HSBC HOLDINGS PLC
Form 20-F
March 12, 2013
Table of Contents

As filed with the Securities and Exchange Commission on March 12, 2013.

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, 2012

Or

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

Or

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

Date of event requiring this shell company report __________

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

Commission file number: 1-14930

HSBC Holdings plc

(Exact name of Registrant as specified in its charter)

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

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, 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 18,476,008,664

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 2012

Certain defined terms

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

Financial statements

The consolidated financial statements of HSBC and the separate financial statements of HSBC Holdings have been prepared in accordance with International Financial Reporting Standards (IFRSs) as issued by the International Accounting Standards Board (IASB) and as endorsed by the European Union (EU). EU-endorsed IFRSs may differ from IFRSs as issued by the IASB if, at any point in time, new or amended IFRSs have not been endorsed by the EU. At 31 December 2012, there were no unendorsed standards effective for the year ended 31 December 2012 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 2012 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, comparative information has been expressed at constant currency (see page 25), eliminating the impact of fair value movements in respect of credit spread changes on HSBC s own debt and adjusting for the effects of acquisitions and disposals as reconciled on page 28. Underlying RoRWA is defined and reconciled on page 52.

Contents

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

Table of Contents

Who we are and what we do

HSBC is one of the world s largest banking and financial services organisations, with around 6,600 offices in both established and faster-growing markets. We aim to be where the economic 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.

We serve around 58 million customers through our four global businesses: Retail Banking and Wealth Management, Commercial Banking, Global Banking and Markets, and Global Private Banking. Our network covers 81 countries and territories in six geographical regions: Europe, Hong Kong, Rest of Asia-Pacific, Middle East and North Africa, North America and Latin America. Our aim is to be acknowledged as the world s leading international bank.

Listed on the London, Hong Kong, New York, Paris and Bermuda stock exchanges, shares in HSBC Holdings plc are held by about 220,000 shareholders in 129 countries and territories.

Highlights

Profit before tax down 6% to US$20.6bn and revenue down 5% to US$68.3bn on a reported basis.

Underlying profit before tax up 18% to US$16.4bn.

Continued to execute our strategy to grow, simplify and restructure the Group.

Underlying revenue up 7% reflecting revenue growth, notably in Global Banking and Markets and Commercial Banking.

Achieved sustainable savings of US$2.0bn, taking our total annualised savings to US$3.6bn, exceeding our cumulative target of US$2.5bn to US$3.5bn since 2011.

Announced 26 disposals and closures of non-strategic businesses and non-core investments in 2012.

Return on equity was 8.4%, down from 10.9% in 2011.

Dividends declared in respect of 2012 US$8.3bn or US$0.45 per ordinary share, up 10% on 2011.

Core tier 1 capital ratio increased during the year from 10.1% to 12.3%.

Cover image

Financing trade has always been at the heart of HSBC s business, especially in our home market of Hong Kong. Today, Hong Kong International Airport is the world s busiest air cargo hub, with its freight volume accounting for over one-third of the total value of Hong Kong s external trade.

1

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Overview

Financial highlights

Earnings per share	Dividends per ordinary share[1]	Net assets per share
US$0.74 *down 20%*	US$0.41	US$9.09 *up 7%*
2011: US$0.92	2011: US$0.39	2011: US$8.48
2010: US$0.73	2010: US$0.34	2010: US$7.94

For the year

Profit before taxation	Underlying profit before taxation	Total operating income
US$20,649m *down 6%*	US$16,385m *up 18%*	US$82,545m *down 1%*
2011: US$21,872m	2011: US$13,861m	2011: US$83,461m
2010: US$19,037m		2010: US$80,014m

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

Profit attributable to the ordinary shareholders of the parent company

US$13,454m *down 17%*

US$68,330m *down 5%*

2011: US$16,224m

2010: US$12,746m

2011: US$72,280m

2010: US$68,247m

At the year-end

Loans and advances to customers	**Customer accounts**	**Ratio of customer advances to customer accounts**
US$998bn *up 6%*	US$1,340bn *up 7%*	74.4%
2011: US$940bn	2011: US$1,254bn	2011: 75.0%
2010: US$958bn	2010: US$1,228bn	2010: 78.1%

Total equity	**Average total shareholders equity to average total assets**	**Risk-weighted assets**
US$183bn *up 10%*	6.2%	US$1,124bn *down 7%*
2011: US$166bn	2011: 5.6%	2011: US$1,210bn
2010: US$155bn	2010: 5.5%	2010: US$1,103bn

