequently defaults. For further information on these arrangements, see Note 40 on the Financial Statements.

Collateral and other credit enhancements obtained

(Audited)

The carrying amount of assets obtained by taking possession of collateral held as security, or calling upon other credit enhancements, is as follows:

Carrying amount of assets obtained

	At 31 December	
	2013	2012
	US$m	US$m
Nature of assets		
Residential property	**408**	353
Commercial and industrial property	**43**	88
Other	**2**	3
	453	444

The increase in foreclosed residential properties was due to the suspension of foreclosure activities at the end of 2011 and during the first half of 2012. In the US we have resumed processing suspended foreclosure actions in all states and have referred the majority of the backlog of loans for foreclosure. We have also begun initiating new foreclosure activities in all states (see page 164 (unaudited)).

We make repossessed properties available for sale in an orderly fashion, with the proceeds used to reduce or repay the outstanding indebtedness. If excess funds arise after the debt has been repaid, they are made available to repay other secured lenders with lower priority or are returned to the customer. We do not generally occupy repossessed properties for our business use.

Impaired loans

(Audited)

Impaired loans and advances are those that meet any of the following criteria:

- wholesale loans and advances classified as Customer Risk Rating (CRR) 9 or CRR 10. These grades are assigned when the bank considers that either the customer is unlikely to pay its credit obligations in full, without recourse to security, or when the customer is past due 90 days or more on any material credit obligation to HSBC.

- retail loans and advances classified as Expected Loss (EL) 9 or EL 10. These grades are assigned to retail loans and advances greater than 90 days past due unless individually they have been assessed as not impaired.

For further details of the CRR and the EL scales see page 267 (unaudited);

185

Report of the Directors: Financial Review (continued)

renegotiated loans and advances that have been subject to a change in contractual cash flows as a result of a concession which the lender would not otherwise consider, and where it is probable that without the concession the borrower would be unable to meet the contractual payment obligations in full, unless the concession is insignificant and there are no other indicators of impairment. Renegotiated loans remain classified as impaired until there is sufficient evidence to demonstrate a significant reduction in the risk of non-payment of future cash flows, and there are no other indicators of impairment.

For loans that are assessed for impairment on a collective basis, the evidence to support reclassification as no longer impaired typically comprises a history of payment performance against the original or revised terms, depending on the nature and volume of renegotiation and the credit

risk characteristics surrounding the renegotiation. For loans that are assessed for impairment on an individual basis, all available evidence is assessed on a case-by-case basis.

In HSBC Finance, where a significant majority of HSBC s loan forbearance activity occurs, the history of payment performance is assessed with reference to the original terms of the contract, reflecting the higher credit risk characteristics of this portfolio. The payment performance periods are monitored to ensure they remain appropriate to the levels of relapse observed within the portfolio.

For further disclosure on loans subject to forbearance, see page 268.

Renegotiated loans and forbearance disclosures are subject to evolving industry practice and regulatory guidance.

Movement in impaired loans by geographical region

(Unaudited)

	Europe US$m	Hong Kong US$m	Rest of Asia-Pacific US$m	MENA US$m	North America US$m	Latin America US$m	Total US$m
Impaired loans at 1 January 2013	**11,145**	**477**	**1,147**	**2,474**	**20,345**	**3,188**	**38,776**
Personal	**2,466**	**172**	**439**	**368**	**18,726**	**1,580**	**23,751**
Corporate and commercial	**8,058**	**267**	**700**	**1,872**	**1,592**	**1,604**	**14,093**
Financial[2]	**621**	**38**	**8**	**234**	**27**	**4**	**932**
Classified as impaired during the year	**4,952**	**371**	**1,053**	**419**	**6,168**	**4,333**	**17,296**
Personal	**1,176**	**224**	**574**	**107**	**5,319**	**1,872**	**9,272**
Corporate and commercial	**3,726**	**144**	**479**	**306**	**837**	**2,453**	**7,945**
Financial[2]	**50**	**3**		**6**	**12**	**8**	**79**
Transferred from impaired to unimpaired during the year	**(1,215)**	**(33)**	**(112)**	**(166)**	**(3,198)**	**(642)**	**(5,366)**
Personal	**(265)**	**(27)**	**(110)**	**(68)**	**(3,172)**	**(266)**	**(3,908)**
Corporate and commercial	**(804)**	**(6)**	**(2)**	**(85)**	**(24)**	**(375)**	**(1,296)**
Financial[2]	**(146)**			**(13)**	**(2)**	**(1)**	**(162)**

Amounts written off	**(1,411)**	**(182)**	**(356)**	**(165)**	**(1,706)**	**(1,957)**	**(5,777)**
Personal	**(423)**	**(149)**	**(295)**	**(79)**	**(1,433)**	**(1,456)**	**(3,835)**
Corporate and commercial	**(927)**	**(30)**	**(61)**	**(75)**	**(270)**	**(499)**	**(1,862)**
Financial[2]	**(61)**	**(3)**		**(11)**	**(3)**	**(2)**	**(80)**
Net repayments and other	**(243)**	**(188)**	**(554)**	**(277)**	**(6,486)**	**(678)**	**(8,426)**
Personal	**(16)**	**(76)**	**(226)**	**(11)**	**(5,771)**	**(382)**	**(6,482)**
Corporate and commercial	**(339)**	**(84)**	**(325)**	**(253)**	**(708)**	**(294)**	**(2,003)**
Financial[2]	**112**	**(28)**	**(3)**	**(13)**	**(7)**	**(2)**	**59**
At 31 December 2013	**13,228**	**445**	**1,178**	**2,285**	**15,123**	**4,244**	**36,503**
Personal	**2,938**	**144**	**382**	**317**	**13,669**	**1,348**	**18,798**
Corporate and commercial	**9,714**	**291**	**791**	**1,765**	**1,427**	**2,889**	**16,877**
Financial[2]	**576**	**10**	**5**	**203**	**27**	**7**	**828**

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

	Europe US$m	Hong Kong US$m	Rest of Asia-Pacific US$m	MENA US$m	North America US$m	Latin America US$m	Total US$m
Impaired loans at 1 January 2012	11,819	608	1,070	2,445	22,758	3,039	41,739
Personal	2,797	190	388	428	21,094	1,646	26,543
Corporate and commercial	8,113	372	667	1,798	1,517	1,391	13,858
Financial[2]	909	46	15	219	147	2	1,338
Classified as impaired during the year	3,482	292	924	648	8,130	4,507	17,983
Personal	933	169	549	73	7,363	2,807	11,894
Corporate and commercial	2,481	123	375	531	739	1,696	5,945
Financial[2]	68			44	28	4	144
Transferred from impaired to unimpaired during the year	(1,164)	(47)	(85)	(321)	(4,223)	(1,765)	(7,605)
Personal	(279)	(38)	(69)	(32)	(4,124)	(1,124)	(5,666)
Corporate and commercial	(858)	(5)	(15)	(289)	(99)	(640)	(1,906)
Financial[2]	(27)	(4)	(1)			(1)	(33)
Amounts written off	(1,891)	(217)	(564)	(264)	(3,514)	(2,112)	(8,562)
Personal	(632)	(127)	(373)	(96)	(3,227)	(1,521)	(5,976)
Corporate and commercial	(1,212)	(90)	(191)	(143)	(202)	(590)	(2,428)
Financial[2]	(47)			(25)	(85)	(1)	(158)
Net repayments and other	(1,101)	(159)	(198)	(34)	(2,806)	(481)	(4,779)
Personal	(353)	(22)	(56)	(5)	(2,380)	(228)	(3,044)
Corporate and commercial	(466)	(133)	(136)	(26)	(363)	(253)	(1,377)
Financial[2]	(282)	(4)	(6)	(3)	(63)		(358)
At 31 December 2012	11,145	477	1,147	2,474	20,345	3,188	38,776
Personal	2,466	172	439	368	18,726	1,580	23,751
Corporate and commercial	8,058	267	700	1,872	1,592	1,604	14,093
Financial[2]	621	38	8	234	27	4	932

For footnote, see page 263.

Impairment of loans and advances

(Audited)

A summary of our current policies and practices regarding impairment assessment is provided in the Appendix to Risk on page 272.

The tables below analyse by geographical region the impairment allowances recognised for impaired loans and advances that are either individually

assessed or collectively assessed, and collective impairment allowances on loans and advances classified as not impaired.

During 2013, we reviewed the impairment allowance methodology used for retail banking and small business portfolios across the Group (see page 72).

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Impairment allowances on loans and advances to customers by geographical region

(Audited)

	Europe US$m	Hong Kong US$m	Rest of Asia-Pacific US$m	MENA US$m	North America US$m	Latin America US$m	Total US$m
At 31 December 2013							
Gross loans and advances to customers							
Individually assessed impaired loans[15] (A)	**11,497**	**377**	**1,073**	**2,117**	**1,736**	**2,595**	**19,395**
Collectively assessed[16] (B)	**498,267**	**195,621**	**147,488**	**26,659**	**164,130**	**43,887**	**1,076,052**
impaired loans[15]	**1,690**	**68**	**105**	**148**	**13,373**	**1,649**	**17,033**
non-impaired loans[17]	**496,577**	**195,553**	**147,383**	**26,511**	**150,757**	**42,238**	**1,059,019**
Total (C)	**509,764**	**195,998**	**148,561**	**28,776**	**165,866**	**46,482**	**1,095,447**
Impairment allowances (c)	**5,563**	**449**	**765**	**1,565**	**4,237**	**2,564**	**15,143**
individually assessed (a)	**4,019**	**174**	**460**	**1,131**	**410**	**878**	**7,072**
collectively assessed (b)	**1,544**	**275**	**305**	**434**	**3,827**	**1,686**	**8,071**
Net loans and advances	**504,201**	**195,549**	**147,796**	**27,211**	**161,629**	**43,918**	**1,080,304**
Of which:							
reverse repos to customers	**48,091**	**1,991**	**4,457**		**33,676**		**88,215**
(a) as a percentage of A	**35.0%**	**46.2%**	**42.9%**	**53.4%**	**23.6%**	**33.8%**	**36.5%**
(b) as a percentage of B	**0.3%**	**0.1%**	**0.2%**	**1.6%**	**2.3%**	**3.8%**	**0.8%**
(c) as a percentage of C	**1.1%**	**0.2%**	**0.5%**	**5.4%**	**2.6%**	**5.5%**	**1.4%**
	US$m	US$m	US$m	US$m	US$m	US$m	US$m
At 31 December 2012							
Gross loans and advances to customers							
Individually assessed impaired loans[15] (D)	9,959	398	1,019	2,251	1,849	1,295	16,771
Collectively assessed[16] (E)	458,802	173,688	137,846	27,629	144,523	54,476	996,964
impaired loans[15]	1,121	79	128	197	18,482	1,893	21,900
non-impaired loans[17]	457,681	173,609	137,718	27,432	126,041	52,583	975,064
Total (F)	468,761	174,086	138,865	29,880	146,372	55,771	1,013,735
Impairment allowances (f)	5,321	473	746	1,794	5,616	2,162	16,112
individually assessed (d)	3,781	192	442	1,323	428	406	6,572
collectively assessed (e)	1,540	281	304	471	5,188	1,756	9,540

Net loans and advances	463,440	173,613	138,119	28,086	140,756	53,609	997,623
Of which:							
reverse repos to customers	27,299	760	307		6,281	4	34,651
(d) as a percentage of D	38.0%	48.2%	43.4%	58.8%	23.1%	31.4%	39.2%
(e) as a percentage of E	0.3%	0.2%	0.2%	1.7%	3.6%	3.2%	1.0%
(f) as a percentage of F	1.1%	0.3%	0.5%	6.0%	3.8%	3.9%	1.6%

For footnotes, see page 263.

After excluding reverse repo balances, (c) as a percentage of C was 1.21% for Europe, 3.21% for North America and 1.5% in total at 31 December 2013. After excluding reverse repos, (f) as a percentage of F was 1.21% for Europe, 4.01% for North America and 1.65% in total at 31 December 2012.

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Net loan impairment charge to the income statement by geographical region

(Unaudited)

	Europe US$m	Hong Kong US$m	Rest of Asia-Pacific US$m	MENA US$m	North America US$m	Latin America US$m	Total US$m
2013							
Individually assessed impairment allowances	**1,376**	**13**	**132**	**(86)**	**262**	**623**	**2,320**
new allowances	**1,828**	**65**	**251**	**196**	**398**	**702**	**3,440**
release of allowances no longer required	**(402)**	**(44)**	**(101)**	**(235)**	**(98)**	**(31)**	**(911)**
recoveries of amounts previously written off	**(50)**	**(8)**	**(18)**	**(47)**	**(38)**	**(48)**	**(209)**
Collectively assessed impairment allowances[18]	**356**	**122**	**216**	**42**	**973**	**2,019**	**3,728**
new allowances net of allowance releases	**943**	**149**	**330**	**82**	**1,058**	**2,253**	**4,815**
recoveries of amounts previously written off	**(587)**	**(27)**	**(114)**	**(40)**	**(85)**	**(234)**	**(1,087)**
Total charge for impairment losses	**1,732**	**135**	**348**	**(44)**	**1,235**	**2,642**	**6,048**
banks					**5**		**5**
customers	**1,732**	**135**	**348**	**(44)**	**1,230**	**2,642**	**6,043**
2012							
Individually assessed impairment allowances	1,387	(8)	97	205	258	200	2,139
new allowances	1,960	32	239	369	380	292	3,272
release of allowances no longer required	(516)	(34)	(117)	(133)	(85)	(49)	(934)
recoveries of amounts previously written off	(57)	(6)	(25)	(31)	(37)	(43)	(199)
Collectively assessed impairment allowances[18]	487	92	243	50	3,204	1,945	6,021
new allowances net of allowance releases	839	117	368	94	3,296	2,254	6,968
recoveries of amounts previously written off	(352)	(25)	(125)	(44)	(92)	(309)	(947)
Total charge for impairment losses	1,874	84	340	255	3,462	2,145	8,160
customers	1,874	84	340	255	3,462	2,145	8,160

For footnote, see page 263.

2013 compared with 2012

(Unaudited)

On a reported basis, loan impairment allowances were US$15bn at 31 December 2013, a 6% decrease compared with the end of 2012. Impaired loans and advances were US$37bn, a decrease of 6% from the end of 2012.

The following commentary is on a constant currency basis.

Loan impairment allowances fell by 5% to US$15bn. The reduction was mainly in North America, driven by the continued run-off and loan sales in the US CML portfolio and improvements in housing market conditions.

Impaired loans decreased by 5% compared with the end of 2012 to US$37bn, reflecting the continued run-off and loan sales in the US CML portfolio.

Releases and recoveries of US$2.2bn were higher than in 2012, mainly in Europe on collectively assessed recoveries in RBWM following debt sales in the UK in 2013 and, in the Middle East and North Africa, due to a small number of individual releases, mainly in GB&M on UAE-related exposures.

Regional analysis

In **Europe**, new loan impairment allowances decreased marginally to US$3bn, primarily due to lower new individual allowances in GB&M and in CMB, mainly in France and on Greek exposures,

Report of the Directors: Financial Review (continued)

reflecting improvements to the challenging economic conditions in 2012. This was largely offset by higher new collective allowances in the UK, mainly in the retail sector.

Impaired loans increased by 16% compared with the end of 2012 to US$13bn, resulting from a small number of individually assessed corporate and commercial loans in the UK and France and portfolio growth in Turkey.

Releases and recoveries in Europe were US$1bn, a rise of 13% compared with the end of 2012, mainly due to higher recoveries from debt sales in the UK in 2013. This was partly offset by lower releases, mainly in France in GB&M and CMB.

In **Hong Kong** and **Rest of Asia-Pacific** new loan impairment allowances and impaired loans remained at low levels.

In the **Middle East and North Africa**, new loan impairment allowances were US$278m, a decrease of US$180m. This was due to a reduction in new individually assessed allowances as a result of the overall improvement in the loan portfolio compared with 2012, and improved property prices in the UAE.

Impaired loans of US$2bn at 31 December 2013 were 7% lower than in 2012, mainly in the UAE due to recoveries and an improvement in credit quality.

Releases and recoveries in the region rose by US$114m on 2012 to US$322m due to a small number of individual releases, mainly in GB&M on UAE-related exposures.

In **North America**, new loan impairment allowances decreased by 60% to US$1.5bn, driven

by lower new collectively assessed allowances as a result of improvements in housing market conditions and the continued run-off and loan sales in the CML portfolio.

Impaired loans fell by 25% to US$15bn compared with the end of 2012 due to the continued run-off and loan sales in the CML portfolio.

Releases and recoveries in North America were broadly in line with 2012.

In **Latin America**, new loan impairment allowances increased by 25% to US$3bn, primarily in Mexico from higher specific impairments in CMB relating to homebuilders due to a change in the public housing policy, and higher collective provisions in RBWM. In Brazil, collectively assessed new allowances increased as a result of impairment methodology changes and assumption revisions for restructured loan account portfolios in RBWM and CMB as well as higher specific impairments across a number of corporate exposures. This was partly offset by improvements in credit quality in Brazil as modifications to credit strategies in previous years to mitigate rising delinquency rates took effect.

Impaired loans increased by 47% from the end of 2012 to US$4bn, mainly relating to homebuilders in Mexico and from methodology changes and higher individually assessed impairments in CMB in Brazil across a number of corporate exposures.

Releases and recoveries in Latin America reduced to US$313m compared with 2012, mainly in RBWM in Brazil and Mexico.

For an analysis of loan impairment charges and other credit risk provisions by global business, see page 94.

190

Report of the Directors: Financial Review (continued)

2012 compared with 2011

(Unaudited)

The following commentary is on a constant currency basis.

Loan impairment allowances were US$16.2bn, a decline of 9% compared with 2011, reflecting lower lending balances in our US CML portfolio which included the reclassification of impairment allowances on non-real estate personal loan balances to Assets held for sale . Releases and recoveries of US$2.1bn were 3% lower, mainly in North America due to lower customer repayments in the corporate and commercial sector, as well as the non-recurrence of a number of releases and recoveries incurred in 2011 in Hong Kong and Rest of Asia-Pacific.

Impaired loans were 3% of total gross loans and advances at the end of 2012, compared with 4% at 31 December 2011.

Regional analysis

In **Europe**, new loan impairment allowances were US$2.8bn, broadly unchanged compared with 2011. New collectively assessed loan impairment allowances declined by 28%, mainly in the UK personal lending book, as we focused our lending growth on higher quality assets and continued to pro-actively identify and monitor customers facing financial hardship. This resulted in lower delinquency rates across both the secured and unsecured lending portfolios. Individually assessed new loan impairment allowances increased by 21% across a range of sectors reflecting the challenging economic conditions in the UK, Greece, Spain and Turkey. In addition, a rise in impairments in Turkey was due to strong balance sheet growth in customer loans and advances in RBWM, notably in credit cards and personal loans, driven by business expansion. Impaired loans of US$11.1bn were 9% lower than at 31 December 2011, mainly due to increased focus on higher quality loans, lower delinquency rates and the continued low interest rate environment.

Releases and recoveries in Europe were US$925m, broadly unchanged on 2011.

In **Hong Kong**, new individually assessed loan impairment allowances fell by 28% compared with 2011 due to lower specific impairment charges in CMB. New collectively assessed loan impairment allowances also declined as delinquency rates continued to improve, reflecting stable loan growth and sound underlying economic conditions. Impaired loans declined by 22% from 31 December 2011, as a number of corporate loans in the international

trade sector were written off or upgraded following repayments, and delinquency rates reduced.

Releases and recoveries in Hong Kong were US$65m, 27% lower than at the end of 2011 when an allowance relating to a loan in GB&M that was no longer considered impaired was released.

New loan impairment allowances in **Rest of Asia-Pacific** increased by 8% to US$607m. This reflected higher new collectively assessed loan impairment allowances, mainly from the growth in Singapore of RBWM s credit card portfolio. New individually assessed loan impairment allowances also increased, as a result of the impairment of a corporate exposure in Australia and individual charges on a small number of corporate exposures in India. Impaired loans in the region increased by 4% to US$1.1bn in 2012 due to the downgrade of a number of customers in Australia and Taiwan, partly offset by the restructuring of a significant loan in Singapore following the renegotiation of terms, which is therefore regarded as no longer impaired.

Releases and recoveries in the region decreased by 7%, mainly in India as the cards portfolio continued to run off, and in Thailand following the sale of the RBWM business. These were partly offset by an impairment allowance release in Singapore compared with a charge in 2011.

In the **Middle East and North Africa**, new loan impairment allowances decreased by 2% to US$463m in 2012. New collectively assessed loan impairment allowances declined, primarily in the UAE, due to the improvement in credit quality reflecting the repositioning of the book towards higher quality lending in previous years. New individually assessed loan impairment allowances rose due to significant loan impairment charges recorded for a small number of large exposures in GB&M. Impaired loans remained broadly unchanged compared with 31 December 2011.

Releases and recoveries in the region increased by 14% to US$208m in 2012, mainly relating to a small number of exposures in UAE.

In **North America**, new loan impairment allowances fell sharply, reducing by 50% to US$3.7bn. New collectively assessed loan impairment allowances declined, largely in the CML portfolio due to the reclassification of impairment allowances on non-real estate personal loan balances to Assets held for sale as well as the continued run-off in the residential portfolios. This was partly offset by a portfolio risk factor adjustment of US$225m which was made to increase the collective

190a

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

loan impairment allowances for our US mortgage lending portfolios. The adjustment was made following a review completed in the fourth quarter of 2012 which concluded that the estimated average period of time from current status to write-off was ten months for real estate loans (previously a period of seven months was used). During 2013, this revised estimate will be incorporated into the statistical impairment allowance models. It was also partly offset by new loan impairment allowances by HSBC Bank Bermuda on a small number of exposures. Releases and recoveries in North America declined by 11% to US$214m. This reflected lower levels of impairments being booked due to improving market conditions within the corporate and commercial sector.

Impaired loans decreased by 11% in 2012 to US$20.3bn, due to the continued run-off of the CML portfolio which included the reclassification of certain non-real estate personal loan balances to held for sale.

In **Latin America**, new loan impairment allowances increased by 23% to US$2.5bn. The increase in new collectively assessed loan impairment allowances was mainly in Brazil, driven by higher delinquency rates in RBWM and CMB, particularly in the Business Banking portfolio, reflecting lower economic growth in 2012. Impaired loans were 9% higher than at the end of 2011, driven by past growth in the CMB portfolio in Brazil.

Releases and recoveries in Latin America decreased by 2% from the end of 2011 to US$401m, mainly in Brazil.

For an analysis of loan impairment charges and other credit risk provisions by global business, see page 94.

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Further analysis of impairment

Movement in impairment allowances by industry sector and by geographical region

(Unaudited)

	Europe US$m	Hong Kong US$m	Rest of Asia-Pacific US$m	MENA US$m	North America US$m	Latin America US$m	Total US$m
Impairment allowances at 1 January 2013	5,361	473	746	1,811	5,616	2,162	16,169
Amounts written off	(2,180)	(187)	(373)	(195)	(1,610)	(2,110)	(6,655)
Personal	(876)	(152)	(309)	(107)	(1,330)	(1,593)	(4,367)
first lien residential mortgages	(83)		(7)	(2)	(779)	(25)	(896)
other personal[1]	(793)	(152)	(302)	(105)	(551)	(1,568)	(3,471)
Corporate and commercial	(1,264)	(32)	(64)	(78)	(277)	(514)	(2,229)
manufacturing and international trade and services	(680)	(30)	(43)	(64)	(80)	(386)	(1,283)
commercial real estate and other property-related	(289)		(7)	(2)	(141)	(23)	(462)
other commercial[10]	(295)	(2)	(14)	(12)	(56)	(105)	(484)
Financial[2]	(40)	(3)		(10)	(3)	(3)	(59)
Recoveries of amounts written off in previous years	637	35	132	87	123	282	1,296
Personal	584	31	122	41	82	237	1,097
first lien residential mortgages	25	3	1		67	23	119
other personal[1]	559	28	121	41	15	214	978
Corporate and commercial	52	4	10	46	41	45	198
manufacturing and international trade and services	19	4	3	2	6	27	61
commercial real estate and other property-related	6		4		18	1	29
other commercial[10]	27		3	44	17	17	108
Financial[2]	1						1
Charge to income statement	1,732	135	348	(44)	1,235	2,642	6,048
Personal	320	140	205	46	963	1,522	3,196
first lien residential mortgages	(11)	(8)	1	(13)	647	11	627
other personal[1]	331	148	204	59	316	1,511	2,569
Corporate and commercial	1,467	8	144	(13)	253	1,115	2,974
manufacturing and international trade and services	800	33	101	37	125	594	1,690
commercial real estate and other property-related	432	(4)	2	(5)	79	322	826
other commercial[10]	235	(21)	41	(45)	49	199	458
Financial[2]	(55)	(13)	(1)	(77)	19	5	(122)
Exchange and other movements[19]	48	(7)	(88)	(76)	(1,122)	(412)	(1,657)

At 31 December 2013	**5,598**	**449**	**765**	**1,583**	**4,242**	**2,564**	**15,201**
Impairment allowances against banks:							
individually assessed	**35**			**18**	**5**		**58**
Impairment allowances against customers:							
individually assessed	**4,019**	**174**	**460**	**1,131**	**410**	**878**	**7,072**
collectively assessed[18]	**1,544**	**275**	**305**	**434**	**3,827**	**1,686**	**8,071**
At 31 December 2013	**5,598**	**449**	**765**	**1,583**	**4,242**	**2,564**	**15,201**

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Movement in impairment allowances by industry sector and by geographical region (continued)

(Unaudited)

	Europe US$m	Hong Kong US$m	Rest of Asia-Pacific US$m	MENA US$m	North America US$m	Latin America US$m	Total US$m
Impairment allowances at 1 January 2012	5,292	581	782	1,731	7,239	2,011	17,636
Amounts written off	(2,375)	(219)	(540)	(305)	(4,181)	(2,192)	(9,812)
Personal	(828)	(128)	(347)	(126)	(3,862)	(1,614)	(6,905)
first lien residential mortgages	(28)		(7)	(2)	(1,952)	(70)	(2,059)
other personal[4]	(800)	(128)	(340)	(124)	(1,910)	(1,544)	(4,846)
Corporate and commercial	(1,428)	(91)	(193)	(154)	(234)	(577)	(2,677)
manufacturing and international trade and services	(661)	(91)	(164)	(137)	(59)	(498)	(1,610)
commercial real estate and other property-related	(377)		(8)	(6)	(97)	(18)	(506)
other commercial[10]	(390)		(21)	(11)	(78)	(61)	(561)
Financial[2]	(119)			(25)	(85)	(1)	(230)
Recoveries of amounts written off in previous years	409	31	150	75	129	352	1,146
Personal	354	30	132	50	88	312	966
first lien residential mortgages	34	4	2	5	46	49	140
other personal[4]	320	26	130	45	42	263	826
Corporate and commercial	51	1	18	25	38	39	172
manufacturing and international trade and services	16	1	5	2	7	28	59
commercial real estate and other property-related	9		11		19	2	41
other commercial[10]	26		2	23	12	9	72
Financial[2]	4				3	1	8
Charge to income statement	1,874	84	340	255	3,462	2,145	8,160
Personal	348	96	234	57	3,228	1,399	5,362
first lien residential mortgages	(56)	(11)	14	7	1,986	(30)	1,910
other personal[4]	404	107	220	50	1,242	1,429	3,452
Corporate and commercial	1,547	(14)	102	169	252	746	2,802
manufacturing and international trade and services	670	(12)	32	80	62	625	1,457
commercial real estate and other property-related	444	7	55	62	94	28	690
other commercial[10]	433	(9)	15	27	96	93	655
Financial[2]	(21)	2	4	29	(18)		(4)
Exchange and other movements[19]	161	(4)	14	55	(1,033)	(154)	(961)
At 31 December 2012	5,361	473	746	1,811	5,616	2,162	16,169
Impairment allowances against banks:							
individually assessed	40			17			57
Impairment allowances against customers:							
individually assessed	3,781	192	442	1,323	428	406	6,572
collectively assessed[18]	1,540	281	304	471	5,188	1,756	9,540
At 31 December 2012	5,361	473	746	1,811	5,616	2,162	16,169

For footnotes, see page 263.

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Movement in impairment allowances over 5 years

(Unaudited)

	2013	2012	2011	2010	2009
	US$m	US$m	US$m	US$m	US$m
Impairment allowances at 1 January	**16,169**	17,636	20,241	25,649	23,972
Amounts written off	**(6,655)**	(9,812)	(12,480)	(19,300)	(24,840)
Personal	**(4,367)**	(6,905)	(10,431)	(16,458)	(22,703)
first lien residential mortgages	**(896)**	(2,059)	(2,662)	(4,163)	(4,704)
other personal[1]	**(3,471)**	(4,846)	(7,769)	(12,295)	(17,999)
Corporate and commercial	**(2,229)**	(2,677)	(2,009)	(2,789)	(1,984)
manufacturing and international trade and services	**(1,283)**	(1,610)	(1,137)	(1,050)	(1,093)
commercial real estate and other property-related	**(462)**	(506)	(392)	(1,280)	(327)
other commercial[10]	**(484)**	(561)	(480)	(459)	(564)
Financial[2]	**(59)**	(230)	(40)	(53)	(153)
Recoveries of amounts written off in previous years	**1,296**	1,146	1,426	1,020	890
Personal	**1,097**	966	1,175	846	712
first lien residential mortgages	**119**	140	86	93	61
other personal[1]	**978**	826	1,089	753	651
Corporate and commercial	**198**	172	242	156	170
manufacturing and international trade and services	**61**	59	135	92	123
commercial real estate and other property-related	**29**	41	20	21	9
other commercial[10]	**108**	72	87	43	38
Financial[2]	**1**	8	9	18	8
Charge to income statement	**6,048**	8,160	11,505	13,548	24,942
Personal	**3,196**	5,362	9,318	11,187	19,781
first lien residential mortgages	**627**	1,910	4,103	3,461	4,185
other personal[1]	**2,569**	3,452	5,215	7,726	15,596
Corporate and commercial	**2,974**	2,802	2,114	2,198	4,711
manufacturing and international trade and services	**1,690**	1,457	901	909	2,392
commercial real estate and other property-related	**826**	690	764	660	1,492
other commercial[10]	**458**	655	449	629	827
Financial[2]	**(122)**	(4)	73	163	450
Exchange and other movements[19]	**(1,657)**	(961)	(3,056)	(676)	685
At 31 December	**15,201**	16,169	17,636	20,241	25,649
Impairment allowances against banks:					
individually assessed	**58**	57	125	158	107
Impairment allowances against customers:					
individually assessed	**7,072**	6,572	6,537	6,457	6,494
collectively assessed	**8,071**	9,540	10,974	13,626	19,048
At 31 December	**15,201**	16,169	17,636	20,241	25,649

For footnotes, see page 263.

Report of the Directors: Financial Review (continued)

Movement in impairment allowances on loans and advances to customers and banks

(Audited)

	Banks individually assessed US$m	Customers Individually assessed US$m	Customers Collectively assessed US$m	Total US$m
At 1 January 2013	**57**	**6,572**	**9,540**	**16,169**
Amounts written off	**(4)**	**(1,937)**	**(4,714)**	**(6,655)**
Recoveries of loans and advances previously written off		**209**	**1,087**	**1,296**
Charge to income statement	**5**	**2,315**	**3,728**	**6,048**
Exchange and other movements[19]		**(87)**	**(1,570)**	**(1,657)**
At 31 December 2013	**58**	**7,072**	**8,071**	**15,201**
Impairment allowances on loans and advances to customers		**7,072**	**8,071**	**15,143**
personal		**589**	**6,013**	**6,602**
corporate and commercial		**6,096**	**1,963**	**8,059**
financial		**387**	**95**	**482**
	%	**%**	**%**	**%**
As a percentage of loans and advances[20,21]	**0.05**	**0.70**	**0.80**	**1.35**
	US$m	US$m	US$m	US$m
At 1 January 2012	125	6,537	10,974	17,636
Amounts written off	(70)	(2,361)	(7,381)	(9,812)
Recoveries of loans and advances previously written off		199	947	1,146
Charge to income statement		2,139	6,021	8,160
Exchange and other movements[19]	2	58	(1,021)	(961)
At 31 December 2012	57	6,572	9,540	16,169
Impairment allowances on loans and advances to customers		6,572	9,540	16,112
personal		685	7,527	8,212
corporate and commercial		5,407	1,939	7,346
financial		480	74	554
	%	%	%	%
As a percentage of loans and advances[20,21]	0.05	0.67	0.98	1.48

For footnotes, see page 263.

Individually and collectively assessed impairment charge to the income statement by industry sector

(Unaudited)

	2013 Total	2012 Total

	Individually assessed	**Collectively assessed**	**US$m**	Individually assessed	Collectively assessed	US$m
	US$m	**US$m**		US$m	US$m	
Banks	**5**		**5**			
Personal	**49**	**3,147**	**3,196**	96	5,266	5,362
first lien residential mortgages	**27**	**600**	**627**	40	1,870	1,910
other personal[1]	**22**	**2,547**	**2,569**	56	3,396	3,452
Corporate and commercial	**2,414**	**560**	**2,974**	2,029	773	2,802
manufacturing and international trade and services	**1,265**	**425**	**1,690**	910	547	1,457
commercial real estate and other property-related	**791**	**35**	**826**	604	86	690
other commercial[10]	**358**	**100**	**458**	515	140	655
Financial	**(148)**	**21**	**(127)**	14	(18)	(4)
Total charge to income statement	**2,320**	**3,728**	**6,048**	2,139	6,021	8,160

For footnotes, see page 263.

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Net loan impairment charge to the income statement

(Unaudited)

	2013	2012	2011	2010	2009
	US$m	US$m	US$m	US$m	US$m
Individually assessed impairment allowances	**2,320**	2,139	1,915	2,625	4,458
new allowances	**3,440**	3,272	2,904	3,617	5,173
release of allowances no longer required	**(911)**	(934)	(798)	(847)	(581)
recoveries of amounts previously written off	**(209)**	(199)	(191)	(145)	(134)
Collectively assessed impairment allowances	**3,728**	6,021	9,590	10,923	20,484
new allowances net of allowance releases	**4,815**	6,968	10,825	11,798	21,240
recoveries of amounts previously written off	**(1,087)**	(947)	(1,235)	(875)	(756)
Total charge for impairment losses	**6,048**	8,160	11,505	13,548	24,942
banks	**5**		(16)	12	70
customers	**6,043**	8,160	11,521	13,536	24,872
At 31 December					
Impaired loans	**36,503**	38,776	41,739	47,064	30,845
Impairment allowances	**15,201**	16,169	17,636	20,241	25,649

Charge for impairment losses as a percentage of average gross loans and advances to customers by geographical region[22]

(Unaudited)

	Europe	Hong Kong	Rest of Asia-Pacific	MENA	North America	Latin America	Total
	%	%	%	%	%	%	%
2013							
New allowances net of allowance releases	**0.59**	**0.09**	**0.34**	**0.15**	**0.91**	**5.93**	**0.78**
Recoveries	**(0.16)**	**(0.02)**	**(0.09)**	**(0.29)**	**(0.08)**	**(0.57)**	**(0.14)**
Total charge for impairment losses	**0.43**	**0.07**	**0.25**	**(0.14)**	**0.83**	**5.36**	**0.64**
Amount written off net of recoveries	**0.39**	**0.08**	**0.17**	**0.38**	**1.00**	**3.68**	**0.56**
2012							
New allowances net of allowance releases	0.58	0.07	0.37	1.16	2.31	4.36	1.00
Recoveries	(0.10)	(0.02)	(0.11)	(0.26)	(0.08)	(0.62)	(0.12)
Total charge for impairment losses	0.48	0.05	0.26	0.90	2.23	3.74	0.88

Amount written off net of recoveries	0.50	0.11	0.30	0.81	2.57	3.21	0.93

Charge for impairment losses as a percentage of average gross loans and advances to customers[22]

(Unaudited)

	2013	2012	2011	2010	2009
	%	*%*	*%*	*%*	*%*
New allowances net of allowance releases	**0.78**	1.00	1.34	1.65	2.92
Recoveries	**(0.14)**	(0.12)	(0.15)	(0.12)	(0.10)
Total charge for impairment losses	**0.64**	0.88	1.19	1.53	2.82
Amount written off net of recoveries	**0.56**	0.93	1.14	2.08	2.71

For footnote, see page 263.

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Reconciliation of reported and constant currency changes by geographical region

(Unaudited)

	31 Dec 12 as reported US$m	Currency translation adjustment[23] US$m	31 Dec 12 at 31 Dec 13 exchange rates US$m	Movement - constant currency basis US$m	**31 Dec 13 as reported US$m**	**Reported change[24] %**	**Constant currency change[24] %**
Impaired loans							
Europe	11,145	231	11,376	1,852	**13,228**	**19**	**16**
Hong Kong	477		477	(32)	**445**	**(7)**	**(7)**
Rest of Asia-Pacific	1,147	(78)	1,069	109	**1,178**	**3**	**10**
Middle East and North Africa	2,474	(6)	2,468	(183)	**2,285**	**(8)**	**(7)**
North America	20,345	(54)	20,291	(5,168)	**15,123**	**(26)**	**(25)**
Latin America	3,188	(291)	2,897	1,347	**4,244**	**33**	**46**
	38,776	(198)	38,578	(2,075)	**36,503**	**(6)**	**(5)**
Impairment allowances							
Europe	5,361	82	5,443	155	**5,598**	**4**	**3**
Hong Kong	473		473	(24)	**449**	**(5)**	**(5)**
Rest of Asia-Pacific	746	(56)	690	75	**765**	**3**	**11**
Middle East and North Africa	1,811	(10)	1,801	(218)	**1,583**	**(13)**	**(12)**
North America	5,616	(27)	5,589	(1,347)	**4,242**	**(24)**	**(24)**
Latin America	2,162	(236)	1,926	638	**2,564**	**19**	**33**
	16,169	(247)	15,922	(721)	**15,201**	**(6)**	**(5)**

For footnotes, see page 263.

Reconciliation of reported and constant currency impairment charge to the income statement

(Unaudited)

	31 Dec 12 as reported US$m	Currency translation adjustment[23] US$m	31 Dec 12 at 31 Dec 13 exchange rates US$m	Movement - constant currency basis US$m	**31 Dec 13 as reported US$m**	**Reported change[24] %**	**Constant currency change[24] %**
Charge for impairment losses							

Europe	1,874	(8)	1,866	(134)	**1,732**	**(8)**	**(7)**
new allowances	3,043	(30)	3,013	69	**3,082**	**1**	**2**
releases	(760)	11	(749)	36	**(713)**	**(6)**	**(5)**
recoveries	(409)	11	(398)	(239)	**(637)**	**56**	**60**
Hong Kong	84		84	51	**135**	**61**	**61**
new allowances	224	(1)	223	75	**298**	**33**	**34**
releases	(109)	1	(108)	(20)	**(128)**	**17**	**19**
recoveries	(31)		(31)	(4)	**(35)**	**13**	**13**
Rest of Asia-Pacific	340	(14)	326	22	**348**	**2**	**7**
new allowances	677	(22)	655		**655**	**(3)**	
releases	(187)	5	(182)	7	**(175)**	**(6)**	**(4)**
recoveries	(150)	3	(147)	15	**(132)**	**(12)**	**(10)**
Middle East and North Africa	255	(5)	250	(294)	**(44)**		
new allowances	580	(4)	576	(168)	**408**	**(30)**	**(29)**
releases	(250)		(250)	(115)	**(365)**	**46**	**46**
recoveries	(75)	(1)	(76)	(11)	**(87)**	**16**	**14**
North America	3,462	(5)	3,457	(2,222)	**1,235**	**(64)**	**(64)**
new allowances	3,889	(5)	3,884	(2,244)	**1,640**	**(58)**	**(58)**
releases	(298)	1	(297)	15	**(282)**	**(5)**	**(5)**
recoveries	(129)	(1)	(130)	7	**(123)**	**(5)**	**(5)**
Latin America	2,145	(165)	1,980	662	**2,642**	**23**	**33**
new allowances	2,581	(188)	2,393	869	**3,262**	**26**	**36**
releases	(84)	5	(79)	(259)	**(338)**	**302**	**328**
recoveries	(352)	18	(334)	52	**(282)**	**(20)**	**(16)**
Total	8,160	(197)	7,963	(1,915)	**6,048**	**(26)**	**(24)**
new allowances	10,994	(250)	10,744	(1,399)	**9,345**	**(15)**	**(13)**
releases	(1,688)	23	(1,665)	(336)	**(2,001)**	**19**	**20**
recoveries	(1,146)	30	(1,116)	(180)	**(1,296)**	**13**	**16**

For footnotes, see page 263.

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Concentration of exposure

(Unaudited)

Concentrations of credit risk are described in the Appendix to Risk on page 273.

The geographical diversification of our lending portfolio and our broad range of global businesses and products ensured that we did not overly depend on a few markets to generate growth in 2013. This diversification also supported our strategy for growth in faster-growing markets and in those with international connectivity.

An analysis of credit quality is provided on page 169.

Financial investments

Our holdings of available-for-sale government and government agency debt securities, corporate debt securities, ABSs and other securities were spread across a wide range of issuers and geographical regions in 2013, with 13% invested in securities issued by banks and other financial institutions and 73% in government or government agency debt securities. We also held assets backing insurance and investment contracts.

For an analysis of financial investments, see Note 19 on the Financial Statements.

Trading assets

Trading assets

(Unaudited)

	2013 US$bn	2012 US$bn
Trading securities[25]	163	171
Loans and advances to banks	28	78
Loans and advances to customers	48	118
	239	367

For footnote, see page 263.

Trading securities remained the largest concentration within trading assets at 68% compared with 47% in 2012. This increase was due to a change in the way GB&M manage reverse repo activities, which led to a significant reduction in these balances in loans and advances to banks and customers. The largest concentration within the trading securities portfolio was in government and government agency debt securities. We had significant exposures to US Treasury and government agency debt securities (US$23bn) and UK (US$12bn) and Hong Kong (US$6bn) government debt securities.

For an analysis of debt and equity securities held for trading, see Note 14 on the Financial Statements.

Derivatives

Derivative assets were US$282bn at 31 December 2013 (2012: US$357bn), of which the largest concentrations were interest rate and, to a lesser extent, foreign exchange derivatives. Our exposure to derivatives decreased by 21% as upward movements in yield curves in major currencies led to a decline in the fair value of interest rate contracts, largely in Europe, although this was partly offset by a reduction in netting.

For an analysis of derivatives, see Note 18 on the Financial Statements.

Loans and advances

Gross loans and advances to customers (excluding the financial sector) of US$957bn at 31 December 2013 increased by US$25bn or 3% compared with the end of 2012 on a reported basis. On a constant currency basis they were US$30bn higher.

The following tables analyse loans and advances by industry sector and by the location of the principal operations of the lending subsidiary or, in the case of the operations of The Hongkong and Shanghai Banking Corporation, HSBC Bank, HSBC Bank Middle East and HSBC Bank USA, by the location of the lending branch.

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Gross loans and advances by industry sector

(Unaudited)

	2013 US$m	Currency effect US$m	Movement US$m	2012 US$m	2011 US$m	2010 US$m	2009 US$m
Personal	**410,728**	**(2,949)**	**(1,416)**	415,093	393,625	425,320	434,206
first lien residential mortgages[26]	**299,875**	**(735)**	**(1,252)**	301,862	278,963	268,681	260,669
other personal[1]	**110,853**	**(2,214)**	**(164)**	113,231	114,662	156,639	173,537
Corporate and commercial	**543,822**	**(2,758)**	**33,087**	513,493	472,816	445,512	383,090
manufacturing	**113,925**	**(1,070)**	**2,846**	112,149	96,054	91,121	80,487
international trade and services	**185,081**	**(993)**	**16,685**	169,389	152,709	146,573	115,641
commercial real estate	**74,846**	**189**	**(2,103)**	76,760	73,941	71,880	69,389
other property-related	**44,832**	**(222)**	**4,522**	40,532	39,539	34,838	30,520
government	**7,342**	**(81)**	**(3,362)**	10,785	11,079	8,594	6,689
other commercial[1]	**117,796**	**(581)**	**14,499**	103,878	99,494	92,506	80,364
Financial	**138,181**	**1,009**	**55,914**	81,258	86,219	101,725	96,650
non-bank financial institutions	**136,195**	**1,076**	**55,302**	79,817	85,275	100,163	95,237
settlement accounts	**1,986**	**(67)**	**612**	1,441	944	1,562	1,413
Asset-backed securities reclassified	**2,716**	**84**	**(1,259)**	3,891	5,280	5,892	7,827
Total gross loans and advances to customers (A)	**1,095,447**	**(4,614)**	**86,326**	1,013,735	957,940	978,449	921,773
Gross loans and advances to banks	**211,579**	**(2,421)**	**61,397**	152,603	181,112	208,429	179,888
Total gross loans and advances	**1,307,026**	**(7,035)**	**147,723**	1,166,338	1,139,052	1,186,878	1,101,661
Of which:							
reverse repos to customers	**88,215**	**799**	**52,765**	34,651	41,419	60,519	58,913
reverse repos to banks	**91,475**	**(388)**	**56,402**	35,461	41,909	66,402	63,332
Impaired loans and advances to customers	**36,428**	**(198)**	**(2,045)**	38,671	41,584	46,871	30,606
as a percentage of A	**3.3%**			3.8%	4.3%	4.8%	3.3%
Impairment allowances on loans and advances to customers	**15,143**	**(246)**	**(723)**	16,112	17,511	20,083	25,542
as a percentage of A	**1.4%**			1.6%	1.8%	2.1%	2.8%
Charge for impairment losses	**6,048**	**(197)**	**(1,915)**	8,160	11,505	13,548	24,942
new allowances net of allowance releases	**7,344**	**(227)**	**(1,735)**	9,306	12,931	14,568	25,832
recoveries	**(1,296)**	**30**	**(180)**	(1,146)	(1,426)	(1,020)	(890)

For footnotes, see page 263.

The following commentary is on a constant currency basis.

Personal lending balances of US$411bn represented 38% of gross lending to customers at 31 December 2013. This was a reduction of US$1.4bn compared with 31 December 2012. First lien residential mortgage lending continued to represent our largest concentration in a single exposure type, the most significant balances being in the UK (44%), Hong Kong (18%) and the US (14%).

Corporate and commercial lending was 50% of gross lending to customers at 31 December 2013, representing our largest lending category. International trade and services, which comprised the largest portion of the corporate and commercial lending category, increased by 10% compared with

31 December 2012. This was due to continued demand for financing by customers in Hong Kong and, to a lesser extent, in Rest of Asia-Pacific.

Commercial real estate lending was 7% of total gross lending to customers, broadly unchanged from 31 December 2012. The main concentrations of commercial real estate lending were in the UK and Hong Kong.

Lending to non-bank financial institutions was US$138bn, an increase of US$56bn compared with 31 December 2012 mainly due to a change in the way GB&M manages reverse repo activities, and increased lending to other financial services companies in Hong Kong. Our exposure was spread across a range of institutions, with the most significant exposures being in the UK, France and the US.

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Loans and advances to banks were widely distributed across many countries and increased by 41% from 31 December 2012. This was driven by a change in the way GB&M manage reverse repo activities, and higher placements with financial institutions in Hong Kong.

The tables that follow provide information on loans and advances by geographical region and by country. The commentary on these loans and advances can be found under Personal lending and Wholesale lending on pages 160 and 165, respectively.

Gross loans and advances to customers by industry sector and by geographical region

(Audited)

	Gross loans and advances to customers							As a % of total
	Europe US$m	Hong Kong US$m	Rest of Asia-Pacific US$m	MENA US$m	North America US$m	Latin America US$m	Total US$m	gross loans
At 31 December 2013								
Personal	**192,107**	**73,556**	**50,973**	**6,484**	**72,690**	**14,918**	**410,728**	**37.5**
first lien residential mortgages[26]	**140,474**	**53,762**	**38,285**	**2,451**	**60,955**	**3,948**	**299,875**	**27.4**
other personal[1]	**51,633**	**19,794**	**12,688**	**4,033**	**11,735**	**10,970**	**110,853**	**10.1**
Corporate and commercial	**239,529**	**114,832**	**89,066**	**19,760**	**50,447**	**30,188**	**543,822**	**49.7**
manufacturing	**55,920**	**11,582**	**19,176**	**3,180**	**11,853**	**12,214**	**113,925**	**10.4**
international trade and services	**77,113**	**43,041**	**36,327**	**8,629**	**11,676**	**8,295**	**185,081**	**16.9**
commercial real estate	**31,326**	**25,358**	**9,202**	**639**	**5,900**	**2,421**	**74,846**	**6.8**
other property-related	**7,308**	**19,546**	**7,601**	**1,333**	**8,716**	**328**	**44,832**	**4.1**
government	**3,340**	**739**	**282**	**1,443**	**564**	**974**	**7,342**	**0.7**
other commercial[10]	**64,522**	**14,566**	**16,478**	**4,536**	**11,738**	**5,956**	**117,796**	**10.8**
Financial	**75,550**	**7,610**	**8,522**	**2,532**	**42,591**	**1,376**	**138,181**	**12.6**
non-bank financial institutions	**73,993**	**7,353**	**8,449**	**2,532**	**42,591**	**1,277**	**136,195**	**12.4**
settlement accounts	**1,557**	**257**	**73**			**99**	**1,986**	**0.2**
Asset-backed securities reclassified	**2,578**				**138**		**2,716**	**0.2**
Total gross loans and advances to customers (A)	**509,764**	**195,998**	**148,561**	**28,776**	**165,866**	**46,482**	**1,095,447**	**100.0**
Of which:								
reverse repos	**48,091**	**1,991**	**4,457**		**33,676**		**88,215**	**8.1**
Percentage of A by geographical region	**46.5%**	**17.9%**	**13.6%**	**2.6%**	**15.2%**	**4.2%**	**100.0%**	
Impaired loans	**13,187**	**445**	**1,178**	**2,265**	**15,109**	**4,244**	**36,428**	
as a percentage of A	**2.6%**	**0.2%**	**0.8%**	**7.9%**	**9.1%**	**9.1%**	**3.3%**	
Total impairment allowances	**5,563**	**449**	**765**	**1,565**	**4,237**	**2,564**	**15,143**	
as a percentage of A	**1.1%**	**0.2%**	**0.5%**	**5.4%**	**2.6%**	**5.5%**	**1.4%**	

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Gross loans and advances to customers by industry sector and by geographical region (continued)

(Audited)

	Gross loans and advances to customers							
	Europe US$m	Hong Kong US$m	Rest of Asia-Pacific US$m	MENA US$m	North America US$m	Latin America US$m	Total US$m	As a % of total gross loans
At 31 December 2012								
Personal	186,274	70,341	49,305	6,232	84,354	18,587	415,093	41.0
first lien residential mortgages[26]	135,172	52,296	36,906	2,144	70,133	5,211	301,862	29.8
other personal[1]	51,102	18,045	12,399	4,088	14,221	13,376	113,231	11.2
Corporate and commercial	223,061	99,199	85,305	22,452	47,886	35,590	513,493	50.6
manufacturing	56,690	10,354	19,213	3,373	9,731	12,788	112,149	11.1
international trade and services	70,954	33,832	32,317	9,115	13,419	9,752	169,389	16.6
commercial real estate	33,279	23,384	9,286	865	6,572	3,374	76,760	7.6
other property-related	7,402	16,399	6,641	2,103	7,607	380	40,532	4.0
government	2,393	2,838	1,136	1,662	774	1,982	10,785	1.1
other commercial[10]	52,343	12,392	16,712	5,334	9,783	7,314	103,878	10.2
Financial	55,732	4,546	4,255	1,196	13,935	1,594	81,258	8.0
non-bank financial institutions	55,262	4,070	3,843	1,194	13,935	1,513	79,817	7.9
settlement accounts	470	476	412	2		81	1,441	0.1
Asset-backed securities reclassified	3,694				197		3,891	0.4
Total gross loans and advances to customers (B)	468,761	174,086	138,865	29,880	146,372	55,771	1,013,735	100.0
Of which:								
reverse repos	27,299	760	307		6,281	4	34,651	3.4
Percentage of B by geographical region	46.3%	17.2%	13.7%	2.9%	14.4%	5.5%	100.0%	
Impaired loans	11,080	477	1,147	2,448	20,331	3,188	38,671	
as a percentage of B	2.4%	0.3%	0.8%	8.2%	13.9%	5.7%	3.8%	
Total impairment allowances	5,321	473	746	1,794	5,616	2,162	16,112	
as a percentage of B	1.1%	0.3%	0.5%	6.0%	3.8%	3.9%	1.6%	

For footnotes, see page 263.

Loans and advances to banks by geographical region

(Unaudited)

	Europe US$m	Hong Kong US$m	Rest of Asia-Pacific US$m	MENA US$m	North America US$m	Latin America US$m	Loans and advances to banks US$m	Impairment allowances[27] US$m
At 31 December 2013	**73,904**	**35,150**	**50,637**	**6,443**	**30,164**	**15,281**	**211,579**	**(58)**
At 31 December 2012	45,320	23,500	44,592	9,198	13,465	16,528	152,603	(57)
At 31 December 2011	54,406	35,159	47,309	8,571	14,831	20,836	181,112	(125)
At 31 December 2010	78,239	33,585	40,437	9,335	19,479	27,354	208,429	(158)
At 31 December 2009	65,614	36,197	35,648	8,435	15,386	18,608	179,888	(107)

For footnote, see page 263.

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Gross loans and advances to customers by country

(*Unaudited*)

	First lien residential mortgages US$m	Other personal US$m	Property-related US$m	Commercial, international trade and other US$m	Total US$m
At 31 December 2013					
Europe	140,474	51,633	38,634	279,023	509,764
UK[28]	132,174	22,913	28,127	219,248	402,462
France	2,661	13,840	8,442	38,333	63,276
Germany	7	218	127	6,361	6,713
Malta	2,007	526	434	1,627	4,594
Switzerland	364	8,616	269	320	9,569
Turkey	833	4,002	305	4,059	9,199
Other	2,428	1,518	930	9,075	13,951
Hong Kong	53,762	19,794	44,904	77,538	195,998
Rest of Asia-Pacific	38,285	12,688	16,803	80,785	148,561
Australia	9,468	1,236	2,511	7,138	20,353
India	1,080	297	425	4,732	6,534
Indonesia	69	447	78	5,361	5,955
Mainland China	4,880	300	5,808	22,178	33,166
Malaysia	5,140	1,994	1,997	5,420	14,551
Singapore	10,283	5,754	3,953	12,188	32,178
Taiwan	3,797	660	158	5,198	9,813
Vietnam	55	264	53	1,464	1,836
Other	3,513	1,736	1,820	17,106	24,175
Middle East and North Africa (excluding Saudi Arabia)	2,451	4,033	1,972	20,320	28,776
Egypt	1	477	146	2,232	2,856
Qatar	13	377	261	1,245	1,896
UAE	2,082	1,842	1,331	12,344	17,599
Other	355	1,337	234	4,499	6,425
North America	60,955	11,735	14,616	78,560	165,866
US[28]	42,317	6,257	10,174	59,150	117,898
Canada	17,036	5,116	3,912	18,557	44,621
Bermuda	1,602	362	530	853	3,347
Latin America	3,948	10,970	2,749	28,815	46,482
Argentina	20	1,425	62	2,103	3,610
Brazil	1,811	6,466	1,268	17,132	26,677
Mexico	2,117	3,079	1,398	8,994	15,588
Other			21	586	607

299,875	**110,853**	**119,678**	**565,041**	**1,095,447**

201

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Gross loans and advances to customers by country (continued)

(*Unaudited*)

	First lien residential mortgages US$m	Other personal US$m	Property-related US$m	Commercial, international trade and other US$m	Total US$m
At 31 December 2012					
Europe	135,172	51,102	40,681	241,806	468,761
UK	127,024	23,446	30,342	179,799	360,611
France	2,643	10,960	8,465	42,891	64,959
Germany	9	284	126	5,212	5,631
Malta	1,821	563	454	1,631	4,469
Switzerland	298	9,403	66	191	9,958
Turkey	1,062	4,084	317	3,356	8,819
Other	2,315	2,362	911	8,726	14,314
Hong Kong	52,296	18,045	39,783	63,962	174,086
Rest of Asia-Pacific	36,906	12,399	15,927	73,633	138,865
Australia	10,037	1,490	2,311	7,208	21,046
India	1,000	394	521	5,389	7,304
Indonesia	83	508	95	5,349	6,035
Mainland China	3,539	302	5,078	19,083	28,002
Malaysia	5,025	2,175	1,813	5,880	14,893
Singapore	10,123	4,812	3,938	9,854	28,727
Taiwan	3,323	597	120	5,180	9,220
Vietnam	50	252	60	1,710	2,072
Other	3,726	1,869	1,991	13,980	21,566
Middle East and North Africa (excluding Saudi Arabia)	2,144	4,088	2,968	20,680	29,880
Egypt	2	479	124	2,600	3,205
Qatar	11	385	484	1,082	1,962
UAE	1,743	1,822	1,533	12,264	17,362
Other	388	1,402	827	4,734	7,351
North America	70,133	14,221	14,179	47,839	146,372
US	49,417	7,382	9,449	29,315	95,563
Canada	19,040	6,444	4,136	17,369	46,989
Bermuda	1,676	395	594	1,155	3,820
Latin America	5,211	13,376	3,754	33,430	55,771
Argentina	28	1,532	85	2,465	4,110
Brazil	1,745	8,042	1,287	18,022	29,096
Mexico	1,989	2,756	1,280	9,447	15,472
Panama	1,402	1,023	1,049	2,405	5,879
Other	47	23	53	1,091	1,214

	301,862	113,231	117,292	481,350	1,013,735

Country distribution of outstandings and cross-border exposures

(Unaudited)

We control the risk associated with cross-border lending through a centralised structure of internal country limits. Exposures to individual countries and cross-border exposure in the aggregate are kept under continual review.

The following table summarises the aggregate of our in-country foreign currency and cross-border outstandings by type of borrower to countries which individually represent in excess of 0.75% of our total

assets. The classification is based on the country of residence of the borrower but also recognises the transfer of country risk in respect of third-party guarantees, eligible collateral held and residence of the head office when the borrower is a branch. In accordance with the Bank of England Country Exposure Report (Form CE) guidelines, outstandings comprise loans and advances (excluding settlement accounts), amounts receivable under finance leases, acceptances, commercial bills, certificates of deposit (CD s) and debt and equity securities (net of short positions), and exclude accrued interest and intra-HSBC exposures.

In-country foreign currency and cross-border amounts outstanding

(Unaudited)

	Banks US$bn	Government and official institutions US$bn	Other US$bn	Total US$bn
At 31 December 2013				
US	**5.9**	**34.3**	**24.5**	**64.7**
Mainland China	**28.8**	**6.9**	**19.3**	**55.0**
UK	**10.0**	**2.3**	**42.5**	**54.8**
Germany	**12.8**	**21.1**	**5.6**	**39.5**
Hong Kong	**10.9**	**0.7**	**26.5**	**38.1**
Japan[75]	**7.2**	**14.8**	**7.0**	**29.0**
France	**6.2**	**8.7**	**11.2**	**26.1**
At 31 December 2012				
US	5.9	37.9	14.7	58.5
UK	18.0	2.8	34.7	55.5
Mainland China	23.4	3.3	16.0	42.7
Germany	11.6	15.9	10.2	37.7
France	12.8	11.3	13.2	37.3
Hong Kong	8.3	1.0	21.3	30.6
Japan[75]	6.7	16.8	1.6	25.1

Ireland[75]	0.8	0.1	19.5	20.4
At 31 December 2011				
UK	9.5	4.5	53.7	67.7
US	8.1	40.8	16.7	65.6
Mainland China	25.4	7.6	13.3	46.3
Japan	8.6	25.8	0.9	35.3
France	11.0	11.3	10.0	32.3
Hong Kong	7.2	1.2	17.7	26.1
Germany	9.7	7.2	5.0	21.9
Ireland	1.7	0.1	17.5	19.3

For footnote, see page 265a.

Report of the Directors: Financial Review (continued)

HSBC Holdings

(Audited)

Risk in HSBC Holdings is overseen by the HSBC Holdings Asset and Liability Management Committee (ALCO). The major risks faced by HSBC Holdings are credit risk, liquidity risk and market risk (in the form of interest rate risk and foreign exchange risk), of which the most significant is credit risk.

Credit risk in HSBC Holdings primarily arises from transactions with Group subsidiaries and from guarantees issued in support of obligations assumed by certain Group operations in the normal conduct of their business. It is reviewed and managed within regulatory and internal limits for exposures by our

Global Risk function, which provides high-level centralised oversight and management of credit risks worldwide.

HSBC Holdings maximum exposure to credit risk at 31 December 2013 is shown below. Its financial assets principally represent claims on Group subsidiaries in Europe and North America.

All of the derivative transactions are with HSBC undertakings that are banking counterparties (2012: 100%) and for which HSBC Holdings has in place master netting arrangements. Since 2012, the credit risk exposure has been managed on a net basis and the remaining net exposure is specifically collateralised in the form of cash.

HSBC Holdings maximum exposure to credit risk

(Audited)

	At 31 December 2013			At 31 December 2012		
	Maximum exposure US$m	**Offset US$m**	**Exposure to credit risk (net) US$m**	Maximum exposure US$m	Offset US$m	Exposure to credit risk (net) US$m
Cash at bank and in hand:						
balances with HSBC undertakings	**407**		**407**	353		353
Derivatives	**2,789**	**(2,755)**	**34**	3,768	(3,768)	
Loans and advances to HSBC undertakings	**53,344**		**53,344**	41,675		41,675
Financial investments	**1,210**		**1,210**	1,208		1,208
Financial guarantees and similar contracts	**52,836**		**52,836**	49,402		49,402
Loan and other credit-related commitments	**1,245**		**1,245**	1,200		1,200
	111,831	**(2,755)**	**109,076**	97,606	(3,768)	93,838

The credit quality of the loans and advances to HSBC undertakings is assessed as strong or good , with 100% of the exposure being neither past due nor impaired (2012: 100%). The financial investments held by HSBC Holdings have a Standard and Poor s (S&P) rating of A (2012: A).

Securitisation exposures and other structured products

(Audited)

This section contains information about our exposure to the following:

- asset-backed securities (ABS s), including mortgage-backed securities (MBS s) and related collateralised debt obligations (CDO s);
- direct lending at fair value through profit or loss;
- monoline insurance companies (monolines);
- leveraged finance transactions; and
- representations and warranties related to mortgage sales and securitisation activities.

Within the above is included information on the GB&M legacy credit activities in respect of Solitaire Funding Limited (Solitaire), the securities investment conduits (SIC s), ABS trading portfolios and derivative transactions with monolines.

Further information in respect of Solitaire and the SICs is provided in Note 42 on the Financial Statements.

Accounting policies

Our accounting policies for the classification and measurement of financial instruments are in accordance with the requirements of IAS 32 Financial Instruments: Presentation , IAS 39 Financial Instruments: Recognition and Measurement and IFRS 13 Fair Value Measurement , as described in Note 2 on the Financial Statements, and the use of assumptions and estimates in respect of the valuation of financial instruments is described in Note 15 on the Financial Statements.

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Balance Sheet Management holds ABSs primarily issued by government agency and sponsored enterprises as part of our investment portfolios.

For further information on Balance Sheet Management, see page 238

Exposure in 2013

(Audited)

2013 saw an improvement in US macro-economic indicators and continued market appetite for structured products. Following the mid-year market response to the expectation that the scale of government repurchase schemes and quantitative measures may decrease, which led to depreciation in the value of MBSs issued by government agencies

and sponsored enterprises, the second half of the year saw the market for these securities moderate and they traded with less volatility in this period. Spreads modestly tightened across the rest of the structured product market in the year, with a notable appreciation in US Alt-A RMBS prices as a result of the improved view on the US housing market.

Within the following table are assets held in the GB&M legacy credit portfolio with a carrying value of US$28bn (2012: US$31.6bn).

A summary of the nature of HSBC s exposures is provided in the Appendix to Risk on page 274.

Overall exposure of HSBC

(Audited)

	At 31 December 2013		At 31 December 2012	
	Carrying amount[29] US$bn	Including sub-prime and Alt-A US$bn	Carrying amount[29] US$bn	Including sub-prime and Alt-A US$bn
Asset-backed securities (ABSs)	50.1	7.2	59.0	7.0
fair value through profit or loss	3.1	0.2	3.4	0.2
available for sale[30]	42.7	6.5	49.6	6.1
held to maturity[30]	1.1		1.6	0.1
loans and receivables	3.2	0.5	4.4	0.6
Direct lending at fair value through profit or loss	0.1	0.1	1.0	0.6
Total ABSs and direct lending at fair value through profit or loss	50.2	7.3	60.0	7.6
Less securities subject to risk mitigation from credit derivatives with monolines and other financial institutions	(1.5)	(0.2)	(1.9)	(0.2)

	48.7	**7.1**	58.1	7.4
Leveraged finance loans	**1.4**		2.8	
loans and receivables	**1.4**		**2.8**	
	50.1	**7.1**	60.9	7.4
Exposure including securities mitigated by credit derivatives with monolines and other financial institutions	**51.6**	**7.3**	62.8	7.6

For footnotes, see page 263.

ABSs classified as available for sale

Our principal holdings of available-for-sale ABSs are held in GB&M structured entities (SE s) established from the outset with the benefit of

external investor first loss protection support, and positions held directly and by Solitaire, where we provide first loss protection of US$1.2bn through credit enhancement and a liquidity facility.

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Movement in the available-for-sale reserve

(Audited)

	2013			2012		
	Directly held/ Solitaire[31]	**SEs**	**Total**	Directly held/ Solitaire[31]	SEs	Total
	US$m	**US$m**	**US$m**	US$m	US$m	US$m
Available-for-sale reserve at 1 January	**(1,473)**	**(720)**	**(2,193)**	(3,085)	(2,061)	(5,146)
Increase/(decrease) in fair value of securities	**(442)**	**599**	**157**	1,195	914	2,109
Effect of impairments[32]	**101**	**61**	**162**	339	394	733
Repayment of capital	**38**	**85**	**123**	164	174	338
Other movements	**262**	**(154)**	**108**	(86)	(141)	(227)
Available-for-sale reserve at 31 December	**(1,514)**	**(129)**	**(1,643)**	(1,473)	(720)	(2,193)

For footnotes, see page 263.

Securities investment conduits

(Unaudited)

The total carrying amount of ABSs held through SEs in the overleaf table represents holdings in which significant first loss protection is provided through capital notes issued by SICs, excluding Solitaire.

At each reporting date, we assess whether there is any objective evidence of impairment in the value of the ABSs held by SEs. Impairment charges incurred on these assets are offset by a

credit to the impairment line for the amount of the loss allocated to capital note holders, subject to the carrying amount of the capital notes being sufficient to offset the loss. Where the aggregate impairment charges exceeded the carrying value of the capital notes, liability write-backs of US$20m (2012: a charge of US$119m) were attributed to HSBC as shown in the table below. In respect of the SICs, the capital notes held by third parties are expected to absorb the cash losses in the vehicles.

Available-for-sale reserve and economic first loss protection in SICs, excluding Solitaire

(Unaudited)

	2013 US$m	2012 US$m
Available-for-sale reserve	**(37)**	(787)
related to asset-backed securities	**(129)**	(720)
Economic first loss protection	**2,286**	2,286
Carrying amount of capital notes liability	**457**	249
Impairment (write-backs)/charge for the year:		
allocated to HSBC	**(20)**	119
allocated to capital note holders	**(96)**	

Impairment methodologies

(Audited)

The accounting policy for impairment and indicators of impairment is set out in Note 2 on the Financial Statements.

A summary of our impairment methodologies is provided in the Appendix to Risk on page 272.

Impairment charges/(write-backs)

(Unaudited)

	Year ended 31 December 2013			Year ended 31 December 2012		
	Directly held/ Solitaire[31]	**SEs**	**Total**	Directly held/ Solitaire[31]	SEs	Total
	US$m	**US$m**	**US$m**	US$m	US$m	US$m
Sub-prime residential	**(16)**	**(100)**	**(116)**	23	(67)	(44)
US Alt-A residential	**(156)**	**(20)**	**(176)**	(209)	190	(19)
Commercial property	**10**	**6**	**16**	125		125
Other assets	**(11)**	**(2)**	**(13)**	74	(4)	70
Total impairment charge/(write-back)	**(173)**	**(116)**	**(289)**	13	119	132

For footnote, see page 263.

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Carrying amount of HSBC s consolidated holdings of ABSs, and direct lending held at fair value through profit or loss[29]

(Audited)

	Trading US$m	Available for sale US$m	Held to maturity US$m	Designated at fair value through profit or loss US$m	Loans and receivables US$m	Total US$m	Of which held through consolidated SEs US$m	Gross principal exposure[33] US$m	Credit default swap protection[34] US$m	Ne principa exposure US$m
31 December 3										
rtgage-related ts:										
-prime dential	178	2,977			403	3,558	2,782	4,504	112	4,392
ect lending	46					46		106		106
Ss and MBS Os	132	2,977			403	3,512	2,782	4,398	112	4,286
Alt-A dential	101	3,538	18		134	3,791	2,926	5,692	100	5,592
ect lending	10					10		14		14
Ss	91	3,538	18		134	3,781	2,926	5,678	100	5,578
Government ncy and nsored erprises:										
Ss	178	18,661	1,110			19,949		19,812		19,812
er residential	618	1,925			399	2,942	1,513	3,981	53	3,928
ect lending										
Ss	618	1,925			399	2,942	1,513	3,981	53	3,928
nmercial perty Ss and MBS Os	133	5,667		104	669	6,573	5,146	7,188		7,188
	1,208	32,768	1,128	104	1,605	36,813	12,367	41,177	265	40,912
eraged nce-related ts:										
Ss and ABS Os	294	5,011			251	5,556	4,310	5,841	365	5,476
dent n-related ts:										
	196	3,705			121	4,022	3,495	4,897	199	4,698

Ss and ABS										
Os										
er assets:										
Ss and ABS Os	1,271	1,265		34	1,186	3,756	989	4,805	1,010	3,795
	2,969	42,749	1,128	138	3,163	50,147	21,161	56,720	1,839	54,881

206

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

	Trading US$m	Available for sale US$m	Held to maturity US$m	Designated at fair value through profit or loss US$m	Loans and receivables US$m	Total US$m	Of which held through consolidated SEs US$m	Gross principal exposure[33] US$m	Credit default swap protection[34] US$m	Net principal exposure[35] US$m
At 31 December 2012										
Mortgage-related assets:										
Sub-prime residential	698	2,455			435	3,588	2,723	5,483	130	5,353
Direct lending	566					566	482	1,221		1,221
MBSs and MBS CDOs	132	2,455			435	3,022	2,241	4,262	130	4,132
US Alt-A residential	157	3,658	118		157	4,090	2,994	6,992	100	6,892
Direct lending	71					71		77		77
MBSs	86	3,658	118		157	4,019	2,994	6,915	100	6,815
US Government agency and sponsored enterprises:										
MBSs	369	23,341	1,455			25,165		23,438		23,438
Other residential	695	2,084			499	3,278	1,459	3,888	87	3,801
Direct lending	322					322		322		322
MBSs	373	2,084			499	2,956	1,459	3,566	87	3,479
Commercial property										
MBSs and MBS CDOs	164	6,995		109	1,319	8,587	5,959	9,489		9,489
	2,083	38,533	1,573	109	2,410	44,708	13,135	49,290	317	48,973
Leveraged finance-related assets:										
ABSs and ABS CDOs	450	5,330			284	6,064	4,303	6,726	717	6,009
Student loan-related assets:										
ABSs and ABS CDOs	179	4,219			156	4,554	3,722	5,826	199	5,627
Other assets:										
ABSs and ABS CDOs	1,511	1,553		49	1,537	4,650	1,140	5,769	1,318	4,451
	4,223	49,635	1,573	158	4,387	59,976	22,300	67,611	2,551	65,060

For footnotes, see page 263.

The above table excludes leveraged finance transactions, which are shown separately on page 209.

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Transactions with monoline insurers

(Audited)

HSBC s exposure to derivative transactions entered into directly with monolines

Our principal exposure to monolines is through a number of OTC derivative transactions, mainly CDSs. We entered into these CDSs primarily to purchase credit protection against securities held in the trading portfolio at the time.

During 2013, the notional value of contracts with monolines and our overall credit exposure to monolines decreased as a result of commutations, contract expiries and amortisations, and narrowing credit spreads. The table below sets out the fair value, of the derivative transactions at 31 December 2013, and hence the amount at risk if the CDS protection purchased were to be wholly ineffective because, for example, the monoline insurer was unable to meet its obligations. In order to further

analyse that risk, the value of protection purchased is shown subdivided between those monolines that were rated by S&P at BBB- or above at 31 December 2013, and those that were below BBB- (BBB- is the S&P cut-off for an investment grade classification). The Credit valuation adjustment column indicates the valuation adjustment taken against the net exposures, and reflects our best estimate of the likely loss of value on purchased protection arising from the deterioration in creditworthiness of the monolines. These valuation adjustments, which reflect a measure of the irrecoverability of the protection purchased, have been charged to the income statement.

Market prices are generally not readily available for CDSs, so their value is based on the market prices of the referenced securities.

HSBC s exposure to derivative transactions entered into directly with monoline insurers

(Audited)

	Notional amount US$m	Net exposure before credit valuation adjustment US$m	Credit valuation adjustment[36] US$m	Net exposure after credit valuation adjustment US$m
At 31 December 2013				
Derivative transactions with monoline counterparties				
Monolines investment grade (BBB or above)	3,297	299	(61)	238
Monolines sub-investment grade (below BBB)	523	190	(110)	80
	3,820	489	(171)	318

At 31 December 2012

Derivative transactions with monoline counterparties				
Monolines investment grade (BBB or above)	4,191	606	(121)	485
Monolines sub-investment grade (below BBB)	957	303	(158)	145
	5,148	909	(279)	630

For footnotes, see page 263.

Credit valuation adjustments for monolines

For monolines, the standard CVA methodology (as described on page 350) applies, with the exception that the future exposure profile is deemed to be constant (equal to the current market value) over the weighted average life of the referenced security.

HSBC s exposure to debt securities which benefit from guarantees provided by monolines

Within both the trading and available-for-sale portfolios, we hold bonds that are wrapped with a credit enhancement from a monoline. As the bonds

are traded explicitly with the benefit of this enhancement, any deterioration in the credit profile of the monoline is reflected in market prices and, therefore, in the carrying amount of these securities at 31 December 2013. For wrapped bonds held in the trading portfolio, the mark-to-market movement has been reflected through the income statement. For wrapped bonds held in the available-for-sale portfolio, the mark-to-market movement is reflected in equity unless there is objective evidence of impairment, in which case the impairment loss is reflected in the income statement.

Report of the Directors: Financial Review (continued)

Leveraged finance transactions

(Audited)

Leveraged finance transactions include sub-investment grade acquisition or event-driven financing. The following table shows our exposure to leveraged finance transactions arising from primary transactions. Our additional exposure to leveraged finance loans through holdings of ABSs from our trading and investment activities is shown in the table on page 206.

We held leveraged finance commitments of US$1.4bn at 31 December 2013 (2012: US$2.8bn), of which US$1.3bn (2012: US$2.6bn) were funded.

At 31 December 2013, our principal exposure was to companies in the communications and infrastructure sector.

HSBC s exposure to leveraged finance transactions

(Audited)

	Exposures at 31 December 2013			Exposures at 31 December 2012		
	Funded[37]	**Unfunded[38]**	**Total**	Funded[37]	Unfunded[38]	Total
	US$m	**US$m**	**US$m**	US$m	US$m	US$m
Europe	**1,256**	**176**	**1,432**	2,108	162	2,270
North America				414	92	506
	1,256	**176**	**1,432**	2,522	254	2,776
Held within:						
loans and receivables	**1,256**	**176**	**1,432**	2,522	252	2,774
fair value through profit or loss					2	2

For footnotes, see page 263.

Representations and warranties related to mortgage sales and securitisation activities

(Unaudited)

We have been involved in various activities related to the sale and securitisation of residential mortgages that are not recognised on our balance sheet. These activities include:

the purchase of US$24bn of third-party originated mortgages by HSBC Bank USA and their securitisation by HSBC Securities (USA) Inc. (HSI) between 2005 and 2007;

HSI acting as underwriter for the third-party issuance of private label MBSs with an original issuance value of US$37bn, most of which were sub-prime; and

the origination and sale by HSBC Bank USA of mortgage loans, primarily to government-sponsored entities.

In selling and securitising mortgage loans, various representations and warranties may be made to purchasers of the mortgage loans and MBSs. When purchasing and securitising mortgages originated by third parties and underwriting third-party MBSs, the obligation to repurchase loans in the event of a breach of loan level representations and warranties resides predominantly with the organisation that originated the loan.

Participants in the US mortgage securitisation market that purchased and repackaged whole loans, such as servicers, originators, underwriters, trustees or sponsors of securitisations, have been the subject of lawsuits and governmental and regulatory investigations and inquiries.

At 31 December 2013, a liability of US$99m (2012: US$219m) was recognised in respect of various representations and warranties regarding the origination and sale by HSBC Bank USA of mortgage loans, primarily to government sponsored entities. These relate to, among other things, the ownership of the loans, the validity of the liens, the loan selection and origination process and compliance with the origination criteria established by the agencies. In the event of a breach of its representations and warranties, HSBC Bank USA may be obliged to repurchase the loans with identified defects or to indemnify the buyers. The estimated liability was based on the level of outstanding repurchase demands, the level of outstanding requests for loan files and the expected future repurchase demands in respect of mortgages sold to date which were either two or more payments delinquent or might become delinquent at an estimated conversion rate. Repurchase demands of US$44m were outstanding at 2013 (2012: US$89m).

For further information on legal proceedings and regulatory matters, see Note 43 on the Financial Statements.

Report of the Directors: Financial Review (continued)

Upon receipt of a repurchase demand, we perform a detailed evaluation of the request. In many cases, we ultimately are not required to repurchase a loan as we are able to resolve the purported defect. From initial inquiry to ultimate resolution, a typical case takes roughly 12 months. Acceptance of a repurchase demand will involve either a) repurchase of the loan at the unpaid principal balance plus accrued interest or b) reimbursement for any realised loss on the sale of a property (make-whole payment).

To date, repurchase demands we have received primarily relate to prime loans sourced during 2004

through 2008 from the legacy broker channel which we exited from in late 2008. Loans sold to GSEs and other third parties originated in 2004 through 2008 subject to representations and warranties for which we may be liable had an outstanding principal balance of approximately US$11.9bn at 31 December 2013, including US$7.6bn of loans sourced from our legacy broker channel.

The trend in repurchase demands received on loans sold to GSEs and other third parties by loan origination vintage, outstanding repurchase demands and movement in repurchase liabilities are as follows:

Trend in repurchase demands received by loans sold to GSEs and other third parties by origination vintage

	2013	2012
	US$m	US$m
Pre-2004	12	7
2004	27	21
2005	43	28
2006	56	80
2007	106	209
2008	60	123
Post-2008	14	18
Total repurchase demands received	318	486

Outstanding repurchase demands received from GSEs and other third parties

	At 31 December	
	2013	2012
	US$m	US$m
GSEs	41	86
Others	3	3
Total	44	89

Movement in repurchase liability for loans sold to GSEs and other third parties

	2013	2012
	US$m	US$m
At 1 January	219	237
Increase in liability recorded through earnings	21	134
Realised losses	(141)	(152)
At 31 December	99	219

Because the level of mortgage loan repurchase losses are dependent upon economic factors, investor demand strategies and other external risk factors such as housing market trends that may change, the estimate of the liability for a mortgage loan repurchase requires significant judgement. Because these estimates are influenced by factors outside our control, there is uncertainty inherent in them, making it reasonably possible that the estimates could change.

Risk elements in the loan portfolio

(Unaudited)

The disclosure of credit risk elements in this section reflects US accounting practice and classifications. The purpose of the disclosure is to present within the US disclosure framework those elements of the loan portfolios with a greater risk of loss. The three main classifications of credit risk elements presented are:

- impaired loans;
- unimpaired loans contractually past due 90 days or more as to interest or principal; and

Report of the Directors: Financial Review (continued)

troubled debt restructurings not included in the above.

Interest foregone on impaired and restructured loans

Interest income that would have been recognised under the original terms of impaired and restructured loans amounted to approximately US$2.5bn in 2013 (2012: US$2.9bn). The table below analyses this by geographic region.

	2013 US$m	2012 US$m
Europe	**214**	215
Hong Kong	**26**	29
Rest of Asia-Pacific	**66**	78
Middle East and North Africa	**147**	118
North America	**1,667**	1,817
Latin America	**421**	610
	2,541	2,867

Interest recognised on impaired and restructured loans

Interest income from such loans of approximately US$1.7bn was recorded in 2013 (2012: US$1.7bn). The table below analyses this by geographical region.

	2013 US$m	2012 US$m
Europe	**97**	41
Hong Kong	**10**	7
Rest of Asia-Pacific	**32**	29
Middle East and North Africa	**28**	29
North America	**1,087**	1,110
Latin America	**410**	491
	1,664	1,707

Impaired loans

In the following tables, we present information on our impaired loans and advances in accordance with the classification approach described on page 185.

A loan is impaired, and an impairment allowance is recognised, when there is objective evidence of a loss event that has an effect on the cash flows of the loan which can be reliably estimated. In accordance with IFRSs, we recognise interest income on assets after they have been written down as a result of an impairment loss.

The balance of impaired loans at 31 December 2013 was US$2.3bn lower than at 31 December 2012. This reduction occurred primarily in North America due to the continued run-off of the CML portfolio, partly offset by increases in individually assessed impaired balances in Europe and Latin America.

Unimpaired loans past due 90 days or more

Examples of unimpaired loans past due 90 days or more include individually assessed mortgages that are in arrears more than 90 days where there are no other indicators of impairment, but where the value of collateral is sufficient to repay both the principal debt and all potential interest for at least one year; and short-term trade facilities past due more than 90 days for technical reasons such as delays in documentation, but where there is no concern over the creditworthiness of the counterparty.

The amount of unimpaired loans past due 90 days or more at 31 December 2013 was US$127m, US$97m lower than at 31 December 2012. The decrease was primarily in the Middle East and North Africa due to a number of repayments.

Troubled debt restructurings

Under US GAAP, a troubled debt restructuring (TDR) is a loan the terms of which have been modified for economic or legal reasons related to the borrower s financial difficulties to grant a concession to the borrower that the lender would not otherwise consider. A modification which results in a delay in payment that is considered insignificant is not regarded as a concession for the purposes of this disclosure. The SEC requires separate disclosure of any loans which meet the definition of a TDR that are not included in the previous two loan categories. These are classified as TDRs in the table on page 209(b). Loans that have been identified as a TDR under the US guidance retain this designation until they are repaid or are derecognised. This treatment differs from the Group s impaired loans disclosure convention under IFRS under which a loan may return to unimpaired status after demonstrating a significant reduction in the risk of non-payment of future cash flows. As a result reported TDRs include those loans that have returned to unimpaired status under the Group s disclosure convention for renegotiated loans.

The balance of TDRs not included as impaired loans at 31 December 2013 was US$286m higher than at 31 December 2012. The increase was mainly in North America and reflects the effect of certain loans returning to unimpaired status after the demonstration of a significant reduction in the risk of non-payment of future cash flows, while retaining the TDR status. This was partly offset by a reduction in Brazil following an update to the previous estimate of the period of time taken for loans to demonstrate a return to performing status. As a result, from 2013, all restructured retail TDR loans

Report of the Directors: Financial Review (continued)

in Brazil have been classified as impaired until full settlement of the loan.

Potential problem loans

Potential problem loans are loans where information on possible credit problems among borrowers causes management to seriously doubt their ability to comply with the loan repayment terms. There are no potential problem loans other than those identified in the table of risk elements on page 209(d). The following concentrations of credit risk have a higher risk of containing potential problem loans.

Mortgage lending on page 161 includes disclosure about certain homogeneous groups of loans which are collectively assessed for impairment, which may represent exposures to potential problem loans, including interest-only mortgages and affordability mortgages, including ARMs. Collectively assessed loans and advances, as set out on page 188 although not classified as impaired until more than 90 days past due, are assessed collectively for losses that have been incurred but have not yet been individually identified. This policy is further described on pages 272 and 435.

Renegotiated loans and forbearance on page 173 includes disclosure about the credit quality of loans whose contractual terms have been changed at some point in the life of the loan because of significant concerns about the borrower s ability to make contractual payments when due. Renegotiated loans are classified as impaired when:

there has been a change in contractual cash flow as a result of a concession which the lender would otherwise not consider; and

it is probable that without the concession, the borrower would be unable to meet contractual payment obligations in full.

This presentation applies unless the concession is insignificant and there are no other indicators of impairment. The renegotiated loan will continue to be disclosed as impaired until there is sufficient evidence to demonstrate a significant reduction in the risk of non-repayment of future cash flows, and there are no other indicators of impairment.

Renegotiated loans that are not classified as impaired may have a higher risk of becoming delinquent in the future, and may therefore be potential problem loans. Further information regarding the credit quality classification of renegotiated loans can be found on page 270.

Areas of special interest on page 147 includes information on refinancing risk in the commercial real estate sector which is a focus of scrutiny. Where a loan which is due to be repaid through refinancing over the short term cannot, at maturity, be refinanced by HSBC or other banks on current market terms this will either lead to the loan being treated as impaired due to repayment default or, if refinanced within HSBC, may result in it being treated as a renegotiated loan because of the degree of forbearance required. Therefore loans in portfolios subject to refinancing risk may include potential problem loans.

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Analysis of risk elements in the loan portfolio by geographical region

(Unaudited)

	At 31 December				
	2013	2012	2011	2010	2009
	US$m	US$m	US$m	US$m	US$m
Impaired loans					
Europe	**13,228**	11,145	11,819	11,500	10,873
Hong Kong	**445**	477	608	665	846
Rest of Asia-Pacific	**1,178**	1,147	1,070	1,324	1,201
Middle East and North Africa	**2,285**	2,474	2,445	2,549	1,666
North America	**15,123**	20,345	22,758	27,902	13,308
Latin America	**4,244**	3,188	3,039	3,124	2,951
	36,503	38,776	41,739	47,064	30,845
Unimpaired loans contractually past due 90 days or more as to principal or interest					
Europe	**25**	33	41	65	57
Hong Kong	**5**	4	3	7	4
Rest of Asia-Pacific	**28**	10	21	40	36
Middle East and North Africa	**56**	108	214	263	215
North America	**13**	69	74	265	217
Latin America			10	3	40
	127	224	363	643	569
Troubled debt restructurings (not included in the classifications above)					
Europe	**1,427**	1,306	753	591	436
Hong Kong	**168**	134	108	205	236
Rest of Asia-Pacific	**109**	102	122	198	135
Middle East and North Africa	**406**	593	444	141	103
North America	**4,643**	3,813	2,300	1,970	9,613
Latin America	**482**	1,001	1,037	1,274	1,518
	7,235	6,949	4,764	4,379	12,041
Trading loans classified as in default					
North America	**133**	166	230	412	798
Risk elements on loans[76]					
Europe	**14,680**	12,484	12,613	12,157	11,366
Hong Kong	**618**	615	719	877	1,086
Rest of Asia-Pacific	**1,315**	1,259	1,213	1,562	1,372
Middle East and North Africa	**2,747**	3,175	3,103	2,953	1,984
North America	**19,912**	24,393	25,362	30,549	23,936
Latin America	**4,726**	4,189	4,086	4,401	4,509
	43,998	46,115	47,096	52,499	44,253
Assets held for resale[77]					
Europe	**46**	51	60	47	52
Hong Kong	**4**	5	4	2	10
Rest of Asia-Pacific	**6**	14	10	5	8

Middle East and North Africa				2	2
North America	**370**	319	359	1,084	707
Latin America	**27**	55	69	121	153
	453	444	502	1,261	932
Total risk elements					
Europe	**14,726**	12,535	12,673	12,204	11,418
Hong Kong	**622**	620	723	879	1,096
Rest of Asia-Pacific	**1,321**	1,273	1,223	1,567	1,380
Middle East and North Africa	**2,747**	3,175	3,103	2,955	1,986
North America	**20,282**	24,712	25,721	31,633	24,643
Latin America	**4,753**	4,244	4,155	4,522	4,662
	44,451	46,559	47,598	53,760	45,185
	%	*%*	*%*	*%*	*%*
Loan impairment allowances as a percentage of risk elements on loans[78]	**34.7**	35.2	37.6	38.9	59.0

For footnotes, see page 265a.