Capital ratios

Core tier 1 ratio	**Tier 1 ratio**	**Total capital ratio**
12.3%	13.4%	16.1%
2011: 10.1%	2011: 11.5%	2011: 14.1%
2010: 10.5%	2010: 12.1%	2010: 15.2%

2

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Overview (continued)

Performance ratios

Credit coverage ratios

Loan impairment charges to total operating income	**Loan impairment charges to average gross customer advances**	**Total impairment allowances to impaired loans at year-end**
9.9%	0.9%	41.7%
2011: 13.8%	2011: 1.2%	2011: 42.3%
2010: 16.9%	2010: 1.5%	2010: 43.0%

Return ratios

Return on average ordinary shareholders equity[3]	**Return on average invested capital[3]**	**Post-tax return on average total assets**	**Pre-tax return on average risk-weighted assets**
8.4%	8.0%	0.6%	1.8%
2011: 10.9%	2011: 10.2%	2011: 0.6%	2011: 1.9%
2010: 9.5%	2010: 8.7%	2010: 0.6%	2010: 1.7%

Efficiency and revenue mix ratios

Cost efficiency ratio[4]	**Net interest income to total operating income**	**Net fee income to total operating income**	**Net trading income to total operating income**

62.8%	45.6%	19.9%	8.6%
2011: 57.5%	2011: 48.7%	2011: 20.6%	2011: 7.8%
2010: 55.2%	2010: 49.3%	2010: 21.7%	2010: 9.0%

Share information at the year-end

		Closing market price		
US$0.50 ordinary shares in issue	**Market capitalisation**	London	Hong Kong	American Depositary Share[5]
18,476m	US$194bn	£6.47	HK$81.3	US$53.07
2011: 17,868m	2011: US$136bn	2011: £4.91	2011: HK$59.00	2011: US$38.10
2010: 17,686m	2010: US$180bn	2010: £6.51	2010: HK$79.70	2010: US$51.04

	Total shareholder return[6]		
	Over 1 year	Over 3 years	Over 5 years
To 31 December 2012	139	104	113
Benchmarks:			
FTSE 100[7]	110	121	111
MSCI World[8]	117	124	97
MSCI Banks[8]	128	106	68

For footnotes, see page 120.

3

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Overview (continued)

Cautionary statement regarding forward-looking statements

The *Annual Report and Accounts 2012* contains certain forward-looking statements with respect to HSBC s financial condition, results of operations and business.

Statements that are not historical facts, including statements about HSBC s beliefs and expectations, are forward-looking statements. Words such as expects , anticipates , intends , plans , believes , seeks , estimates , 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 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.

Report of the Directors: Overview (continued)

Group Chairman s Statement

2012 was a year of considerable progress in delivering on the strategic priorities which the Board has tasked management to address. Our decision to focus on reshaping the Group through targeted disposals and closures and internal reorganisation is paying dividends. It is bringing greater clarity and focus and is delivering sustainable cost savings while allowing incremental investment to be available and directed towards the areas of greatest opportunity.

This progress is all the more notable given that during 2012, the banking sector, including HSBC, faced continuing and in many ways unprecedented challenges. Banking has been given a huge wake-up call and we are determined to play our part in restoring its reputation and thereby regaining society s trust. Thus our restructuring agenda is not only justified economically but is helping the Group shape its response to the media, the regulatory and political challenges, and societal expectations which, simply put, all revolve around restoring the trust of all stakeholders. From depositors to investors, regulators to employees, public policy makers to consumer lobbyists we need to ensure the business model of banking is fair, transparent, sustainable and meeting its core objective of serving society.

Never has it been more important to put the customer first and provide the means and support to help them fulfil their financial aspirations and ambitions. That is our prime purpose and one of which we should never lose sight.

Over the last two years the Board was exercised greatly by the major US regulatory and law enforcement investigations we faced. I covered the background to these investigations, settlement of

which we reached in December, in our Interim Report.

Management is now delivering the required enhancements to our control framework and on top of this we have significantly augmented the Board s oversight and governance capabilities. This is dealt with in more detail below.

Encouragingly, there is now growing external recognition of the progress being made in delivering against our stated strategic priorities. This, together with our overweight exposure to the world s more attractive economies, contributed to a total shareholder return of 39% over the year 7% from dividends paid and 32% from share price appreciation. Over the course of the year the market capitalisation of HSBC grew by US$58bn from US$136bn to US$194bn, returning shareholders once again to the position where their company is worth more than its contributed capital. We remained among the highest dividend payers in the FTSE 100, a performance which we know is of great importance to our shareholders.