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Eurozone exposures

(Unaudited)

Exposures to countries in the eurozone

The disclosure in this section is limited to the peripheral eurozone countries of Spain, Ireland, Italy, Greece, Portugal and Cyprus, which exhibited levels of market volatility that exceeded other eurozone countries, demonstrating fiscal or political uncertainty that persisted throughout 2013. During the year, core eurozone countries such as Germany and the Netherlands demonstrated an improvement in economic fundamentals, and the risk of contagion leading to a broadly based failure of the euro abated considerably. Should a

peripheral country need to leave the euro it is now expected to be on a managed basis that is less likely to present a risk to the eurozone itself.

The tables in this section summarise our selected eurozone country exposures, including to:

- governments, central banks and quasi government agencies;
- banks;
- other financial institutions and corporates; and
- personal lending.

Exposures to banks, other financial institutions, other corporates and personal lending are based on the counterparty s country of domicile.

Summary of exposures to peripheral eurozone countries

(Audited)

						Total net exposure			
	On-balance sheet	Off-balance sheet	Total gross exposures	Risk miti-gation	Total net exposure	Sovereign and agencies	Banks	Other financial institutions	Personal

	exposures US$bn	exposures US$bn	US$bn	US$bn	US$bn	US$bn	US$bn	and corporates US$bn	US$bn
At 31 December 2013									
Spain	**13.4**	**3.6**	**17.0**	**(5.8)**	**11.2**	**0.8**	**2.6**	**7.7**	**0.1**
Ireland	**9.1**	**2.2**	**11.3**	**(1.9)**	**9.4**	**0.1**	**0.9**	**8.3**	**0.1**
Italy	**13.4**	**3.5**	**16.9**	**(8.7)**	**8.2**	**1.4**	**1.4**	**5.2**	**0.2**
Greece	**6.5**	**1.2**	**7.7**	**(0.4)**	**7.3**	**0.1**	**2.2**	**4.0**	**1.0**
Portugal	**1.0**	**0.3**	**1.3**	**(0.2)**	**1.1**	**0.3**	**0.3**	**0.5**	
Cyprus	**0.3**		**0.3**		**0.3**			**0.2**	**0.1**
	43.7	**10.8**	**54.5**	**(17.0)**	**37.5**	**2.7**	**7.4**	**25.9**	**1.5**
At 31 December 2012									
Spain	15.3	3.2	18.5	(6.4)	12.1	1.0	2.8	8.3	
Ireland	20.7	1.3	22.0	(12.1)	9.9	0.4	1.8	7.6	0.1
Italy	12.6	3.0	15.6	(6.0)	9.6	2.7	1.6	5.2	0.1
Greece	5.9	0.7	6.6	(0.8)	5.8	0.1	0.6	4.1	1.0
Portugal	1.1	0.3	1.4	(0.4)	1.0	0.2	0.4	0.4	
Cyprus	0.3	0.1	0.4		0.4			0.4	
	55.9	8.6	64.5	(25.7)	38.8	4.4	7.2	26.0	1.2

Basis of preparation

(Audited)

In the above table, Total gross exposure represents the on-balance sheet carrying amounts recorded in accordance with IFRSs and off-balance sheet exposures.

Total net exposure is stated after taking into account mitigating offsets that are incorporated into the risk management view of the exposure but do not meet accounting offset requirements. These risk mitigating offsets include:

short positions managed together with trading assets;

derivative liabilities for which a legally enforceable right of offset with derivative assets exists; and

collateral received on derivative assets.

Short positions managed together with trading assets mitigate the risk to which we are exposed at the balance sheet date when, in the event of default, the trading assets and related short positions crystallise gains and losses simultaneously. When such relationships exist, an element of the risk will remain if the short and long positions do not match exactly, for example, if the maturity of the short position is less than the trading asset or the short position is not identical to the security. The remaining risk is reflected in the gross balance sheet exposure shown before risk mitigation. However, as the net position best reflects the effects of a credit event should it occur at the

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

balance sheet date, we consider that this measure is a key view of risk at that date.

Credit risk mitigation includes derivative liabilities with the same counterparty when a master netting arrangement is in place and the credit risk exposure is managed on a net basis or the position is specifically collateralised, normally in the form of cash. These amounts do not qualify for net presentation for accounting purposes as settlement may not actually be made on a net basis, though we consider the net presentation more accurately reflects the risk exposure.

The effect of the transfer of risk to policyholders under unit linked insurance contracts and trading assets which represent collateral to support associated liabilities are not deducted from the total net exposure.

Off-balance sheet exposures mainly relate to commitments to lend and the amounts shown in the table represent the amounts that could be drawn down by the counterparties. In the majority of cases, we are bound to fulfil these commitments. In some instances, limitations are imposed on a counterparty s ability to draw down on a facility. These limitations are governed by the documentation, which differs from counterparty to counterparty.

Commentary on exposures

At 31 December 2013, our net exposure to the peripheral eurozone countries was US$37.5bn, US$1.3bn lower than at the end of 2012. This was primarily due to a reduction in exposure to sovereign borrowers and agencies in Italy, to banks in Ireland and to other financial institutions and corporates in Spain. These were partly offset by an increase in exposure to banks in Greece due to reverse repo activity backed by high quality bonds.

Redenomination risk

(Unaudited)

Despite some improvements, the peripheral eurozone countries continue to exhibit distress, and there is the continuing possibility of a member state exiting from the eurozone. There remains no established legal framework within the European treaties to facilitate such an event; consequently, it is not possible to accurately predict the course of events and legal consequences that would ensue.

Based on our assessment of the likelihood of a each country leaving the euro, and the related materiality of our exposures subject to the risk of redenomination it is our view that the greatest estimated impact of a eurozone exit is presented by

Greece, Italy or Spain. As a result, only exposures in Greece, Italy and Spain (described as in-country) are reported in the table below.

Key risks associated with an exit by a eurozone member include:

Foreign exchange losses: an exit would probably be accompanied by the passing of laws in the country concerned establishing a new local currency and providing for a redenomination of euro assets into the new local currency. The value of assets and liabilities in the country would immediately fall assuming the value of the redenominated currency is less than the original euros when translated into the carrying amounts. It is not possible to predict what the total consequential loss might be as it is uncertain which assets and liabilities would be legally re-denominated or the extent of the devaluation. These assets and liabilities predominantly comprise loans and deposits arising from our commercial banking operations in these countries, and the net assets represent our net funding exposure. The table also identifies in-country off-balance sheet exposures as these are at risk of redenomination should they be called, giving rise to a balance sheet exposure. It is to be noted that this analysis can only be an indication as it does not include euro-denominated exposures booked by HSBC outside the countries at risk which are connected with those countries (see external contracts below).

External contracts redenomination risk: contracts entered into between HSBC businesses based outside a country exiting the euro with in-country counterparties or those otherwise closely connected with the relevant country may be affected by redenomination. The effect remains subject to a high level of uncertainty. Factors such as the country law under which the contract is documented, the HSBC entity involved and the payment mechanism may all be relevant to this assessment, as will the precise exit scenario as the consequences for external contracts of a disorderly exit may differ from one sanctioned under EU law. In addition, capital controls could be introduced which may affect our ability to repatriate funds including currencies not affected by the redenomination event.

We continue to identify and monitor potential redenomination risks and, where possible, take steps to mitigate them and/or reduce our overall exposure to losses that might arise in the event of a redenomination. We recognise, however, that a euro exit could take different forms, depending on the scenario. These could have distinct legal consequences which could significantly alter the

Report of the Directors: Financial Review (continued)

potential effectiveness of any mitigation initiatives, and it is accordingly not possible to predict how effective particular measures may be until they are

tested against the precise circumstances of a redenomination event.

In-country funding exposure

(Unaudited)

		Denominated in:			
		Euros	US dollars	Other currencies	Total
		US$bn	US$bn	US$bn	US$bn
At 31 December 2013					
Greece	In-country assets	**1.5**	**0.1**		**1.6**
	In-country liabilities	**(1.4)**	**(0.6)**	**(0.1)**	**(2.1)**
	Net in-country funding exposure	**0.1**	**(0.5)**	**(0.1)**	**(0.5)**
	Off-balance sheet exposure	**(0.2)**		**0.3**	**0.1**
Italy	In-country assets	**0.9**			**0.9**
	In-country liabilities[39]	**(1.9)**			**(1.9)**
	Net in-country funding exposure	**(1.0)**			**(1.0)**
	Off-balance sheet exposure	**1.0**			**1.0**
Spain	In-country assets	**1.5**	**0.8**		**2.3**
	In-country liabilities	**(1.0)**	**(0.2)**		**(1.2)**
	Net in-country funding exposure	**0.5**	**0.6**		**1.1**
	Off-balance sheet exposure	**0.5**	**0.4**		**0.9**
At 31 December 2012					
Greece	In-country assets	2.1	0.1		2.2
	In-country liabilities	(1.5)	(0.8)	(0.1)	(2.4)
	Net in-country funding exposure	0.6	(0.7)	(0.1)	(0.2)
	Off-balance sheet exposure	(0.3)	0.2	0.2	0.1
Italy	In-country assets	1.0			1.0
	In-country liabilities[39]	(2.0)			(2.0)
	Net in-country funding exposure	(1.0)			(1.0)
	Off-balance sheet exposure	0.8			0.8
Spain	In-country assets	2.4	0.8		3.2
	In-country liabilities	(1.7)	(0.1)		(1.8)

Net in-country funding exposure	0.7	0.7	1.4
Off-balance sheet exposure	0.7	0.2	0.9

For footnote, see page 263.

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Liquidity and funding

1 *Appendix to Risk risk policies and practices.*

Report of the Directors: Financial Review (continued)

Liquidity risk is the risk that the Group does not have sufficient financial resources to meet its obligations as they fall due, or will have to do so at an excessive cost. The risk arises from mismatches in the timing of cash flows.

There were no material changes to our policies and practices for the management of liquidity and funding risks in 2013.

A summary of our current policies and practices regarding liquidity and funding is provided in the Appendix to Risk on page 276.

Our liquidity and funding risk management framework

The objective of our liquidity framework is to allow us to withstand very severe liquidity stresses. It is designed to be adaptable to changing business models, markets and regulations.

Our liquidity and funding risk management framework requires:

- liquidity to be managed by operating entities on a stand-alone basis with no implicit reliance on the Group or central banks;
- all operating entities to comply with their limits for the advances to core funding ratio; and
- all operating entities to maintain a positive stressed cash flow position out to three months under prescribed Group stress scenarios.

Liquidity and funding in 2013

(Unaudited)

The liquidity position of the Group strengthened in 2013, and we continued to enjoy strong inflows of customer deposits and maintained good access to wholesale markets. During 2013, customer accounts grew by 11% (US$143bn) while loans and advances to customers increased by 8% (US$83bn), leading to a small decrease in our advances to deposits ratio to 73% (2012: 74%).

HSBC UK recorded a decrease in its advances to core funding (ACF) ratio to 100% at 31 December 2013 (2012: 106%) mainly because core deposits increased more than advances.

The Hongkong and Shanghai Banking Corporation recorded a decrease in its ACF ratio to 72% at 31 December 2013 (2012: 73%) mainly because core deposits increased more than advances.

HSBC USA recorded an increase in its ACF ratio to 85% at 31 December 2013 (2012: 78%). This increase was mainly because surplus core deposits were deployed into loans and advances to customers.

HSBC UK, The Hongkong and Shanghai Banking Corporation and HSBC USA are defined in footnotes 41 to 43 on pages 264 and 265. The ACF ratio is discussed on page 215.

Customer deposit markets

Customer accounts increased by 11% in 2013. After excluding repo balances, the year-on-year increase was 4% (US$50bn).

Retail Banking and Wealth Management

RBWM customer account balances grew by 3% with significant growth in our home markets partly offset by reductions in deposit balances in certain markets either due to surplus funding requirements or disposal of our operations.

Commercial Banking

Customer accounts rose by 5% in 2013, mainly from increases in Payments and Cash Management accounts. The growth in these customer accounts and the strong growth in payment volumes was evidence of the correlation between this funding source and the operational services that HSBC provides to the CMB customer base.

Global Banking and Markets

Customer accounts increased by 36% in 2013. After excluding repo balances with customers, GB&M deposits rose by 8% year on year, with the majority resulting from increases in Payments and Cash Management accounts.

Global Private Banking

GPB customer account balances decreased by 9% as we continued to reposition our business from offshore to domestic banking and refocus our client base towards higher net worth relationships. Outflows from the adoption of stricter compliance and tax transparency standards also contributed to the overall decline.

Wholesale funding markets

Conditions in the bank wholesale debt markets were generally positive in 2013, supported by strong investor demand and improvements in the economic outlook in developed markets, although there was some volatility caused by interest rate uncertainty. Subordinated debt issuance volumes increased as investor confidence grew and further regulatory clarity emerged. While there was some regional variation, the overall volume of term debt issued by banks globally decreased from previous years, primarily due to reduced issuance in the UK and Europe.

In 2013, we issued the equivalent of US$15.6bn (2012: US$10.5bn) of term debt securities in the

Report of the Directors: Financial Review (continued)

public capital markets in a range of currencies and maturities from a number of Group entities.

Liquidity regulation

(Unaudited)

The European adoption of the Basel Committee framework via CRD IV was published in June 2013. They require the reporting of the liquidity coverage ratio (LCR) and the net stable funding ratio (NSFR) from March 2014. The regulatory LCR outlined in the regulation document has been initially set at 60% from January 2015, increasing to 100% by January 2018, although individual member states are able to set a higher standard. We expect the PRA to set an 80% LCR requirement from January 2015. During 2013, additional guidance was given on the definition of the LCR, much of which takes the form of an impact assessment and recommendations that have been submitted to the European Commission by the EBA. We expect these recommendations to be materially adopted by the Commission into the final LCR delegated act on 30 June 2014. Regarding the finalisation of the NSFR metric, in January 2014 the Basel Committee on Banking Supervision issued a consultation document on a revised framework. This is intended to be implemented as a minimum standard at the beginning of January 2018.

Management of liquidity and funding risk

(Audited)

Our liquidity and funding risk management framework (LFRF) employs two key measures to define, monitor and control the liquidity and funding risk of each of our operating entities. The advances to core funding ratio is used to monitor the structural long-term funding position, and the stressed coverage ratio, incorporating Group-defined stress scenarios, is used to monitor the resilience to severe liquidity stresses.

The three principal entities listed in the tables below represented 66% (2012: 62%) of the Group s customer accounts (excluding repos). Including the other principal entities, the percentage was 94% (2012: 94%).

Advances to core funding ratio

The table below shows the extent to which loans and advances to customers in our principal banking entities were financed by reliable and stable sources of funding.

ACF limits set for principal operating entities at 31 December 2013 ranged between 80% and 115%.

Advances to core funding ratios[40]

(Audited)

	At 31 December	
	2013	2012
	%	%
HSBC UK[41]		
Year-end	**100**	106
Maximum	**107**	106

Minimum	**100**	100
Average	**104**	103
The Hongkong and Shanghai Banking Corporation[42]		
Year-end	**72**	73
Maximum	**77**	75
Minimum	**70**	71
Average	**74**	73
HSBC USA[43]		
Year-end	**85**	78
Maximum	**85**	86
Minimum	**78**	68
Average	**82**	78
Total of HSBC s other principal entities[44]		
Year-end	**93**	91
Maximum	**93**	92
Minimum	**89**	85
Average	**91**	88

For footnotes, see page 264.

Core funding represents the core component of customer deposits and any term professional funding with a residual contractual maturity beyond one year. Capital is excluded from our definition of core funding.

Stressed coverage ratios

The ratios tabulated below express stressed cash inflows as a percentage of stressed cash outflows over both one-month and three-month time horizons. Operating entities are required to maintain a ratio of 100% or greater out to three months.

Inflows included in the numerator of the stressed coverage ratio are generated from liquid assets net of assumed haircuts, and cash inflows related to assets contractually maturing within the time period.

In general, customer advances are assumed to be renewed and as a result do not generate a cash inflow.

215

Report of the Directors: Financial Review (continued)

Stressed one-month and three-month coverage ratios[40]

(Audited)

	Stressed one-month coverage ratios at 31 December 2013	2012	Stressed three-month coverage ratios at 31 December 2013	2012
HSBC UK[41]	%	%	%	%
Year-end	**106**	114	**109**	103
Maximum	**114**	117	**109**	103
Minimum	**100**	108	**101**	101
Average	**106**	112	**103**	102
The Hongkong and Shanghai Banking Corporation[42]				
Year-end	**119**	129	**114**	126
Maximum	**131**	134	**126**	126
Minimum	**113**	123	**109**	118
Average	**119**	129	**114**	123
HSBC USA[43]				
Year-end	**114**	126	**110**	119
Maximum	**126**	137	**119**	130
Minimum	**110**	115	**109**	113
Average	**115**	127	**112**	123
Total of HSBC s other principal entities[44]				
Year-end	**121**	127	**114**	117
Maximum	**128**	127	**119**	117
Minimum	**113**	117	**109**	108
Average	**120**	121	**113**	111

For footnotes, see page 264.

The one-month stressed coverage ratio for HSBC UK decreased due to higher contractual repos on level 3 assets maturing beyond one month and higher cash outflows modelled for non-core deposits. The three-month stressed coverage ratio increased due to the reclassification of equities that qualify as level 3 liquid assets under LFRF.

The stressed coverage ratios for The Hongkong and Shanghai Banking Corporation decreased as a result of a methodology change with regards to intraday liquidity requirements.

The stressed coverage ratios for HSBC USA decreased as the surplus liquidity was deployed into loans and advances to customers.

The stressed coverage ratios for the total of HSBC s other principal entities remained broadly unchanged.

Liquid assets of HSBC s principal operating entities

The table below shows the estimated liquidity value (before assumed haircuts) of assets categorised as liquid used for the purposes of calculating the

three-month stressed coverage ratios, as defined under the LFRF.

Unencumbered assets held as a consequence of a reverse repo transaction with a residual contractual maturity within the stressed coverage ratio time period and unsecured interbank loans maturing within three months are not included in liquid assets, but are treated as contractual cash inflows.

Liquid assets are held and managed on a stand-alone operating entity basis. Most of the liquid assets shown are held directly by each operating entity s Balance Sheet Management function, primarily for the purpose of managing liquidity risk, in line with the LFRF.

Liquid assets also include any unencumbered liquid assets held outside Balance Sheet Management for any other purpose. The LFRF gives ultimate control of all unencumbered assets and sources of liquidity to Balance Sheet Management.

For a summary of our liquid asset policy and definitions of the classifications shown in the table below, see the Appendix to Risk on page 278.

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Liquid assets of HSBC s principal entities

(Audited)

	Estimated liquidity value[45]	
	31 December 2013	31 December 2012
	US$m	US$m
HSBC UK[41]		
Level 1	**168,877**	138,812
Level 2	**1,076**	374
Level 3	**63,509**	27,656
	233,462	166,842
The Hongkong and Shanghai Banking Corporation[42]		
Level 1	**108,713**	112,167
Level 2	**5,191**	5,740
Level 3	**7,106**	3,968
	121,010	121,875
HSBC USA[43]		
Level 1	**43,446**	60,981
Level 2	**12,709**	15,609
Level 3	**5,044**	5,350
Other	**8,000**	6,521
	69,199	88,461
Total of HSBC s other principal entities[44]		
Level 1	**144,774**	154,445
Level 2	**12,419**	18,048
Level 3	**13,663**	6,468
Other		2,447
	170,856	181,408

For footnotes, see page 264.

All assets held within the liquid asset portfolio are unencumbered.

Liquid assets held by HSBC UK increased as a result of a rise in customer accounts, which led to an increase in the level of non-core deposits and, consequently, liquid assets. Liquid assets also increased due to the reclassification of equities qualifying as liquid assets under LFRF.

Liquid assets held by The Hongkong and Shanghai Banking Corporation remained broadly unchanged.

Liquid assets held by HSBC USA decreased as a result of the increase in loans and advances to customers.

Net contractual cash flows

The following table quantifies the contractual cash flows from interbank and intra-Group loans and deposits, and reverse repo, repo (including intra-Group transactions) and short positions for the principal entities shown. These contractual cash inflows and outflows are reflected gross in the numerator and denominator, respectively, of the one and three-month stressed coverage ratios and should be considered alongside the level of liquid assets.

Outflows included in the denominator of the stressed coverage ratios include the principal outflows associated with the contractual maturity of wholesale debt securities reported in the table headed Wholesale funding cash flows payable by HSBC under financial liabilities by remaining contractual maturities on page 222.

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Net cash inflows/(outflows) for interbank and intra-Group loans and deposits and reverse repo, repo and short positions

(Audited)

	At 31 December 2013		At 31 December 2012	
	Cash flows within one month US$m	**Cash flows from one to three months US$m**	Cash flows within one month US$m	Cash flows from one to three months US$m
Interbank and intra-Group loans and deposits				
HSBC UK[41]	**(19,033)**	**(5,272)**	(16,464)	(1,429)
The Hongkong and Shanghai Banking Corporation[42]	**2,314**	**7,487**	4,402	9,685
HSBC USA[43]	**(24,268)**	**729**	(30,269)	(473)
Total of HSBC s other principal entities[44]	**4,295**	**10,149**	5,419	10,511
Reverse repo, repo, stock borrowing, stock lending and outright short positions (including intra-Group)				
HSBC UK[41]	**(39,064)**	**149**	(4,184)	(13,776)
The Hongkong and Shanghai Banking Corporation[42]	**12,662**	**4,297**	13,672	2,501
HSBC USA[43]	**(11,001)**		(4,003)	62
Total of HSBC s other principal entities[44]	**(40,223)**	**9,551**	(31,951)	(231)

For footnotes, see page 264.

Net cash flow arising from interbank and intragroup loans and deposits

Under the LFRF, a net cash inflow within three months arising from interbank and intragroup loans and deposits will give rise to a lower liquid asset requirement. Conversely, a net cash outflow within three months arising from interbank and intra-Group loans and deposits will give rise to a higher liquid assets requirement.

Net cash flow arising from reverse repo, repo, stock borrowing, stock lending and outright short positions (including intra-Group)

A net cash inflow represents liquid resources in addition to liquid assets because any unencumbered asset held as a consequence of a reverse repo transaction with a residual contractual maturity within the stressed coverage ratio time period is not reflected as a liquid asset.

The impact of net cash outflow depends on whether the underlying collateral encumbered as a result will qualify as a liquid asset when released at the maturity of the repo. The majority of the Group s repo transactions are collateralised by liquid assets and, as such, any net cash outflow shown is offset by the return of liquid assets, which are excluded from the liquid asset table above.

Contingent liquidity risk arising from committed lending facilities

(Audited)

The Group s operating entities provide commitments to various counterparties. In terms of liquidity risk, the most significant risk relates to committed lending facilities which, whilst undrawn, give rise to contingent liquidity risk as they could be drawn during a period of liquidity stress. Commitments are given to customers and committed lending facilities are provided to consolidated multi-seller conduits established to enable clients to access flexible market-based sources of finance (see page 550), consolidated securities investment conduits and third-party sponsored conduits.

The consolidated securities investment conduits includes Solitaire and Mazarin Funding Limited (Mazarin) (see page 551). They issue asset-backed commercial paper secured against the portfolio of securities held by them. At 31 December 2013, HSBC UK had undrawn committed lending facilities to these conduits of US$15bn (2012: US$18bn), of which Solitaire represented US$11bn (2012: US$13bn) and the remaining US$4bn (2012: US$5.1bn) pertained to Mazarin. Although HSBC UK provides a liquidity facility, Solitaire and Mazarin have no need to draw on it so long as HSBC purchases the CP issued, which it intends to do for the foreseeable future. At 31 December 2013, the commercial paper issued by Solitaire and Mazarin was entirely held by HSBC UK. Since HSBC controls the size of the portfolio of securities held by these conduits, no contingent liquidity risk exposure arises as a result of these undrawn committed lending facilities.

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

The table below shows the level of undrawn commitments to customers outstanding for the five

largest single facilities and the largest market sector, and the extent to which they are undrawn.

The Group s contractual undrawn exposures at 31 December monitored under the contingent liquidity risk limit structure

(Audited)

	HSBC UK[41]		HSBC USA[43]		HSBC Canada		The Hongkong and Shanghai Banking Corporation[42]	
	2013 US$bn	2012 US$bn	**2013 US$bn**	2012 US$bn	**2013 US$bn**	2012 US$bn	**2013 US$bn**	2012 US$bn
Commitments to conduits								
Consolidated multi-seller conduits								
total lines	**10.1**	7.8	**2.5**	2.3	**1.0**	1.0		
largest individual lines	**0.7**	0.7	**0.5**	0.5	**0.7**	0.8		
Consolidated securities investment conduits								
total lines	**14.8**	18.1						
Third party conduits								
total lines			**0.7**	0.8				
Commitments to customers								
five largest[46]	**4.4**	6.0	**6.3**	6.0	**1.5**	1.7	**2.4**	2.1
largest market sector[47]	**9.5**	11.0	**8.2**	7.5	**3.4**	4.5	**2.7**	2.4

For footnotes, see page 264.

Sources of funding

(Audited)

Our primary sources of funding are customer current accounts and customer savings deposits payable on demand or at short notice. We issue wholesale securities (secured and unsecured) to supplement our customer deposits and change the currency mix, maturity profile or location of our liabilities.

The Funding sources and uses table below, which provides a consolidated view of how our balance sheet is funded, should be read in the light of the LFRF, which requires operating entities to manage liquidity and funding risk on a stand-alone basis.

The table analyses our consolidated balance sheet according to the assets that primarily arise from operating activities and the sources of funding primarily supporting these activities. The assets and liabilities that do not arise from operating activities are presented as a net balancing source or deployment of funds.

The level of customer accounts continued to exceed the level of loans and advances to customers. Excluding the effect of repos from customer accounts and reverse repos from loans and advances to customers, the advances to deposits ratio at 31 December 2013 was 73% (2012: 73%). The positive funding gap was predominantly deployed in liquid assets; cash and balances with central banks and financial investments, as required by the LFRF.

Loans and other receivables due from banks continued to exceed deposits taken from banks. The Group remained a net unsecured lender to the banking sector.

Repos and stock lending

GB&M provides collateralised security financing services to its clients, providing them with cash financing or specific securities. When cash is provided to clients against collateral in the form of securities, the cash provided is recognised on the balance sheet as a reverse repo. When securities are provided to clients against cash collateral the cash received is recognised on the balance sheet as a repo or, if the securities are equity securities, as stock lending.

Each operating entity manages its collateral through a central collateral pool, in line with the LFRF. When specific securities need to be delivered and the entity does not have them currently available within the central collateral pool, the securities are borrowed on a collateralised basis. When securities are borrowed against cash collateral the cash provided is recognised on the balance sheet as a reverse repo or, if the securities are equity securities, as stock borrowing.

Operating entities may also borrow cash against collateral in the form of securities, using the securities available in the central collateral pool. Repos and stock lending can be used in this way to fund the cash requirement arising from securities owned outright by

Report of the Directors: Financial Review (continued)

Markets to facilitate client business, and the net cash requirement arising from financing client securities activity.

Reverse repos, stock borrowing, repos and stock lending are reported net when the IFRSs offsetting criteria are met. In some cases transactions to borrow or lend securities are collateralised using securities. These transactions are off-balance sheet.

Securities reflected on the balance sheet that are pledged as collateral against an existing liability or lent are reflected as encumbered for the duration of the transaction. When securities are received as collateral or borrowed, and when we have the right to sell or re-pledge these securities, they are reflected as available and unencumbered for the duration of the transaction, unless re-pledged or sold. Further analysis regarding the encumbrance of securities resulting from repos and stock lending and available unencumbered assets arising from reverse repos and stock borrowing is provided under the heading Encumbered and unencumbered assets starting on page 223.

In the normal course of business we do not seek to utilise repo financing as a source of funding to finance customer assets, beyond the collateralised security financing activities within Global Markets described above.

The original contractual maturity of reverse repo, stock borrowing, repo and stock lending is short term with the vast majority of transactions being for less than 90 days.

The residual contractual maturity profile of the balance sheet is set out on in Note 33 on the Financial Statements.

Any security accepted as collateral for a reverse repo or stock borrowing transaction must be of very high quality and its value subject to an appropriate haircut. Securities borrowed under reverse repo or stock borrowing transactions can only be recognised as part of the liquidity asset buffer for the duration of the transactions and only if the security received is eligible under the liquid asset policy within the LFRF.

Credit controls are in place to ensure that the fair value of any collateral received remains appropriate to collateralise the cash or fair value of securities given.

In 2013, GB&M changed the way it manages repo and reverse repo activities in the Credit and Rates businesses, which were previously being managed in a trading environment. During the year, the repo and reverse repo business activities were organised into trading and non-trading portfolios, with separate risk management procedures. As demonstrated in the Funding sources and uses table below, this resulted in an increase in the amount of reverse repos classified as Loans and advances to customers and Loans and advances to banks , and a decline in the amount classified as Trading assets at 31 December 2013, compared with previous year-ends. Similarly, at 31 December 2013 there was an increase in the amount of repos classified as Customer accounts and Deposits by banks with a decline in the amount classified as Trading liabilities , compared with previous year-ends.

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Funding sources and uses

(Audited)

	2013 US$m	2012 US$m
Sources		
Customer accounts	**1,482,812**	1,340,014
repos	**121,515**	28,618
cash deposits	**1,361,297**	1,311,396
Deposits by banks	**129,212**	107,429
repos	**42,705**	11,949
cash deposits	**86,507**	95,480
Debt securities issued	**104,080**	119,461
Liabilities of disposal groups held for sale	**2,804**	5,018
Subordinated liabilities	**28,976**	29,479
Financial liabilities designated at fair value	**89,084**	87,720
Liabilities under insurance contracts	**74,181**	68,195
Trading liabilities	**207,025**	304,563
repos	**17,421**	130,223
stock lending	**12,218**	6,818
settlement accounts	**17,428**	17,108
other trading liabilities	**159,958**	150,414
Total equity	**190,459**	183,129
	2,308,633	2,245,008

	2013 US$m	2012 US$m
Uses		
Loans and advances to customers	**1,080,304**	997,623
reverse repos	**88,215**	34,651
stock borrowing	**65**	13
loans and other receivables	**992,024**	962,959
Loans and advances to banks	**211,521**	152,546
reverse repos	**91,475**	35,461
loans and other receivables	**120,046**	117,085
Assets held for sale	**4,050**	19,269
Trading assets	**303,192**	408,811
reverse repos	**10,120**	118,681
stock borrowing	**10,318**	16,071
settlement accounts	**19,435**	14,510
other trading assets	**263,319**	259,549

Financial investments	**425,925**	421,101
Cash and balances with central banks	**166,599**	141,532
Net deployment in other balance sheet assets and liabilities	**117,042**	104,126
	2,308,633	2,245,008

Cross-border, intra-Group and

cross-currency liquidity and funding risk

(Unaudited)

The stand-alone operating entity approach to liquidity and funding mandated by the LFRF restricts the exposure of our operating entities to the risks that can arise from extensive reliance on cross-border funding. Operating entities manage their funding sources locally, focusing predominantly on the local customer deposit base. The RBWM, CMB and GPB customer relationships that give rise to core deposits within an operating entity generally reflect a local customer relationship with that operating entity. Access to public debt markets is co-ordinated globally by the Global Head of Balance Sheet Management and the Group Treasurer with Group ALCO monitoring all planned public debt issuance on a monthly basis. As a general principle, operating entities are only permitted to issue in their local currency and are encouraged to focus on local private placements. The public issuance of debt instruments in foreign currency is tightly controlled and generally restricted to HSBC Holdings and HSBC Bank.

A central principle of our stand-alone approach to LFRM is that operating entities place no future reliance on other Group entities. However, operating entities may, at their discretion, utilise their respective committed facilities from other Group entities if

necessary. In addition, intra-Group large exposure limits are applied by national regulators to individual legal entities locally, which restricts the unsecured exposures of legal entities to the rest of the Group to a percentage of the lender s regulatory capital.

Our LFRF also considers the ability of each entity to continue to access foreign exchange markets under stress when a surplus in one currency is used to meet a deficit in another currency, for example, by using the foreign currency swap markets. Where appropriate, operating entities are required to monitor stressed coverage ratios and ACF ratios for non-local currencies and set limits for them. Foreign currency swap markets in currency pairs settled through the Continuous Link Settlement Bank are considered to be extremely deep and liquid and it is assumed that capacity to access these markets is not exposed to idiosyncratic risks.

For the majority of operating entities within the Group, the only material non-local currency (exceeding 10% of balance sheet liabilities) is the US dollar. The euro is in an additional material non-local currency for HSBC UK and offshore renminbi is material for The Hongkong and Shanghai Banking Corporation. Singapore dollars and Indian rupees are also material currencies for The Hongkong and Shanghai Banking Corporation, but these currencies are managed onshore within the local country branch operations on a stand-alone branch basis.

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Wholesale funding cash flows payable by HSBC under financial liabilities by remaining contractual maturities

(Unaudited)

	Due not more than 1 month US$m	Due over 1 month but not more than 3 months US$m	Due over 3 months but not more than 6 months US$m	Due over 6 months but not more than 9 months US$m	Due over 9 months but not more than 1 year US$m	Due over 1 year but not more than 2 years US$m	Due over 2 years but not more than 5 years US$m	Due over 5 years US$m	Total US$m
At 31 December 2013									
Debt securities issued	**25,426**	**9,752**	**17,942**	**11,659**	**10,587**	**31,839**	**46,934**	**31,066**	**185,205**
unsecured CDs and CP	**7,589**	**7,206**	**9,867**	**3,239**	**5,043**	**4,449**	**2,749**		**40,142**
unsecured senior MTNs	**6,284**	**71**	**5,448**	**4,221**	**3,062**	**21,428**	**33,091**	**21,433**	**95,038**
unsecured senior structured notes	**987**	**1,423**	**1,952**	**1,689**	**1,718**	**3,712**	**6,036**	**5,021**	**22,538**
secured covered bonds				**1,250**		**225**	**2,747**	**3,317**	**7,539**
secured ABCP	**10,383**								**10,383**
secured ABS	**74**	**1,052**	**675**	**1,260**	**764**	**1,861**	**2,311**		**7,997**
others	**109**					**164**		**1,295**	**1,568**
Subordinated liabilities		**28**	**1,171**	**144**	**6**	**1,460**	**3,374**	**41,801**	**47,984**
subordinated debt securities		**28**	**1,171**	**144**	**6**	**460**	**3,374**	**34,899**	**40,082**
preferred securities						**1,000**		**6,902**	**7,902**
	25,426	**9,780**	**19,113**	**11,803**	**10,593**	**33,299**	**50,308**	**72,867**	**233,189**
At 31 December 2012									
Debt securities issued	19,280	20,724	22,479	10,269	14,934	27,716	56,543	25,970	197,915
unsecured CDs and CP	3,736	12,176	6,707	1,632	1,709	3,502	763		30,225
unsecured senior MTNs	201	5,360	12,655	6,772	10,411	15,318	41,381	17,299	109,397
unsecured senior structured notes	487	1,112	1,694	1,075	897	2,584	5,779	6,208	19,836
secured covered bonds			1,133	422	758	3,578	4,557	826	11,274
secured ABCP	14,583	1,891							16,474
secured ABS	104	175	211	339	633	1,677	2,072	525	5,736
others	169	10	79	29	526	1,057	1,991	1,112	4,973
Subordinated liabilities	7	44			10	1,296	2,550	43,949	47,856

subordinated debt securities	7	44			10	1,296	1,550	36,005	38,912
preferred securities							1,000	7,944	8,944
	19,287	20,768	22,479	10,269	14,944	29,012	59,093	69,919	245,771

Report of the Directors: Financial Review (continued)

Measured in terms of consolidated total liabilities excluding capital, only four currencies (US dollar, sterling, euro and Hong Kong dollar) represent more than 5% of total liabilities.

Wholesale term debt maturity profile

(Unaudited)

The maturity profile of our wholesale term debt obligations is set out above in the table headed Wholesale funding principal cash flows payable by HSBC under financial liabilities by remaining contractual maturities .

The balances in the table do not agree directly with those in the consolidated balance sheet as the table presents gross cash flows relating to principal payments and not the balance sheet carrying value, which includes debt securities and subordinated liabilities measured at fair value.

The basis of preparation of this table has changed from that presented in the *Annual Report and Accounts 2012*, which included future coupon payments in addition to the principal amounts. The disclosure of principal amounts only is consistent with how we manage the associated liquidity and funding risk.

Encumbered and unencumbered assets

(Unaudited)

The table on page 225, Analysis of on-balance sheet encumbered and unencumbered assets , summarises the total on and off-balance sheet assets that are capable of supporting future funding and collateral

needs and shows the extent to which these assets are currently pledged for this purpose. The objective of this disclosure is to facilitate an understanding of available and unrestricted assets that are valued on a liquidity and funding risk basis and could be used to support potential future funding and collateral needs.

The disclosure is not designed to identify assets which would be available to meet the claims of creditors or to predict assets that would be available to creditors in the event of a resolution or bankruptcy.

An asset is defined as encumbered if it has been pledged as collateral against an existing liability, and as a result is no longer available to the Group to secure funding, satisfy collateral needs or be sold to reduce the funding requirement. An asset is therefore categorised as unencumbered if it has not been pledged against an existing liability. Unencumbered assets are further analysed into four separate sub-categories; readily realisable assets , other realisable assets , reverse repo/stock borrowing receivables and derivative assets and cannot be pledged as collateral .

At 31 December 2013, the Group held US$1,824bn of unencumbered assets that could be used to support potential future funding and collateral needs, representing 83% of the total assets that can support funding and collateral needs (on and off-balance sheet). Of this amount, US$754bn (US$723bn on-balance sheet) were assessed to be readily realisable.

Summary of assets available to support potential future funding and collateral needs (on and off-balance sheet)

(Unaudited)

	2013 US$bn	2012 US$bn
Total on-balance sheet assets	**2,671**	2,693
Less:		
Reverse repo/stock borrowing receivables and derivative assets	**(481)**	(562)
Other assets that cannot be pledged as collateral	**(257)**	(247)
Total on-balance sheet assets that can support funding and collateral needs	**1,933**	1,884
Add off-balance sheet assets:		
Fair value of collateral received from reverse repo/stock borrowing that is available to sell or repledge	**260**	296
Fair value of collateral received from derivatives that is available to sell or repledge	**5**	6
Total assets that can support funding and collateral needs (on and off-balance sheet)	**2,198**	2,186
Less:		
On-balance sheet assets pledged	**(187)**	(233)
Off-balance sheet collateral received from reverse repo/stock borrowing which has been repledged or sold	**(186)**	(203)
Off-balance sheet collateral received from derivative transactions which has been repledged or sold	**(1)**	(1)
Assets available to support future funding and collateral needs	**1,824**	1,749

223

The effect of active collateral management

Collateral is managed on an operating entity basis, consistent with the approach adopted in managing liquidity and funding. Available collateral held by each operating entity is managed as a single collateral pool. In deciding which collateral to pledge, each operating entity seeks to optimise the use of the available collateral pool within the confines of the LFRF, irrespective of whether the collateral pledged is recognised on-balance sheet or was received in respect of reverse repo, stock borrowing or derivative transactions.

Managing collateral in this manner affects the presentation of asset encumbrance in that we may encumber on-balance sheet holdings while maintaining available unencumbered off-balance sheet holdings, even though we are not seeking to directly finance the on-balance sheet holdings pledged.

In quantifying the level of encumbrance of negotiable securities, the encumbrance is analysed by individual security. When a particular security is encumbered and we hold the security both on-balance sheet and off-balance sheet with the right to repledge, we assume for the purpose of this disclosure that the off-balance sheet holding is encumbered ahead of the on-balance sheet holding.

An on-balance sheet encumbered and off-balance sheet unencumbered asset will occur, for example, if we receive a specific security as a result of a reverse repo/stock borrowing transaction, but finance the cash lent by pledging a generic collateral basket, even if the security received is eligible for the collateral basket pledged. It will also occur if we receive a generic collateral basket as a result of a reverse repo transaction but finance the cash lent by pledging specific securities, even if the securities pledged are eligible for the collateral basket.

Off-balance sheet collateral received and pledged for reverse repo and stock borrowing transactions

The fair value of assets accepted as collateral that we are permitted to sell or repledge in the absence

of default was US$260bn at 31 December 2013 (2012: US$296bn). The fair value of any such collateral sold or repledged was US$186bn (2012: US$203bn). We are obliged to return equivalent securities. These transactions are conducted under terms that are usual and customary to standard reverse repo and stock borrowing transactions.

The fair value of collateral received and repledged in relation to reverse repos and stock borrowing is reported on a gross basis. The related balance sheet receivables and payables are reported on a net basis where required under IFRSs netting criteria.

As a consequence of reverse repo and stock borrowing transactions where the collateral received could be but had not been sold or re-pledged, we held US$74bn (2012: US$93bn) of unencumbered collateral available to support potential future funding and collateral needs at 31 December 2013.

Off-balance sheet non-cash collateral received and pledged for derivative transactions

The fair value of assets accepted as collateral related to derivative transactions that we are permitted to sell or repledge in the absence of default was US$5bn (2012: US$6bn). The fair value of any such collateral sold or repledged was US$1bn (2012: US$1bn). We are obliged to return equivalent securities. These transactions are conducted under terms that are usual and customary to derivative transactions.

Analysis of on-balance sheet encumbered and unencumbered assets

The table below presents an analysis of on-balance sheet holdings only, and shows the amounts of balance sheet assets on a liquidity and funding basis that are encumbered. The table therefore excludes any available off-balance sheet holdings received in respect of reverse repos, stock borrowing or derivatives.

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Analysis of on-balance sheet encumbered and unencumbered assets

(Unaudited)

	Encumbered	Unencumbered				
	Assets pledged as collateral US$m	Readily realisable assets US$m	Other realisable assets US$m	Reverse repos/stock borrowing receivables & derivative assets US$m	Cannot be pledged as collateral US$m	Total US$m
At 31 December 2013						
Cash and balances at central banks		161,240	269		5,090	166,599
Items in the course of collection from other banks					6,021	6,021
Hong Kong Government certificates of indebtedness					25,220	25,220
Trading assets	99,326	142,211	14,654	20,438	26,563	303,192
Treasury and other eligible bills	3,402	17,976	206			21,584
debt securities	83,563	57,850			231	141,644
equity securities	8,373	55,156	363			63,892
loans and advances to banks	1,796	2,813	6,151	5,263	11,861	27,884
loans and advances to customers	2,192	8,416	7,934	15,175	14,471	48,188
Financial assets designated at fair value	19	2,706	1,883		33,822	38,430
Treasury and other eligible bills					50	50
debt securities	19	826	776		10,968	12,589
equity securities		1,874	1,103		22,734	25,711
loans and advances to banks		6	4		66	76
loans and advances to customers					4	4
Derivatives				282,265		282,265
Loans and advances to banks	162	8,342	80,231	91,475	31,311	211,521
Loans and advances to customers	32,218	102,203	854,724	86,346	4,813	1,080,304
Financial investments	54,473	289,093	31,096		51,263	425,925
Treasury and other eligible bills	2,985	72,849	2,052		226	78,112
debt securities	51,488	210,516	25,720		50,949	338,673
equity securities		5,728	3,324		88	9,140
Assets held for sale			4,050			4,050
Other assets	990	16,134	14,216		19,599	50,939
Current tax assets					985	985
Prepayments and accrued income					11,006	11,006
Interest in associates and joint ventures		12	16,356		272	16,640
Goodwill and intangible assets					29,918	29,918
Property, plant and equipment	38	654	6,353		3,802	10,847
Deferred tax					7,456	7,456
	187,226	722,595	1,023,832	480,524	257,141	2,671,318

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Analysis of on-balance sheet encumbered and unencumbered assets (continued)

	Encumbered	Unencumbered				
	Assets pledged as collateral US$m	Readily realisable assets US$m	Other realisable assets US$m	Reverse repos/stock borrowing receivables & derivative assets US$m	Cannot be pledged as collateral US$m	Total US$m
At 31 December 2012						
Cash and balances at central banks		139,963	220		1,349	141,532
Items in the course of collection from other banks					7,303	7,303
Hong Kong Government certificates of indebtedness					22,743	22,743
Trading assets	143,019	116,395	10,330	134,752	4,315	408,811
Treasury and other eligible bills	2,309	23,973				26,282
debt securities	97,157	47,311	205		4	144,677
equity securities	5,592	35,420	622			41,634
loans and advances to banks	20,588	1,909	2,582	50,376	2,816	78,271
loans and advances to customers	17,373	7,782	6,921	84,376	1,495	117,947
Financial assets designated at fair value		447	610		32,525	33,582
Treasury and other eligible bills		14			40	54
debt securities		431	128		11,992	12,551
equity securities		2	482		20,384	20,868
loans and advances to banks					55	55
loans and advances to customers					54	54
Derivatives				357,450		357,450
Loans and advances to banks	1,191	4,722	81,802	35,461	29,370	152,546
Loans and advances to customers	40,792	85,626	827,903	34,664	8,638	997,623
Financial investments	46,678	300,255	7,990		66,178	421,101
Treasury and other eligible bills	2,024	84,991	156		379	87,550
debt securities	44,654	214,545	4,112		64,451	327,762
equity securities		719	3,722		1,348	5,789
Assets held for sale			19,269			19,269
Other assets	1,600	18,601	11,621		22,894	54,716
Current tax assets					515	515
Prepayments and accrued income					9,502	9,502
Interest in associates and joint ventures			17,480		354	17,834
Goodwill and intangible assets					29,853	29,853
Property, plant and equipment			6,772		3,816	10,588
Deferred tax					7,570	7,570
	233,280	666,009	983,997	562,327	246,925	2,692,538

The US$32bn (2012: US$41bn) of loans and advances to customers reported in the table above as encumbered have been pledged predominantly to support the issuance of secured debt instruments such as covered bonds and ABSs, including asset-backed commercial paper issued by consolidated multi-seller conduits. It also includes those pledged in relation to any other form of secured borrowing.

In total, the Group pledged US$150bn (2012: US$152bn) of negotiable securities, predominantly as a result of market-making in securities financing to our clients.

Additional contractual obligations

Under the terms of our current collateral obligations under derivative contracts (which are ISDA compliant CSA contracts and contracts entered for pension obligations, and exclude the contracts entered for SPVs and ATEs) and based on the positions at 31 December 2013, we estimate that we could be required to post additional collateral of up to US$0.7bn (2012: US$1.5bn) in the event of a one-notch downgrade in credit ratings, which would increase to US$1.2bn (2012: US$2.5bn) in the event of a two-notch downgrade.

Report of the Directors: Financial Review (continued)

Definitions of the categories included in the table Analysis of on-balance sheet encumbered and unencumbered assets :

Encumbered assets are assets on our balance sheet which have been pledged as collateral against an existing liability, and as a result are assets which are unavailable to the bank to secure funding, satisfy collateral needs or be sold to reduce potential future funding requirements.

Unencumbered readily realisable assets are assets regarded by the bank to be readily realisable in the normal course of business to secure funding, meet collateral needs, or be sold to reduce potential future funding requirements, and are not subject to any restrictions on their use for these purposes.

Unencumbered other realisable assets are assets where there are no restrictions on their use to secure funding, meet collateral needs, or be sold to reduce potential future funding requirements, but they are not readily realisable in the normal course of business in their current form.

Unencumbered reverse repo/stock borrow receivables and derivative assets are assets related specifically to reverse repo, stock borrowing and derivative transactions. They are shown separately as these on-balance sheet assets cannot be pledged but often give rise to the receipt of non-cash assets which are not recognised on the balance sheet, and can additionally be used to raise secured funding, meet additional collateral requirements or be sold.

Unencumbered cannot be pledged as collateral are assets that have not been pledged and which we have assessed could not be pledged and therefore could not be used to secure funding, meet collateral needs, or be sold to reduce potential future funding requirements. An example is assets held by the Group s insurance subsidiaries that back liabilities to policyholders and support the solvency of these entities.

Historically, the Group has not recognised any contingent liquidity value for assets other than those assets defined under the LFRF as being liquid assets, and any other negotiable instruments that under stress are assumed to be realisable after three months, even though they may currently be realisable. This approach has generally been driven by our risk appetite not to place any reliance on central banks. In a few cases, we have recognised the contingent value of discrete pools of assets, but the amounts involved are insignificant. As a result, we have reported the majority of our loans and advances to customers and banks in the category Other realisable assets as management would need to perform additional actions in order to make the assets transferable and readily realisable.

Additional information

The amount of assets pledged to secure liabilities reported in Note 36 on the Financial Statements may be greater than the book value of assets reported as being encumbered in the table on page 225. Examples of where such differences occur are:

ABSs and covered bonds, where the amount of liabilities issued plus the required mandatory over-collateralisation is lower than the book value of assets pledged to the pool. Any difference is categorised in the table above as Unencumbered readily realisable assets ;

negotiable securities held by custodians or settlement agents, where a floating charge has been given over the entire holding to secure intra-day settlement liabilities, are only reported as encumbered to the extent that we have a liability to the custodian or settlement agent at the reporting date, with the balance reported as Unencumbered readily realisable assets ; and

assets pre-positioned with central banks or government agencies are only reported as encumbered to the extent that we have secured funding with the collateral. The unutilised pre-positioned collateral is reported as Unencumbered readily realisable assets .

Contractual maturity of financial liabilities

(Audited)

The balances in the table below do not agree directly with those in our consolidated balance sheet as the table incorporates, on an undiscounted basis, all cash flows relating to principal and future coupon payments (except for trading liabilities and derivatives not treated as hedging derivatives). Undiscounted cash flows payable in relation to hedging derivative liabilities are classified according to their contractual maturities. Trading liabilities and derivatives not treated as hedging derivatives are included in the On demand time bucket and not by contractual maturity.

A maturity analysis of repos and debt securities in issue included in trading liabilities is presented in Note 33 on the Financial Statements.

In addition, loan and other credit-related commitments and financial guarantees and similar contracts are generally not recognised on our balance sheet. The undiscounted cash flows potentially payable under financial guarantees and similar contracts are classified on the basis of the earliest date they can be called.

227

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Cash flows payable by HSBC under financial liabilities by remaining contractual maturities

(Audited)

	On demand US$m	Due within 3 months US$m	Due between 3 and 12 months US$m	Due between 1 and 5 years US$m	Due after 5 years US$m
At 31 December 2013					
Deposits by banks	**65,839**	**54,175**	**5,612**	**2,819**	**686**
Customer accounts	**1,124,635**	**277,459**	**69,542**	**15,520**	**726**
Trading liabilities	**207,025**				
Financial liabilities designated at fair value	**18,689**	**1,967**	**3,223**	**39,554**	**64,144**
Derivatives	**269,554**	**456**	**1,684**	**6,099**	**1,638**
Debt securities in issue	**2,528**	**35,401**	**33,695**	**46,141**	**6,526**
Subordinated liabilities	**55**	**391**	**2,687**	**11,871**	**44,969**
Liabilities of disposal groups held for sale	**1,011**	**241**	**229**	**66**	**5**
Other financial liabilities	**30,985**	**30,465**	**6,335**	**2,310**	**1,295**
	1,720,321	**400,555**	**123,007**	**124,380**	**119,989**
Loan and other credit-related commitments	**377,352**	**79,599**	**55,124**	**59,747**	**16,872**
Financial guarantees and similar contracts	**18,039**	**4,796**	**12,040**	**7,479**	**3,988**
	2,115,712	**484,950**	**190,171**	**191,606**	**140,849**
At 31 December 2012					
Deposits by banks	45,290	51,321	4,495	11,718	789
Customer accounts	1,035,636	229,642	62,650	17,508	720
Trading liabilities	304,564				
Financial liabilities designated at fair value	7,778	1,211	7,825	42,683	62,279
Derivatives	351,367	355	995	4,785	1,855
Debt securities in issue	64	37,938	37,167	45,433	6,034
Subordinated liabilities	7	386	1,149	9,058	46,322
Liabilities of disposal groups held for sale	1,416	993	707	201	24
Other financial liabilities	26,963	31,557	5,381	3,467	829
	1,773,085	353,403	120,369	134,853	118,852
Loan and other credit-related commitments	375,818	76,394	51,330	57,506	18,421
Financial guarantees and similar contracts	14,321	5,506	12,104	9,266	3,796
	2,163,224	435,303	183,803	201,625	141,069

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

HSBC Holdings

(Audited)

Liquidity Risk in HSBC Holdings is overseen by the HSBC Holdings Asset and Liability Committee (HALCO). Liquidity Risk arises because of HSBC Holdings obligation to make payments to debt holders as they fall due. The liquidity risk related to these cashflows is managed by matching debt obligations with internal loan cashflows and by maintaining an appropriate liquidity buffer that is monitored by HALCO. During 2013, HSBC Holdings issued US$2bn (2012: nil) of debt securities that qualify as capital in the UK but did not issue any senior debt (2012: US$2bn).

The balances in the table below do not agree directly with those on the balance sheet

of HSBC Holdings as the table incorporates, on an undiscounted basis, all cash flows relating to principal and future coupon payments (except for derivatives not treated as hedging derivatives). Undiscounted cash flows payable in relation to hedging derivative liabilities are classified according to their contractual maturities. Derivatives not treated as hedging derivatives are included in the On demand time bucket.

In addition, loan commitments and financial guarantees and similar contracts are generally not recognised on our balance sheet. The undiscounted cash flows potentially payable under financial guarantees and similar contracts are classified on the basis of the earliest date on which they can be called.

Cash flows payable by HSBC Holdings under financial liabilities by remaining contractual maturities

(Audited)

	On demand US$m	Due within 3 months US$m	Due between 3 and 12 months US$m	Due between 1 and 5 years US$m	Due after 5 years US$m
At 31 December 2013					
Amounts owed to HSBC undertakings	2,053	1,759	2,315	857	5,654
Financial liabilities designated at fair value		299	671	4,921	26,518
Derivatives	704				
Debt securities in issue		37	1,780	279	1,451
Subordinated liabilities		225	676	5,699	24,812
Other financial liabilities		885	284		
	2,757	3,205	5,726	11,756	58,435
Loan commitments	1,245				
Financial guarantees and similar contracts	52,836				
	56,838	3,205	5,726	11,756	58,435
At 31 December 2012					

Amounts owed to HSBC undertakings	3,032	604	1,096	1,918	7,570
Financial liabilities designated at fair value		269	807	5,345	31,970
Derivatives	760				
Debt securities in issue		36	107	1,946	1,487
Subordinated liabilities		205	614	3,273	25,049
Other financial liabilities		394	211		
	3,792	1,508	2,835	12,482	66,076
Loan commitments	1,200				
Financial guarantees and similar contracts	49,402				
	54,394	1,508	2,835	12,482	66,076

Report of the Directors: Financial Review (continued)

Market risk

1 *Appendix to Risk risk policies and practices.*

Report of the Directors: Financial Review (continued)

Market risk is the risk that movements in market factors, including foreign exchange rates and commodity prices, interest rates, credit spreads and equity prices, will reduce our income or the value of our portfolios.

There were no material changes to our policies and practices for the management of market risk in 2013 other than the introduction of Model Oversight Committees. These govern model risk at the regional and global levels of wholesale credit and market risk and are described in more detail on page 282.

A summary of our current policies and practices regarding market risk is provided in the Appendix to Risk on page 281.

Exposure to market risk

Exposure to market risk is separated into two portfolios:

Trading portfolios comprise positions arising from market-making and warehousing of customer-derived positions.

Non-trading portfolios comprise positions that primarily arise from the interest rate management of our retail and commercial banking assets and liabilities, financial investments designated as available for sale and held to maturity, and exposures arising from our insurance operations (see page 234).

Monitoring and limiting market risk exposures

Our objective is to manage and control market risk exposures while maintaining a market profile consistent with our risk appetite.

We use a range of tools to monitor and limit market risk exposures, including:

sensitivity analysis measures the impact of individual market factor movements on specific instruments or portfolios including interest rates, foreign exchange rates and equity prices for example the impact of a one basis point change in yield;

value at risk (VaR) is a technique that estimates the potential losses that could occur on risk positions as a result of movements in market rates and prices over a specified time horizon and to a given level of confidence; and

in recognition of VaR s limitations we augment it with *stress testing* to evaluate the potential impact on portfolio values of more extreme, though plausible, events or movements in a set of financial variables. Examples of scenarios reflecting current market concerns are the slowdown of mainland China and the potential effects of a sovereign debt default, including its wider contagion effects.

Market risk in 2013

(Audited)

Global financial markets generally continued to be supported by the accommodative monetary policies followed by leading central banks in 2013. However, the year was dominated by discussions around when and how quickly the US Federal Reserve would taper off its asset purchase programme. In addition, market sentiment worsened due to fears of negative spillovers for some emerging markets that had experienced slower economic growth and continued external imbalances. This led to interest rates climbing rapidly and volatile markets across most asset classes.

The delay by the US Federal Reserve in implementing the tapering process, coupled with the resolution of concerns around the US fiscal policy and the improving economic outlook in some developed countries, provided support for major equity markets reaching recent highs, credit spreads narrowing further and lower interest rates.

Against this backdrop, the defensive risk profile of the equity and foreign exchange businesses lead to lower trading VaR. Non-trading VaR increased during the period mainly as a result of an extension of the asset profile in the non-trading book.

Trading and non-trading portfolios

(Audited)

The following table provides an overview of the types of risks within our different global businesses.

Types of risk by global business

Risk types	Global businesses
Trading risk Foreign exchange and commodities Interest rate Equities Credit spread	GB&M including Balance Sheet Management (BSM)
Non-trading risk Foreign exchange (structural) Interest rate Credit spread	GB&M including BSM, RBWM, CMB and GPB

The vast majority of trading risk arises from GB&M businesses. The market risk for insurance operations is reported separately on page 254.

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Market risk reporting measures

The following table provides an overview of the reporting of risks within this section:

Overview of risk reporting

	Portfolio	
	Trading	**Non-trading**
Risk type		
Foreign exchange and commodity	**VaR**	**VaR**
Interest rate	**VaR**	**VaR/ Sensitivity**
Equity	**VaR**	**Sensitivity**
Credit spread	**VaR**	**VaR**
Structural foreign exchange	**n/a**	**Sensitivity**

The use of VaR is integrated into market risk management and is calculated for all trading positions regardless of how we capitalise those exposures. Where there is not an approved internal model, we use the appropriate local rules to capitalise exposures. In addition, we calculate VaR for non-trading portfolios in order to have a complete picture of risk. Our models are predominantly based on historical simulation. VaR is calculated at a 99% confidence level for a one-day holding period.

Where we do not calculate VaR explicitly, we use alternative tools as described in the table above. Structural foreign exchange risk is monitored using sensitivity analysis (see page 285).

The interest rate risk on the fixed-rate securities issued by HSBC Holdings is not included in the Group VaR. The management of this risk is described on page 286.

For a description of the parameters used in calculating VaR, see the Appendix to Risk on page 282.

Trading portfolios

(Audited)

Value at risk of the trading portfolios

Our Group trading VaR for the year is shown in the graph below.

Trading value at risk

	2013	2012
	US$m	US$m

At 31 December	**52.1**	78.8
Average	**49.9**	74.2
Minimum	**38.6**	47.3
Maximum	**81.3**	130.9

The daily levels of total trading VaR and trading VaR by risk type over the course of 2013 are set out in the graph below. The corresponding period-end levels and statistics for 2013 are illustrated in the table VaR by risk type for trading activities below.

Daily VaR (trading portfolios) (US$m)

(Unaudited)

Report of the Directors: Financial Review (continued)

Almost all trading VaR resides within Markets. The VaR for trading activity at 31 December 2013 was lower than at 31 December 2012 due primarily to the defensive risk profile of the equity and foreign exchange businesses. These contributions and a higher diversification benefit across asset classes led

to VaR trending lower during the year, even though a less defensive profile towards the end of the year resulted in a rising VaR. The spike observed during September was due to a syndicated underwriting undertaken by the Rates business and the risk was placed with investors.

VaR by risk type for trading activities[48]

(Audited)

	Foreign exchange and commodity US$m	Interest rate US$m	Equity US$m	Credit spread US$m	Portfolio diversification[49] US$m	Total[50] US$m
At 31 December 2013	**16.0**	**33.4**	**9.2**	**14.2**	**(20.7)**	**52.1**
Average	**15.2**	**33.4**	**5.1**	**16.5**	**(20.3)**	**49.9**
Minimum	**6.5**	**22.8**	**2.2**	**11.2**		**38.6**
Maximum	**26.4**	**71.9**	**14.1**	**25.5**		**81.3**
At 31 December 2012	20.5	37.5	17.7	16.1	(12.9)	78.8
Average	23.5	42.7	9.3	26.8	(28.1)	74.2
Minimum	6.9	29.5	2.7	12.2		47.3
Maximum	46.0	60.0	24.9	77.9		130.9

For footnotes, see page 265.

We routinely validate the accuracy of our VaR models by back-testing them against the hypothetical profit and loss that excludes non-modelled items such as fees, commissions and revenues of intra-day transactions from the actual reported profit and loss. The VaR (and hypothetical profit and loss) presented here is used for internal management purposes and differs from that used for managing our regulatory exposures.

We would expect on average to see two to three profits, and two or three losses, in excess of VaR at the 99% confidence level over a one-year period. The actual number of profits or losses in excess of VaR over this period can therefore be used to gauge how well the models are performing. To ensure a conservative approach to calculating our risk exposures, it is important to note that profits in excess of VaR are only considered when back-testing the accuracy of our models and are not used to calculate the VaR numbers used for risk management or capital purposes.

We back-test our Group VaR at various levels which reflect a full legal entity scope of HSBC, including entities that do not have local permission to use VaR for regulatory purposes. In 2013, there were no loss exceptions for the Group and major entities within the Group, including the Hongkong and Shanghai Banking Corporation, HSBC Bank and HNAH. However, there was one profit exception for the Group. There is no evidence of model errors or control failures. The exception was due primarily to gains from exposures to major interest rates and some emerging markets, positions on peripheral European sovereigns and client-driven trading positions in currency options.

The graph below shows the daily trading VaR against hypothetical profit and loss for the Group during 2013. On a case by case basis, the PRA may allow loss exceptions to be exempted for regulatory capital purposes.

233

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Backtesting of trading VaR against hypothetical profit and loss for the Group (US$m)

(Unaudited)

Stressed value at risk of the trading portfolios

(Unaudited)

Stressed VaR is primarily used for regulatory capital purposes and is integrated into the risk management process to facilitate efficient capital management and to highlight potentially risky positions based on previous market volatility. Stressed VaR complements other risk measures by providing the potential losses arising from market turmoil. Calculations are based on a continuous one-year period of stress for the trading portfolio, based on the assessment at the Group level of the most volatile period in recent history.

Stressed value at risk (one-day equivalent)

(Unaudited)

	2013	2012
	US$m	US$m
At 31 December	**92.7**	172.4

Stressed VaR reduced significantly, mainly due to defensive positions taken by the Equity and Foreign Exchange businesses at the start of 2013. As

a result, the overall risk profile minimised the losses from highly volatile periods and led to a relatively low stressed VaR compared with trading VaR. Stressed VaR increased towards the end of the year due to a less defensive profile in these businesses.

Non-trading portfolios

(Audited)

Value at risk of the non-trading portfolios

Non-trading value at risk

	2013	2012

	US$m	US$m
At 31 December	**154.6**	119.2
Average	**170.2**	197.9
Minimum	**114.7**	118.1
Maximum	**252.3**	322.5

The daily levels of non-trading total VaR and non-trading VaR by risk type over the course of 2013 are set out in the graph below. The corresponding period-end levels and statistics for 2013 are illustrated in the table VaR by risk type for non-trading activities below.

Daily VaR (non-trading portfolios) (US$m)

(Unaudited)

Report of the Directors: Financial Review (continued)

VaR by risk type for non-trading activities

(Unaudited)

	At 31 December Interest rate US$m	Credit spread US$m	Portfolio divers-ification US$m	Total US$m
2013	**150.6**	**80.4**	**(76.4)**	**154.6**
Average	**145.7**	**106.6**	**(82.1)**	**170.2**
Minimum	**84.6**	**80.4**		**114.7**
Maximum	**221.7**	**135.7**		**252.3**
2012	89.6	113.4	(83.7)	119.2
Average	103.7	179.9	(85.7)	197.9
Minimum	81.1	111.3		118.1
Maximum	122.8	322.1		322.5

Most of the Group non-trading VaR relates to Balance Sheet Management (BSM) or local treasury management functions. Contributions to Group non-trading VaR are driven by interest rates and credit spread risks arising from all global businesses, as illustrated on page 234. The increase of non-trading VAR during 2013 was due primarily to the extension of the asset profile in the non-trading book. This was partially offset by the reduced contribution of credit spread risks, as a result of lower volatilities and credit spread baselines utilised in the VaR calculations. This movement included the reduction in credit spread risks relating to the Group s holdings of available-for-sale debt securities (excluding those held in insurance operations), which is discussed further in the following section.

Non-trading VaR also includes the interest rate risk of non-trading financial instruments held by the global businesses and transferred into portfolios managed by BSM or local treasury functions. In measuring, monitoring and managing risk in our non-trading portfolios, VaR is just one of the tools used. The management of interest rate risk in the banking book is described further in Non-trading interest rate risk below, including the role of BSM.

Non-trading VaR excludes equity risk on available-for-sale securities, structural foreign exchange risk, and interest rate risk on fixed rate securities issued by HSBC Holdings, the scope and management of which are described in the relevant sections below.

Credit spread risk for available-for-sale debt securities

Credit spread VaR for available-for-sale debt securities, excluding those held in insurance operations, is included in the Group non-trading VaR. However, SICs are not included.

Movements in credit spreads can lead to losses in excess of those borne by the SICs capital note holders, which will impact our equity capital. At 31 December 2013, the sensitivity of equity capital to the effect of movements in credit spreads on our available-for-sale debt securities, including the gross exposure for the SICs consolidated within our balance sheet, based on credit spread VaR, was US$113m (2012: US$150m). This sensitivity was calculated before taking into account losses which would have been absorbed by the capital note holders. Excluding the gross exposure for SICs consolidated in our balance sheet, this exposure reduced to US$83m (2012: US$119m).

The decrease in this sensitivity at 31 December 2013 compared with 31 December 2012 was due mainly to the effect of lower volatilities and credit spread baselines observed during the year.

At 31 December 2013, the capital note holders would absorb the first US$2.3bn (2012: US$2.3bn) of any losses incurred by the SICs before we incur any equity losses.

Equity securities classified as available for sale

The fair value of the constituents of equity securities classified as available for sale can fluctuate considerably. The table below sets out the maximum possible loss on shareholders equity from available-for-sale equity securities. The increase in other strategic investments is largely due to the reclassification of our investment in Industrial Bank.

Fair value of equity securities

(Audited)

	2013 US$bn	2012 US$bn
Private equity holdings[51]	**2.7**	**2.9**
Funds invested for short-term cash management		0.2
Investment to facilitate ongoing business[52]	**1.2**	1.1
Other strategic investments	**5.2**	1.6
	9.1	5.8

For footnotes, see page 265.

Report of the Directors: Financial Review (continued)

Market risk balance sheet linkages

(Unaudited)

The information below aims to facilitate the understanding of linkages between line items in the

balance sheet and positions included in our market risk disclosures, in line with recommendations made by the Enhanced Disclosure Task Force.

Market risk linkages to the accounting balance sheet

Trading assets and liabilities

The Group s trading assets and liabilities are in substantially all cases originated by GB&M. The assets and liabilities are classified as held for trading if they have been acquired or incurred principally for the purpose of selling or repurchasing in the near term, or form part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent pattern of short-term profit-taking. These assets and liabilities are treated as traded risk for the purposes of market risk management, other than a limited number of exceptions, primarily in Global Banking where the short-term acquisition and disposal of the assets are linked to other non-trading related activities such as loan origination.

Financial assets designated at fair value

Financial assets designated at fair value within HSBC are predominantly held within the Insurance entities. The majority of these assets are linked to policyholder liabilities for either unit-linked or insurance and investment contracts with DPF. The risks of these assets largely offset the market risk on the liabilities under the policyholder contracts, and are risk managed on a non-trading basis.

hedge our own risks. Most of our derivative exposures arise from sales and trading activities within GB&M and are treated as traded risk for market risk management purposes.

Within derivative assets and liabilities there are portfolios of derivatives which are not risk managed on a trading intent basis and are treated as non-traded risk for VaR measurement purposes. These arise when the derivative was entered into in order to manage risk arising from non-traded exposures. They include non-qualifying hedging derivatives and derivatives qualifying for fair value and cash flow hedge accounting. The use of non-qualifying hedges whose primary risks relate to interest rate and foreign exchange exposure is described on page 285. Details of derivatives in fair value and cash flow hedge accounting relationships are given in Note 18 on the Financial Statements. Our primary risks in respect of these instruments relate to interest rate and foreign exchange risks.

Loans and advances to customers

The primary risk on assets within loans and advances to customers is the credit risk of the borrower. The risk of these assets is treated as non-trading risk for market risk management purposes.

Financial liabilities designated at fair value

Financial liabilities designated at fair value within HSBC are primarily fixed-rate securities issued by HSBC entities for funding purposes. An accounting mismatch would arise if the debt securities were accounted for at amortised cost because the derivatives which economically hedge market risks on the securities would be accounted for at fair value with changes recognised in the income statement. The market risks of these liabilities are treated as non-traded risk, the principal risks being interest rate and/or foreign exchange risks. We also incur liabilities to customers under investment contracts, where the liabilities on unit-linked contracts are based on the fair value of assets within the unit-linked funds. The exposures on these funds are treated as non-traded risk and the principal risks are those of the underlying assets in the funds.

Derivative assets and liabilities

We undertake derivative activity for three primary purposes; to create risk management solutions for clients, to manage the portfolio risks arising from client business and to manage and

Financial investments

Financial investments include assets held on an available-for-sale and held-to-maturity basis. An analysis of the Group s holdings of these securities by accounting classification and issuer type is provided in Note 19 on the Financial Statements and by business activity on page 69. The majority of these securities are mainly held within Balance Sheet Management in GB&M. The positions which are originated in order to manage structural interest rate and liquidity risk are treated as non-trading risk for the purposes of market risk management. Available-for-sale security holdings within insurance entities are treated as non-trading risk and are largely held to back non-linked insurance policyholder liabilities.

The other main holdings of available-for-sale assets are the ABSs within GB&M s legacy credit business, which are treated as non-trading risk for market risk management purposes, the principal risk being the credit risk of the obligor.

The Group s held-to-maturity securities are principally held within the Insurance business. Risks of held-to-maturity assets are treated as non-trading for risk management purposes.

For information on the accounting policies applied to financial instruments at fair value, see Note 2l on the Financial Statements.

Market risk for insurance operations is discussed on page 254.

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Balances included and not included in trading VaR

(Unaudited)

	At 31 December 2013			
	Balance sheet US$m	Balances included in trading VaR US$m	Balances not included in trading VaR US$m	Primary market risk sensitivities
Assets				
Cash and balances at central banks	**166,599**		**166,599**	**B**
Trading assets	**303,192**	**283,390**	**19,802**	**A**
Financial assets designated at fair value	**38,430**		**38,430**	**A**
Derivatives	**282,265**	**274,881**	**7,384**	**A**
Loans and advances to banks	**211,521**		**211,521**	**B**
Loans and advances to customers	**1,080,304**		**1,080,304**	**B**
Financial investments	**425,925**		**425,925**	**A**
Assets held for sale	**4,050**		**4,050**	**C**
Liabilities				
Deposits by banks	**129,212**		**129,212**	**B**
Customer accounts	**1,482,812**		**1,482,812**	**B**
Trading liabilities	**207,025**	**189,929**	**17,096**	**A**
Financial liabilities designated at fair value	**89,084**		**89,084**	**A**
Derivatives	**274,284**	**269,657**	**4,627**	**A**
Debt securities in issue	**104,080**		**104,080**	**C**
Liabilities of disposal groups held for sale	**2,804**		**2,804**	**C**

The table represents account lines where there is some exposure to market risk according to the following asset classes:

A *Foreign exchange, interest rate, equity and credit spread.*

B *Foreign exchange and interest rate.*

C *Foreign exchange, interest rate and credit spread.*

The table above splits the assets and liabilities into two categories:

those that are included in the trading book and measured by VaR; and those that are not in the trading book and/or measured by VaR.

The breakdown of financial instruments included and not included in trading VaR provides a linkage with market risk to the extent that it is reflected in our risk framework. However, it is important to highlight that the table does not reflect how we manage market risk, since we do not discriminate between assets and liabilities in our VaR model.

The assets and liabilities included in trading VaR give rise to a large proportion of the income included in net trading income. As disclosed in the income statement on page 51, HSBC s net trading income in 2013 was US$8,690m (2012: US$7,091m). Adjustments to trading income such as valuation adjustments do not feed the trading VaR model.

Structural foreign exchange exposures

(Unaudited)

For our policies and procedures for managing structural foreign exchange exposures, see page 285 of the Appendix to Risk.

For details of structural foreign exchange exposures see Note 35 on the Financial Statements.

Non-trading interest rate risk

(Unaudited)

For our policies regarding the funds transfer pricing process for non-traded interest rate risk and liquidity and funding risk, see page 280 and page 276, respectively, of the Appendix to Risk.

Asset, Liability and Capital Management (ALCM) is responsible for measuring and controlling non-trading interest rate risk under the supervision of the Risk Management Meeting. Its primary responsibilities are:

- to define the rules governing the transfer of non-traded interest rate risk from the global businesses to BSM;
- to define the rules governing the interest rate risk behaviouralisation applied to non-trading assets/liabilities (see below);
- to ensure that all market interest rate risk that can be neutralised is transferred from the global businesses to BSM; and
- to define the rules and metrics for monitoring the residual interest rate risk in the global businesses, including any market risk that can be neutralised.

The different types of non-trading interest rate risk and the controls which we use to quantify and limit exposure to these risks can be categorised as follows:

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

risk which is transferred to BSM and managed by BSM within a defined market risk mandate, predominantly through the use of fixed rate liquid assets (government bonds) held in available-for-sale portfolios and/or interest rate derivatives which are part of fair value hedging or cash flow hedging relationships. This non- traded interest rate risk is reflected in non-traded VaR, as well as in our net interest income or economic value of equity (EVE) sensitivity (see below);

risk which remains outside BSM because it cannot be hedged or which arises due to our behaviouralised transfer pricing assumptions. This risk is not reflected in non-traded VaR, but is captured by our net interest income or EVE sensitivity and corresponding limits are part of our global and regional risk appetite statements for non-trading interest rate risk. A typical example would be margin compression created by unusually low rates in key currencies;

basis risk which is transferred to BSM when it can be hedged. Any residual basis risk remaining in the global businesses is reported to ALCO. This risk is not reflected in non-traded VaR, but is captured by our net interest income or EVE sensitivity. A typical example would be a managed rate savings product transfer-priced using a Libor-based interest rate curve; and

model risks which cannot be captured by non-traded VaR, net interest income or EVE sensitivity, but are controlled by our stress testing framework. A typical example would be prepayment risk on residential mortgages or pipeline risk.

Interest rate risk behaviouralisation

Unlike liquidity risk which is assessed on the basis of a very severe stress scenario, non-traded market interest rate risk is assessed and managed on the basis of business-as-usual . In many cases the contractual profile of non-traded assets/liabilities arising from assets/liabilities created outside Markets or BSM does not reflect the behaviour observed under business-as-usual conditions. Behaviouralisation is therefore used to assess the market interest rate risk of non-traded assets/liabilities and this assessed market risk is transferred to BSM, in accordance with the rules governing the transfer of interest rate risk from the global businesses to BSM.

Behaviouralisation is applied in three key areas:

the assessed re-pricing frequency of managed rate balances;

the assessed duration of non-interest bearing balances, typically capital and current accounts; and

the base case expected prepayment behaviour or pipeline take-up rate for fixed rate balances with embedded optionality.

Interest rate behaviouralisation policies have to be formulated in line with the Group s behaviouralisation policies and approved at least annually by local ALCO, regional ALCM and Group ALCM, in conjunction with local, regional and Group market risk monitoring teams.

The extent to which balances can be behaviouralised is driven by:

the amount of the current balance that can be assessed as stable under business-as-usual conditions; and

- for managed rate balances the historic market interest rate re-pricing behaviour observed; or

- for non-interest bearing balances the duration for which the balance is expected to remain under business-as-usual conditions. This assessment is often driven by the re-investment tenors available to BSM to neutralise the risk through the use of fixed rate government bonds or interest rate derivatives, and for derivatives the availability of cash flow hedging capacity.

Balance Sheet Management

(Unaudited)

Effective governance across BSM is supported by the dual reporting lines it has to the CEO of GB&M and to the Group Treasurer. In each operating entity, BSM is responsible for managing liquidity and funding under the supervision of the local ALCO. It also manages the non-trading interest rate positions transferred to it within a Global Markets limit structure.

In executing the management of the liquidity risk on behalf of ALCO, and managing the non-trading interest rate positions transferred to it, BSM invests in highly-rated liquid assets in line with the Group s liquid asset policy. The majority of the liquidity is invested in central bank deposits and government, supranational and agency securities with most of the remainder held in short-term interbank and central bank loans.

Report of the Directors: Financial Review (continued)

Analysis of third-party assets in Balance Sheet Management

(Unaudited)

	At 31 December	
	2013	2012
	US$m	US$m
Cash and balances at central banks	134,086	93,946
Trading assets	5,547	8,724
Financial assets designated at fair value	72	74
Loans and advances:		
to banks	86,406	72,771
to customers	34,063	22,052
Financial investments	314,427	293,421
Other	3,700	2,948
	578,301	493,936

Withdrawable central bank deposits are accounted for as cash balances. Interbank loans, statutory central bank reserves and loans to central banks are accounted for as loans and advances to banks. BSM s holdings of securities are accounted for as available-for-sale or, to a lesser extent, held-to- maturity assets.

Statutory central bank reserves are not recognised as liquid assets. The statutory reserves that would be released in line with the Group s stressed customer deposit outflow assumptions are reflected as stressed inflows.

Third-party assets in BSM increased by 17% during 2013, reflecting an increase in commercial surplus which is reinvested by BSM. Deposits with central banks grew by US$40bn, driven by the placement of surplus funds in Europe and North America. Financial investments rose by 7% with an increase in Hong Kong due to the deployment of funds, partially offset by a reduction in North America due to net sales and maturities of government debt securities. Loans and advances to banks increased with higher levels of placements in Hong Kong and Rest of Asia-Pacific along with an increase in reverse repos in Europe.

BSM is permitted to use derivatives as part of its mandate to manage interest rate risk. Derivative activity is predominantly through the use of vanilla interest rate swaps which are part of cash flow hedging and fair value hedging relationships.

Credit risk in BSM is predominantly limited to short-term bank exposure created by interbank lending, exposure to central banks and high quality sovereigns, supranationals or agencies which constitute the majority of BSM s liquidity portfolio. BSM does not manage the structural credit risk of any Group entity balance sheets.

BSM is permitted to enter into single name and index credit derivatives activity, but it does so to manage credit risk on the exposure specific to its securities portfolio in limited circumstances only.

The risk limits are extremely limited and closely monitored. At 31 December 2013 and 31 December 2012 BSM had no open credit derivative index risk.

VaR is calculated on both trading and non-trading positions held in BSM. It is calculated by applying the same methodology used for the Markets business and utilised as a tool for market risk control purposes.

BSM holds trading portfolio instruments in only very limited circumstances. Positions and the associated VaR were not significant during 2013 and 2012.

Sensitivity of net interest income

(Unaudited)

The table below sets out the effect on our future net interest income of an incremental 25 basis points parallel rise or fall in all yield curves worldwide at the beginning of each quarter during the 12 months from 1 January 2014. The sensitivities shown represent the change in the base case projected net interest income that would be expected under the two rate scenarios assuming that all other non-interest rate risk variables remain constant, and there are no management actions. In deriving our base case net interest income projections the re-pricing rate of assets and liabilities used is derived from current yield curves.

A sequence of four parallel 25bps rises at the beginning of each quarter during the 12 months from 1 January 2014 (up-shock) would increase planned net interest income for 2014 by US$938m (2013: US$1,403m), while a sequence of four 25bps declines (down-shock) would decrease planned net interest income by US$1,734m (2013: US$1,550m).

The up-shock sensitivity declined in 2013, mostly as a result of a partial reversal of the margin compression experienced as rates dropped near to zero. This was partly due to the steepening of the yield curves in 2013 reflected in a higher base case net interest income projection, and partly due to an enhancement in our up-shock assumptions around customer managed rate re-pricing in the UK.

Net interest income and its associated sensitivity include the expense of funding trading assets, while related revenue is reported in Net trading income .

The asymmetry observed between the year-on-year change in the up-shock and the

Report of the Directors: Financial Review (continued)

down-shock is driven to some extent by the increase in repos recognised at amortised cost used to fund trading assets, following the change in the way GB&M manage repo and reverse repo activities. These repos were previously recognised as trading liabilities.

These figures incorporate the effect of any option features in the underlying exposures.

The interest rate sensitivities set out below are indicative and based on simplified scenarios. The limitations of this analysis are discussed in the Appendix to Risk on page 286.

Sensitivity of projected net interest income[53]

(Unaudited)

	US dollar bloc US$m	Rest of Americas bloc US$m	Hong Kong dollar bloc US$m	Rest of Asia bloc US$m	Sterling bloc US$m	Euro bloc US$m	Total US$m
Change in 2014 projected net interest income arising from a shift in yield curves of:							
+25 basis points at the beginning of each quarter	**(107)**	**12**	**327**	**236**	**598**	**(128)**	**938**
25 basis points at the beginning of each quarter	**(291)**	**(23)**	**(412)**	**(233)**	**(761)**	**(14)**	**(1,734)**
Change in 2013 projected net interest income arising from a shift in yield curves of:							
+25 basis points at the beginning of each quarter	133	64	246	237	679	44	1,403
25 basis points at the beginning of each quarter	(366)	(52)	(305)	(168)	(602)	(57)	(1,550)

For footnote, see page 265.

We monitor the sensitivity of reported reserves to interest rate movements on a monthly basis by assessing the expected reduction in valuation of available-for-sale portfolios and cash flow hedges due to parallel movements of plus or minus 100bps

in all yield curves. The table below describes the sensitivity of our reported reserves to these movements and the maximum and minimum month-end figures during the year.

Sensitivity of reported reserves to interest rate movements

(Unaudited)

		Maximum impact	Minimum impact
	US$m	US$m	US$m
At 31 December 2013			
+ 100 basis point parallel move in all yield curves	**(5,762)**	**(5,992)**	**(5,507)**
As a percentage of total shareholders equity	**(3.2%)**	**(3.3%)**	**(3.0%)**
100 basis point parallel move in all yield curves	**5,634**	**5,786**	**4,910**
As a percentage of total shareholders equity	**3.1%**	**3.2%**	**2.7%**
At 31 December 2012			
+ 100 basis point parallel move in all yield curves	(5,602)	(5,748)	(5,166)
As a percentage of total shareholders equity	(3.2%)	(3.3%)	(2.9%)
100 basis point parallel move in all yield curves	4,996	5,418	4,734
As a percentage of total shareholders equity	2.9%	3.1%	2.7%

Report of the Directors: Financial Review (continued)

The sensitivities above are indicative and based on simplified scenarios. The table shows the potential sensitivity of reported reserves to valuation changes in available-for-sale portfolios and from cash flow hedges following the specified shifts in yield curves. These particular exposures form only a part of our overall interest rate exposures. The accounting treatment of our remaining interest rate exposures, while economically largely offsetting the exposures shown in the above table, does not require revaluation movements to go to reserves.

Defined benefit pension schemes

(Audited)

Market risk arises within our defined benefit pension schemes to the extent that the obligations of the schemes are not fully matched by assets with determinable cash flows.

HSBC s defined benefit pension schemes

(Audited)

	2013 US$bn	2012 US$bn
Liabilities (present value)	**40.5**	38.1
	%	%
Assets:		
Equities	**18**	18
Debt securities	**70**	71
Other (including property)	**12**	11
	100	100

For details of our defined benefit schemes, see Note 7 on the Financial Statements, and for pension risk management see page 295.

Additional market risk measures applicable only to the parent company

(Audited)

The principal tools used in the management of market risk are VaR for foreign exchange rate risk and the projected sensitivity of HSBC Holdings net interest income to future changes in yield curves and interest rate gap re-pricing tables for interest rate risk.

Foreign exchange risk

Total foreign exchange VaR arising within HSBC Holdings in 2013 was as follows:

HSBC Holdings foreign exchange VaR

(Audited)

	2013	2012
	US$m	US$m
At 31 December	**54.1**	69.9
Average	**51.1**	51.4
Minimum	**46.7**	39.2
Maximum	**64.1**	69.9

The foreign exchange risk largely arises from loans to subsidiaries of a capital nature that are not denominated in the functional currency of either the provider or the recipient and which are accounted for as financial assets. Changes in the carrying amount of these loans due to foreign exchange rate differences are taken directly to HSBC Holdings income statement. These loans, and most of the associated foreign exchange exposures, are eliminated on a Group consolidated basis.

Sensitivity of net interest income

(Audited)

HSBC Holdings monitors net interest income sensitivity over a 5-year time horizon reflecting the longer-term perspective on interest rate risk management appropriate to a financial services holding company. The table below sets out the effect on HSBC Holdings future net interest income over a 5-year time horizon of incremental 25 basis point parallel falls or rises in all yield curves worldwide at the beginning of each quarter during the 12 months from 1 January 2014.

Assuming no management actions, a sequence of such rises would increase planned net interest income for the next five years by US$602m (2012: increase of US$532m), while a sequence of such falls would decrease planned net interest income by US$464m (2012: decrease of US$329m). These figures incorporate the effect of any option features in the underlying exposures.

241

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Sensitivity of HSBC Holdings net interest income to interest rate movements[53]

(Audited)

	US dollar bloc US$m	Sterling bloc US$m	Euro bloc US$m	Total US$m
Change in projected net interest income as at 31 December arising from a shift in yield curves				
2013				
of + 25 basis points at the beginning of each quarter				
0-1 year	**104**	**(14)**	**2**	**92**
2-3 years	**382**	**(93)**	**38**	**327**
4-5 years	**245**	**(101)**	**38**	**182**
of 25 basis points at the beginning of each quarter				
0-1 year	**(53)**	**13**	**(2)**	**(42)**
2-3 years	**(300)**	**91**	**(33)**	**(242)**
4-5 years	**(243)**	**101**	**(38)**	**(180)**
2012				
of + 25 basis points at the beginning of each quarter				
0-1 year	83	(23)	4	64
2-3 years	303	(108)	37	232
4-5 years	319	(120)	37	236
of 25 basis points at the beginning of each quarter				
0-1 year	(34)	21	(2)	(15)
2-3 years	(139)	65	(17)	(91)
4-5 years	(306)	118	(35)	(223)

For footnote, see page 265.

The interest rate sensitivities tabulated above are indicative and based on simplified scenarios. The figures represent hypothetical movements in net interest income based on our projected yield curve scenarios, HSBC Holdings current interest rate risk profile and assumed changes to that profile during the next five years. Changes to assumptions concerning the risk profile over the next five years can have a significant impact on the net interest income sensitivity for that period. However, the figures do not take into

account the effect of actions that could be taken to mitigate this interest rate risk.

Interest rate repricing gap table

The interest rate risk on the fixed-rate securities issued by HSBC Holdings is not included within the Group VaR but is managed on a repricing gap basis. The interest rate repricing gap table below analyses the full-term structure of interest rate mismatches within HSBC Holdings balance sheet.