The cover to this year s Annual Report again illustrates our strategy of connecting customers and markets. The scene depicted is the cargo terminal at Hong Kong International Airport, which has been ranked as the busiest airport for international air cargo since 1996. Today the airport s trade throughput represents over one third of Hong Kong s external trade. HSBC s connection with trade financing and trade services through Hong Kong goes back to our earliest days and remains one of our core strengths. Projections of trade growth in Asia and Hong Kong s role therein reinforce our investment focus in this area.

Performance in 2012

There was much to be positive about in HSBC s performance in 2012. The majority of our core businesses in Asia, particularly in Hong Kong, continued to perform well, achieving good underlying revenue growth in the year. Increased market confidence around eurozone recovery contributed to a significant turnaround in Global Banking and Markets results in Europe. Targeted disposals and the continuing run-off from our exit portfolios in the United States, together with evidence of recovery in many housing areas were reflected in significantly lower US loan impairment charges.

Progress in managing costs to reflect a lower economic growth environment in developed markets was encouraging. Offsetting these positive factors, credit demand remained muted throughout Europe,

Report of the Directors: Overview (continued)

low interest rates continued to constrain the value of our liquid balance sheet and customer redress costs continued to weigh heavily in the UK.

The Group Chief Executive s Business Review covers financial performance and progress on strategy delivery in more detail.

Reported results include the benefit of profits arising from the significant disposals made in the year as well as bearing the burden of the fines and penalties levied as part of the settlement with US regulatory and law enforcement agencies and increased customer redress provisions in the UK. When the Board assesses management performance as part of reward measurement, these disposal gains are eliminated but the legal settlement and customer redress costs are not.

Looking through the reported results to underlying financial performance, the Board viewed positively the 2012 outcome.

Although earnings per share of US$0.74 were 20% lower than 2011, this largely reflected a US$9.1bn negative swing in the fair value of our own debt as credit spreads tightened, together with a higher tax rate.

With the Group s capital position strengthened from retained profits and from capital released from the divestments made in the year, the Board has approved a 29% increase in the final dividend in respect of the year to US$0.18 per share, US$0.04 higher than the final dividend in respect of 2011. Total dividends in respect of 2012 of US$8.3bn, amounted to US$0.45 per share, US$0.9bn higher than in 2011. The Board also intends to increase the quarterly dividends in respect of the first three quarters of 2013 by US$0.01 per share to US$0.10 per share.

Shareholders equity at the end of 2012 stood at US$175bn, US$17bn or some 10 % higher than at the beginning of the year. The core tier 1 capital ratio strengthened from 10.1% to 12.3% and the Group remains on track to deliver compliance with the more onerous Basel III requirements in the accelerated timetable being sought by UK regulators.

During 2012, the UK government increased the rate of levy applied on the global balance sheets of UK domiciled banks. The cost to HSBC of the revised levy for the current year was US$571m of which US$295m related to non-UK banking activity. The 2012 levy, which is not tax deductible, is the equivalent of US$0.03 per ordinary share and, as indicated last year, would otherwise have been available for distribution to shareholders or used to strengthen the capital base further.

Progress on regulatory reform

2012 was a further year of progress in delivering key elements of the regulatory reform agenda mandated by the G20 in response to the financial crisis. After a long consultation period, the proposed Liquidity Coverage Ratio within the Basel III framework was recalibrated to better match industry experience, and so strengthen bank liquidity without unnecessarily constraining credit formation.

The list of banks to be designated as globally significant was announced and, as expected, HSBC was one of four placed in the highest category. Good progress was made on clarifying the possible approaches to resolving the failure of a bank with operations in multiple jurisdictions. One approach was directly applicable to the subsidiarised model favoured by HSBC.

On structural reform of banking entities, the Liikanen Group in Europe produced its report for consideration while draft alternatives have been proposed in France and Germany. In the UK, the Government substantially accepted the recommendations of the Independent Commission on Banking in a policy paper and a draft Financial Services (Banking Reform) Bill is expected to be approved in the first half of 2013. Thereafter, the government has signalled its intention to pass secondary legislation by the end of this parliament in 2015, with final implementation of the new regime by 2019.

The key structural change being legislated remains the separation of certain banking activities for personal and small business customers into a ring-fenced bank with its own financial and governance arrangements. The recently appointed Parliamentary Commission on Banking Standards in the UK has reviewed the proposed legislation and *inter alia* recommended strengthening the ring fence by empowering regulators to force full separation in the event of attempts to frustrate the objectives of the ring fence.