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Repricing gap analysis of HSBC Holdings

(Audited)

	Total US$m	Up to 1 year US$m	From over 1 to 5 years US$m	From over 5 to 10 years US$m	More than 10 years US$m	Non-interest bearing US$m
At 31 December 2013						
Cash at bank and in hand:						
balances with HSBC undertakings	407	357				50
Derivatives	2,789					2,789
Loans and advances to HSBC undertakings	53,344	49,979	290	1,239	645	1,191
Financial investments	1,210	300		731		179
Investments in subsidiaries	92,695					92,695
Other assets	391					391
Total assets	150,836	50,636	290	1,970	645	97,295
Amounts owed to HSBC undertakings	(11,685)	(10,865)				(820)
Financial liabilities designated at fair values	(21,027)	(1,928)	(4,655)	(7,810)	(4,325)	(2,309)
Derivatives	(704)					(704)
Debt securities in issue	(2,791)	(1,722)			(1,069)	
Other liabilities	(1,375)					(1,375)
Subordinated liabilities	(14,167)		(3,030)	(2,066)	(8,912)	(159)
Total equity	(99,087)					(99,087)
Total liabilities and equity	(150,836)	(14,515)	(7,685)	(9,876)	(14,306)	(104,454)
Off-balance sheet items attracting interest rate sensitivity		(18,620)	4,382	9,876	4,421	(59)
Net interest rate risk gap		17,501	(3,013)	1,970	(9,240)	(7,218)
Cumulative interest rate gap		17,501	14,488	16,458	7,218	
At 31 December 2012						
Cash at bank and in hand:						
balances with HSBC undertakings	353	312				41
Derivatives	3,768					3,768
Loans and advances to HSBC undertakings	41,675	38,473		1,477	630	1,095
Financial investments	1,208		300	731		177
Investments in subsidiaries	92,234					92,234
Other assets	246					246
Total assets	139,484	38,785	300	2,208	630	97,561
Amounts owed to HSBC undertakings	(12,856)	(12,259)				(597)
Financial liabilities designated at fair values	(23,195)	(1,654)	(6,334)	(7,708)	(4,301)	(3,198)
Derivatives	(760)					(760)
Debt securities in issue	(2,691)		(1,648)		(1,051)	8
Other liabilities	(1,048)					(1,048)
Subordinated liabilities	(11,907)		(808)	(2,110)	(8,828)	(161)
Total equity	(87,027)					(87,027)

Total liabilities and equity	(139,484)	(13,913)	(8,790)	(9,818)	(14,180)	(92,783)
Off-balance sheet items attracting interest rate sensitivity		(18,583)	6,348	7,341	4,325	569
Net interest rate risk gap		6,289	(2,142)	(269)	(9,225)	5,347
Cumulative interest rate gap		6,289	4,147	3,878	(5,347)	

Report of the Directors: Financial Review (continued)

Operational risk

(Unaudited)

1 *Appendix to Risk risk policies and practices.*

Operational risk is relevant to every aspect of our business and covers a wide spectrum of issues, in particular legal, compliance, security and fraud. Losses arising from breaches of regulation and law, unauthorised activities, error, omission, inefficiency, fraud, systems failure or external events all fall within the definition of operational risk.

Responsibility for minimising operational risk lies with HSBC s management and staff. Each regional, global business, country, business unit and functional head is required to maintain oversight over the operational risks and internal controls of the business and operational activities for which they are responsible.

A summary of our current policies and practices regarding operational risk is provided in the Appendix to Risk on page 287.

Operational risk management framework

The Group Operational Risk function and the operational risk management framework (ORMF) directs business management in discharging their responsibilities.

The ORMF defines minimum standards and processes, and the governance structure for operational risk and internal control across the Group. To implement the ORMF a three lines of defence model is used for the management of risk, as described below:

Three lines of defence

A diagrammatic representation of the ORMF is presented below:

Report of the Directors: Financial Review (continued)

Operational risk management framework

RCAs are used to inform the evaluation of the effectiveness of controls over top risks.
KIs are used to help monitor the risks and controls.
TRAs (scenarios) provide management with a quantified view of our top and emerging operational risks.
Internal incidents are used to forecast typical losses.
External sources are used to inform the assessment of extreme TRAs.

We continued to refine our ORMF policies and procedures in 2013 and undertook various activities such as a global training programme to further embed the use of the framework in the management of the Group.

Articulating our risk appetite for material operational risks helps the organisation understand the level of risk HSBC is willing to accept. A Group Operational Risk appetite statement is approved annually by the Board under advice from the GRC. Monitoring operational risk exposure against risk appetite on a regular basis and implementing our risk acceptance process drives risk awareness in a forward-looking manner. It assists management in determining whether further action is required.

Operational risk and control assessments are performed by individual business units and functions. The risk and control assessment process is designed to provide business areas and functions with a forward looking view of operational risks and an assessment of the effectiveness of controls, and a tracking mechanism for action plans so that they can proactively manage operational risks within acceptable levels. Risk and control assessments are reviewed and updated at least annually.

Appropriate means of mitigation and controls are considered. These include:

- making specific changes to strengthen the internal control environment;
- investigating whether cost-effective insurance cover is available to mitigate the risk; and
- other means of protecting us from loss.

In addition, an enhanced Top Risk Analysis process is being implemented across material legal entities to improve the quantification and management of material risks through scenario analysis.

Operational risk in 2013

During 2013, our operational top and emerging risk profile continued to be dominated by compliance and legal risks as referred to in the 'Top and emerging risks' section and Note 43 on the Financial Statements. Losses were realised relating to events that occurred in previous years, albeit at a lower level than in 2012. These events included the possible historical mis-selling of payment protection insurance ('PPI') and interest rate protection products in the UK (see Note 31 on the Financial Statements). A number of mitigating actions continued to be taken to prevent future mis-selling incidents, including enhanced new product approval processes.

The incidence of regulatory proceedings and other adversarial proceedings against financial service firms is increasing. Proposed changes relating to capital and liquidity requirements, remuneration and/or taxes could increase our cost of doing business, reducing future profitability. Various regulators and competition authorities around the world are also

Report of the Directors: Financial Review (continued)

investigating and reviewing certain past submissions made by panel banks and the process for making submissions in connection with the setting of Libor, Euribor and other benchmark interest and foreign exchange rates. In response, we have undertaken a number of initiatives which seek to address the issues identified, including creating a Global management structure, enhancing our governance and oversight, increasing our compliance function resource, emphasising HSBC Values and designing and implementing new Global Standards as described on page 23. For further information, see Note 43 on the Financial Statements.

Other operational risks included:

fraud risks: the threat of fraud perpetrated by or against our customers, especially in retail and commercial banking, may grow during adverse economic conditions. We have increased monitoring, analysed root causes and reviewed internal controls to enhance our defences against external attacks and reduce the level of loss in these areas. In addition, Group Security and Fraud Risk worked closely with the global businesses to continually assess these threats as they evolve and adapt our controls to mitigate these risks;

level of change creating operational complexity: management and the Risk function are engaged in business transformation initiatives to ensure robust internal controls are maintained. This includes Risk participating in all relevant management committees. The Global Transactions team has developed a framework to be applied to the management of disposal risks;

information security: the security of our information and technology infrastructure is crucial for maintaining our banking applications and processes while protecting our customers and the HSBC brand. A failure of our defences against such attacks could result in financial loss and the loss of customer data and other sensitive information which could undermine both our reputation and our ability to retain the trust of our customers.

In common with other banks and multinational organisations, we continue to be target of distributed denial of service (DDoS) attacks which impact the availability of customer-facing websites. No evidence of customer data being breached was discovered as a result of these attacks.

This area will continue to be a focus of ongoing initiatives to strengthen the control environment.

Significant investment has already been made in enhancing controls, including increased training to raise staff awareness of the requirements, improved controls around data access and heightened monitoring of potential DDoS attacks. The Cyber Intelligence and Threat team continues to pro-actively develop our intelligence-driven responses to these attacks based on lessons learnt from previous attacks and through information sharing with other financial institutions, government agencies and external intelligence providers. We continue to refine our operational processes and contingency plans:

vendor risk management: we remain focused on the management of vendor risks and a pilot has commenced with our most critical suppliers to introduce a global performance tracking process; and

compliance with regulatory agreements and orders: in relation to the DPAs, the Group has committed to take or continue to adhere to a number of remedial measures. Breach of the DPAs at any time during its term may allow the DoJ or the New York County District Attorney s Office to prosecute HSBC in relation to the matters which are the subject of the DPAs. For further details see Note

43 on the Financial Statements.

Other operational risks are also monitored and managed through the use of the ORMF, including investments made to further improve the resilience of our payments infrastructure.

Further information on the nature of these risks is provided in Top and emerging risks on page 141.

Frequency and amount of operational risk losses

The profile of operational risk incidents and associated losses is summarised below, showing the distribution of operational risk incidents in terms of their frequency of occurrence and total loss amount in US dollars.

As in 2012, the operational risk incident profile in 2013 comprised both high frequency, low impact events and high impact events that occurred much less frequently. For example, losses due to external fraud incidents such as credit card fraud occurred more often than other types of event, but the amounts involved were often small in value. By contrast, operational risk incidents in the compliance category were relatively low frequency events, but the total cost was significant.

Report of the Directors: Financial Review (continued)

The number of fraud cases decreased in the past year due to the strengthening of the fraud control environment including transaction fraud monitoring capabilities. The total amount of fraud losses increased due to Madoff-related litigation costs.

Losses due to significant historical events including the possible mis-selling of PPI and interest rate protection products in the UK and the incidence of regulatory matters described in Note 43 on the Financial Statements remained substantial, but were significantly reduced from 2012.

Frequency of operational risk incidents by risk category (individual loss >US$10k)

Distribution of operational risk losses in US dollars by risk category

Compliance risk

(Unaudited)

Compliance risk is the risk that we fail to observe the letter and spirit of all relevant laws, codes, rules, regulations and standards of good market practice, and incur fines and penalties and suffer damage to our business as a consequence.

All Group companies and employees are required to observe the letter and spirit of all relevant laws, codes, rules, regulations and standards of good market practice.

In line with our ambition to be the world s leading international bank, we have committed to adopt and adhere to industry-leading compliance standards across the Group. One of the ways to achieve this is to ensure that we put in place a robust compliance risk management infrastructure.

In December 2012, we appointed a Global Head of Financial Crime Compliance with particular expertise and experience in US law and regulation. When we appointed a Global Head of Regulatory Compliance in April 2013, we restructured our previous Compliance sub-function within Global Risk into two new sub-functions: Financial Crime Compliance and Regulatory Compliance, jointly supported by Compliance Shared Services. This restructuring allows us to:

- manage different types of regulatory and financial crime compliance risk more effectively;
- focus our efforts appropriately in addressing the issues highlighted by regulatory investigations and reviews, internal audits and risk assessments of our past business activities; and

- ensure we have in place clear, robust accountability and appropriate expertise and processes for all areas of compliance risk.

Financial Crime Compliance sets policy and manages risks in the following areas:

- anti-money laundering, counter terrorist financing and proliferation finance;
- sanctions; and
- anti-bribery and corruption.

Regulatory Compliance sets policy and manages risks in the following areas:

- conduct of business;
- market conduct; and
- other applicable laws, rules and regulations.

We continue to invest in the Compliance sub- functions to ensure that, through their operation and the execution of the Group strategy, including measures to implement Global Standards, we are well positioned to meet increased levels of regulation and scrutiny from regulators and law enforcement agencies. In addition, the measures we have put in place are designed to ensure we have the appropriate people, processes and procedures to manage evolving markets, emerging risks and new products and business.

Report of the Directors: Financial Review (continued)

The Group s focus on compliance and conduct issues is further reinforced by the Financial System Vulnerabilities Committee which reports to the Board on matters relating to financial crime and financial system abuse and provides a forward-looking perspective on financial crime risk (see page 358). In addition, the Conduct & Values Committee which was established in January 2014, will report to the Board on matters relating to responsible business conduct and adherence to HSBC s Values (see page 25).

It is clear that the level of inherent compliance risk that we face will continue to remain high for the foreseeable future. However, we consider that good progress is being made and will continue to be made in ensuring that we are well placed to effectively manage those risks.

Fiduciary risk

(Unaudited)

Fiduciary risk is the risk to the Group of breaching our fiduciary duties when we act in a fiduciary capacity as trustee or investment manager or as mandated by law or regulation.

A fiduciary duty is one where HSBC holds, manages, oversees or has responsibility for assets for a third

party that involves a legal and/or regulatory duty to act with a high standard of care and with good faith. A fiduciary must make decisions and act in the interests of the third party and must place the wants and needs of the client first, above the needs of the Group.

We may be held liable for damages or other penalties caused by failure to act in accordance with these duties. Fiduciary duties may also arise in other circumstances, such as when we act as an agent for a principal, unless the fiduciary duties are specifically excluded (e.g. under the agency appointment contract).

Our principal fiduciary businesses (the designated businesses) have developed fiduciary risk appetite statements for their various fiduciary roles and have put in place key indicators to monitor their related risks.

Following a joint review between Global Operational Risk and RBWM, an appropriate governance structure is now in place to monitor fiduciary risk in the non-designated businesses conducting fiduciary activity within RBWM.

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Risk management of insurance operations

(Audited)

1 *Appendix to Risk policies and practices.*

The majority of the risk in our insurance business derives from manufacturing activities and can be categorised as insurance risk and financial risk. Insurance risk is the risk, other than financial risk, of loss transferred from the holder of the insurance contract to the issuer (HSBC). Financial risks include market risk, credit risk and liquidity risk.

There were no material changes during 2013 to our policies and practices for the management of risks arising in the insurance operations, including the risks relating to different life and non-life products. The RBWM Risk Management Committee assumed the responsibilities of the Group Insurance Risk Management Committee.

A summary of our policies and practices regarding the risk management of insurance operations, and the main contracts we manufacture, are provided in the Appendix to Risk on page 290 (unaudited).

HSBC s bancassurance model

We operate an integrated bancassurance model which provides insurance products principally for customers with whom we have a banking relationship. Insurance products are sold through all

global businesses, but predominantly by RBWM and CMB through our branches and direct channels worldwide.

The insurance contracts we sell relate to the underlying needs of our banking customers, which we can identify from our point-of-sale contacts and customer knowledge. The majority of sales are of savings and investment products and term and credit life contracts. By focusing largely on personal and SME lines of business we are able to optimise volumes and diversify individual insurance risks.

Where we have operational scale and risk appetite, mostly in life insurance, these insurance products are manufactured by HSBC subsidiaries. Manufacturing insurance allows us to retain the risks and rewards associated with writing insurance contracts by keeping part of the underwriting profit, investment income and distribution commission within the Group.

Where we do not have the risk appetite or operational scale to be an effective insurance manufacturer, we engage with a handful of leading external insurance companies in order to provide insurance products to our customers through our banking network and direct channels. These arrangements are generally structured with our exclusive strategic partners and earn the Group a

Report of the Directors: Financial Review (continued)

combination of commissions, fees and a share of profits.

We distribute insurance products in all of our geographical regions. We have core life insurance manufacturing entities, the majority of which are direct subsidiaries of legal banking entities, in seven countries (Argentina, Brazil, Mexico, France, UK, Hong Kong and Singapore). There are also manufacturing subsidiaries in mainland China, Malaysia, Malta and Ireland. The majority of our non-life insurance manufacturing entities and portfolios were disposed of between 2011 and 2013.

Risk management of insurance operations in 2013

The risk profile of our life insurance manufacturing businesses did not change materially during 2013 despite the increase in liabilities to policyholders on these contracts to US$74bn (2012: US$68bn). This growth in liabilities largely resulted from new premiums received during 2013 and market value gains on underlying financial assets.

The disposals of the remaining non-core non-life insurance manufacturing businesses were completed during the year. Net written non-life premiums therefore declined to US$84m (2012:

US$656m). At the reporting date substantially all remaining manufacturing business was life business.

Balance sheet of insurance manufacturing subsidiaries

(Audited)

A principal tool used to manage exposures to both financial and insurance risk, in particular for life insurance contracts, is asset and liability matching. In many markets in which we operate it is neither possible nor appropriate to follow a perfect asset and liability matching strategy. For long-dated non-linked contracts, in particular, this results in a duration mismatch between assets and liabilities. We therefore structure portfolios to support projected liabilities from non-linked contracts.

In the absence of insurable events occurring, unit-linked contracts match assets more directly with liabilities. This results in the policyholder bearing the majority of the financial risk exposure.

The tables below show the composition of assets and liabilities by contract and by geographical region and demonstrate that there were sufficient assets to cover the liabilities to policyholders in each case at the end of 2013.

Balance sheet of insurance manufacturing subsidiaries by type of contract

(Audited)

	Insurance contracts					Investment contracts				
	With	Unit-linked	Annu-ities	Other	Non-life US$m	With	Unit-	Non-	Other	Total US$m

	DPF US$m	US$m	US$m	long term[54] US$m		DPF[55] US$m	linked US$m	linked US$m	assets[56] US$m	
At 31 December 2013										
Financial assets	26,382	13,348	1,651	4,703	25	25,676	9,720	4,375	5,846	91,726
trading assets			3							3
financial assets designated at fair value	3,850	13,131	532	753	8	6,867	9,293	1,706	1,757	37,897
derivatives	1	3				215	5		55	279
financial investments	19,491		959	3,769	11	16,556		1,853	3,745	46,384
other financial assets	3,040	214	157	181	6	2,038	422	816	289	7,163
Reinsurance assets	182	291	522	436	3				2	1,436
PVIF[57]									5,335	5,335
Other assets and investment properties	757	284	23	113		791	19	31	546	2,564
Total assets	27,321	13,923	2,196	5,252	28	26,467	9,739	4,406	11,729	101,061
Liabilities under investment contracts:										
designated at fair value							9,730	3,761		13,491
carried at amortised cost								448		448
Liabilities under insurance contracts	26,920	13,804	2,158	4,848	24	26,427				74,181
Deferred tax[58]	12		17		1				1,163	1,193
Other liabilities									2,048	2,048
Total liabilities	26,932	13,804	2,175	4,848	25	26,427	9,730	4,209	3,211	91,361
Total equity									9,700	9,700
Total equity and liabilities[59]	26,932	13,804	2,175	4,848	25	26,427	9,730	4,209	12,911	101,061

250

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

	Insurance contracts					Investment contracts				
	With DPF US$m	Unit-linked US$m	Annu-ities US$m	Other long term[54] US$m	Non-life US$m	With DPF[55] US$m	Unit-linked US$m	Non-linked US$m	Other assets[56] US$m	Total US$m
At 31 December 2012										
Financial assets	24,288	12,619	1,785	4,350	356	23,620	8,780	4,315	4,692	84,805
trading assets			4							4
financial assets designated at fair value	2,333	12,440	571	756	196	6,043	8,206	1,486	987	33,018
derivatives	40	4		6		117	13	86	69	335
financial investments	18,283		932	3,315	73	16,022		1,853	2,928	43,406
other financial assets	3,632	175	278	273	87	1,438	561	890	708	8,042
Reinsurance assets	124	593	494	320	14				22	1,567
PVIF[57]									4,847	4,847
Other assets and investment properties	448	7	34	110	11	754	24	28	2,420	3,836
Total assets	24,860	13,219	2,313	4,780	381	24,374	8,804	4,343	11,981	95,055
Liabilities under investment contracts:										
designated at fair value							8,691	3,765		12,456
carried at amortised cost								455		455
Liabilities under insurance contracts	24,477	13,056	2,287	3,920	81	24,374				68,195
Deferred tax[58]	13		13	12	1				1,161	1,200
Other liabilities									2,760	2,760
Total liabilities	24,490	13,056	2,300	3,932	82	24,374	8,691	4,220	3,921	85,066
Total equity									9,989	9,989
Total equity and liabilities[59]	24,490	13,056	2,300	3,932	82	24,374	8,691	4,220	13,910	95,055

For footnotes, see page 265.

Our exposure to financial risks arising in the above balance sheet varies depending on the type of contract issued. For unit-linked contracts, the policyholder bears the majority of the exposure to financial risks whereas, for non-linked contracts, the majority of financial risks are borne by the

shareholder (HSBC). For contracts with DPF, the shareholder is exposed to financial risks to the extent that the exposure cannot be managed by utilising any discretionary participation (or bonus) features within the policy contracts issued.

251

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Balance sheet of insurance manufacturing subsidiaries by geographical region[60]

(Audited)

	Europe	Hong Kong	Rest of Asia-Pacific	North America[61]	Latin America	Total
	US$m	US$m	US$m	US$m	US$m	US$m
At 31 December 2013						
Financial assets	**41,557**	**39,338**	**3,014**		**7,817**	**91,726**
trading assets					**3**	**3**
financial assets designated at fair value	**20,742**	**9,824**	**1,596**		**5,735**	**37,897**
derivatives	**272**	**7**				**279**
financial investments	**18,080**	**25,247**	**1,258**		**1,799**	**46,384**
other financial assets	**2,463**	**4,260**	**160**		**280**	**7,163**
Reinsurance assets	**823**	**586**	**10**		**17**	**1,436**
PVIF[57]	**1,156**	**3,455**	**275**		**449**	**5,335**
Other assets and investment properties	**868**	**1,058**	**43**		**595**	**2,564**
Total assets	**44,404**	**44,437**	**3,342**		**8,878**	**101,061**
Liabilities under investment contracts:						
designated at fair value	**8,760**	**4,731**				**13,491**
carried at amortised cost					**448**	**448**
Liabilities under insurance contracts	**31,786**	**32,941**	**2,678**		**6,776**	**74,181**
Deferred tax[58]	**407**	**581**	**64**		**141**	**1,193**
Other liabilities	**1,474**	**282**	**89**		**203**	**2,048**
Total liabilities	**42,427**	**38,535**	**2,831**		**7,568**	**91,361**
Total equity	**1,977**	**5,902**	**511**		**1,310**	**9,700**
Total equity and liabilities[59]	**44,404**	**44,437**	**3,342**		**8,878**	**101,061**
At 31 December 2012						
Financial assets	37,325	35,632	2,594		9,254	84,805
trading assets					4	4
financial assets designated at fair value	17,590	7,356	1,370		6,702	33,018
derivatives	203	126	6			335
financial investments	17,139	23,275	994		1,998	43,406
other financial assets	2,393	4,875	224		550	8,042
Reinsurance assets	809	715	8		35	1,567
PVIF[57]	1,140	2,846	304		557	4,847
Other assets and investment properties	849	983	230	1,573	201	3,836
Total assets	40,123	40,176	3,136	1,573	10,047	95,055
Liabilities under investment contracts:						
designated at fair value	7,783	4,673				12,456
carried at amortised cost					455	455
Liabilities under insurance contracts	28,954	29,402	2,200		7,639	68,195

Deferred tax[58]	403	532	88		177	1,200
Other liabilities	782	347	267	1,037	327	2,760
Total liabilities	37,922	34,954	2,555	1,037	8,598	85,066
Total equity	2,201	5,222	581	536	1,449	9,989
Total equity and liabilities[59]	40,123	40,176	3,136	1,573	10,047	95,055

For footnotes, see page 265.

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Movement in total equity of insurance operations

(Audited)

	Total equity	
	2013 US$m	2012 US$m
At 1 January	**9,989**	10,629
Change in PVIF of long-term insurance business[57]	**525**	737
Return on net assets	**848**	1,232
Capital transactions	**(590)**	(1,525)
Disposals of subsidiaries/portfolios	**(675)**	(382)
Exchange differences and other	**(397)**	(702)
At 31 December	**9,700**	9,989

For footnote, see page 265.

Financial risks

(Audited)

Details on the nature of financial risks and how they are managed are provided in the Appendix to Risk on page 290.

Financial risks can be categorised into:

- *market risk* risk arising from changes in the fair values of financial assets or their future cash flows from fluctuations in variables such as interest rates, foreign exchange rates and equity prices;
- *credit risk* the risk of financial loss following the failure of third parties to meet their obligations; and
- *liquidity risk* the risk of not being able to make payments to policyholders as they fall due as there are insufficient assets that can be realised as cash.

The following table analyses the assets held in our insurance manufacturing subsidiaries at 31 December 2013 by type of contract, and provides a view of the exposure to financial risk. For unit-linked contracts, which pay benefits to policyholders determined by reference to the value of the investments supporting the policies, we typically designate assets at fair value; for non-linked contracts, the classification of the assets is driven by the nature of the underlying contract.

Financial assets held by insurance manufacturing subsidiaries

(Audited)

	Unit-linked contracts[62] US$m	Non-linked contracts[63] US$m	Other assets[56] US$m	Total US$m
At 31 December 2013				
Trading assets				
Debt securities		3		3
Financial assets designated at fair value	22,424	13,716	1,757	37,897
Treasury bills			50	50
Debt securities	7,809	3,910	546	12,265
Equity securities	14,615	9,806	1,161	25,582
Financial investments				
Held-to-maturity: debt securities		21,784	2,142	23,926
Available-for-sale:		20,855	1,603	22,458
debt securities		20,855	1,594	22,449
equity securities			9	9
Derivatives	8	216	55	279
Other financial assets[64]	636	6,238	289	7,163
Total financial assets[59]	23,068	62,812	5,846	91,726

253

Report of the Directors: Financial Review (continued)

Financial assets held by insurance manufacturing subsidiaries (continued)

(Audited)

	Unit-linked contracts[62] US$m	Non-linked contracts[63] US$m	Other assets[56] US$m	Total US$m
At 31 December 2012				
Trading assets				
Debt securities		4		4
Financial assets designated at fair value	20,646	11,385	987	33,018
Treasury bills		39		39
Debt securities	8,028	3,803	408	12,239
Equity securities	12,618	7,543	579	20,740
Financial investments				
Held-to-maturity: debt securities		20,245	1,548	21,793
Available-for-sale:		20,233	1,380	21,613
debt securities		20,226	1,354	21,580
equity securities		7	26	33
Derivatives	17	249	69	335
Other financial assets[64]	736	6,598	708	8,042
Total financial assets[59]	21,399	58,714	4,692	84,805

For footnotes, see page 265.

Approximately 64% of financial assets were invested in debt securities at 31 December 2013 (2012: 66%) with 28% (2012: 25%) invested in equity securities.

Under unit-linked contracts, premium income less charges levied is invested in a portfolio of assets. We manage the financial risks of this product on behalf of the policyholders by holding appropriate assets in segregated funds or portfolios to which the liabilities are linked. These assets represented 25% (2012: 25%) of the total financial assets of our insurance manufacturing subsidiaries at the end of 2013.

The remaining financial risks are managed either solely on behalf of the shareholder, or jointly on behalf of the shareholder and policyholders where DPF exist.

Market risk

(Audited)

Market risk arises when mismatches occur between product liabilities and the investment assets which back them. For example, mismatches between asset and liability yields and maturities give rise to interest rate risk.

Long-term insurance or investment products may incorporate benefits that are guaranteed. Fixed guaranteed benefits, for example for annuities in payment, are reserved for as part of the calculation of liabilities under insurance contracts.

In the case of products that offer guaranteed financial returns, if mismatches exist as a result of current yields falling below guaranteed levels for a prolonged period, the risk that shareholder capital is required to meet liabilities to policyholders increases. The table below shows the total reserve held for the stochastically modelled cost of guarantees under products manufactured by our insurance subsidiaries that offer a guaranteed level of financial return. The cost of guarantees is reserved for through policyholder liabilities to the extent that local reserving requirements require liabilities to be held, with the remainder accounted for as a deduction to PVIF on the relevant product. The table also shows the range of investment returns on the assets supporting these products and the implied investment returns that would enable the business to meet the guarantees.

The only portfolios of contracts where current investment returns are below guaranteed rates are reported in the nominal annual return 4.1-5.0% category in the table below. These relate to closed portfolios in Hong Kong (guaranteed rate 5.0%, current yield 4.1%) and France (guaranteed rate 4.5%, current yield 4.4%).

Report of the Directors: Financial Review (continued)

Financial return guarantees[59,65]

(Audited)

	2013			2012		
	Investment returns implied by guarantee %	**Current yields %**	**Cost of guarantees US$m**	Investment returns implied by guarantee %	Current yields %	Cost of guarantees US$m
Capital	**0.0**	**0.0 4.4**	**57**	0.0	0.0 3.3	83
Nominal annual return	**0.1 2.0**	**4.1 4.1**	**9**	0.1 2.0	3.1 3.1	10
Nominal annual return	**2.1 4.0**	**4.2 4.4**	**471**	2.1 4.0	3.3 4.3	503
Nominal annual return	**4.1 5.0**	**4.1 4.4**	**25**	4.1 5.0	3.3 4.1	22
Real annual return[66]	**0.0 6.0**	**6.4 6.4**	**13**	0.0 6.0	7.3 7.3	20
			575			638

For footnotes, see page 265.

In addition to the above a deduction from PVIF of US$134m (2012: US$214m) is made in respect of the modelled cost of guaranteed annuity options attached to certain unit-linked pension products.

The following table illustrates the effects of selected interest rate, equity price, foreign exchange rate and credit spread scenarios on our profit for the year and the total equity of our insurance manufacturing subsidiaries.

Where appropriate, we include the impact of the stress on the PVIF in the results of the sensitivity

tests. The relationship between the profit and total equity and the risk factors is non-linear and, therefore, the results disclosed should not be extrapolated to measure sensitivities to different levels of stress. The sensitivities are stated before allowance for management actions which may mitigate the effect of changes in market rates. The sensitivities presented allow for adverse changes in policyholder behaviour that may arise in response to changes in market rates.

Sensitivity of HSBC s insurance manufacturing subsidiaries to market risk factors

(Audited)

	2013		2012	
	Effect on profit after tax	**Effect on total equity**	Effect on profit after tax	Effect on total equity
	US$m	**US$m**	US$m	US$m
+ 100 basis points parallel shift in yield curves	**151**	**(199)**	125	(263)
100 basis points parallel shift in yield curves	**(230)**	**139**	(208)	205
10% increase in equity prices	**149**	**149**	91	91
10% decrease in equity prices	**(129)**	**(129)**	(92)	(92)
10% increase in US dollar exchange rate compared to all currencies	**21**	**21**	40	40
10% decrease in US dollar exchange rate compared to all currencies	**(21)**	**(21)**	(40)	(40)
Sensitivity to credit spread increases	**(21)**	**(46)**	(18)	(50)

Credit risk

(Audited)

Credit risk can give rise to losses through default and can lead to volatility in our income statement and balance sheet figures through movements in credit spreads, principally on the US$51bn (2012: US$48bn) bond portfolio supporting non-linked contracts and shareholders funds.

As tabulated above, the sensitivity of the net profit after tax of our insurance subsidiaries to the effects of increases in credit spreads has increased since 2012 due to portfolio growth during 2013. The balance and related movement are small because about 90% of the debt securities held by our

insurance subsidiaries are classified as either held to maturity or available for sale, and consequently any changes in the fair value of these financial investments, absent impairment, would have no effect on the profit after tax. We calculate the sensitivity using simplified assumptions based on a one-day movement in credit spreads over a two-year period. A confidence level of 99%, consistent with our Group VaR, is applied.

Credit quality

(Audited)

The following table presents an analysis of treasury bills, other eligible bills and debt securities within our insurance business by measures of credit quality.

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Only assets supporting liabilities under non-linked insurance and investment contracts and shareholders funds are included in the table as financial risk on assets supporting unit-linked liabilities is predominantly borne by the

policyholder. 83.4% (2012: 83.5%) of the assets included in the table are invested in investments rated as strong .

For a definition of the five credit quality classifications, see page 267 (unaudited).

Treasury bills, other eligible bills and debt securities in HSBC s insurance manufacturing subsidiaries

(Audited)

	Neither past due nor impaired				
	Strong US$m	Good US$m	Satisfactory US$m	Sub-standard US$m	Total US$m
At 31 December 2013					
Supporting liabilities under non-linked insurance and investment contracts					
Trading assets debt securities	**3**				**3**
Financial assets designated at fair value	**2,780**	**691**	**224**	**215**	**3,910**
debt securities	**2,780**	**691**	**224**	**215**	**3,910**
Financial investments debt securities	**36,113**	**4,596**	**1,699**	**231**	**42,639**
	38,896	**5,287**	**1,923**	**446**	**46,552**
Supporting shareholders funds[57]					
Financial assets designated at fair value	**191**	**298**	**73**	**34**	**596**
treasury and other eligible bills	**50**				**50**
debt securities	**141**	**298**	**73**	**34**	**546**
Financial investments debt securities	**3,356**	**176**	**139**	**65**	**3,736**
	3,547	**474**	**212**	**99**	**4,332**
Total[59]					
Trading assets debt securities	**3**				**3**
Financial assets designated at fair value	**2,971**	**989**	**297**	**249**	**4,506**
treasury and other eligible bills	**50**				**50**
debt securities	**2,921**	**989**	**297**	**249**	**4,456**
Financial investments debt securities	**39,469**	**4,772**	**1,838**	**296**	**46,375**
	42,443	**5,761**	**2,135**	**545**	**50,884**
At 31 December 2012					
Supporting liabilities under non-linked insurance and investment contracts					
Trading assets debt securities	1		3		4
Financial assets designated at fair value	2,807	638	219	178	3,842
treasury and other eligible bills	39				39
debt securities	2,768	638	219	178	3,803
Financial investments debt securities	34,392	4,265	1,627	187	40,471

	37,200	4,903	1,849	365	44,317
Supporting shareholders funds[57]					
Financial assets designated at fair value debt securities	229	146	13	20	408
Financial investments debt securities	2,356	353	131	62	2,902
	2,585	499	144	82	3,310
Total[59]					
Trading assets debt securities	1		3		4
Financial assets designated at fair value	3,036	784	232	198	4,250
treasury and other eligible bills	39				39
debt securities	2,997	784	232	198	4,211
Financial investments debt securities	36,748	4,618	1,758	249	43,373
	39,785	5,402	1,993	447	47,627

For footnotes, see page 265.

Report of the Directors: Financial Review (continued)

Credit risk also arises when assumed insurance risk is ceded to reinsurers. The split of liabilities ceded to reinsurers and outstanding reinsurance recoveries, analysed by credit quality, is shown

below. Our exposure to third parties under the reinsurance agreements described in the Appendix to Risk on page 293 is included in this table.

Reinsurers share of liabilities under insurance contracts

(Audited)

	Neither past due nor impaired				Past due	
	Strong US$m	Good US$m	Satisfactory US$m	Sub-standard US$m	but not impaired US$m	Total US$m
At 31 December 2013						
Unit-linked insurance	**72**	**218**				**290**
Non-linked insurance[68]	**1,103**	**8**	**7**			**1,118**
Total[59]	**1,175**	**226**	**7**			**1,408**
Reinsurance debtors	**17**	**1**			**10**	**28**
At 31 December 2012						
Unit-linked insurance	55	400				455
Non-linked insurance [68]	936	4	6		6	952
Total[59]	991	404	6		6	1,407
Reinsurance debtors	19	133			8	160

For footnotes, see page 265.

Liquidity risk

(Audited)

The following tables show the expected undiscounted cash flows for insurance contract liabilities and the remaining contractual maturity of investment contract liabilities at 31 December 2013. The liquidity risk exposure is borne in conjunction

with policyholders for the majority of our business, and wholly borne by the policyholder in the case of unit-linked business.

The profile of the expected maturity of the insurance contracts at 31 December 2013 remained comparable with 2012.

Expected maturity of insurance contract liabilities

(Audited)

	Expected cash flows (undiscounted)				
	Within 1 year US$m	1-5 years US$m	5-15 years US$m	Over 15 years US$m	Total US$m
At 31 December 2013					
Unit-linked insurance	**1,106**	**3,609**	**9,757**	**13,725**	**28,197**
Non-linked insurance[68]	**3,977**	**11,731**	**26,848**	**31,306**	**73,862**
Total[59]	**5,083**	**15,340**	**36,605**	**45,031**	**102,059**
At 31 December 2012					
Unit-linked insurance	1,243	3,761	10,446	13,497	28,947
Non-linked insurance[68]	4,254	12,202	23,420	27,836	67,712
Total[59]	5,497	15,963	33,866	41,333	96,659

For footnotes, see page 265.

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Remaining contractual maturity of investment contract liabilities

(Audited)

	Liabilities under investment contracts issued by insurance manufacturing subsidiaries[59]			
	Unit-linked investment contracts US$m	Investment contracts with DPF US$m	Other investment contracts US$m	Total US$m
At 31 December 2013				
Remaining contractual maturity:				
due within 1 year	**232**		**454**	**686**
due over 1 year to 5 years	**778**			**778**
due over 5 years to 10 years	**852**			**852**
due after 10 years	**2,254**			**2,254**
undated[60]	**5,614**	**26,427**	**3,755**	**35,796**
	9,730	**26,427**	**4,209**	**40,366**
At 31 December 2012				
Remaining contractual maturity:				
due within 1 year	195	4	458	657
due over 1 year to 5 years	675			675
due over 5 years to 10 years	731			731
due after 10 years	2,061			2,061
undated[60]	5,029	24,370	3,762	33,161
	8,691	24,374	4,220	37,285

For footnotes, see page 265.

Insurance risk

Following disposals of non-life entities and portfolios in 2012 and 2013, substantially all remaining manufacturing business is life business. Insurance risk is principally measured in terms of liabilities under the contracts.

A principal risk we continue to face is that, over time, the cost of acquiring and administering a contract, claims and benefits may exceed the aggregate amount of premiums received and investment income. The cost of claims and benefits

can be influenced by many factors, including mortality and morbidity experience, lapse and surrender rates and, if the policy has a savings element, the performance of the assets held to support the liabilities.

The following tables analyse our insurance risk exposures by geographical region and by type of business. The insurance risk profile and related exposures remained largely consistent with those observed at 31 December 2012.

Analysis of insurance risk liabilities under insurance contracts[60,61]

(Audited)

	Europe US$m	Hong Kong US$m	Rest of Asia-Pacific US$m	Latin America US$m	Total US$m
At 31 December 2013					
Non-linked insurance[68]	**1,383**	**28,588**	**1,966**	**2,013**	**33,950**
Insurance contracts with DPF[70]	**380**	**25,964**	**576**		**26,920**
Credit life	**130**		**74**		**204**
Annuities	**622**		**129**	**1,407**	**2,158**
Term assurance and other long-term contracts	**250**	**2,624**	**1,171**	**599**	**4,644**
Non-life insurance	**1**		**16**	**7**	**24**
Unit-linked insurance	**3,976**	**4,353**	**712**	**4,763**	**13,804**
Investment contracts with DPF[55,70]	**26,427**				**26,427**
Liabilities under insurance contracts	**31,786**	**32,941**	**2,678**	**6,776**	**74,181**

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

	Europe US$m	Hong Kong US$m	Rest of Asia-Pacific US$m	Latin America US$m	Total US$m
At 31 December 2012					
Non-linked insurance[68]	1,334	25,615	1,602	2,214	30,765
Insurance contracts with DPF[70]	353	23,685	439		24,477
Credit life	160		61		221
Annuities	586		122	1,579	2,287
Term assurance and other long-term contracts	220	1,930	965	584	3,699
Non-life insurance	15		15	51	81
Unit-linked insurance	3,249	3,786	594	5,427	13,056
Investment contracts with DPF[55,70]	24,370		4		24,374
Liabilities under insurance contracts	28,953	29,401	2,200	7,641	68,195

For footnotes, see page 265.

Our most significant life insurance products are investment contracts with DPF issued in France, insurance contracts with DPF issued in Hong Kong and unit-linked contracts issued in Latin America, Hong Kong and the UK.

Sensitivities to non-economic assumptions

(Audited)

Policyholder liabilities and PVIF for life manufacturers are determined by reference to non-economic assumptions including mortality and/or morbidity, lapse rates and expense rates. The table below shows the sensitivity of profit for 2013 and total equity at 31 December 2013 to reasonably possible changes in these non-economic assumptions at that date across all our insurance manufacturing subsidiaries, with comparatives for 2012.

Mortality and morbidity risk is typically associated with life insurance contracts. The effect on profit of an increase in mortality or morbidity depends on the type of business being written. Our largest exposures to mortality and morbidity risk exist in Brazil, France and Hong Kong.

Sensitivity to lapse rates depends on the type of contracts being written. For insurance contracts, claims are funded by premiums received and income earned on the investment portfolio supporting the

liabilities. For a portfolio of term assurance, an increase in lapse rates typically has a negative effect on profit due to the loss of future premium income on the lapsed policies. However, some contract lapses have a positive effect on profit due to the existence of policy surrender charges. Brazil, France, Hong Kong and the UK are where we are most sensitive to a change in lapse rates.

Expense rate risk is the exposure to a change in the cost of administering insurance contracts. To the extent that increased expenses cannot be passed on to policyholders, an increase in expense rates will have a negative effect on our profits.

Sensitivity analysis

(Audited)

	2013 US$m	2012 US$m
Effect on profit after tax and total equity at 31 December		
10% increase in mortality and/or morbidity rates	**(76)**	(88)
10% decrease in mortality and/or morbidity rates	**79**	92
10% increase in lapse rates[71]	**(119)**	(130)
10% decrease in lapse rates[71]	**133**	145
10% increase in expense rates	**(101)**	(106)
10% decrease in expense rates	**100**	107

For footnote, see page 265.

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Report of the Directors: Financial Review (continued)

Other material risks

1 *Appendix to Risk risk policies and practices.*

Reputational risk

(Unaudited)

Reputational risk can arise from issues, activities and associations that might pose a threat to the reputation of the Group locally, regionally or internationally.

We have continued to take steps to tackle the root causes of the deficiencies that, amongst other things, led to the Group entering into DPAs with various US authorities in relation to investigations regarding inadequate compliance with anti-money laundering and sanctions law in December 2012.

A number of measures to address the requirements of the DPAs and otherwise to enhance our anti-money laundering and sanctions compliance framework have been taken and are ongoing. These measures, which should also serve over time to enhance our reputational risk management, include the following:

- simplifying our business through the ongoing implementation of our Group strategy, including the adoption of a global risk filter which is helping to standardise our approach to doing business in higher risk countries;

- a substantial increase in resources and investment allocated to the Compliance function, and its reorganisation into two sub-functions (see Compliance risk on page 247);

- an increase in dedicated reputational risk resources centrally and in each region in which we operate and the introduction of a central case management and tracking process for reputational risk and client relationship matters;

- the continued roll-out of training and communication about the HSBC Values programme that defines the way everyone in the Group should act and seeks to ensure that the Values are embedded into our business as usual operations; and

- the ongoing development and implementation of the Global Standards by which we conduct our businesses. This includes ensuring there is a globally consistent approach to knowing and retaining our customers and enforcing a uniform global sanctions policy.

Detecting and preventing illicit actors access to the global financial system calls for constant vigilance and we will continue to cooperate closely with all governments to achieve success. This is integral to the execution of our strategy, to our core values and to preserving and enhancing our reputation.

Pension risk

(Audited)

We operate a number of pension plans throughout the world. Some are defined benefit plans, of which the largest is the HSBC Bank (UK) Pension Scheme (the principal plan).

There were no material changes to our policies and procedures for the management of pension risk in 2013.

During 2013, the Group s defined benefit pension plans increased from a net asset of US$32m to a net asset of US$125m. This was mainly due to reductions in plan liabilities outside the UK exceeding the deterioration in the UK principal plan net balance sheet position.

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

The principal plan

(Audited)

In 2006 the principal plan s assets consisted of a portfolio which reflected a largely equity-based strategy. At the time, HSBC and the Trustee of the principal plan agreed to change the investment strategy in order to reduce the investment risk and also to reduce the interest rate inflation risk of the principal plan. The target asset allocations for this strategy at that time, as revised in 2012 and at this year-end are shown below, demonstrating the ongoing evolution of the strategy. The strategy is to hold the majority of assets in bonds, with the remainder in a more diverse range of investments, and includes a portfolio of interest rate and inflation swaps (see Note 44 on the Financial Statements) by which the principal plan makes Libor-related interest payments in exchange for the receipt of cash flows which are based on projected future benefit payments to be made from the principal plan. HSBC and the Trustee have developed a general framework, which, over time, will see the Scheme s asset strategy evolve to be less risky: this is described in further detail below.

The principal plan target asset allocation

	2013 %	2012 %	2006 %
Equities[72]	**19.4**	15.5	15.0
Bonds	**64.5**	60.5	50.0
Alternative assets[73]	**10.6**	9.5	10.0
Property	**5.5**	9.0	10.0
Cash[74]		5.5	15.0
	100.0	100.0	100.0

For footnotes, see page 265.

As a result of a special contribution to the principal plan in June 2010 of £1,760m (US$2,638m), a cash generating portfolio was established. The portfolio comprised supra-national, agency and government-guaranteed securities, ABSs, corporate subordinated debt and auction rate securities. A further special contribution in December 2011 of £184m (US$286m) added to this portfolio. The contribution was used to purchase ABSs from HSBC at an arm s length value determined by the principal plan s independent third-party advisers. However, these assets may be supplemented with other assets from time to time.

The latest actuarial valuation of the principal plan was made as at 31 December 2011 by C G Singer, Fellow of the Institute of Actuaries, of Towers Watson Limited. At that date, the market value of the HSBC Bank (UK) Pension Scheme s assets was £18.3bn (US$28.3bn) (including assets

relating to the defined benefit plan, the defined contribution plan and additional voluntary contributions). The market value of the plan assets represented 100% of the amount expected to be required, on the basis of the assumptions adopted, to provide the benefits accrued to members after allowing for expected future increases in earnings. There was therefore no resulting surplus/deficit. The method adopted for this valuation was the projected unit method.

The expected cash flows from the principal plan were projected by reference to the Retail Price Index (RPI) swap break-even curve at 31 December 2011. Salary increases were assumed to be 0.5% per annum above RPI and inflationary pension increases, subject to a minimum of 0% and a maximum of 5% (maximum of 3% per annum in respect of service accrued since 1 July 2009), were assumed to be in line with RPI. The projected cash flows were discounted at the Libor swap curve at 31 December 2011 plus a margin for the expected return on the investment strategy of 160bps per annum. The mortality experience of the principal plan s pensioners over the six-year period (2006-2011) was analysed and, on the basis of this analysis, the mortality assumptions were set, based on the SAPS S1 series of tables adjusted to reflect the pensioner experience. Allowance was made for future improvements to mortality rates in line with the Continuous Mortality Investigation core projections with a long run improvement rate set at 2% for males and 1.5% for females. The benefits payable from the defined benefit plan from 2014 are expected to be as shown in the chart below.

Benefit payments (US$m)

As part of the 31 December 2011 valuation, calculations were also made of the amount of assets that might be needed to meet the liabilities if the principal plan was discontinued and the members benefits bought out with an insurance company (although in practice this may not be possible for a plan of this size) or the Trustee continued to run the plan without the support of HSBC. The amount

Report of the Directors: Financial Review (continued)

required under this approach was estimated to be £26.2bn (US$40.6bn) as at 31 December 2011. In arriving at this estimation, a more prudent assumption about future mortality was made than for the assessment of the ongoing position and it was assumed that the Trustee would alter the investment strategy to be an appropriately matched portfolio of UK government bonds. An explicit allowance for expenses was also included.

Based on the latest valuation as at 31 December 2011 and there being no deficit, no technical provisions recovery plan is required and the schedule of future funding payments agreed after the 2008 actuarial valuation was dissolved.

HSBC and the Trustee have developed a general framework which, over time, will see the principal plan s asset strategy evolve to be less risky and further aligned to the expected future cash-flows, referred to as the Target Matching Portfolio (TMP). The TMP would therefore contain sufficient assets, the majority of which will be bond-like in nature, which are more closely aligned to the liability profile. Progress towards the TMP can be achieved by asset returns in excess of that assumed and/or additional funding. In 2013, HSBC agreed to make general framework contributions of £64m (US$103m) in each of the calendar years 2013, 2014 and 2015 as well as £128m (US$212m) in 2016. Contingent upon the continued implementation of the general framework, further contributions have been agreed to be made in future years.

After the 2008 valuation, HSBC considered that the agreed recovery plan payments, together with investment returns (at an expected level of 240 basis points above the Libor swap curve), would be sufficient to meet the deficit as at 31 December 2008 over the agreed period. HSBC also agreed with the Trustee that at each subsequent actuarial valuation any shortfall in investment returns relative to this expected level, subject to a maximum of 50 basis points per annum, would be eliminated by payment of equal cash instalments over the remaining years to the end of the recovery plan period.

Although the 2011 triennial valuation disclosed no deficit and therefore no technical provisions recovery plan is required, HSBC and the Trustee have agreed to maintain this investment performance underwriting agreement. The investment performance will be assessed every three years, with an end date of 31 December 2017. Any payments due would only be payable if a technical provisions deficit is present at the reference date.

HSBC Bank is also making contributions to the principal plan in respect of the accrual of benefits of

defined benefit section members. Since April 2010, after completion of the 2008 valuation, HSBC has paid contributions at the rate of 34% of pensionable salaries (less member contributions).

Following completion of the 2011 triennial valuation, HSBC will pay contributions at the rate of 43% of pensionable salaries (less member contributions) from 1 April 2013. An additional employer contribution was paid in April 2013 equal to 9% of pensionable salaries, in respect of the period 1 January 2012 to 31 March 2013.

Future developments

(Unaudited)

In June 2013, following consultation on various employee benefit proposals, HSBC announced to employees in the UK that the future service accrual for active members of the Defined Benefit Section (DBS) would cease with effect from 30 June 2015. As a result, defined benefit pensions based on service to 30 June 2015 will continue to be linked to final salary on retirement (underpinned by increases in CPI) but all active members of the DBS will become members of the Defined Contribution Section from 1 July 2015. As part of these amendments, the HSBC Bank (UK) Pension Scheme (the Scheme) will cease to deliver ill-health benefits to active members of the DBS, and these benefits will, instead, be covered via insurance policies from 1 January 2015, consistent with other UK employees. This resulted in a reduction in the defined benefit obligation of the Scheme and a corresponding gain of US$430m, recorded in Past service cost and (gains)/losses on settlements .

The HSBC Group Hong Kong Local Staff Retirement Benefit Scheme

(Audited)

The scheme mainly invests in bonds with a smaller portion in equities and each investment manager has been assigned an investment mandate with the targeted asset allocation. The ranges of target asset allocations for the portfolio are as follows: bonds and cash 55-100%, equity 0-25% and alternative investments 0-20%. Alternative investments refer to high-return and high-risk alternatives including, but not limited to, private equity funds, hedge funds, energy, gold, agriculture, commodities and distressed assets.

The latest actuarial valuation of the defined benefit scheme was made at 31 December 2012 by Wing Lui, Fellow of the Society of Actuaries, of Towers Watson Hong Kong Limited. At that valuation date, the market value of the defined benefit scheme s assets was US$1,087m. On an

Report of the Directors: Financial Review (continued)

ongoing basis, the defined benefit scheme s assets represented 100% of the actuarial present value of the benefits accrued to members, after allowing for expected future increases in salaries. On a wind-up basis, the scheme s assets represented 107% of the members vested benefits, based on current salaries, and the resulting surplus amounted to US$68m. The attained age method has been adopted for the valuation and the major assumptions used in this valuation were a discount rate of 5% per annum and long-term salary increases of 4% per annum. The recommended employer contribution rate as a percentage of scheme salaries is 15% over the period 1 January 2013 to 31 December 2013, and 16.1% (local staff category) and 20% (senior staff category) over the period 1 January 2014 to 31 December 2015. No additional special contributions have been agreed.

The HSBC North America (US) Retirement Income Plan

(Audited)

In 2010, the Investment Committee (the Committee) unanimously agreed to transition the retirement income plan s target asset allocation mix to 40% equity securities, 59% fixed income securities and 1% cash over a 24-month period. In 2011, the Committee decided to accelerate this shift to the 2011 year-end and the target asset allocation mix was maintained during 2012. Should interest rates rise faster than currently projected by the Committee, a further shift to a higher percentage of fixed income securities may be made.

In the third quarter of 2012, it was agreed to cease all future contributions under the cash balance formula and freeze the plan with effect from 1 January 2013. The participants no longer accrue benefits, though those with existing balances continue to receive interest credits until the account is distributed.

The most recent actuarial valuation of the plan to determine compliance with US statutory funding requirements was made at 1 January 2013. At that date, the market value of the plan s assets was US$3,614m. The assets represented 122% of the benefits accrued to members as valued under the provisions of the Pension Protection Act of 2006 that was effective for the plan year beginning 1 January 2008. The resulting surplus amounted to US$646m. The method employed for this valuation was the traditional unit credit method and the discount rate was determined using a segment rate method as selected by HSBC under the relevant regulations, which resulted in an effective interest rate of 6.42% per annum.

Sustainability risk

(Unaudited)

Assessing the environmental and social impacts of providing finance to our customers is integral to our overall risk management processes.

In 2013, we implemented several changes to our policies and procedures to streamline the management of sustainability risks. This ranged from producing guidelines on how we extend the Equator Principles beyond project finance into corporate loans, to technical improvements in our systems to improve the accuracy of our management information.

A summary of our current policies and practices regarding reputational risk, pension risk and sustainability risk is provided in the Appendix to Risk on page 297.

Footnotes to Risk

Credit risk

1 *Other personal lending includes second lien mortgages and other property-related lending.*
2 *Financial includes loans and advances to banks.*
3 *The loans and advances offset relates to customer loans and deposits and balances where there is a legally enforceable right of offset in the event of counterparty default and where, as a result, there is a net exposure for credit risk management purposes. However, as there is no intention to settle these balances on a net basis under normal circumstances, they do not qualify for net presentation for accounting purposes. The effects of collateral held are not taken into account.*
4 *The amount of the loan commitments reflects, where relevant, the expected level of take-up of pre-approved loan offers made by mailshots to personal customers. In addition to those amounts, there is a further maximum possible exposure to credit risk of US$34bn (2012: US$28bn), reflecting the full take-up of such irrevocable loan commitments. The take-up of such offers is generally at modest levels.*
5 *Includes residential mortgages of HSBC Bank USA and HSBC Finance.*
6 *Comprising Rest of Asia-Pacific, Middle East and North Africa, and Latin America.*
7 *HSBC Finance lending is shown on a management basis and includes loans transferred to HSBC USA Inc. which are managed by HSBC Finance.*

Report of the Directors: Financial Review (continued)

8 *Property acquired through foreclosure is initially recognised at the lower of the carrying amount of the loan or its fair value less estimated costs to sell (initial foreclosed property carrying amount). The average loss on sale of foreclosed properties is calculated as cash proceeds less the initial foreclosed properties carrying amount divided by the unpaid loan principal balance prior to write-down (excluding any accrued finance income) plus certain other ancillary disbursements that, by law, are reimbursable from the cash proceeds (e.g. real estate tax advances) and were incurred prior to our taking title to the property. This ratio represents the portion of our total loss on foreclosed properties that occurred after we took title to the property.*

9 *The average total loss on foreclosed properties includes both the loss on sale of the foreclosed property as discussed in footnote 8 and the cumulative write-downs recognised on the loans up to the time we took title to the property.*

10 *Other commercial loans and advances include advances in respect of agriculture, transport, energy and utilities.*

11 *Impairment allowances are not reported for financial instruments, for which the carrying amount is reduced directly for impairment and not through the use of an allowance account.*

12 *Impairment is not measured for assets held in trading portfolios or designated at fair value as assets in such portfolios are managed according to movements in fair value, and the fair value movement is taken directly to the income statement. Consequently, we report all such balances under Neither past due nor impaired .*

13 *Loans and advances to customers includes asset-backed securities that have been externally rated as strong (2013: US$1.7bn; 2012: US$2.3bn), good (2013: US$255m; 2012: US$457m), satisfactory (2013: US$200m; 2012: US$390m), sub-standard (2013: US$283m; 2012: US$422m) and impaired (2013: US$252m; 2012: US$259m).*

14 *Included in this category are loans of US$1.9bn (2012: US$2.3bn) that have been re-aged once and were less than 60 days past due at the point of re-age. These loans are not classified as impaired following re-age due to the overall expectation that these customers will perform on the original contractual terms of their borrowing in the future.*

15 *Individually assessed impaired loans and advances are those classified as CRR 9, CRR 10, EL 9 or EL 10, loans and advances 90 days or more past due, unless individually they have been assessed as not impaired (see page 172, Past due but not impaired gross financial instruments) and renegotiated loans and advances meeting the criteria to be disclosed as impaired (see page 185).*

16 *Collectively assessed loans and advances comprise homogeneous groups of loans that are not considered individually significant, and loans subject to individual assessment where no impairment has been identified on an individual basis, but on which a collective impairment allowance has been calculated to reflect losses which have been incurred but not yet identified.*

17 *Collectively assessed loans and advances not impaired are those classified as CRR1 to CRR8 and EL1 to EL8 but excluding loans and advances 90 days or more past due and renegotiated loans and advances meeting the criteria to be disclosed as impaired.*

18 *Collectively assessed impairment allowances are allocated to geographical segments based on the location of the office booking the allowances or provisions. Consequently, the collectively assessed impairment allowances booked in Hong Kong may cover assets booked in branches located outside Hong Kong, principally in Rest of Asia-Pacific, as well as those booked in Hong Kong.*

19 *Included within Exchange and other movements is US$0.2bn of impairment allowances reclassified to held for sale (2012: US$0.8bn).*

20 *Net of repo transactions, settlement accounts and stock borrowings.*

21 *As a percentage of loans and advances to banks and loans and advances to customers, as applicable.*

22 *Loans and advances to customers are excluded from balances when reclassified to Assets held for sale .*

23 *Currency translation is the effect of translating the results of subsidiaries and associates for the previous year at the average rates of exchange applicable in the current year.*

24 *Negative numbers are favourable: positive numbers are unfavourable.*

25 *Equity securities not included.*

26 *First lien residential mortgages include Hong Kong Government Home Ownership Scheme loans of US$3.2bn at 31 December 2013 (2012: US$3.2bn). Where disclosed, earlier comparatives were 2011: US$3.3bn; 2010: US$3.5bn; 2009: US$3.5bn.*

27 *The impairment allowances on loans and advances to banks in 2013 relate to the geographical regions, Europe, North America, and Middle East and North Africa; (2012: Europe and Middle East and North Africa).*

28 *In 2013, GB&M changed the way it manages repo and reverse repo activities in the Credit and Rates businesses as set out on page 219. This led to an increase in the amount of reverse repo agreements classified as Loans and advances to customers at amortised cost. The increase in amortised cost balances primarily occurred in Europe and North America, specifically in the UK and the US.*

29 *Carrying amount of the net principal exposure.*

30 *Total includes holdings of ABSs issued by The Federal Home Loan Mortgage Corporation (Freddie Mac) and The Federal National Mortgage Association (Fannie Mae).*

31 *Directly held includes assets held by Solitaire where we provide first loss protection and assets held directly by the Group.*

32 *Effect of impairments represents the reduction or increase in the reserve on initial impairment and subsequent reversal of impairment of the assets.*

33 *The gross principal is the redemption amount on maturity or, in the case of an amortising instrument, the sum of the future redemption amounts through the residual life of the security.*

34 *Credit default swap gross protection is the gross principal of the underlying instrument that is protected by CDSs.*

35 *Net principal exposure is the gross principal amount of assets that are not protected by CDSs. It also includes assets that benefit from monoline protection.*

36 *Cumulative fair value adjustment recorded against exposures to OTC derivative counterparties to reflect their creditworthiness.*

37 *Funded exposures represent the loan amounts advanced to the customer, net of fees held on deposit.*
38 *Unfunded exposures represent the contractually committed loan facility amount not yet drawn down by the customer, less any fair value write-downs, net of fees held on deposit.*
39 *In-country liabilities in Italy include liabilities issued under local law but booked outside the country.*

Liquidity and funding

40 *The most favourable metrics are a smaller advances to core funding and larger stressed one-month and three-month coverage ratios.*
41 *The HSBC UK entity shown comprises five legal entities; HSBC Bank plc (including all overseas branches, and SPEs consolidated by HSBC Bank plc for Financial Statement purposes), Marks and Spencer Financial Services Limited, HSBC Private Bank (UK) Ltd, HFC Bank Ltd and HSBC Trust Company (UK) Limited, managed as a single operating entity, in line with the application of UK liquidity regulation as agreed with the UK PRA.*
42 *The Hongkong and Shanghai Banking Corporation represents the bank in Hong Kong including all overseas branches. Each branch is monitored and controlled for liquidity and funding risk purposes as a stand-alone operating entity.*

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

43 *The HSBC USA principal entity shown represents the HSBC USA Inc consolidated group; predominantly HSBC USA Inc and HSBC Bank USA, NA. The HSBC USA Inc consolidated group is managed as a single operating entity.*

44 *The total shown for other principal HSBC operating entities represents the combined position of all the other operating entities overseen directly by the Risk Management Meeting of the GMB.*

45 *Estimated liquidity value represents the expected realisable value of assets prior to management assumed haircuts.*

46 *The undrawn balance for the five largest committed liquidity facilities provided to customers other than facilities to conduits.*

47 *The undrawn balance for the total of all committed liquidity facilities provided to the largest market sector, other than facilities to conduits.*

Market risk

48 *Trading portfolios comprise positions arising from the market-making and warehousing of customer-derived positions.*

49 *Portfolio diversification is the market risk dispersion effect of holding a portfolio containing different risk types. It represents the reduction in unsystematic market risk that occurs when combining a number of different risk types, for example, interest rate, equity and foreign exchange, together in one portfolio. It is measured as the difference between the sum of the VaR by individual risk type and the combined total VaR. A negative number represents the benefit of portfolio diversification. As the maximum and minimum occur on different days for different risk types, it is not meaningful to calculate a portfolio diversification benefit for these measures.*

50 *The total VaR is non-additive across risk types due to diversification effects.*

51 *Investments in private equity are primarily made through managed funds that are subject to limits on the amount of investment. Potential new commitments are subject to risk appraisal to ensure that industry and geographical concentrations remain within acceptable levels for the portfolio as a whole. Regular reviews are performed to substantiate the valuation of the investments within the portfolio.*

52 *Investments held to facilitate ongoing business include holdings in government-sponsored enterprises and local stock exchanges.*

53 *Instead of assuming that all interest rates move together, we group our interest rate exposures into currency blocs whose rates are considered likely to move together. See Cautionary statement regarding forward-looking statements on page 574.*

Risk management of insurance operations

54 *Other long-term includes term assurance, credit life insurance, and universal life insurance.*

55 *Although investment contracts with discretionary participation features (DPF) are financial investments, HSBC continues to account for them as insurance contracts as permitted by IFRS 4.*

56 *No assets and liabilities are classified as held for sale in the current period. In the comparative period assets and liabilities that were classified as held for sale were reported in the Other assets column together with shareholder assets. The majority of these assets (which totalled US$2.0bn) were debt securities with a strong credit rating and were reported as Other assets and investment properties . All liabilities for insurance businesses classified as held for sale were reported in Other liabilities and totalled US$1.2bn. The majority of these liabilities were life and non-life policyholder liabilities expected to mature after five years.*

57 *Present value of in-force long-term insurance contracts and investment contracts with DPF.*

58 *Deferred tax includes the deferred tax liabilities arising on recognition of PVIF.*

59 *Does not include associated insurance company SABB Takaful Company or joint venture insurance company Canara HSBC Oriental Bank of Commerce Life Insurance Company Limited.*

60 *HSBC has no insurance manufacturing subsidiaries in the Middle East and North Africa.*

61 *The life insurance business in North America previously reported as held-for-sale was disposed of in the first half of 2013.*

62 *Comprise unit-linked life insurance contracts and linked long-term investment contracts.*

63 *Comprise non-linked insurance contracts and non-linked long-term investment contracts.*

64 *Comprise mainly loans and advances to banks, cash and intercompany balances with other non-insurance legal entities.*

65 *The cost of guarantees figure presented comprises the modelled cost of guarantees under products manufactured by our insurance subsidiaries, including both the cost of guarantees reserved for through policyholder liabilities and the amount accounted for as a deduction to PVIF. This is considered to provide more relevant information than the total liabilities to policyholders established for guaranteed products manufactured by our insurance subsidiaries as disclosed in prior periods.*

66 *Real annual return guarantees provide the policyholder a guaranteed return in excess of the rate of inflation, and are supported by inflation-linked debt securities with yields that are also expressed in real terms.*

67 *Shareholders funds comprise solvency and unencumbered assets.*

68 *Non-linked insurance includes remaining non-life business.*

69 *In most cases, policyholders have the option to terminate their contracts at any time and receive the surrender values of their policies. These may be significantly lower than the amounts shown.*

70 *Insurance contracts and investment contracts with DPF can give policyholders the contractual right to receive, as a supplement to their guaranteed benefits, additional benefits that may be a significant portion of the total contractual benefits, but whose amount and timing are determined by HSBC. These additional benefits are contractually based on the performance of a specified pool of contracts or assets, or the profit of the company issuing the contracts.*

71 *Sensitivity to lapse rates has been updated to show the effect of a ±10% stress compared to the effect of a ±50% stress disclosed in prior periods since this is considered to provide more relevant information which is better aligned to the severity of the other sensitivities to non-economic assumptions disclosed.*

Pension risk

72 *Option overlay strategies which are expected to improve the risk/return profile of the equity allocation will be targeted.*

73 *In 2012 and 2013, alternative assets included ABSs, MBSs and infrastructure assets. In 2006, alternative assets included loans and infrastructure assets.*

74 *Whilst there is no target cash allocation, the amount of cash is expected to vary between 0-5% depending upon the liquidity requirements of the scheme, which will affect the actual allocation of bonds correspondingly.*

Report of the Directors: Financial Review (continued)

Country distribution of outstandings and cross-border exposures

75 *These balances were between 0.75% and 1% of total assets. All other balances were above 1%.*

Risk elements in the loan portfolio

76 *In addition to the numbers presented there were US$0.2bn of impaired loans (2012: US$1.3bn); US$0.04bn unimpaired loans contractually past due 90 days or more as to principal or interest (2012: nil); and US$0.07bn of troubled debt restructurings (not included in the classifications above) (2012: US$0.4bn), all relating to assets held for sale at 31 December 2013.*

77 *Assets held for resale represent assets obtained by taking possession of collateral held as security for financial assets.*

78 *Ratio excludes trading loans classified as in default.*

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Appendix to Risk

Risk policies and practices

This appendix describes the significant policies and practices employed by HSBC in managing our credit risk, liquidity and funding, market risk, operational risk (including compliance risk, legal risk and fiduciary risk), insurance risk, reputational risk, pension risk and sustainability risk.

Risk governance

(Unaudited)

Our strong risk governance reflects the importance placed by the Board and the Group Risk Committee (GRC) on shaping the Group s risk strategy and managing risks effectively. It is supported by a clear policy framework of risk ownership, a risk appetite process through which the types and levels of risk that we are prepared to accept in executing our strategy are articulated and monitored, performance scorecards cascaded from the Group Management Board (GMB) that align business and risk objectives, and the accountability of all staff for identifying, assessing and managing risks within the scope of their assigned responsibilities. This personal accountability, reinforced by the governance structure, experience and mandatory learning, helps to foster a disciplined and constructive culture of risk management and control throughout HSBC.

Credit risk

Credit risk management

(Audited)

The role of an independent credit control unit is fulfilled by the Global Risk function. Credit approval authorities are delegated by the Board to certain executive officers of HSBC Holdings. Similar credit approval authorities are delegated by the boards of subsidiary companies to executive officers of the relevant subsidiaries. In each major subsidiary, a Chief Risk Officer reports to the local Chief Executive Officer on credit-related issues, while maintaining a direct functional reporting line to the Group Chief Risk Officer in Global Risk. Details of the roles and responsibilities of the credit risk management function and the policies and procedures for managing credit risk are set out below. Apart from the creation of a new Group Models Oversight Committee and supportive framework, there were no significant changes in 2013.

The high-level oversight and management of credit risk provided globally by the Credit Risk function in Global Risk

to formulate Group credit policy. Compliance, subject to approved dispensations, is mandatory for all operating companies which must develop local credit policies consistent with Group policies;

to guide operating companies on our appetite for credit risk exposure to specified market sectors, activities and banking products and controlling exposures to certain higher-risk sectors;

to undertake an independent review and objective assessment of risk. Global Risk assesses all commercial non-bank credit facilities and exposures over designated limits, prior to the facilities being committed to customers or transactions being undertaken;

to monitor the performance and management of portfolios across the Group;

to control exposure to sovereign entities, banks and other financial institutions, as well as debt securities which are not held solely for the purpose of trading;

to set Group policy on large credit exposures, ensuring that concentrations of exposure by counterparty, sector or geography do not become excessive in relation to our capital base, and remain within internal and regulatory limits;

to control our cross-border exposures (see page 274);

to maintain and develop our risk rating framework and systems, the governance of which is under the general oversight of the Group Model Oversight Committee (MOC). The Group MOC meets bi-monthly and reports to the Risk Management Meeting. It is chaired by the risk function and its membership is drawn from Global Risk and global businesses;

to report to the Risk Management Meeting, the GRC and the Board on high risk portfolios, risk concentrations, country limits and cross-border exposures, large impaired accounts, impairment allowances, stress testing results and recommendations and retail portfolio performance; and

to act on behalf of HSBC Holdings as the primary interface, for credit-related issues, with the Bank of England, the PRA, local regulators, rating agencies, analysts and counterparts in major banks and non-bank financial institutions.

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Principal objectives of our credit risk management

- to maintain across HSBC a strong culture of responsible lending and a robust risk policy and control framework;
- to both partner and challenge our businesses in defining, implementing and continually re-evaluating our risk appetite under actual and scenario conditions; and
- to ensure there is independent, expert scrutiny of credit risks, their costs and their mitigation.

Credit quality of financial instruments

(Audited)

Our credit risk rating systems and processes differentiate exposures in order to highlight those with greater risk factors and higher potential severity of loss. In the case of individually significant accounts that are predominantly within our wholesale businesses, risk ratings are reviewed regularly and any amendments are implemented promptly. Within our retail businesses, risk is assessed and managed using a wide range of risk and pricing models to generate portfolio data.

Our risk rating system facilitates the internal ratings-based (IRB) approach under Basel II adopted by the Group to support calculation of our minimum credit regulatory capital requirement. Our credit quality classifications are defined below.

Special attention is paid to problem exposures in order to accelerate remedial action. When appropriate, our operating companies use specialist units to provide customers with support to help them avoid default wherever possible.

Group and regional Credit Review and Risk Identification teams regularly review exposures and processes in order to provide an independent, rigorous assessment of credit risk across the Group, reinforce secondary risk management controls and share best practice. Internal audit, as a tertiary control function, focuses on risks with a global perspective and on the design and effectiveness of primary and secondary controls, carrying out oversight audits via the sampling of global/regional control frameworks, themed audits of key or emerging risks and project audits to assess major change initiatives.

The five credit quality classifications defined below each encompass a range of granular internal credit rating grades assigned to wholesale and retail lending businesses and the external ratings attributed by external agencies to debt securities. There is no direct correlation between the internal and external ratings at granular level, except to the extent each falls within a single quality classification.

Credit quality classification

(Unaudited)

	Debt securities	Wholesale lending	Retail lending

	and other bills	and derivatives			
	External credit rating	Internal credit rating	12 month probability of default %	Internal credit rating[1]	Expected loss %
Quality classification					
Strong	A and above	CRR[2]1 to CRR2	0 0.169	EL[3]1 to EL2	0 0.999
Good	BBB+ to BBB	CRR3	0.170 0.740	EL3	1.000 4.999
Satisfactory	BB+ to B+ and unrated	CRR4 to CRR5	0.741 4.914	EL4 to EL5	5.000 19.999
Sub-standard	B to C	CRR6 to CRR8	4.915 99.999	EL6 to EL8	20.000 99.999
Impaired	Default	CRR9 to CRR10	100	EL9 to EL10	100+ or defaulted[4]

1 *We observe the disclosure convention that, in addition to those classified as EL9 to EL10, retail accounts classified EL1 to EL8 that are delinquent by 90 days or more are considered impaired, unless individually they have been assessed as not impaired (see page 172, Past due but not impaired gross financial instruments).*
2 *Customer risk rating.*
3 *Expected loss.*
4 *The EL percentage is derived through a combination of PD and LGD, and may exceed 100% in circumstances where the LGD is above 100% reflecting the cost of recoveries.*

Report of the Directors: Financial Review (continued)

Quality classification definitions

Strong exposures demonstrate a strong capacity to meet financial commitments, with negligible or low probability of default and/or low levels of expected loss. Retail accounts operate within product parameters and only exceptionally show any period of delinquency.

Good exposures require closer monitoring and demonstrate a good capacity to meet financial commitments, with low default risk. Retail accounts typically show only short periods of delinquency, with any losses expected to be minimal following the adoption of recovery processes.

Satisfactory exposures require closer monitoring and demonstrate an average to fair capacity to meet financial commitments, with moderate default risk. Retail accounts typically show only short periods of delinquency, with any losses expected to be minor following the adoption of recovery processes.

Sub-standard exposures require varying degrees of special attention and default risk is of greater concern. Retail portfolio segments show longer delinquency periods of generally up to 90 days past due and/or expected losses are higher due to a reduced ability to mitigate these through security realisation or other recovery processes.

Impaired exposures have been assessed as impaired. Wholesale exposures where the bank considers that either the customer is unlikely to pay its credit obligations in full, without recourse by the bank to the actions such as realising security if held, or the customer is past due more than 90 days on any material credit obligation. Retail loans and advances greater than 90 days past due unless individually they have been assessed as not impaired. Renegotiated loans that have met the requirements to be disclosed as impaired and have not yet met the criteria to be returned to the unimpaired portfolio (see below).

The customer risk rating (CRR) 10-grade scale summarises a more granular underlying 23-grade scale of obligor probability of default (PD). All HSBC customers are rated using the 10 or 23-grade scale, depending on the degree of sophistication of the Basel II approach adopted for the exposure.

The expected loss (EL) 10-grade scale for retail business summarises a more granular underlying EL scale for this customer segment; this combines obligor and facility/product risk factors in a composite measure.

For debt securities and certain other financial instruments, external ratings have been aligned to the five quality classifications. The ratings of S&P are cited, with those of other agencies being treated equivalently. Debt securities with short-term issue ratings are reported against the long-term rating of the issuer of those securities. If major rating agencies have different ratings for the same debt securities, a prudent rating selection is made in line with regulatory requirements.

Renegotiated loans and forbearance

(Audited)

A range of forbearance strategies is employed in order to improve the management of customer relationships, maximise collection opportunities and, if possible, avoid default, foreclosure or repossession. They include extended payment terms, a reduction in interest or principal repayments, approved external debt management plans, debt consolidations, the deferral of foreclosures and other forms of loan modifications and re-ageing.

Our policies and practices are based on criteria which enable local management to judge whether repayment is likely to continue. These typically provide a customer with terms and conditions that are more favourable than those provided initially. Loan forbearance is only granted in situations where the customer has showed a willingness to repay their loan and is expected to be able to meet the revised obligations.

For retail lending our credit risk management policy sets out restrictions on the number and frequency of renegotiations, the minimum period an account must have been opened before any renegotiation can be considered and the number of qualifying payments that must be received. The application of this policy varies according to the nature of the market, the product and the management of customer relationships through the occurrence of exceptional events.

Identifying renegotiated loans

The contractual terms of a loan may be modified for a number of reasons including changing market conditions, customer retention and other factors not related to the current or potential credit deterioration of a customer. When the contractual payment terms of a loan are modified because we have significant concerns about the borrower s ability to meet contractual payments when due, these loans are classified as renegotiated loans .

For retail lending, when considering whether there is significant concern regarding a customer s ability to meet contractual loan repayments when due, we assess the customer s delinquency status, account behaviour, repayment history, current financial situation and continued ability to repay. If the customer is not meeting contractual repayments or it is evident that they will be unable to do so without the renegotiation, there will be a significant

Report of the Directors: Financial Review (continued)

concern regarding their ability to meet contractual payments, and the loan will be disclosed as impaired, unless the concession granted is insignificant as discussed below.

For loan restructurings in wholesale lending, indicators of significant concerns regarding a borrower s ability to pay include:

- the debtor is currently in default on any of its debt;
- the debtor has declared or is in the process of declaring bankruptcy or entering into a similar process;
- there is significant doubt as to whether the debtor will continue to be a going concern;
- currently, the debtor has securities that have been delisted, are in the process of being delisted, or are under threat of being delisted from an exchange as a result of trading or financial difficulties;
- based on estimates and projections that only encompass current business capabilities, the bank forecasts that the debtor s entity-specific cash flows will be insufficient to service the debt (both interest and principal) in accordance with the contractual terms of the existing agreement through maturity. In this instance, actual payment default may not yet have occurred; and
- absent the modification, the debtor cannot obtain funds from sources other than its existing creditors at an effective interest rate equal to the current market interest rate for similar debt for a non-distressed debtor.

Where the modification of a loan s contractual payment terms represents a concession for economic or legal reasons relating to the borrower s financial difficulty, and is a concession that we would not otherwise consider, then the renegotiated loan is disclosed as impaired in accordance with our impaired loan disclosure convention described in more detail on page 185, unless the concession is insignificant and there are no other indicators of impairment. Insignificant concessions are primarily restricted to our CML portfolio in HSBC Finance, where loans which are in the early stages of delinquency (less than 60 days delinquent) and typically have the equivalent of two payments deferred for the first time are excluded from our impaired loan classification, as the contractual payment deferrals are deemed to be insignificant compared with payments due on the loan as a whole. For details of HSBC Finance s loan renegotiated programmes and portfolios, see pages 176 to 178.

Credit quality classification of renegotiated loans

(Audited)

Under IFRSs, an entity is required to assess whether there is objective evidence that financial assets are impaired at the end of each reporting period. A loan is impaired and an impairment allowance is recognised when there is objective evidence of a loss event that has an effect on the cash flows of the loan which can be reliably estimated. Granting a concession to a customer that we would not otherwise consider, as a result of their financial difficulty, is objective evidence of impairment and impairment losses are measured accordingly.

A renegotiated loan is presented as impaired when:

- there has been a change in contractual cash flows as a result of a concession which the lender would otherwise not consider, and

- it is probable that without the concession, the borrower would be unable to meet contractual payment obligations in full.

This presentation applies unless the concession is insignificant and there are no other indicators of impairment.

The renegotiated loan will continue to be disclosed as impaired until there is sufficient evidence to demonstrate a significant reduction in the risk of non-payment of future cash flows, and there are no other indicators of impairment. For loans that are assessed for impairment on a collective basis, the evidence typically comprises a history of payment performance against the original or revised terms, as appropriate to the circumstances. For loans that are assessed for impairment on an individual basis, all available evidence is assessed on a case-by-case basis.

For retail lending the minimum period of payment performance required depends on the nature of loans in the portfolio, but is typically not less than six months. Where portfolios have more significant levels of forbearance activity, such as that undertaken by HSBC Finance, the minimum repayment performance period required may be substantially more (for further details on HSBC Finance see page 176). Payment performance periods are monitored to ensure they remain appropriate to the levels of recidivism observed within the portfolio. These performance periods are in addition to a minimum of two payments which must be received within a 60-day period for the customer to initially qualify for the renegotiation (in the case of HSBC Finance, in certain circumstances, for example where debt has been restructured in bankruptcy proceedings, fewer or no qualifying payments may be required). The qualifying payments are required in order to demonstrate that the renegotiated terms are sustainable

Table of Contents

for the borrower. For corporate and commercial loans, which are individually assessed for impairment and where non-monthly payments are more commonly agreed, the history of payment performance will depend on the underlying structure of payments agreed as part of the restructuring.

Renegotiated loans are classified as unimpaired where the renegotiation has resulted from significant concern about a borrower s ability to meet their contractual payment terms but the renegotiated terms are based on current market rates and contractual cash flows are expected to be collected in full following the renegotiation. Unimpaired renegotiated loans also include previously impaired renegotiated loans that have demonstrated satisfactory performance over a period of time or have been assessed based on all available evidence as having no remaining indicators of impairment.

Loans that have been identified as renegotiated retain this designation until maturity or derecognition. When a loan is restructured as part of a forbearance strategy and the restructuring results in derecognition of the existing loan, such as in some debt consolidations, the new loan is disclosed as renegotiated.

When determining whether a loan that is restructured should be derecognised and a new loan recognised, we consider the extent to which the changes to the original contractual terms result in the renegotiated loan, considered as a whole, being a substantially different financial instrument. The following are examples of circumstances that are likely to result in this test being met and derecognition accounting being applied:

- an uncollateralised loan becomes fully collateralised;
- the addition or removal of cross-collateralisation provisions;
- multiple facilities are consolidated into a single new facility;
- removal or addition of conversion features attached to the loan agreement;
- a change in the currency in which the principal or interest is denominated;
- a change in the liquidation preference or ranking of the instrument; or
- the contract is altered in any other manner so that the terms under the new or modified contract are substantially different from those under the original contract.

The following are examples of factors that we consider may indicate that the revised loan is a substantially different financial instrument, but are unlikely to be conclusive in themselves:

changes in guarantees or loan covenants provided;

less significant changes to collateral arrangements; or

the addition of repayment provisions or prepayment premium clauses.

Renegotiated loans and recognition of impairment allowances

(Audited)

For retail lending, renegotiated loans are segregated from other parts of the loan portfolio for collective impairment assessment to reflect the higher rates of losses often encountered in these segments. When empirical evidence indicates an increased propensity to default and higher losses on such accounts, such as for re-aged loans in the US, the use of roll-rate methodology ensures these factors are taken into account when calculating impairment allowances by applying roll rates specifically calculated on the pool of loans subject to forbearance. When the portfolio size is small or when information is insufficient or not reliable enough to adopt a roll-rate methodology, a basic formulaic approach based on historical loss rate experience is used. As a result of our roll-rate methodology, we recognise collective impairment allowances on homogeneous groups of loans, including renegotiated loans, where there is historical evidence that there is a likelihood that loans in these groups will progress through the various stages of delinquency, and ultimately prove irrecoverable as a result of events occurring before the balance sheet date. This treatment applies irrespective of whether or not those loans are presented as impaired in accordance with our impaired loans disclosure convention. When we consider that there are additional risk factors inherent in the portfolios that may not be fully reflected in the statistical roll rates or historical experience, these risk factors are taken into account by adjusting the impairment allowances derived solely from statistical or historical experience. For further details of the risk factor adjustments see Critical accounting policies on page 72.

In the corporate and commercial sectors, renegotiated loans are typically assessed individually. Credit risk ratings are intrinsic to the impairment assessment. A distressed restructuring is classified as an impaired loan. The individual impairment assessment takes into account the higher risk of the non-payment of future cash flows inherent in renegotiated loans.

Report of the Directors: Financial Review (continued)

Corporate and commercial forbearance

(Unaudited)

In the corporate and commercial sectors, forbearance activity is undertaken selectively where it has been identified that repayment difficulties against the original terms already have, or are very likely to, materialise. These cases are treated as impaired loans where:

- the customer is experiencing, or is very likely to experience, difficulty in meeting a payment obligation to the Group (i.e. due to current credit distress); and
- the Group is offering to the customer revised payment arrangements which constitute a concession (i.e. it is offering terms it would not normally be prepared to offer).

These cases are described as distressed restructurings. The agreement of a restructuring which meets the criteria above requires all loans, advances and counterparty exposures to the customer to be treated as impaired. Against the background of this requirement, as a customer approaches the point at which it becomes clear that there is an increasing risk that a restructuring of this kind might be necessary, the exposures will typically be regarded as sub-standard to reflect the deteriorating credit risk profile and will be graded as impaired when the restructure is proposed for approval, or sooner if there is sufficient concern regarding the customer s likeliness to pay.

For the purposes of determining whether changes to a customer s agreement should be treated as a distressed restructuring the following types of modification are regarded as concessionary:

- transfers from the customer of receivables from third parties, real estate, or other assets to satisfy fully or partially a debt;
- issuance or other granting of an equity interest to satisfy fully or partially a debt unless the equity interest is granted pursuant to existing terms for converting the debt into an equity interest; and
- modification of the terms of a debt, such as one or more of the following:
  - reduction (absolute or contingent) of the stated interest rate for the remaining original life of the debt;
  - extension of the maturity date or dates at a stated interest rate lower than the current market rate for new debt with similar risk;
  - reduction (absolute or contingent) of the face amount or maturity amount of the debt; and

reduction (absolute or contingent) of accrued interest.

Modifications that are unrelated to payment arrangements, such as the restructuring of collateral or security arrangements or the waiver of rights under covenants within documentation, are not regarded by themselves to be evidence of credit distress affecting payment capacity. Typically, covenants are in place to give the Group rights of repricing or acceleration, but they are frequently set at levels where payment capacity has yet to be affected providing rights of action at earlier stages of credit deterioration. Such concessions do not directly affect the customer s ability to service the original contractual debt and are not reported as renegotiated loans. However, where a customer requests a non-payment related covenant waiver, the significance of the underlying breach of covenant will be considered together with any other indicators of impairment, and where there is a degree of severity of credit distress evidencing uncertainty of payment, all available evidence will be considered in determining whether a loss event has occurred. The waiver will not, however, trigger classification as a renegotiated loan as payment terms have not been modified.

When both payment-related and non-payment related modifications are made together as a result of significant concerns regarding the payment of contractual cash flows, the loan is treated as a distressed restructuring and disclosed as a renegotiated loan.

Within corporate and commercial business segments, modifications of several kinds are frequently agreed for a customer contemporaneously. Transfer to an interest-only arrangement is the most common type of modification granted in the UK, whether in isolation or in combination with other concessions. Throughout the rest of the world term extensions occur more frequently with other types of concession such as interest rate changes occurring less often across all jurisdictions.

In assessing whether payment-related forbearance is a satisfactory and sustainable strategy, the customer s entire exposure and facilities will be reviewed and the customer s ability to meet the terms of both the revised obligation and other credit facilities not amended in the renegotiation is assessed. Should this assessment identify that a renegotiation will not deal with a customer s payment capacity issues satisfactorily, other special management options may be applied. This process may identify the need to provide assistance to a customer specifically to restructure their business operations and activities so as to restore satisfactory payment capacity. When considering

Report of the Directors: Financial Review (continued)

acceptable restructuring terms we consider the ability of the customer to be able to service the revised interest payments as a necessity. When principal payment modifications are considered, again we require the customer to be able to comply with the revised terms as a necessary pre-condition for the restructuring to proceed. When principal payments are modified resulting in permanent forgiveness, or when it is otherwise considered that there is no longer a realistic prospect of recovery of outstanding principal, the affected balances are written off. When principal repayments are postponed, it is expected that the customer will be capable of paying in line with the renegotiated terms, including instances when the postponed principal repayment is expected from refinancing. In all cases, a loan renegotiation is only granted when the customer is expected to be able to meet the revised terms.

Modifications may be made on a temporary basis when time is needed for the customer to make arrangements for payment, when deterioration in payment capacity is expected to be acute but short lived, or when more time is needed to accommodate discussions regarding a more permanent accommodation with other bankers, for example in syndicated facilities where multilateral negotiation commonly features.

If a restructuring proceeds and the customer demonstrates satisfactory performance over a period of time, the case may be returned to a non-impaired grade (CRR1-8) provided no other indicators of impairment remain. Such a case cannot be returned to a non-impaired grade when a specific impairment allowance remains against any of the customer s credit facilities. The period of performance will vary depending on the frequency of payments to be made by the customer under the amended agreement and the extent to which the customer s financial position is considered to have improved.

Refinance risk

(Unaudited)

Many types of lending require the repayment of a significant proportion of the principal at maturity. Typically, the mechanism of repayment for the customer is through the acquisition of a new loan to settle the existing debt. Refinance risk arises where a customer is unable to repay such term debt on maturity, or to refinance debt at commercial rates. When there is evidence that this risk may apply to a specific contract, HSBC may need to refinance the loan on concessionary terms that it would not otherwise have considered, in order to recoup the maximum possible cash flows from the contract and potentially avoid the customer defaulting on the repayment of principal. When there is sufficient evidence that borrowers, based on their current financial capabilities, may fail at maturity to repay or refinance their loans, these loans are disclosed as impaired with recognition of a corresponding impairment allowance where appropriate.

Impairment assessment

(Audited)

It is our policy that each operating company in HSBC creates impairment allowances for impaired loans promptly and appropriately.

For details of our impairment policies on loans and advances and financial investments, see Notes 2g and 2j on the Financial Statements.

Impairment and credit risk mitigation

The existence of collateral has an effect when calculating impairment on individually assessed impaired loans. When we no longer expect to recover the principal and interest due on a loan in full or in accordance with the original terms and conditions, it is assessed for impairment. If exposures are secured, the current net realisable value of the collateral will be taken into account when assessing the need for an impairment allowance. No impairment allowance is recognised in cases where all amounts due are expected to be settled in full on realisation of the security.

Personal lending portfolios are generally assessed for impairment on a collective basis as the portfolios typically consist of large groups of homogeneous loans. Two methods are used to calculate allowances on a collective basis: a roll-rate methodology or a more basic formulaic approach based on historical losses. In 2013, we reviewed the impairment allowance methodology used for retail banking and small business portfolios across the Group to ensure that the assumptions used in our collective assessment models continued to appropriately reflect the period of time between a loss event occurring and the account proceeding to delinquency and eventual write-off.