Ongoing work remains extensive. Major areas of policy development covering augmenting loss absorbency through bailing-in certain categories of creditor, addressing the systemic impact of central clearing counterparties, establishing a banking union within the eurozone and revisiting the risk weighting of assets to enhance transparency and consistency, are among the most important.

On top of this, the UK Parliamentary Commission on Banking Standards is currently examining all aspects of conduct, behaviour and

Report of the Directors: Overview (continued)

culture with a view to making recommendations designed to restore trust and confidence in banks.

We are committed to working constructively with public policy makers and our regulators to give effect to these proposals. We note, however, two areas of concern.

First, it is perplexing that, after the great international effort invested in the G20 programme of sound and consistent global financial regulation, and the extent of reform currently underway, an increasing number of countries now appear to be acting unilaterally, thereby putting globally consistent regulation at risk of fragmentation and balkanising the capital and liquidity resources of firms.

Second, we believe the sheer scale and timescale of the reform programme is hampering investors line of sight to the long-term returns available.

Resolving these two issues, which will require inter-governmental direction and co-operation, would contribute to enhancing the ability of the industry to support the economic growth agenda now being prioritised in most parts of the world.

Enforcing global standards

The Board is determined to adopt and enforce the highest behavioural and compliance standards in HSBC. For well documented reasons, the last two years have been extremely damaging to HSBC s reputation and to our perception of ourselves. We faced serious failings both 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. Our strategy is entirely configured to eliminate the possibility of this happening again.

We have apologised unreservedly to all our stakeholders and have paid huge penalties both in monetary cost and reputational damage. More important than apologies, however, are the steps being taken to prevent recurrence. Management under Stuart Gulliver, the Group Chief Executive, is leading the work to simplify business and so reinforce risk management and control.

Our success in meeting our objectives will be subject to independent validation not simply through ongoing regulatory review but additionally through the appointment of an independent Monitor who will report to both UK and US authorities. We welcome the additional rigour this will bring to the process of upgrading and enforcing our global standards.

To reinforce the Board s ability to exercise rigorous governance over these endeavours, we announced the creation of a new Board committee, the Financial System Vulnerabilities Committee on 30 January 2013. This committee will provide governance, oversight and policy guidance over the framework of controls and procedures designed to identify areas where HSBC may become exposed and, through that exposure, expose the financial system more broadly to financial crime or system abuse.

Five subject matter experts drawn from the highest levels of public service will support the committee. Their expertise includes the combating of organised crime, terrorist financing, narcotics trafficking, tax evasion and money laundering as well as expertise in intelligence gathering and international payments systems. They will provide invaluable guidance and advice, and most importantly challenge, as we strengthen our capabilities and enforce the highest standards. Further details of the background and experience of these individuals are contained in the Directors Report.

Recognising the need to augment the Board s own experience and expertise we have also added specialist expertise at Board level.

Board changes

At the end of 2012 we said farewell to Narayana Murthy, who stepped down from the Board after serving with distinction for five years. Narayana, as co-founder and long-term CEO of Infosys, brought to the Board exceptional expertise in technology, operational efficiency and outsourcing matters as well as an in-depth knowledge of India and of international business through his experience on many multinational and educational boards. On behalf of the Board and shareholders I want to record our appreciation and gratitude for his contribution to HSBC.

We welcome two new directors to the Board.

Renato Fassbind joined the Board on 1 January and will serve on the Audit and Remuneration Committees. Renato brings to the Board considerable international business and financial expertise from a distinguished career in industrial, service and financial companies. He is currently Vice Chairman of the Supervisory Board and a member of the audit and the compensation committees of Swiss Reinsurance Company, a member of the Supervisory Board and audit committee of Kühne + Nagel International AG

Report of the Directors: Overview (continued)

and a member of the Supervisory Board of the Swiss Federal Audit Oversight Authority.

Renato stepped down as Chief Financial Officer and a member of the executive board of Credit Suisse Group in September 2010, having served in that role since 2004.