The historical loss methodology is typically used to calculate collective impairment allowances for secured or low default portfolios such as mortgages until the point at which they are individually identified and assessed as impaired. For loans which are collectively assessed using historical loss methodology, the historical loss rate is

Table of Contents

Report of the Directors: Financial Review (continued)

derived from the average contractual write-off net of recoveries over a defined period. The net contractual write-off rate is the actual amount of loss experienced after the realisation of collateral and receipt of recoveries.

A roll-rate methodology is more commonly adopted for unsecured portfolios when there are sufficient volumes of empirical data to develop robust statistical models. In certain circumstances mortgage portfolios have a statistically significant number of defaults and losses available, enabling reliable roll rates to be generated. In these cases a roll-rate methodology is applied until the point at which the loans are individually identified and assessed as impaired, and the average loss rate for each delinquency bucket is adjusted to reflect the average loss expected following realisation of security and receipt of recoveries. The average loss expected is derived from average historical collateral realisation values.

The nature of the collective allowance assessment prevents individual collateral values or LTV ratios from being included within the calculation. However, the loss rates used in the collective assessment are adjusted for the collateral realisation experiences which will vary depending on the LTV composition of the portfolio. For example mortgage portfolios under a historical loss rate methodology with lower LTV ratios will typically experience lower loss history and consequently a lower net contractual write-off rate.

For wholesale collectively assessed loans, historical loss methodologies are applied to measure loss event impairments which have been incurred but not reported. Loss rates are derived from the observed contractual write-off net of recoveries over a defined period, typically no lower than 60 months. The net contractual write-off rate is the actual or expected amount of loss experienced after realisation of collateral and receipt of recoveries. These historical loss rates are adjusted by an economic factor which adjusts the historical averages to better represent current economic conditions affecting the portfolio. In order to reflect the likelihood of a loss event not being identified and assessed an emergence period assumption is applied which reflects the period between a loss occurring and its identification. The emergence period is estimated by local management for each identified portfolio. The factors that may influence this estimation include economic and market conditions, customer behaviour, portfolio management information, credit management techniques and collection and recovery experiences in the market. A fixed range for the period between a loss occurring and its identification is not defined across the Group and as it is assessed empirically on a periodic basis it may vary over time as these factors change. Given that credit management policies require all customers to be reviewed at least annually, we expect this estimated period would be at most 12 months in duration

Write-off of loans and advances

For details of our policy on the write-off of loans and advances, see Note 2g on the Financial Statements.

In HSBC Finance, the carrying amounts of residential mortgage and second lien loans in excess of net realisable value are written off at or before the time foreclosure is completed or settlement is reached with the borrower. If there is no reasonable expectation of recovery, and foreclosure is pursued, the loan is normally written off no later than the end of the month in which the loan becomes 180 days contractually past due. We regularly obtain new appraisals for loans (every 180 days) and adjust carrying value to the most recent appraisal whether it has increased or decreased as the best estimate of the cash flows that will be received on the disposal of the collateral for these collateral dependent loans.

Unsecured personal facilities, including credit cards, are generally written off at between 150 and 210 days past due, the standard period being the end of the month in which the account becomes 180 days contractually delinquent. Write-off periods may be extended, generally to no more than 360 days past due but, in very exceptional circumstances, to longer than that figure in a few countries where local regulation or legislation constrain earlier write-off or where the realisation of collateral for secured real estate lending takes this time.

In retail lending, final write-off should occur within 60 months of the default at the latest.

In the event of bankruptcy or analogous proceedings, write-off may occur earlier than at the periods stated above. Collections procedures may continue after write-off.

Concentration of exposure

(Audited)

Concentrations of credit risk arise when a number of counterparties or exposures have comparable economic characteristics or such counterparties are engaged in similar activities or operate in the same geographical areas or industry sectors so that their collective ability to meet contractual obligations is uniformly affected by changes in

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

economic, political or other conditions. We use a number of controls and measures to minimise undue concentration of exposure in our portfolios across industry, country and global business. These include portfolio and counterparty limits, approval and review controls, and stress testing.

Wrong-way risk occurs when a counterparty s exposures are adversely correlated with its credit quality. There are two types of wrong-way risk:

- general wrong-way risk occurs when the probability of counterparty default is positively correlated with general risk factors such as, for example, where the counterparty is resident and/or incorporated in a higher-risk country and seeks to sell a non-domestic currency in exchange for its home currency; and
- specific wrong-way risk occurs when the exposure to a particular counterparty is positively correlated with the probability of counterparty default such as a reverse repo on the counterparty s own bonds. It is HSBC policy that specific wrong-way transactions are approved on a case-by-case basis.

We use a range of tools to monitor and control wrong-way risk, including requiring the business to obtain prior approval before undertaking wrong-way risk transactions outside pre-agreed guidelines.

Cross-border exposures

We assess the vulnerability of countries to foreign currency payment restrictions, including economic and political factors, when considering impairment allowances on cross-border exposures. Impairment allowances are assessed in respect of all qualifying exposures within vulnerable countries unless these exposures and the inherent risks are:

- performing, trade-related and of less than one year s maturity;
- mitigated by acceptable security cover which is, other than in exceptional cases, held outside the country concerned;
- in the form of securities held for trading purposes for which a liquid and active market exists, and which are measured at fair value daily; and
- performing facilities with a principal (excluding security) of US$1m or below and/or with maturity dates shorter than three months.

Nature of HSBC s securitisation and other structured exposures

(Audited)

Mortgage-backed securities (MBS s) are securities that represent interests in groups of mortgages and provide investors with the right to receive cash from future mortgage payments (interest and/or principal). An MBS which references mortgages with different risk profiles is classified according to the highest risk class.

Collateralised debt obligations (CDO s) are securities backed by a pool of bonds, loans or other assets such as asset-backed securities (ABS s). CDOs may include exposure to sub-prime or Alt-A mortgage assets where these are part of the underlying assets or reference assets. As there is often uncertainty surrounding the precise nature of the underlying collateral supporting CDOs, all CDOs supported by residential mortgage-related assets are classified as sub-prime. Our holdings of ABSs and CDOs and direct lending positions, and the categories of mortgage collateral and lending activity, are described overleaf.

Our exposure to non-residential mortgage-related ABSs and direct lending includes securities with collateral relating to commercial property mortgages, leveraged finance loans, student loans, and other assets such as securities with other receivable-related collateral.

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Definitions and classifications of ABSs and CDOs

Categories of ABSs and CDOs	Definition	Classification
Sub-prime	Loans to customers who have limited credit histories, modest incomes or high debt-to-income ratios or have experienced credit problems caused by occasional delinquencies, prior charge-offs, bankruptcy or other credit-related actions.	For US mortgages, a FICO score of 620 or less has primarily been used to determine whether a loan is sub-prime. For non-US mortgages, management judgement is used.
US Home Equity Lines of Credit (HELoC s)	A form of revolving credit facility provided to customers, which is supported in the majority of circumstances by a second lien or lower ranking charge over residential property.	Holdings of HELoCs are classified as sub-prime.
US Alt-A	Lower risk loans than sub-prime, but they share higher risk characteristics than lending under fully conforming standard criteria.	US credit scores and the completeness of documentation held (such as proof of income), are considered when determining whether an Alt-A classification is appropriate. Non sub-prime mortgages in the US are classified as Alt-A if they are not eligible for sale to the major US Government mortgage agencies or sponsored entities.
US Government agency and sponsored enterprises mortgage-related assets	Securities that are guaranteed by US Government agencies such as the Government National Mortgage Association (Ginnie Mae), or by US Government sponsored entities including the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac).	Holdings of US Government agency and US Government sponsored enterprises mortgage-related assets are classified as prime exposures.
UK non-conforming mortgages	UK mortgages that do not meet normal lending criteria. Examples include mortgages where the expected level of documentation is not provided (such as income with self-certification), or where poor credit history increases risk and results in pricing at a higher than normal lending rate.	UK non-conforming mortgages are treated as sub-prime exposures.
Other mortgages	Residential mortgages, including prime mortgages, that do not meet any of the classifications described above.	Prime residential mortgage-related assets are included in this category.

Impairment methodologies

(Audited)

To identify objective evidence of impairment for available-for-sale ABSs, an industry standard valuation model is normally applied which uses data with reference to the underlying asset pools and models their projected future cash flows. The estimated future cash flows of the securities are assessed at the specific financial asset level to determine whether any of them are unlikely to be recovered as a result of loss events occurring on or before the reporting date.

The principal assumptions and inputs to the models are typically the delinquency status of the underlying loans, the probability of delinquent loans progressing to default, the prepayment profiles of the underlying assets and the loss severity in the event of default. However, the models utilise other variables relevant to specific classes of collateral to forecast future defaults and recovery rates. Management uses externally available data and applies judgement when determining the appropriate assumptions in respect of these factors. We use a modelling approach which incorporates historically observed progression rates to default to determine if the decline in aggregate projected cash flows from the underlying collateral will lead to a shortfall in contractual cash flows. In such cases, the security is considered to be impaired.

In respect of CDOs, expected future cash flows for the underlying collateral are assessed to determine whether there is likely to be a shortfall in the contractual cash flows of the CDO.

When a security benefits from a contract provided by a monoline insurer that insures payments of principal and interest, the expected recovery on the contract is assessed in determining the total expected credit support available to the ABS.

Report of the Directors: Financial Review (continued)

Liquidity and funding

(Audited)

The management of liquidity and funding is primarily undertaken locally (by country) in our operating entities in compliance with the Group s liquidity and funding risk management framework (the LFRF), and with practices and limits set by the GMB through the Risk Management Meeting and approved by the Board. These limits vary according to the depth and the liquidity of the markets in which the entities operate. Our general policy is that each defined operating entity should be self-sufficient in funding its own activities. Where transactions exist between operating entities, they are reflected symmetrically in both entities.

As part of our Asset, Liability and Capital Management (ALCM) structure, we have established ALCOs at Group level, in the regions and in operating entities. The terms of reference of all ALCOs include the monitoring and control of liquidity and funding.

The primary responsibility for managing liquidity and funding within the Group s framework and risk appetite resides with the local operating entities ALCOs. Our most significant operating entities are overseen by regional ALCOs, Group ALCO and the Risk Management Meeting. The remaining smaller operating entities are overseen by regional ALCOs, with appropriate escalation of significant issues to Group ALCO and the Risk Management Meeting.

Operating entities are predominately defined on a country basis to reflect our local management of liquidity and funding. Typically, an operating entity will be defined as a single legal entity. However, to take account of the situation where operations in a country are booked across multiple subsidiaries or branches:

- an operating entity may be defined as a wider sub-consolidated group of legal entities if they are incorporated in the same country, liquidity and funding are freely fungible between the entities and permitted by local regulation, and the definition reflects how liquidity and funding are managed locally; or
- an operating entity may be defined more narrowly as a principal office (branch) of a wider legal entity operating in multiple countries, reflecting the local country management of liquidity and funding.

The Risk Management Meeting reviews and agrees annually the list of entities it directly oversees and the composition of these entities.

Primary sources of funding

(Audited)

Customer deposits in the form of current accounts and savings deposits payable on demand or at short notice form a significant part of our funding, and we place considerable importance on maintaining their stability. For deposits, stability depends upon maintaining depositor confidence in our capital strength and liquidity, and on competitive and transparent pricing.

We also access wholesale funding markets by issuing senior secured and unsecured debt securities (publically and privately) and borrowing from the secured repo markets against high quality collateral, in order to obtain funding for non-banking subsidiaries that do not accept deposits, to align asset and liability maturities and currencies and to maintain a presence in local wholesale markets.

The management of funding and liquidity risk

(Audited)

Inherent liquidity risk categorisation

We place our operating entities into one of three categories (low, medium and high) to reflect our assessment of their inherent liquidity risk considering political, economic and regulatory factors within the host country and factors specific to the operating entities themselves, such as their local market, market share and balance sheet strength. The categorisation involves management judgement and is based on the perceived liquidity risk of an operating entity relative to other entities in the Group. The categorisation is intended to reflect the possible impact of a liquidity event, not the probability of an event, and forms part of our risk appetite. It is used to determine the prescribed stress scenario that we require our operating entities to be able to withstand and manage to.

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Core deposits

A key element of our internal framework is the classification of customer deposits into core and non-core based on our expectation of their behaviour during periods of liquidity stress. This characterisation takes into account the inherent liquidity risk categorisation of the operating entity originating the deposit, the nature of the customer and the size and pricing of the deposit. No deposit is considered to be core in its entirety unless it is contractually collateralising a loan. The core deposit base in each operating entity is considered to be a long-term source of funding and therefore is assumed not to be withdrawn in the liquidity stress scenario that we use to calculate our principal liquidity risk metrics.

The three filters considered in assessing whether a deposit in any operating entity is core are:

- *price:* any deposit priced significantly above market or benchmark rates is generally treated as entirely non-core;
- *size:* depositors with total funds above certain monetary thresholds are excluded. Thresholds are established by considering the business line and inherent liquidity risk categorisation; and
- *line of business:* the element of any deposit remaining after the application of the price and size filters is assessed on the basis of the line of business with which the deposit is associated. The proportion of any customer deposit that can be considered core under this filter is between 35% and 90%.

Repo transactions and bank deposits cannot be classified as core deposits.

Advances to core funding ratio

Core customer deposits are an important source of funding to finance lending to customers, and militate against reliance on short-term wholesale funding. Limits are placed on operating entities to restrict their ability to increase loans and advances to customers without corresponding growth in core customer deposits or long-term debt funding with a residual maturity beyond one year; this measure is referred to as the advances to core funding ratio.

Advances to core funding ratio limits are set by the Risk Management Meeting for the most significant operating entities, and by regional ALCOs for smaller operating entities, and are monitored by ALCM teams. The ratio describes current loans and advances to customers as a percentage of the total of core customer deposits and term funding with a remaining term to maturity in excess of one year. In general, customer loans are assumed to be renewed and are included in the numerator of the ratio, irrespective of the contractual maturity date. Reverse repo arrangements are excluded from the advances to core funding ratio.

Stressed coverage ratios

Stressed coverage ratios are derived from stressed cash flow scenario analyses and express stressed cash inflows as a percentage of stressed cash outflows over one-month and three-month time horizons.

The stressed cash inflows include:

- inflows (net of assumed haircuts) expected to be generated from the realisation of liquid assets; and
- contractual cash inflows from maturing assets that are not already reflected as a utilisation of liquid assets.

In line with the approach adopted for the advances to core funding ratio, customer loans are generally assumed not to generate any cash inflows under stress scenarios and are therefore excluded from the numerator of the stressed coverage ratio, irrespective of the contractual maturity date.

A stressed coverage ratio of 100% or higher reflects a positive cumulative cash flow under the stress scenario being monitored. Group operating entities are required to maintain a ratio of 100% or greater out to three months under the combined market-wide and HSBC-specific stress scenario defined by the inherent liquidity risk categorisation of the operating entity concerned.

Compliance with operating entity limits is monitored by ALCM teams and reported monthly to the Risk Management Meeting for the main operating entities and to regional ALCOs for the smaller operating entities.

Stressed scenario analysis

(Unaudited)

We use a number of standard Group stress scenarios designed to model:

- combined market-wide and HSBC-specific liquidity crisis scenarios; and
- market-wide liquidity crisis scenarios.

Report of the Directors: Financial Review (continued)

These scenarios are modelled by all operating entities. The appropriateness of the assumptions for each scenario is reviewed by ALCM regularly and formally approved by the Risk Management Meeting and the Board annually as part of the liquidity and funding risk appetite approval process.

Stressed cash outflows are determined by applying a standard set of prescribed stress assumptions to the Group s cash flow model. Our framework prescribes the use of two market-wide scenarios and three further combined market-wide and HSBC-specific stress scenarios of increasing severity. In addition to our standard stress scenarios, individual operating entities are required to design their own scenarios to reflect specific local market conditions, products and funding bases.

The three combined market-wide and HSBC-specific scenarios model a more severe scenario than the two market-wide scenarios. The relevant combined market-wide and HSBC-specific stress scenario that an operating entity manages to is based upon its inherent liquidity risk categorisation. The key assumptions factored into the three combined market-wide and HSBC-specific stress scenarios are summarised as follows:

- all non-core deposits are deemed to be withdrawn within three months (80% within one month), with the level of non-core deposits dependent on the operating entity s inherent liquidity risk categorisation;

- the ability to access interbank funding and unsecured term debt markets ceases for the duration of the scenario;

- the ability to generate funds from illiquid asset portfolios (securitisation and secured borrowing) is restricted to 25-75% of the lower of issues in the last six months or expected issues in the next six months. The restriction is based on current market conditions and is dependent on the operating entity s inherent liquidity risk categorisation;

- the ability to access repo funding ceases for any asset not classified as liquid under our liquid asset policy for the duration of the scenario;

- drawdowns on committed lending facilities must be consistent with the severity of the market stress being modelled and dependent on the inherent liquidity risk categorisation of the operating entity;

- outflows are triggered by a defined downgrade in long-term ratings. We maintain an ongoing assessment of the appropriate number of notches to reflect;

- customer loans are assumed to be renewed at contractual maturity;

- interbank loans and reverse repos are assumed to run off contractually; and assets defined as liquid assets are assumed to be realised in cash ahead of their contractual maturity, after applying a defined stressed haircut of up to 20%.

Liquid assets of HSBC s principal operating entities

(Audited)

Stressed scenario analysis and the numerator of the coverage ratio include the assumed cash inflows that would be generated from the realisation of liquid assets, after applying the appropriate stressed haircut. These assumptions are made on the basis of management s expectation of when an asset is deemed to be realisable.

Liquid assets are unencumbered assets that meet the Group s definition of liquid assets and are either held outright or as a consequence of a reverse repo transaction with a residual contractual maturity beyond the time horizon of the stressed coverage ratio being monitored. Any unencumbered asset held as a result of reverse repo transactions with a contractual maturity within the time horizon of the stressed coverage ratio being monitored is excluded from the stock of liquid assets and is instead reflected as a contractual cash inflow.

Our framework defines the asset classes that can be assessed locally as high quality and realisable within one month and between one month and three months. Each local ALCO has to be satisfied that any asset which may be treated as liquid in accordance with the Group s liquid asset policy will remain liquid under the stress scenario being managed to.

Inflows from the utilisation of liquid assets within one month can generally only be based on confirmed withdrawable central bank deposits, gold or the sale or repo of government and quasi-government exposures generally restricted to those denominated in the sovereign s domestic currency. High quality ABSs (predominantly US MBSs) and covered bonds are also included but inflows assumed for these assets are capped.

Inflows after one month are also reflected for high quality non-financial and non-structured corporate bonds and equities within the most liquid indices.

Report of the Directors: Financial Review (continued)

Internal categorisation	Cash inflow recognised	Asset classes
Level 1	Within one month	Central government
		Central bank (including confirmed withdrawable reserves)
		Supranationals
		Multilateral development banks
		Coins and banknotes
Level 2	Within one month but capped	Local and regional government
		Public sector entities
		Secured covered bonds and pass-through ABSs
		Gold
Level 3	From one to three months	Unsecured non-financial entity securities
		Equities listed on recognised exchanges and within liquid indices

Any entity owned and controlled by central or local/regional government but not explicitly guaranteed is treated as a public sector entity.

Any exposure explicitly guaranteed is reflected as an exposure to the ultimate guarantor.

In terms of the criteria used to ensure liquid assets are of a high quality, the Group s liquid asset policy sets out the following additional criteria:

1. Central bank and central government exposures denominated in the domestic currency of the related sovereign and held onshore in the domestic banking system qualify as level 1 liquid assets.

2. Central bank and central government exposures denominated in the domestic currency of the related sovereign and held offshore must be risk weighted 20% or lower under the Basel standardised risk weighting methodology to qualify as level 1 liquid assets.

3. Central bank and central government exposures denominated in a currency other than the currency of the related sovereign (i.e. foreign currency) must be risk weighted 20% or lower under the Basel standardised risk weighting methodology and issued in a limited number of major currencies to qualify as level 1 liquid assets.

The treatment of eurozone countries using the euro as their domestic currency depends on whether the exposures are held onshore in the domestic banking system or offshore. Central bank and central government exposures held onshore in the domestic banking system qualify as level 1 liquid assets under criteria 1, but central bank and central government exposures held offshore are considered to be denominated in a foreign currency under criteria 3.

4. Local/regional government exposures held onshore and considered by the local regulator to be the same risk as central government exposures can be considered central government exposures.

5. Supranationals and multilateral development banks must be 0% risk weighted under the Basel standardised risk- weighting methodology to qualify as level 1 liquid assets.

6. To qualify as a level 2 liquid asset, the exposure must be risk weighted 20% or lower under the Basel standardised risk-weighting methodology.

7. To qualify as a level 3 liquid asset, an unsecured non-financial corporate debt exposure must satisfy a minimum internal rating requirement.

On a case-by-case basis operating entities are permitted to treat other assets as liquid if these assets are realistically assessed to be liquid under stress. These liquid assets are reported as Other separately from level 1, level 2 and level 3 liquid assets.

Wholesale debt monitoring

(Unaudited)

Where wholesale debt term markets are accessed to raise funding, ALCO is required to establish cumulative rolling three-month and 12-month debt maturity limits to ensure no concentration of maturities within these timeframes.

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Liquidity behaviouralisation

(Unaudited)

Liquidity behaviouralisation is applied to reflect our assessment of the expected period for which we are confident that we will have access to our liabilities, even under a severe liquidity stress scenario, and the expected period for which we must assume that we will need to fund our assets. Behaviouralisation is applied when the contractual terms do not reflect the expected behaviour. Liquidity behaviouralisation is reviewed and approved by local ALCO in compliance with policies set by the Risk Management Meeting. Our approach to liquidity risk management will often mean different approaches are applied to assets and liabilities. For example, management may assume a shorter life for liabilities and a longer-term funding requirement for assets. All core deposits are assumed under the Group s core/non-core and advances to core funding frameworks to have a liquidity behaviouralised life beyond one year and to represent a homogeneous source of core funding. The behaviouralisation of assets is far more granular and seeks to differentiate the period for which we must assume that we will need to fund the asset.

Contingent liquidity risk

(Unaudited)

Operating entities provide customers with committed facilities and committed backstop lines to the conduit vehicles we sponsor. These commitments increase our funding requirements when customers draw down. The liquidity risk associated with the potential drawdown on non-cancellable commitments is factored into our stressed scenarios and limits are set for these facilities.

Management of cross-currency liquidity and funding risk

(Unaudited)

Our liquidity and funding risk framework also considers the ability of each entity to continue to access foreign exchange markets under stress when a surplus in one currency is used to meet a deficit in another currency, for example, by the use of the foreign currency swap markets. Where appropriate, operating entities are required to monitor stressed coverage ratios and advances to core funding ratios for non-local currencies.

Funds transfer pricing

(Unaudited)

Our funds transfer pricing policies give rise to a two-stage funds transfer pricing approach, reflecting the fact that we separately manage interest rate risk and liquidity and funding risk under different assumptions. They have been developed to be consistent with our risk management frameworks. Each operating entity is required to apply the Group s transfer pricing policy framework to determine for each material currency the most appropriate interest rate risk transfer pricing curve, a liquidity premium curve (which is the spread over the interest rate risk transfer pricing curve) and a liquidity recharge assessment (which is the spread under or over the interest rate risk transfer pricing curve).

The interest rate risk transfer pricing policy seeks to ensure that all market interest rate risk arising structurally from non-trading (banking book) assets and liabilities, which is capable of being neutralised externally in the market or neutralised internally by off-setting transfers, is transferred to BSM to be managed centrally as non-traded market risk. For each material currency each operating entity employs a single interest rate risk transfer pricing curve. The transfer price curve used for this purpose reflects how BSM in each operating entity is best able to neutralise the interest rate risk in the market at the point of transfer. Where basis risk can be identified between the re-pricing basis of an external asset or external liability and the re-pricing basis of the interest rate risk transfer pricing curve, this basis risk may be transferred to BSM provided it can neutralise the basis risk in the market.

Liquidity and funding risk is transfer priced independently from interest rate risk because the liquidity and funding risk of an operating entity is transferred to ALCO to be managed centrally. ALCO monitors and manages the advances to core funding ratio and delegates the management of the liquid asset portfolio and execution of the wholesale term debt funding plan to BSM, requiring BSM to ensure the Group s stressed coverage ratios remain above 100% out to three months.

The liquidity and funding risk transfer price consists of two components:

Liquidity recharge: the cost of holding the benchmark liquid asset (the yield under the transfer price) to meet stressed cash outflows. The benchmark liquid asset is decided by ALCO and based on the weighted average duration that can be achieved by investing in level 1 liquid assets, with a residual duration of up to one year.

280

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Liquidity premium: the assessed cost/value of term funding (the yield over the transfer price) to pay for term debt and core deposits. The assessed cost of holding liquid assets is allocated to the outflows modelled by the Group s internal stressed coverage ratio framework.

Liquidity premium is charged to any asset that affects our three-month stressed coverage ratios based on the assessed behaviouralised liquidity life of the asset, with any asset affecting the Group s advances to core funding metric required to have a minimum behaviouralised life of at least one year, and the prevailing liquidity premium curve rate set by ALCO and calibrated in line with Group s calibration principles. Core deposits therefore share equally in the liquidity premiums charged to the assets they support, after deducting the cost of any term funding.

HSBC Holdings

(Audited)

HSBC Holdings primary sources of cash are dividends received from subsidiaries, interest on and repayment of intra-group loans and interest earned on its own liquid funds. HSBC Holdings also raises ancillary funds in the debt capital markets through subordinated and senior debt issuance. Cash is primarily used for the provision of capital to subsidiaries, interest payments to debt holders and dividend payments to shareholders.

HSBC Holdings is also subject to contingent liquidity risk by virtue of loan and other credit-related commitments and guarantees and similar contracts issued. Such commitments and guarantees are only issued after due consideration of HSBC Holdings ability to finance the commitments and guarantees and the likelihood of the need arising.

HSBC Holdings actively manages the cash flows from its subsidiaries to optimise the amount of cash held at the holding company level. The ability of subsidiaries to pay dividends or advance monies to HSBC Holdings depends on, among other things, their respective regulatory capital requirements, statutory reserves, and financial and operating performance. The wide range of our activities means that HSBC Holdings is not dependent on a single source of profits to fund its dividend payments to shareholders.

Market risk

Overview of market risk in global businesses

The diagram below illustrates the main business areas where trading and non-trading market risks reside.

Monitoring and limiting market risk exposures

(Audited)

We employ a range of tools to monitor and limit market risk exposures. These include sensitivity analysis, value at risk (VaR), stressed VaR and stress testing. While VaR provides the GMB with a measure of the market risk in the Group, sensitivity analysis and VaR are more commonly utilised for the management of the business units. Stress testing and stressed VaR complement these measures with estimates of potential losses arising from market turmoil.

Market risk is managed and controlled through limits approved by the GMB for HSBC Holdings and our various global businesses. These limits are allocated across business lines and to the Group s legal entities.

Report of the Directors: Financial Review (continued)

The management of market risk is principally undertaken in Markets, where 85% of the total value at risk of HSBC Holdings (excluding insurance) and almost all trading VaR resides, using risk limits approved by the GMB. Limits are set for portfolios, products and risk types, with market liquidity being a primary factor in determining the level of limits set. Group Risk, an independent unit within Group Head Office, is responsible for our market risk management policies and measurement techniques. Each major operating entity has an independent market risk management and control function which is responsible for measuring market risk exposures in accordance with the policies defined by Group Risk, and monitoring and reporting these exposures against the prescribed limits on a daily basis. The risk appetite is governed according to the framework illustrated to the left.

Each operating entity is required to assess the market risks arising on each product in its business and to transfer them to either its local Markets unit for management, or to separate books managed under the supervision of the local ALCO. Our aim is to ensure that all market risks are consolidated within operations that have the necessary skills, tools, management and governance to manage them professionally. In certain cases where the market risks cannot be fully transferred, we identify the impact of varying scenarios on valuations or on net interest income resulting from any residual risk positions. Further details on the control and management process for residual risks are provided on page 284.

Model risk is governed through Model Oversight Committees (MOC s) at the regional and global Wholesale Credit and Market Risk (WCMR) levels. They have direct oversight and approval responsibility for all traded risk models utilised for risk measurement and management and stress testing. The Committees prioritise the development of models, methodologies and practices used for traded risk management within the Group and ensure that they remain within our risk appetite and business plans. The Global WCMR MOC reports into the Group MOC, which oversees all risk types at Group level. Group MOC informs the Group Risk Management Meeting (RMM) about material issues at least on a bi-annual basis. The RMM is the Group s Designated Committee according to the regulatory rules and it has delegated day-to-day governance of all traded risk models to the Global WCMR MOC.

Sensitivity analysis

(Unaudited)

We use sensitivity measures to monitor the market risk positions within each risk type, for example, the present value of a basis point movement in interest rates for interest rate risk. Sensitivity limits are set for portfolios, products and risk types, with the depth of the market being one of the principal factors in determining the level of limits set.

Value at risk and stressed value at risk

(Audited)

VaR is a technique that estimates the potential losses on risk positions as a result of movements in market rates and prices over a specified time horizon and to a given level of confidence. Stressed VaR is primarily used for regulatory capital purposes but is integrated into the risk management process to facilitate efficient capital management and to highlight possible high-risk positions based on previous market volatility.

Both the VaR and stressed VaR models we use are based predominantly on historical simulation. These models derive plausible future scenarios from past series of recorded market rates and prices, taking into account inter-relationships between different markets and rates such as interest rates and foreign exchange rates. The models also incorporate the effect of option features on the underlying exposures.

Report of the Directors: Financial Review (continued)

The historical simulation models used incorporate the following features:

- historical market rates and prices are calculated with reference to foreign exchange rates and commodity prices, interest rates, equity prices and the associated volatilities;
- potential market movements utilised for VaR are calculated with reference to data from the past two years,
- potential market movements employed for stressed VaR calculations are based on a continuous one-year period of stress for the trading portfolio; the choice of period (March 2008 to February 2009) is based on the assessment at the Group level of the most volatile period in recent history; and
- VaR measures are calculated to a 99% confidence level and use a one-day holding period scaled to 10 days, whereas stressed VaR uses a 10-day holding period.

The nature of the VaR models means that an increase in observed market volatility will lead to an increase in VaR without any changes in the underlying positions.

We routinely validate the accuracy of our VaR models by back-testing the actual daily profit and loss results, adjusted to remove non-modelled items such as fees and commissions, against the corresponding VaR numbers. We expect on average to see losses in excess of VaR 1% of the time over a one-year period.

Although a valuable guide to risk, VaR should always be viewed in the context of its limitations. For example:

- the use of historical data as a proxy for estimating future events may not encompass all potential events, particularly those which are extreme in nature;
- the use of a holding period assumes that all positions can be liquidated or the risks offset during that period. This may not fully reflect the market risk arising at times of severe illiquidity, when the holding period may be insufficient to liquidate or hedge all positions fully;
- the use of a 99% confidence level by definition does not take into account losses that might occur beyond this level of confidence;
- VaR is calculated on the basis of exposures outstanding at the close of business and therefore does not necessarily reflect intra-day exposures; and

VaR is unlikely to reflect loss potential on exposures that only arise under conditions of significant market movement.
Our VaR model is designed to capture significant basis risks such as CDS versus bond, asset swap spreads and cross-currency basis. Other basis risks which are not completely covered in VaR, such as the Libor tenor basis, are complemented by our risk-not-in-VaR (RNIV) (unaudited) calculations and are integrated into our capital framework. Stress testing is also used as one of the market risk tools for managing basis risks.

The RNIV framework aims to capture and capitalise material market risks that are not adequately covered in the VaR model. Risks covered by RNIV represent 14% of market risk RWAs for models with regulatory approval and include those resulting from underlying risk factors which are not observable on a daily basis across asset classes and products, such as dividend risk and correlation risks. Risk factors are reviewed on a regular basis and either incorporated directly in the VaR models, where possible, or quantified through the VaR-based RNIV approach or a stress test approach within the RNIV framework. The severity of the scenarios is calibrated to be in line with the capital adequacy requirements. The outcome of the VaR-based RNIV is included in the VaR calculation and back-testing; a stressed VaR RNIV is also computed for the risk factors considered in the VaR-based RNIV approach.

The fair value of Level 3 assets in trading portfolios, comprising trading securities and derivatives, is immaterial. Market risk arising from Level 3 assets is managed by various market risk techniques such as stress testing and notional limits to limit our exposure. We generally do not hold Level 3 assets within our trading portfolios. The table on page 489 shows the movement in Level 3 financial instruments.

Stress testing

(Audited)

In recognition of the limitations of VaR, we augment it with stress testing as an integrated risk management tool to evaluate the potential impact on portfolio values of more extreme, although plausible, events or movements in a set of financial variables.

Stress testing is implemented at the legal entity, regional and overall Group levels. A standard set of scenarios is utilised consistently across all regions within the Group. Scenarios are tailored in order to capture the relevant events or market movements at each level. The risk appetite around potential stress losses for the Group is set and monitored against referral limits.

Report of the Directors: Financial Review (continued)

The process is governed by the Stress Testing Review Group forum which, in conjunction with regional risk management, determines the scenarios to be applied at portfolio and consolidated levels, as follows:

- single risk factor stress scenarios that are unlikely to be captured within the VaR models, such as the break of a currency peg;
- technical scenarios consider the largest move in each risk factor without consideration of any underlying market correlation;
- hypothetical scenarios consider potential macroeconomic events, for example, the slowdown in mainland China and the potential effects of a sovereign debt default, including its wider contagion effects; and
- historical scenarios incorporate historical observations of market movements during previous periods of stress which would not be captured within VaR.

Representative scenarios utilised for stress testing at the regional and global levels include the following:

- *China hard landing:* This scenario is designed to capture the effect of an economic slowdown in mainland China and in other emerging markets. The objective of this scenario is to quantify the impact of market reactions to an economic deterioration in Asia followed by Latin America. Under such an event, investors risk aversion and drops in commodity prices are assumed to affect a range of market factors. Credit spreads and yield curves would rise while stock prices would fall, particularly in the regions of focus. Emerging currencies would mostly depreciate against the US dollar.
- *US selective default:* This scenario assumes that the US debt ceiling cannot be raised any higher and the US government defaults on a specific set of treasury bonds. This type of event is considered in two stages. A direct impact is assessed from missing coupons and bond principals. A secondary impact captures wider market reactions such as a sharp rise of short-term US interest rates, a widening of credit spreads, a flight to alternative safe havens to the US debt and the US dollar and a general risk aversion in emerging markets.
- *Currency de-peg:* The managed peg of the Hong Kong dollar, renminbi and Middle Eastern currencies to the US dollar is assumed to break down. Wide and sudden exchange rate shocks for each currency pair are designed to capture the impact on our exposures.

Stress testing results are submitted to the GMB and Risk Management Committee (RMC) meetings in order to provide senior management with an assessment of the financial effect such events would have. Risk management either provides recommendations to maintain exposures which are deemed to be acceptable or proposes mitigating actions that bring risk within our appetite.

In addition, reverse stress tests are undertaken, based upon the premise that there is a fixed loss. The stress test process identifies which scenarios lead to this loss. The rationale behind the reverse stress test is to understand scenarios which are beyond normal business settings that could have contagion and systemic implications.

Stressed VaR and stress testing, together with reverse stress testing and the management of gap risk, provide management with insights regarding the tail risk beyond VaR. HSBC appetite for tail risk is limited.

Trading portfolios

(Audited)

Our control of market risk in the trading portfolios is based on a policy of restricting individual operations to trading within a list of permissible instruments authorised for each site by Group Risk, of enforcing new product approval procedures, and of restricting trading in the more complex derivative products only to offices with appropriate levels of product expertise and robust control systems.

Gap risk

Certain transactions are structured to render the risk to HSBC negligible under a wide range of market conditions or events. However, there exists a remote possibility that a gap event could lead to loss. A gap event could arise from a significant change in market price with no accompanying trading opportunity, with the result that the threshold is breached beyond which the risk profile changes from no risk to full exposure to the underlying structure. Such movements may occur, for example, when, in reaction to an adverse event or unexpected news announcement, the market for a specific investment becomes illiquid, making hedging impossible.

Given their characteristics, these transactions make little or no contribution to VaR or to traditional market risk sensitivity measures. We capture their risks within our stress testing scenarios and monitor gap risk on an ongoing

Report of the Directors: Financial Review (continued)

basis. We regularly consider the probability of gap loss, and fair value adjustments are booked against this risk where significant.

Gap risk derived from certain transactions in legacy portfolios remained immaterial and limits continued to be managed down during 2013. We did not incur any material gap loss in 2013.

ABS/MBS exposures

The ABS/MBS exposures within the trading portfolios are managed within sensitivity and VaR limits as described on page 232, and are included within the stress testing scenarios described above.

Non-trading portfolios

(Audited)

The principal objective of market risk management of non-trading portfolios is to optimise net interest income.

Interest rate risk in non-trading portfolios arises principally from mismatches between the future yield on assets and their funding cost, as a result of interest rate changes. Analysis of this risk is complicated by having to make assumptions on embedded optionality within certain product areas such as the incidence of mortgage prepayments, and from behavioural assumptions regarding the economic duration of liabilities which are contractually repayable on demand such as current accounts, and the re-pricing behaviour of managed rate products.

Our control of market risk in the non-trading portfolios is based on transferring the assessed market risk of non-trading assets and liabilities created outside BSM or Markets, to the books managed by BSM, provided the market risk can be neutralised. The net exposure is typically managed by BSM through the use of fixed rate government bonds (liquid assets held in available-for-sale books) and interest rate swaps. The interest rate risk arising from fixed rate government bonds held within available-for-sale portfolios is reflected within the Group s non-traded VaR. Interest rate swaps used by BSM are typically classified as either a fair value hedge or a cash flow hedge and are included within the Group s non-traded VaR. Any market risk that cannot be neutralised in the market is managed by local ALCO in segregated ALCO books.

Our funds transfer pricing policies give rise to a two stage funds transfer pricing approach. For details see page 280.

Credit spread risk for available-for-sale debt instruments

The risk associated with movements in credit spreads is primarily managed through sensitivity limits, stress testing and VaR. The VaR shows the effect on income from a one-day movement in credit spreads over a two-year period, calculated to a 99% confidence interval.

Available-for-sale equity securities

Potential new commitments are subject to risk appraisal to ensure that industry and geographical concentrations remain within acceptable levels for the portfolio. Regular reviews are performed to substantiate the valuation of the investments within the portfolio and investments held to facilitate ongoing business, such as holdings in government-sponsored enterprises and local stock exchanges.

Structural foreign exchange exposures

(Unaudited)

Structural foreign exchange exposures represent net investments in subsidiaries, branches and associates, the functional currencies of which are currencies other than the US dollar. An entity s functional currency is that of the primary economic environment in which the entity operates.

Exchange differences on structural exposures are recognised in Other comprehensive income . We use the US dollar as our presentation currency in our consolidated financial statements because the US dollar and currencies linked to it form the major currency bloc in which we transact and fund our business. Our consolidated balance sheet is, therefore, affected by exchange differences between the US dollar and all the non-US dollar functional currencies of underlying subsidiaries.

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

We hedge structural foreign exchange exposures only in limited circumstances. Our structural foreign exchange exposures are managed with the primary objective of ensuring, where practical, that our consolidated capital ratios and the capital ratios of individual banking subsidiaries are largely protected from the effect of changes in exchange rates. This is usually achieved by ensuring that, for each subsidiary bank, the ratio of structural exposures in a given currency to risk-weighted assets denominated in that currency is broadly equal to the capital ratio of the subsidiary in question.

We may also transact hedges where a currency in which we have structural exposures is considered likely to revalue adversely, and it is possible in practice to transact a hedge. Any hedging is undertaken using forward foreign exchange contracts which are accounted for under IFRSs as hedges of a net investment in a foreign operation, or by financing with borrowings in the same currencies as the functional currencies involved.

Sensitivity of net interest income

(Unaudited)

A principal part of our management of market risk in non-trading portfolios is to monitor the sensitivity of projected net interest income under varying interest rate scenarios (simulation modelling). We aim, through our management of market risk in non-trading portfolios, to mitigate the effect of prospective interest rate movements which could reduce future net interest income, while balancing the cost of such hedging activities on the current net revenue stream.

Entities apply a combination of scenarios and assumptions relevant to their local businesses, and standard scenarios which are required throughout HSBC. The latter are consolidated to illustrate the combined pro forma effect on our consolidated net interest income.

Projected net interest income sensitivity figures represent the effect of the pro forma movements in net interest income based on the projected yield curve scenarios and the Group s current interest rate risk profile. This effect, however, does not incorporate actions which would probably be taken by BSM or in the business units to mitigate the effect of interest rate risk. In reality, BSM seeks proactively to change the interest rate risk profile to minimise losses and optimise net revenues. The net interest income sensitivity calculations assume that interest rates of all maturities move by the same amount in the up-shock scenario. Rates are not assumed to become negative in the down-shock scenario which may, in certain currencies, effectively result in non-parallel shock. In addition, the net interest income sensitivity calculations take account of the effect on net interest income of anticipated differences in changes between interbank interest rates and interest rates over which the entity has discretion in terms of the timing and extent of rate changes.

Defined benefit pension schemes

(Audited)

Market risk arises within our defined benefit pension schemes to the extent that the obligations of the schemes are not fully matched by assets with determinable cash flows. Pension scheme obligations fluctuate with changes in long-term interest rates, inflation, salary levels and the longevity of scheme members. Pension scheme assets include equities and debt securities, the cash flows of which change as equity prices and interest rates (and credit risk) vary. There is a risk that market movements in equity prices and interest rates could result in asset values which, taken together with regular ongoing contributions, are insufficient over time to cover the level of projected obligations and these, in turn, could increase with a rise in inflation and members living longer. Management, and in certain instances trustees (who act on behalf of the pension schemes beneficiaries), assess these risks using reports prepared by independent external consultants, take action and, where appropriate, adjust investment strategies and contribution levels accordingly.

HSBC Holdings

(Audited)

As a financial services holding company, HSBC Holdings has limited market risk activity. Its activities predominantly involve maintaining sufficient capital resources to support the Group s diverse activities; allocating these capital resources across our businesses; earning dividend and interest income on its investments in our businesses; providing dividend payments to HSBC Holdings equity shareholders and interest payments to providers of debt capital; and maintaining a supply of short-term capital resources for deployment under extraordinary circumstances. It does not take proprietary trading positions.

The main market risks to which HSBC Holdings is exposed are interest rate risk and foreign currency risk. Exposure

Report of the Directors: Financial Review (continued)

to these risks arises from short-term cash balances, funding positions held, loans to subsidiaries, investments in long-term financial assets and financial liabilities including debt capital issued. The objective of HSBC Holdings market risk management strategy is to reduce exposure to these risks and minimise volatility in capital resources, cash flows and distributable reserves. Market risk for HSBC Holdings is monitored by HSBC Holdings ALCO in accordance with its risk appetite statement.

HSBC Holdings uses interest rate swaps and cross currency interest rate swaps to manage the interest rate risk and foreign currency risk arising from its long-term debt issues.

Operational risk

(Unaudited)

The objective of our operational risk management is to manage and control operational risk in a cost effective manner within targeted levels of operational risk consistent with our risk appetite, as defined by the GMB.

Operational risk is organised as a specific risk discipline within Global Risk, and a formal governance structure provides oversight over its management. The Global Operational Risk function reports to the Group Chief Risk Officer and supports the Global Operational Risk and Control Committee. It is responsible for establishing and maintaining the operational risk management framework (ORMF), monitoring the level of operational losses and the effectiveness of the control environment. It is also responsible for operational risk reporting at Group level, including the preparation of reports for consideration by the Risk Management Meeting and Group Risk Committee. The Global Operational Risk and Control Committee meets at least quarterly to discuss key risk issues and review the effective implementation of the ORMF.

The ORMF defines minimum standards and processes and the governance structure for the management of operational risk and internal control in our geographical regions, global businesses and global functions. The ORMF has been codified in a high level standards manual supplemented with detailed policies which describe our approach to identifying, assessing, monitoring and controlling operational risk and give guidance on mitigating action to be taken when weaknesses are identified.

Business managers throughout the Group are responsible for maintaining an acceptable level of internal control commensurate with the scale and nature of operations, and for identifying and assessing risks, designing controls and monitoring the effectiveness of these controls. The ORMF helps managers to fulfil these responsibilities by defining a standard risk assessment methodology and providing a tool for the systematic reporting of operational loss data.