Jim Comey joins the Board today and will serve on the newly created Financial System Vulnerabilities Committee. Jim brings to the Board outstanding governance experience from both the private and public sectors. In his private sector roles he acted as General Counsel to leading international businesses and in public life served at the apex of law enforcement in the United States. Most recently, within the private sector, Jim Comey served as General Counsel of Bridgewater Associates, LP and prior to that as Senior Vice President and General Counsel of the Lockheed Martin Corporation. In public life, from 2003 to 2005, he served as US Deputy Attorney General, where he was responsible for supervising the operations of the Department of Justice, and chaired the President s Corporate Fraud Task Force. From 2002 to 2003, he served as US Attorney for the Southern District of New York.

Fuller details of their background and experience are set out in the Directors Report.

Social contribution

Much is currently being written and debated about the role banks should play in society. In large part, this reflects the fact that the economic success that underpins a harmonious society depends upon sustainable financing, confidence and trust in the financial system. That trust is founded upon the broader role that banks play in their local communities.

Within HSBC, many of my colleagues make tremendous personal contributions to their communities and I want to take this opportunity to pay tribute to them. HSBC s outreach in terms of community investment is primarily in the areas of education and the environment and, in 2012, in financial terms it amounted to some US$120m.

In 2012, we extended our commitment to support disadvantaged and vulnerable young people who are neither in education, employment nor training. We support local and international charities working in this area, and also run our own staff-driven Future First programme, which helps street children, children in care and orphans to access education. Initiatives under this programme are developed and supported by HSBC colleagues

around the world and, in 2012, 2,717 members of staff volunteered to support the programme.

Importantly in all our community work we increasingly look to involve our staff to reinforce our links with the communities we serve. In 2012, for example, 114,982 HSBC colleagues spent 724,650 hours in volunteer activity.

We also launched the HSBC Water Programme last year. This is a five-year, US$100m commitment to support Water Aid, WWF and Earthwatch to deliver freshwater and sanitation to poor rural communities in Asia and Africa, educate local communities on sustainable water management in five major river basins around the world, and involve more than 7,500 HSBC staff with local conservation partners to address urban water management issues and learn to carry out scientific water research tasks.

Looking ahead

It is often said that people come together in adversity, learning lessons from the past and each other to create the bonds that ensure a better future. I believe that this has happened within HSBC. The last year has been a difficult one for all at HSBC as we addressed the restructuring of the firm against a lower-growth economic backdrop and with legacy issues and regulatory challenges imposing a further set of imperatives. Our 270,000 staff have had to face up to bewildering descriptions of HSBC that contrasted with the way they conduct their relationships with the firm s customers and clients.

What has been inspirational is how everyone has pulled together, focused on the future and committed to do all and everything necessary to restore a reputation that we all believe can be positively distinctive. On behalf of the Board, I want to thank all our employees for that commitment and their loyal support.

I also want to thank our clients and customers, our shareholders, our regulators and those in government who believe, as we do, that we will meet the commitments we have made to allow us better to serve the communities who entrust their financial needs to HSBC.

D J Flint, *Group Chairman*

4 March 2013

Report of the Directors: Overview (continued)

Group Chief Executive s

Business Review

HSBC made significant progress in 2012 despite a challenging operating environment characterised by low economic growth and a changing regulatory landscape. We continued to pursue the strategy outlined in May 2011, announcing the sale or closure of 26 businesses or non-core investments, surpassing our sustainable savings target and recording underlying revenue growth in the majority of our faster-growing regions. We also reached agreement with the US authorities and the FSA in relation to past inadequate compliance with anti-money laundering and sanction laws. Although reported pre-tax profit fell by 6% to US$20.6bn in 2012, underlying profit, which includes the impact of fines and penalties and UK customer redress provisions totalling US$4.3bn, grew by 18%. This was primarily due to revenue growth, notably in Global Banking and Markets and Commercial Banking, and lower loan impairment charges in North America. We regard this as a good performance.

Our strategy is founded on a clear sense of purpose to be where the growth is, connecting customers to opportunities and enabling businesses to thrive, economies to prosper and individuals to realise their ambitions. This has given us clear parameters around the way that we behave and conduct business and where and how we compete.

Since 2011, we have created a consistent global structure with strong governance, consisting of four global businesses and 11 global functions. In 2012, we continued to execute our strategic priorities to grow, restructure and simplify HSBC.

We grew our business in 2012, achieving underlying revenue growth in most of our priority

markets. The growth in these markets was a factor in generating a record reported profit before tax in Commercial Banking as we maintained our position as the world s largest global trade finance bank, as reported in the *Oliver Wyman Global Transaction Banking Survey 2012*. The collaboration between Commercial Banking and Global Banking and Markets delivered incremental gross revenues of over US$0.1bn in 2012. Wealth Management achieved more than US$0.5bn of additional revenues, although further progress is required to achieve our strategic goals.