A centralised database is used to record the results of the operational risk management process. Operational risk and control self-assessments are input and maintained by business units. Business and functional management and Business Risk and Control Managers monitor the progress of documented action plans to address shortcomings. To ensure that operational risk losses are consistently reported and monitored at Group level, all Group companies are required to report individual losses when the net loss is expected to exceed US$10,000, and to aggregate all other operational risk losses under US$10,000. Losses are entered into the operational risk system and are reported to the Group Operational Risk function quarterly.

For further details, see the *Pillar 3 Disclosures 2013* report, page 84.

Compliance risk

(Unaudited)

Compliance risk falls within the definition of operational risk. All Group companies are required to observe the letter and spirit of all relevant laws, codes, rules, regulations and standards of good market practice. These rules, regulations, standards and Group policies include those relating to anti-money laundering, anti-bribery and corruption, counter-terrorist and proliferation financing, sanctions compliance, conduct of business, market conduct and other financial regulations.

In 2013, HSBC transformed its existing Global Compliance team into two distinct sub-functions: Financial Crime Compliance (FCC) and Regulatory Compliance (RC), jointly supported by Compliance Shared Services. These are control functions working as part of our Global Risk function. They are responsible for functional resourcing decisions, performance reviews, objectives, strategy, budget and accountability. They are empowered to set standards and have the authority to ensure those standards are met. The Global Head of Financial Crime Compliance and the Global Head of Regulatory Compliance both report to the Group Chief Risk Officer.

There are compliance teams in each of the countries where we operate and in all global businesses. These compliance

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

teams are principally overseen by Heads of Financial Crime Compliance and Regulatory Compliance located in Europe, the US, Canada, Latin America, Asia-Pacific and the Middle East and North Africa. There is an Assurance team within Compliance Shared Services that reviews the effectiveness of the Regional and Global Business Compliance teams.

Global policies and procedures require the prompt identification and escalation to Global Regulatory or Financial Crime Compliance of all actual or suspected breaches of any law, rule, regulation, policy or other relevant requirement. These escalation procedures are supplemented by a requirement for the submission of compliance certificates at the half-year and year-end by all Group companies and functions detailing any known breaches as above. The contents of these escalation and certification processes are used for reporting to the Risk Management Meeting, the Group Risk Committee and the Board. They are disclosed in the *Annual Report and Accounts* and *Interim Report*, as appropriate.

Legal risk

(Unaudited)

Each operating company is required to have processes and procedures in place to manage legal risk that conform to Group standards.

Legal risk falls within the definition of operational risk and includes:

- contractual risk, which is the risk that the rights and/or obligations of an HSBC company within a contractual relationship are defective;
- dispute risk, which is made up of the risks that an HSBC company is subject to when it is involved in or managing a potential or actual dispute;
- legislative risk, which is the risk that an HSBC company fails to adhere to the laws of the jurisdictions in which it operates; and
- non-contractual rights risk, which is the risk that an HSBC company s assets are not properly owned or are infringed by others, or an HSBC company infringes another party s rights.

Our Global Legal function assists management in controlling legal risk. There are legal departments in 51 of the countries in which we operate. In addition to the Group Legal function, there are regional legal functions in each of Europe, North America, Latin America, the Middle East and North Africa and Asia-Pacific headed by Regional General Counsels as well as a global General Counsel responsible for each of the global businesses.

Global security and fraud risk

(Unaudited)

Security and fraud risk issues are managed at Group level by Global Security and Fraud Risk. This unit, which has responsibility for physical risk, fraud, information and contingency risk, and geopolitical risk and business intelligence is fully integrated within Global Risk. This enables management to identify and mitigate the permutations of these and other non-financial risks to its business lines across the jurisdictions in which we operate.

The Fraud Risk function is responsible for ensuring that effective protection measures are in place against all forms of fraudulent activity, whether initiated internally or externally, and is available to support any part of the business. To achieve that and to attain the level of integration needed to face the threat, the management of all types of fraud (e.g. card fraud, non-card fraud and internal fraud, including investigations), is established within one management structure and is part of the Global Risk function.

We use technology extensively to prevent and detect fraud. For example, customers credit and debit card spending is monitored continuously and suspicious transactions are highlighted for verification, internet banking sessions are reviewed and transactions monitored in a similar way and all new account applications are screened for fraud. We have a fraud systems strategy which is designed to provide minimum standards and allow easier sharing of best practices to detect fraud and minimise false alerts.

We have developed a holistic and effective anti-fraud strategy comprising fraud prevention policies and practices, the implementation of strong internal controls, an investigations response team and liaison with law enforcement where appropriate.

The Business Continuity Planning function is responsible for ensuring that the group s critical systems, processes and functions have the resilience to maintain continuity in the face of major disruptive events. Within this wider risk,

Report of the Directors: Financial Review (continued)

Business Continuity Management covers the pre-planning for recovery, seeking to minimise the adverse effects of major business disruption, either globally, regionally or within country, against a range of actual or emerging risks. The pre-planning concentrates on the protection of customer services, our staff, revenue generation and the integrity of data and documents.

Each business and function has its own recovery plans, which are developed following the completion of a Business Impact Analysis. This determines how much time the business or function could sustain an outage before the level of losses becomes unacceptable, i.e. its criticality. These plans are reviewed and tested every year. The planning is undertaken against Group policy and standards and each business confirms in an annual compliance certificate that all have been met. Should there be exceptions, these are raised and their short-term resolution is overseen by Group and regional business continuity teams.

It is important that plans are dynamic and meet all risks, particularly those of an emerging nature such as possible pandemics and the eurozone crisis. The ORMF is used to measure our resilience to these risks, and is confirmed to Group and regional risk committees.

Resilience is managed through various risk mitigation measures. These include agreeing with IT acceptable recovery times of systems, ensuring our critical buildings have the correct infrastructure to enable ongoing operations, requiring critical vendors to have their own recovery plans and arranging with Group insurance appropriate cover for business interruption costs.

Systems risk

(Unaudited)

Systems risk is the risk of failure or other deficiency in the automated platforms that support the Group s daily execution (application systems) and the systems infrastructure on which they reside (data centres, networks and distributed computers).

The management of systems risk is overseen globally by the HTS organisation. Oversight is provided through monthly risk management committee meetings that provide a comprehensive overview of existing top and emerging risks.

HTS line management manages the control environment over systems risks using risk and control assessments and top risk analysis. Key risk indicators are used to assure a consistent basis of risk evaluation across geographic and line of business boundaries.

Business critical services have been identified through a central, global oversight body. Quantitative scorecards called Risk Appetite Statements have been established for each of these services.

Service Resilience and Systems Continuity Planning functions are in place to ensure systems meet agreed target service levels and in the event of major disruptive events, can be recovered within recovery time objectives agreed with the business.

Vendor risk management

(Unaudited)

Our vendor risk management (VRM) programme is a global framework for managing risk with third party vendors, especially where we are reliant on outsourced agreements to provide critical services to our customers. VRM contains a rigorous process to identify material contracts and their key risks and ensure controls are in place to manage and mitigate these risks.

Fiduciary risk

(Unaudited)

Business activities in which fiduciary risk is inherent should only be undertaken within designated lines of business. Fiduciary risk is managed within the designated businesses via a comprehensive policy framework and monitoring of key indicators. The Group s principal fiduciary businesses (designated businesses) are:

HSBC Securities Services, where it is exposed to fiduciary risk via its Funds Services and Corporate Trust and loan agency activities;

HSBC Global Asset Management, which is exposed to fiduciary risks via its investment management activities on behalf of clients;

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

- HSBC Global Private Banking, which is exposed to fiduciary risks via its Private Wealth Services division and discretionary investment management;

- HSBC Insurance, which is exposed to fiduciary risks via the investment management activities it undertakes when providing insurance products and services; and

- RBWM Trust Investment Wrappers, required by regulation for the provision of normal RBWM Wealth Management products and services.

The Group s requirements for the management of fiduciary risk are laid down in the Fiduciary section of the Global Risk Functional Instruction Manual, which is owned by Global Operational Risk. No business other than the designated businesses may undertake fiduciary activities without notifying Global Operational Risk and receiving specific dispensations from the relevant Fiduciary policy requirements.

Other policies around the provision of advice, including investment advice and corporate advisory, and the management of potential conflicts of interest, also mitigate our fiduciary risks.

Risk management of insurance operations

Overview of insurance products

(Audited)

HSBC manufactures the following main classes of life insurance contracts:

- life insurance contracts with discretionary participation features (DPF);

- credit life insurance business;

- annuities;

- term assurance and critical illness policies;

- linked life insurance;

- investment contracts with DPF;
- unit-linked investment contracts; and
- other investment contracts (including pension contracts written in Hong Kong).

We additionally write a small amount of non-life insurance business primarily covering personal and commercial property.

Nature and extent of risks

(Audited)

The majority of the risks in our Insurance business derive from manufacturing activities and can be categorised between financial risks and insurance risk; financial risks include market risk, credit risk and liquidity risk. Operational and sustainability risks are also present and are covered by the Group s respective overall risk management processes.

The following sections describe how financial risks and insurance risk are managed. The assets of insurance manufacturing subsidiaries are included within the consolidated risk disclosures on pages 134 to 265, although separate disclosures in respect of insurance manufacturing subsidiaries are provided in the Risk management of insurance operations section on pages 249 to 259.

Insurance manufacturers establish control procedures complying with the guidelines and requirements issued by Group Insurance and local regulatory requirements. Country level oversight is exercised by local risk management committees. Country Chief Risk Officers have direct reporting lines into local Insurance Chief Executive Officers and functional reporting lines into the Group Insurance Chief Risk Officer, who has overall accountability for risk management in insurance operations globally. The Group Insurance Executive Committee oversees the control framework globally and is accountable to the RBWM Risk Management Committee on risk matters.

In addition, local ALCOs monitor and review the duration and cash flow matching of insurance assets and liabilities.

All insurance products, whether manufactured internally or by a third party, are subjected to a product approval process prior to introduction.

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Financial risks

(Audited)

Our insurance businesses are exposed to a range of financial risks, including market risk, credit risk and liquidity risk. Market risk includes interest rate, equity and foreign exchange risks. The nature and management of these risks is described below.

Manufacturing subsidiaries are exposed to financial risks when, for example, the proceeds from financial assets are not sufficient to fund the obligations arising from insurance and investment contracts. In many jurisdictions, local regulatory requirements prescribe the type, quality and concentration of assets that these subsidiaries must maintain to meet insurance liabilities. These requirements complement Group-wide policies.

Market risk

(Audited)

Description of market risk

The main features of products manufactured by our insurance manufacturing subsidiaries which generate market risk, and the market risk to which these features expose the subsidiaries, are discussed below.

Interest rate risk arises to the extent that yields on the assets are lower than the investment returns implied by the guarantees payable to policyholders by insurance manufacturing subsidiaries. When the asset yields are below guaranteed yields, products may be discontinued, repriced or restructured. A list of the different types of guarantees within our insurance contracts is outlined below.

Categories of guaranteed benefits

- annuities in payment;
- deferred/immediate annuities: these consist of two phases the savings and investing phase and the retirement income phase;
- annual return: the annual return is guaranteed to be no lower than a specified rate. This may be the return credited to the policyholder every year, or the average annual return credited to the policyholder over the life of the policy, which may occur on the maturity date or the surrender date of the contract; and
- capital: policyholders are guaranteed to receive no less than the premiums paid plus declared bonuses less expenses.

The proceeds from insurance and investment products with DPF are primarily invested in bonds with a proportion allocated to other asset classes in order to provide customers with the potential for enhanced returns. Subsidiaries with portfolios of such products are exposed to the risk of falls in market prices which cannot be fully reflected in the discretionary bonuses. An increase in market volatility could also result in an increase in the value of the guarantee to the policyholder.

Long-term insurance and investment products typically permit the policyholder to surrender the policy or let it lapse at any time. When the surrender value is not linked to the value realised from the sale of the associated supporting assets, the subsidiary is exposed to market risk. In particular, when customers seek to surrender their policies when asset values are falling, assets may have to be sold at a loss to fund redemptions.

A subsidiary holding a portfolio of long-term insurance and investment products, especially with DPF, may attempt to reduce exposure to its local market by investing in assets in countries other than that in which it is based. These assets may be denominated in currencies other than the subsidiary s local currency. Where the foreign exchange exposure associated with these assets is not hedged, for example because it is not cost effective to do so, this exposes the subsidiary to the risk of its local currency strengthening against the currency of the related assets.

For unit-linked contracts, market risk is substantially borne by the policyholder, but market risk exposure typically remains as fees earned for management are related to the market value of the linked assets.

Asset and liability matching

It is not always possible to match asset and liability durations, partly because there is uncertainty over policyholder behaviour which introduces uncertainty over the receipt of all future premiums and the timing of claims, and partly because the forecast payment dates of liabilities may exceed the duration of the longest dated investments available.

We use models to assess the effect of a range of future scenarios on the values of financial assets and associated liabilities, and ALCOs employ the outcomes in determining how to best structure asset holdings to support liabilities. The scenarios include stresses applied to factors which affect insurance risk such as mortality and lapse rates. Of

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

particular importance is assessing the expected pattern of cash inflows against the benefits payable on the underlying contracts, which can extend for many years.

Our current portfolio of assets includes debt securities issued at a time when yields were higher than those observed in the current market. As a result, yields on extant holdings of debt securities exceed those available on current issues. We reduced short-term bonus rates paid to policyholders on certain participating contracts to manage the immediate strain on the business. Should interest rates and yield curves remain low further reductions may be necessary.

How market risk is managed

All our insurance manufacturing subsidiaries have market risk mandates which specify the investment instruments in which they are permitted to invest and the maximum quantum of market risk which they may retain. They manage market risk by using some or all of the techniques listed below, depending on the nature of the contracts they write.

Techniques for managing market risk

for products with DPF, adjusting bonus rates to manage the liabilities to policyholders. The effect is that a significant portion of the market risk is borne by the policyholder;

structuring asset portfolios to support projected liability cash flows;

using derivatives, to a limited extent, to protect against adverse market movements or better match liability cash flows;

for new products with investment guarantees, considering the cost when determining the level of premiums or the price structure;

periodically reviewing products identified as higher risk, which contain investment guarantees and embedded optionality features linked to savings and investment products;

including features designed to mitigate market risk in new products, such as charging surrender penalties to recoup losses incurred when policyholders surrender their policies;

exiting, to the extent possible, investment portfolios whose risk is considered unacceptable; and repricing of premiums charged to policyholders.

In the product approval process, the risks embedded in new products are identified and assessed. When, for example, options and guarantees are embedded in new products, the due diligence process ensures that complete and appropriate risk management procedures are in place. For all but the simplest of guaranteed benefits the assessment is undertaken by Group Insurance. Management reviews certain exposures more frequently when markets are more volatile to ensure that any matters arising are dealt with in a timely fashion.

How the exposure to market risk is measured

Our insurance manufacturing subsidiaries monitor exposures against mandated limits regularly and report them to Group Insurance. Exposures are aggregated and reported on a quarterly basis to senior risk management forums in Group Insurance.

In addition, large insurance manufacturing subsidiaries perform a high-level monthly assessment of market risk exposure against risk appetite. This is submitted to Group Insurance and a global assessment presented to the RBWM Risk Management Committee.

Standard measures for quantifying market risks

- for interest rate risk, the sensitivities of the net present values of asset and expected liability cash flows, in total and by currency, to a one basis point parallel shift in the discount curves used to calculate the net present values;
- for equity price risk, the total market value of equity holdings and the market value of equity holdings by region and country; and
- for foreign exchange risk, the total net short foreign exchange position and the net foreign exchange positions by currency.

The standard measures are relatively straightforward to calculate and aggregate, but they have limitations. The most significant one is that a parallel shift in yield curves of one basis point does not capture the non-linear relationships between the values of certain assets and liabilities and interest rates. Non-linearity arises, for example, from investment guarantees and product features which enable policyholders to surrender their policies. We bear the shortfall if the yields on investments held to support contracts with guaranteed benefits are less than the investment returns implied by the guaranteed benefits.

Report of the Directors: Financial Review (continued)

We recognise these limitations and augment our standard measures with stress tests which examine the effect of a range of market rate scenarios on the aggregate annual profits and total equity of our insurance manufacturing subsidiaries, after taking into consideration tax and accounting treatments where material and relevant. The results of these tests are reported to Group Insurance and risk committees every quarter.

The table, Sensitivity of HSBC s insurance manufacturing subsidiaries to market risk factors on page 255), indicates the sensitivity of insurance manufacturers profit and total equity to market risk factors.

Credit risk

(Audited)

Description of credit risk

Credit risk arises in two main areas for our insurance manufacturers:

(i) risk of default by debt security counterparties after investing premiums to generate a return for policyholders and shareholders; and

(ii) risk of default by reinsurance counterparties and non-reimbursement for claims made after ceding insurance risk.

How credit risk is managed

Our insurance manufacturing subsidiaries are responsible for the credit risk, quality and performance of their investment portfolios. Our assessment of the creditworthiness of issuers and counterparties is based primarily upon internationally recognised credit ratings and other publicly available information.

Investment credit exposures are monitored against limits by our local insurance manufacturing subsidiaries, and are aggregated and reported to Group Insurance Credit Risk and Group Credit Risk. Stress testing is performed by Group Insurance on the investment credit exposures using credit spread sensitivities and default probabilities.

We use a number of tools to manage and monitor credit risk. These include a Credit Watch Report which contains a watch-list of investments with current credit concerns and is circulated fortnightly to senior management in Group Insurance and the individual Country Chief Risk Officers to identify investments which may be at risk of future impairment.

Liquidity risk

(Audited)

Description of liquidity risk

It is an inherent characteristic of almost all insurance contracts that there is uncertainty over the amount of claims liabilities that may arise and the timing of their settlement, and this creates liquidity risk.

There are three aspects to liquidity risk. The first arises in normal market conditions and is referred to as funding liquidity risk; specifically, the capacity to raise sufficient cash when needed to meet payment obligations. Secondly, market liquidity risk arises when the size of a particular holding may be so large that a sale cannot be completed around the market price. Finally, standby liquidity risk refers to the capacity to meet payment terms in abnormal conditions.

How liquidity risk is managed

Our insurance manufacturing subsidiaries primarily fund cash outflows arising from claim liabilities from the following sources of cash inflows:

- premiums from new business, policy renewals and recurring premium products;
- interest and dividends on investments and principal repayments of maturing debt investments;
- cash resources; and
- the sale of investments.

They manage liquidity risk by utilising some or all of the following techniques:

- matching cash inflows with expected cash outflows using specific cash flow projections or more general asset and liability matching techniques such as duration matching;
- maintaining sufficient cash resources;

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

- investing in good credit-quality investments with deep and liquid markets to the degree to which they exist;
- monitoring investment concentrations and restricting them where appropriate, for example, by debt issues or issuers; and
- establishing committed contingency borrowing facilities.

Each of these techniques contributes to mitigating the three types of liquidity risk described above.

Every quarter, our insurance manufacturing subsidiaries are required to complete and submit liquidity risk reports to Group Insurance for collation and review. Liquidity risk is assessed in these reports by measuring changes in expected cumulative net cash flows under a series of stress scenarios designed to determine the effect of reducing expected available liquidity and accelerating cash outflows. This is achieved, for example, by assuming new business or renewals are lower, and surrenders or lapses are greater, than expected.

Insurance risk

(Audited)

Insurance risk is the risk, other than financial risk, of loss transferred from the holder of the insurance contract to the issuer (HSBC). The principal risk we face in manufacturing insurance contracts is that, over time, the cost of acquiring and administering a contract, claims and benefits may exceed the aggregate amount of premiums received and investment income.

The cost of claims and benefits can be influenced by many factors, including mortality and morbidity experience, lapse and surrender rates and, if the policy has a savings element, the performance of the assets held to support the liabilities.

Insurance risks are controlled by high-level policies and procedures set both centrally and locally, taking into account where appropriate local market conditions and regulatory requirements. Formal underwriting, reinsurance and claims-handling procedures designed to ensure compliance with regulations are applied, supplemented with stress testing.

As well as exercising underwriting controls, we use reinsurance as a means of mitigating exposure to insurance risk. Where we manage our exposure to insurance risk through the use of third-party reinsurers, the associated revenue and manufacturing profit is ceded to the reinsurers. Although reinsurance provides a means of managing insurance risk, such contracts expose us to credit risk, the risk of default by the reinsurer.

The principal drivers of our insurance risk are described below. The liabilities for long-term contracts are set by reference to a range of assumptions around these drivers. These typically reflect the issuers own experiences. The type and quantum of insurance risk arising from life insurance depends on the type of business, and varies considerably.

- *mortality and morbidity:* the main contracts which generate exposure to these risks are term assurance, whole life products, critical illness and income protection contracts and annuities. The risks are monitored on a regular basis, and are primarily mitigated by underwriting controls and reinsurance and by retaining the ability in certain cases to amend premiums in the light of experience;

lapses and surrenders: the risks associated with this are generally mitigated by product design, the application of surrender charges and management actions, for example, managing the level of bonus payments to policyholders. A detailed persistency analysis at a product level is carried out at least on an annual basis; and

expense risk is mitigated by pricing, for example, retaining the ability in certain cases to amend premiums and/or policyholder charges based on experience, and cost management discipline.

Liabilities are affected by changes in assumptions (see Sensitivity analysis on page 259).

Reputational risk

(Unaudited)

We regularly review our policies and procedures for safeguarding against reputational risk. This is an evolutionary process which takes account of relevant developments, industry guidance, best practice and societal expectations.

We have always aspired to the highest standards of conduct and, as a matter of routine, take account of reputational risks to our business. Reputational risks can arise from a wide variety of causes. As a banking group, our good reputation depends not only upon the way in which we conduct our business, but also by the way in which clients,

Report of the Directors: Financial Review (continued)

to whom we provide financial services, conduct themselves.

Group functions with responsibility for activities that attract reputational risk are represented at the Group Reputational Risk Policy Committee (GRRPC), which is chaired by the Group Chairman. The primary role of the GRRPC is to consider areas and activities presenting significant reputational risk and, where appropriate, to make recommendations to the Global Standards Steering Meeting for policy or procedural changes to mitigate such risk. Each of the Group s geographical regions is required to ensure that reputational risks are also considered at a regional level, either through a special section of their respective Regional Risk Management Committee or a regional Reputational Risk Policy Committee. Minutes from the regional meetings are tabled at GRRPC.

Each of the global businesses is required to have a procedure to assess and address reputational risks potentially arising from proposed business transactions and client activity. These are supported by a central team which ensures that issues are directed to the appropriate forum, that decisions taken are implemented and that management information is collated and actions reported to senior management.

Standards on all major aspects of business are set for HSBC and for individual subsidiaries, businesses and functions. Reputational risks, including environmental, social and governance matters, are considered and assessed by the Board, the GMB, the Risk Management Meeting, the Global Standards Steering Meeting, subsidiary company boards, Board committees and senior management during the formulation of policy and the establishment of our standards. These policies, which form an integral part of the internal control system (see page 364), are communicated through manuals and statements of policy and are promulgated through internal communications and training. The policies set out our risk appetite and operational procedures in all areas of reputational risk, including money laundering deterrence, counter-terrorist financing, environmental impact, anti-bribery and corruption measures and employee relations. The policy manuals address risk issues in detail and co-operation between Group departments and businesses is required to ensure a strong adherence to our risk management system and our sustainability practices.

Pension risk

(Audited)

We operate a number of pension plans throughout the world, as described in Note 7 on the Financial Statements, the Pension risk section on page 260 and below. Some of them are defined benefit plans, of which the largest is the HSBC Bank (UK) Pension Scheme (the principal plan).

In order to fund the benefits associated with these plans, sponsoring Group companies (and, in some instances, employees) make regular contributions in accordance with advice from actuaries and in consultation with the scheme s trustees (where relevant). The defined benefit plans invest these contributions in a range of investments designed to meet their long-term liabilities.

The level of these contributions has a direct impact on HSBC s cash flow and would normally be set to ensure that there are sufficient funds to meet the cost of the accruing benefits for the future service of active members. However, higher contributions will be required when plan assets are considered insufficient to cover the existing pension liabilities. Contribution rates are typically revised annually or triennially, depending on the plan. The agreed contributions to the principal plan are revised triennially.

A deficit in a defined benefit plan may arise from a number of factors, including:

- investments delivering a return below that required to provide the projected plan benefits. This could arise, for example, when there is a fall in the market value of equities, or when increases in long-term interest rates cause a fall in the value of fixed income securities held;
- the prevailing economic environment leading to corporate failures, thus triggering write-downs in asset values (both equity and debt);
- a change in either interest rates or inflation which causes an increase in the value of the scheme liabilities; and
- scheme members living longer than expected (known as longevity risk).

A plan s investment strategy is determined after taking into consideration the market risk inherent in the investments and its consequential impact on potential future contributions. The long-term investment objectives of both HSBC and, where relevant and appropriate, the trustees are:

- to limit the risk of the assets failing to meet the liabilities of the plans over the long-term; and
- to maximise returns consistent with an acceptable level of risk so as to control the long-term costs of the defined benefit plans.

Report of the Directors: Financial Review (continued)

In pursuit of these long-term objectives, a benchmark is established for the allocation of the defined benefit plan assets between asset classes. In addition, each permitted asset class has its own benchmarks, such as stock market or property valuation indices and, where relevant, desired levels of out-performance. The benchmarks are reviewed at least triennially within 18 months of the date at which an actuarial valuation is made, or more frequently if required by local legislation or circumstances. The process generally involves an extensive asset and liability review.

Ultimate responsibility for investment strategy rests with either the trustees or, in certain circumstances, a management committee. The degree of independence of the trustees from HSBC varies in different jurisdictions.

Pension plans in the UK

HSBC s largest plan exists in the UK, where the HSBC Bank (UK) Pension Scheme (the Scheme) covers employees of HSBC Bank plc and certain other employees of HSBC. This comprises a funded final salary defined benefit plan (the principal plan), which is closed to new entrants, and a defined contribution plan which was established in July 1996 for new employees.

The principal plan, which accounts for approximately 71% of the obligations of our defined benefit pension plans, is overseen by a corporate trustee who has a fiduciary responsibility for the operation of the pension scheme. The trustee is responsible for monitoring and managing the investment strategy and administration of scheme benefits.

The principal plan holds a diversified portfolio of investments to meet future cash flow liabilities arising from accrued benefits as they fall due to be paid. The trustee of the principal plan is required to produce a written Statement of Investment Principles which governs decision-making about how investments are made and the need for adequate diversification is taken into account in the choice of asset allocation and manager structure in the defined benefit section.

Longevity risk in the principal plan is assessed as part of the measurement of the pension liability and managed through the funding process of the scheme.

Pension plans in Hong Kong

In Hong Kong, the HSBC Group Hong Kong Local Staff Retirement Benefit Scheme covers employees of The Hongkong and Shanghai Banking Corporation and certain other employees of HSBC. The scheme comprises a funded defined benefit scheme and a defined contribution scheme. The defined benefit section of the scheme is a final salary lump sum scheme and therefore its exposure to longevity and interest rate risk is limited; it was closed to new members from 1999.

The trustee assumes the overall responsibility for the scheme but a management committee and a number of sub-committees have also been established. These committees have been established to broaden the governance and manage the concomitant issues. The finance and investment sub-committee review and make recommendations on the various issues in relation to both assets and liabilities of the scheme, to the management committee.

Pension plans in North America

The HSBC North America (US) Retirement Income Plan covers all employees of HSBC Bank USA, HSBC Finance and other HSBC entities in the US who have reached the age of 21 and met the one year of service participation requirement. The Retirement Income Plan is a funded defined benefit plan which provides final average pay benefits to legacy participants and cash balance benefits to all other participants. Prior to 1 January 2013, all new employees participated in the cash balance section of the plan. With effect from 1 January 2013, it was agreed to cease all future contributions under the cash balance formula and freeze the plan. Whilst participants with existing balances will no longer accrue benefits, they will continue to receive interest credits. In November 2009, the Board of Directors of HSBC North America Holdings, Inc.

(HNAH) approved actions to cease all future benefit accruals for legacy participants under the final average pay formula components of the HSBC North America Retirement Income Plan with effect from 1 January 2011.

The Plan is governed by the Employee Retirement Security Act of 1974 (ERISA), which regulations serve as guidance for the management of plan assets. In this regard, an investment committee (the committee) for the Plan has been established and its members have been appointed by the Chief Executive Officer as authorised by the Board of Directors of HNAH. The committee is responsible for establishing the funding policy and investment objectives supporting the Plan including allocating the assets of the Plan, monitoring the diversification of the Plan s

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

investments and investment performance, assuring the Plan does not violate any provisions of ERISA and the appointment, removal and monitoring of investment advisers and the trustee.

A key factor shaping the committee s attitude towards risk is the generally long-term nature of the underlying benefit obligations. The asset allocation decision reflects this long-term horizon as well as the ability and willingness to accept some short-term variability in the performance of the portfolio in exchange for the expectation of competitive long-term investment results for its participants.

Sustainability risk

(Unaudited)

Sustainability risks arise from the provision of financial services to companies or projects which run counter to the needs of sustainable development; in effect this risk arises when the environmental and social effects outweigh economic benefits. Within Group Head Office, a separate function, Global Corporate Sustainability, is mandated to manage these risks globally working through local offices as appropriate. Sustainability Risk Managers have regional or national responsibilities for advising on and managing environmental and social risks.

Global Corporate Sustainability s risk management responsibilities include:

- formulating sustainability risk policies. This includes overseeing our sustainability risk standards, our implementation of the Equator Principles for project finance lending, and our sector-based sustainability policies covering those sectors with high environmental or social impacts (forestry, freshwater infrastructure, chemicals, energy, mining and metals, and defence-related lending); undertaking an independent review of transactions where sustainability risks are assessed to be high; and supporting our operating companies to assess similar risks of a lower magnitude;

- building and implementing systems-based processes to ensure consistent application of policies, reduce the costs of sustainability risk reviews and capture management information to measure and report on the effect of our lending and investment activities on sustainable development; and

- providing training and capacity building within our operating companies to ensure sustainability risks are identified and mitigated consistently to either our own standards, international standards or local regulations, whichever is higher.

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Capital

1 *Appendix to Capital.*

Report of the Directors: Financial Review (continued)

Our objective in the management of Group capital is to maintain appropriate levels of capital to support our business strategy and meet our regulatory requirements.

Capital highlights

Core tier 1 capital ratio 13.6%, up from 12.3% in 2012, as a result of capital generation and management actions.

Our end point CET1 ratio 10.9%, up from 9.5% in 2012, as a result of similar drivers.

Capital overview

Capital ratios

(Unaudited)

	At 31 December	
	2013	2012
	%	%
Core tier 1 ratio	**13.6**	12.3
Tier 1 ratio	**14.5**	13.4
Total capital ratio	**17.8**	16.1
CRD IV		
Common equity tier 1 ratio (end point)[1]	**10.9**	9.5
Common equity tier 1 ratio (Year 1 transition)	**10.8**	

For footnote, see page 318.

In November 2013, the Prudential Regulation Authority (PRA) published its expectations in relation to capital ratios for major UK banks and building societies. These were that from 1 January 2014, capital resources should be held equivalent to at least 7% of risk-weighted assets using a CRD IV end point definition of common equity tier 1 (CET1) but after taking into account any adjustments set by the PRA to reflect the Financial Policy Committee s (FPC s) capital shortfall exercise recommendations. These include an assessment of expected future losses, future costs of conduct redress and adjusting for a more prudent calculation of risk weights.

In addition to the above, the PRA has established a forward-looking Basel III end point CET1 target ratio post-FPC adjustments for the Group to be met by 2019. This effectively replaced the Capital Resources Floor that was set by the FSA towards the end of 2012.

In December 2013, the PRA issued its final rules on CRD IV in Policy Statement (PS 7/13). This transposes the various areas of national discretion within the final CRD IV legislation into UK law that is applicable from 1 January 2014. In its final rules,

the PRA did not adopt most of the transitional provisions available in CRD IV, thereby opting for an acceleration of the CRD IV end point definition of CET1. Notwithstanding this, the CRD IV transitional provisions for unrealised gains have been applied, so that unrealised gains on investment property are derecognised until 1 January 2015. As a result, our transitional ratio is slightly lower than end point.

Despite the final PRA rules, there remains continued uncertainty around the amount of capital that banks will be required to hold. This relates to the quantification and interaction of capital buffers and Pillar 2, where further PRA consultations are due in 2014. Furthermore, there are a significant number of draft and unpublished European Banking Authority (EBA) technical and implementation standards due in 2014 which could potentially affect our capital position and RWAs.

Our approach to managing Group capital is designed to ensure that we exceed current regulatory requirements, and are well placed to meet those expected in the future.

In 2013 we managed our capital position to meet an internal target ratio of 9.5 10.5% on a CET1 end-point basis, changing to greater than 10% from 1 January 2014. We continue to keep this under review.

A summary of our policies and practices regarding capital management, measurement and allocation is provided in the Appendix to Capital on page 319.

Risk-weighted assets

RWAs by risk type

(Unaudited)

	At 31 December	
	2013	2012
	US$m	US$m
Credit risk	**864,300**	898,416
Standardised approach	**329,464**	374,469
IRB foundation approach	**13,612**	10,265
IRB advanced approach	**521,224**	513,682
Counterparty credit risk	**45,731**	48,319
Standardised approach[2]	**3,583**	2,645
IRB approach	**42,148**	45,674
Market risk	**63,416**	54,944
Operational risk	**119,206**	122,264
Total	**1,092,653**	1,123,943
Of which:		
Run-off portfolios	**104,869**	145,689
Legacy credit in GB&M	**26,348**	38,587
US CML and Other	**78,521**	107,102
Card and Retail Services[3]	**1,143**	6,858

For footnotes, see page 318.

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Market risk RWAs

(Unaudited)

	At 31 December	
	2013	2012
	US$m	US$m
VaR	**4,870**	7,616
Stressed VaR	**9,402**	11,048
Incremental risk charge	**23,088**	11,062
Comprehensive risk measure	**2,626**	3,387
Other VaR and stressed VaR	**12,231**	11,355
Internal model based	**52,217**	44,468
PRA standard rules	**11,199**	10,476
	63,416	54,944

RWAs by global businesses

(Unaudited)

	At 31 December	
	2013	2012
	US$bn	US$bn
Retail Banking and Wealth Management	**233.5**	276.6
Commercial Banking	**391.7**	397.0
Global Banking and Markets	**422.3**	403.1
Global Private Banking	**21.7**	21.7
Other	**23.5**	25.5
Total	**1,092.7**	1,123.9

RWAs by geographical regions[4]

(Unaudited)

	At 31 December	
	2013	2012
	US$bn	US$bn
Total	**1,092.7**	1,123.9
Europe	**300.1**	314.7
Hong Kong	**138.3**	111.9
Rest of Asia-Pacific	**292.4**	302.2
MENA	**62.5**	62.2

North America	**223.8**	253.0
Latin America	**89.5**	97.9

For footnote, see page 318.

Credit risk RWAs

(Unaudited)

Credit risk RWAs are calculated using three approaches as permitted by the PRA. For consolidated Group reporting we have adopted the advanced IRB approach for the majority of our business, with a small proportion on the foundation IRB approach and the remaining portfolios being on the standardised approach.

Standardised approach RWAs

For portfolios treated under the standardised approach, credit risk RWAs reduced by US$45bn of which US$2.7bn was due to foreign exchange movements. The reduction was primarily due to the

reclassification of Industrial Bank from an associate to a financial investment. As a result, the holding was removed from the regulatory consolidation of RWAs and the investment was deducted from capital, resulting in a year-on-year reduction in RWAs of US$39.2bn. This was partly offset by loan growth in Bank of Communications, increasing RWAs by US$14.5bn.

The disposal of operations in Latin America, reduced RWAs by US$6.2bn, although this was partly offset by RWA growth of US$3.7bn in Brazil, mainly driven by corporate term lending and trade finance growth in GB&M and CMB.

RWAs reduced by US$1.2bn in the Middle East and North Africa, mainly driven by reductions in CMB in the UAE and Oman of US$2.2bn, although this was partly offset by growth in our associate, The Saudi British Bank, of US$1.1bn.

During the year there were changes in approach for several portfolios:

- In Europe, income producing real estate portfolios in CMB, GPB and GB&M were moved from the standardised approach to the IRB slotting approach, reducing RWAs on the standardised approach by US$15.1bn and increasing RWAs on the IRB approach by US$13.4bn. In addition, as a result of a business restructuring, a GB&M corporate portfolio was moved to the IRB approach, reducing RWAs on the standardised approach by US$3.8bn and increasing RWAs on the IRB approach by US$2.4bn.

- In North America, commercial real estate portfolios in CMB and GB&M were moved from IRB to the standardised approach, increasing RWAs on the standardised approach by US$6.7bn and reducing RWAs on the IRB approach by US$3.1bn.

- In Hong Kong and Rest of Asia-Pacific, corporate exposures in CMB and GB&M were identified which did not meet full modelling requirements and these were moved temporarily to the standardised approach, increasing RWAs on the standardised approach by US$7.0bn and reducing RWAs on the IRB approach by US$6.3bn.

IRB approach RWAs

Credit risk RWA movements by key driver for portfolios treated under the IRB approach are set out in the tables on pages 302 and 303. For the basis of preparation, see the Appendix to Capital on page 319.

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

Foreign exchange movements reduced RWAs under the IRB approach by US$4.6bn; the discussion of the remaining drivers excludes the effects of foreign currency translation.

Acquisitions and disposals

Disposals reduced Group IRB RWAs by US$11.8bn. In line with our objectives to accelerate the run-off of the US CML portfolio there were sales of non-real estate and personal homeowner loans with an RWA reduction of US$8.2bn in North America RBWM. Additional sales of defaulted mortgage exposures for the US CML portfolio, which do not generate RWAs, also had a beneficial impact on the capital position through lower deductions for regulatory expected losses in North America.

The sale of the HFC Bank UK secured loan portfolio in Europe RBWM reduced RWAs by US$1.4bn. In Latin America GB&M, the disposal of our businesses in Panama, Peru and Paraguay, reduced RWAs by US$1.7bn.

Book size

Movements in the size of the book increased Group IRB RWAs by US$14.3bn. Growth in Hong Kong and Rest of Asia-Pacific for CMB and GB&M, mainly driven by corporate term and trade-related lending and trade finance business, resulted in an RWA increase of US$14.5bn, with a further increase of US$1.8bn relating to higher institutional exposures. In Hong Kong RBWM, credit card and unsecured lending portfolio growth resulted in an increase in RWAs of US$1.2bn.

Corporate exposure growth in Europe CMB and GB&M increased RWAs by US$2.1bn, while reductions for securitisation exposures resulted in a reduction in RWAs of US$1.4bn in Europe, reflecting sales and the amortisation of assets, mainly in the GB&M legacy credit portfolio. North America RBWM balance reductions reduced RWAs by US$14bn, primarily from the continued run-off of the US CML retail mortgage portfolio. In North America CMB, corporate lending growth resulted in an increase in RWAs of US$3.2bn.

Sovereign exposure growth increased RWAs by US$4.3bn, mainly in Rest of Asia-Pacific, Middle East and North Africa and Hong Kong.

Book quality

Movements in the quality of the book reduced Group IRB RWAs by US$6.0bn. In the US CML retail mortgage portfolio, accounts moving into default reduced RWAs by US$4.2bn in RBWM. This was

accompanied by a rise in regulatory expected losses, leading to higher deductions from capital.

Book quality movements in Europe GB&M were mainly the result of credit quality changes for securitisation exposures, reducing RWAs by US$4.5bn and partly reflecting the effect of exposures moving from RWAs to capital deductions. There was a reduction in RWAs of US$3.2bn from favourable shifts in corporate and institutional portfolio quality in Europe GB&M. There were further movements in book quality in Europe, including a US$5.3bn RWA management overlay applied for corporate exposures in CMB and GB&M in response to increased loss rates and in advance of model recalibration. In Europe RBWM, RWAs reduced by US$1.7bn on retail mortgage and credit card portfolios, mainly reflecting favourable changes in customer risk and the risk distribution in these portfolios.

In Hong Kong, changes in book quality for GB&M and CMB corporate customers increased RWAs by US$4.7bn, mainly due to adverse movements in customer credit standing, partly offset by favourable shifts in loss given default metrics and the risk distribution of the portfolio. In Hong Kong RBWM, improvements in the quality of the credit card and unsecured lending portfolio reduced RWAs by US$0.5bn.

RWA movements from adverse internal rating changes for sovereign exposures in Middle East and North Africa and Hong Kong were broadly offset by favourable changes in North America.

Model updates

Model updates increased Group IRB RWAs by US$11.5bn. In Europe, income producing real estate portfolios in CMB, GPB and GB&M were moved on to the IRB slotting approach, reducing RWAs on the standardised approach by US$15.1bn and increasing them on the IRB approach by US$13.4bn. This was accompanied by a rise in regulatory expected losses, leading to higher deductions from capital. Further updates included the implementation of a new corporate exposure model, reducing RWAs in Europe GB&M by US$2.3bn, with lower credit conversion factors that are more reflective of historical experience.

Methodology and policy

Methodology and policy updates increased Group IRB RWAs by US$7.5bn. In Hong Kong and Rest of Asia-Pacific, corporate exposures in CMB and GB&M were identified which did not meet full modelling requirements, and these were moved

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Financial Review (continued)

temporarily to the standardised approach, increasing standardised RWAs by US$7.0bn and reducing RWAs on the IRB approach by US$6.3bn. In Europe CMB, business restructuring enabled the application of a retail approach to the management of a portfolio of SME customers, reducing RWAs by US$0.8bn.

Sovereign exposures were a key driver of external methodology and policy RWA movements in GB&M across a number of regions. On implementation of the PRA-determined 45% loss

given default floor, RWAs increased by US$19bn, mainly in North America, Hong Kong and Rest of Asia-Pacific.

In North America, commercial real estate portfolios in CMB and GB&M were moved on to the standardised approach as required by the PRA, increasing standardised RWAs by US$6.7bn and reducing RWAs on the IRB approach by US$3.1bn, as reflected in external methodology updates.

RWA movement by geographical regions by key driver credit risk IRB only[5]

(Unaudited)

	Europe US$bn	Hong Kong US$bn	Rest of Asia-Pacific US$bn	MENA US$bn	North America US$bn	Latin America US$bn	Total US$bn
RWAs at 1 January 2013	**150.7**	**70.2**	**92.1**	**12.6**	**187.1**	**11.2**	**523.9**
Foreign exchange movement	**3.3**		**(4.5)**	**(0.5)**	**(1.9)**	**(1.0)**	**(4.6)**
Acquisitions and disposals	**(1.5)**				**(8.6)**	**(1.7)**	**(11.8)**
Book size	**2.1**	**11.0**	**10.2**	**1.4**	**(10.6)**	**0.2**	**14.3**
Book quality	**(1.5)**	**5.6**	**(0.3)**	**1.3**	**(10.8)**	**(0.3)**	**(6.0)**
Model updates	**11.6**			**0.1**	**(0.2)**		**11.5**
Portfolios moving onto IRB approach	**13.4**						**13.4**
New/updated models	**(1.8)**			**0.1**	**(0.2)**		**(1.9)**
Methodology and policy	**2.2**	**(1.0)**	**(0.4)**	**0.1**	**6.5**	**0.1**	**7.5**
Internal updates	**(0.2)**	**(5.0)**	**(2.8)**	**0.1**	**(0.6)**	**0.1**	**(8.4)**
External updates	**2.4**	**4.0**	**2.4**		**7.1**		**15.9**
Total RWA movement	**16.2**	**15.6**	**5.0**	**2.4**	**(25.6)**	**(2.7)**	**10.9**
RWAs at 31 December 2013	**166.9**	**85.8**	**97.1**	**15.0**	**161.5**	**8.5**	**534.8**
RWAs at 1 January 2012	156.5	68.0	82.3	12.9	254.5	12.0	586.2
Foreign exchange movement	4.7	0.1	0.8	(0.2)	0.7	0.1	6.2
Acquisitions and disposals			(0.1)	(0.7)	(40.3)	(0.9)	(42.0)
Book size	(1.8)	3.6	5.4	1.0	(7.6)	(0.6)	

Book quality	(6.6)	1.5	(1.1)	(0.3)	(17.9)	0.1	(24.3)
Model updates	0.4			0.1			0.5
Portfolios moving onto IRB approach	1.4			0.1			1.5
New/updated models	(1.0)						(1.0)