The restructuring of the US business progressed in 2012 as we continued to run off the Consumer and Mortgage Lending portfolio, resulting in a US$14bn reduction in the value of average risk-weighted assets and a reduced loss before tax of US$3.1bn, reflecting improved loan impairment charges. Following our agreement with the US authorities and the FSA in December 2012, we are adopting global standards as part of our effort to raise our practices to an industry-leading level. This is part of our wholehearted commitment to protect the integrity of the organisation and the financial system, and to do our part to fight financial crime.

We further simplified the Group structure in 2012, bringing the total number of announced disposals and closures of non-strategic businesses or non-core investments to 47 since the beginning of 2011, including 4 in 2013.

During 2012, we completed the disposal of the Card and Retail Services business and the upstate New York branches in the United States, and the sale or closure of our retail businesses in Thailand, Honduras, El Salvador and Costa Rica, as well as the full service retail brokerage businesses in Canada. Additionally we announced the sale of our operations in Colombia, Peru, Uruguay and Paraguay.

Following completion of all the announced transactions we will have completed the refocus of Retail Banking and Wealth Management (RBWM) to 20 of our 22 home and priority markets, which represented 98% of the RBWM, excluding US CRS and the US run-off portfolio, profit before tax in 2012, plus a limited number of important network and smaller markets.

Notably, on top of the above, we reached agreement in December 2012 to sell our stake in Ping An for an aggregate cash consideration, the equivalent of US$9.4bn. This transaction completed in two tranches, in December 2012 and February 2013, generating a profit of US$3.0bn. In 2012 our share of Ping An s earnings was US$0.8bn.

Report of the Directors: Overview (continued)

We also made progress in eliminating unnecessary organisational layers and streamlining various processes, achieving an additional US$2.0bn in sustainable cost savings. This takes our total annualised savings to US$3.6bn, surpassing our cumulative target of US$2.5bn to US$3.5bn of sustainable savings since 2011. Taken together, these changes have made HSBC much easier to manage and control.

Although we made some good progress in 2012, the cost efficiency ratio at 62.8% and ROE at 8.4% were outside our target ranges. These were both affected by UK customer redress provisions, as well as payments we were required to make as part of the settlement of the investigations noted above.

Implementing our strategy can add significant value to HSBC. We are on the right track and remain fully committed to achieving our ambition of being the world s leading international bank.

We are investing to build this distinctive international competitive position.

In Retail Banking and Wealth Management, we accelerated the transformation of the Wealth Management business in HSBC with infrastructure investment to improve customer experience and so drive growth. Technology solutions improved the customer offering in foreign exchange services and we introduced enhanced risk profiling and strategic financial planning tools.

In Commercial Banking we maintained our investment in the faster-growing regions in support of the strong network that helps connect customers with both developed and developing markets as they expand internationally. A great deal of attention is being devoted to the increasing internationalisation of the renminbi. During 2012, we were the first bank to settle cross-border renminbi trade across six continents with capabilities in over 50 countries, offering a competitive advantage to our customers as the renminbi positions to be a major global trade and investment currency. We have expanded our global network of dedicated China desks to cover our top markets, representing about half of the world s GDP. These are staffed by Mandarin-speaking experts who support mainland Chinese businesses to identify new opportunities to expand overseas.

In Global Banking and Markets, we invested in selective recruitment to support key strategic markets. We continued the successful build-out of our equities and e-FX platforms to broaden our product offerings. In Hong Kong we led the market in Hong Kong dollar bond issuance and were the leading bookrunner for high yield bonds in Asia,

excluding Japan. We now also rank in the top five of equities brokers in Hong Kong. We reinforced our leading position in the renminbi market in 2012, supporting a number of significant client transactions and, as an entity, issuing the first international renminbi bond outside Chinese sovereign territory. Reflecting our capabilities in Latin America, the Middle East and Asia-Pacific, HSBC was recognised as the Best Global Emerging Markets Debt House at the 2012 *Euromoney* Awards for Excellence and was also recognised as RMB House of the Year at the 2012 Asia Risk Awards.

I would like to thank all of our employees for their dedication and endurance throughout a difficult year for the bank. They have shown a real sense of passion, pride and duty in the face of critical and often deeply embarrassing media headlines and I too am very grateful for their efforts.

Group performance headlines

Reported profit before tax was US$20.6bn, US$1.2bn lower than in 2011, including US$5.2bn of adverse movements in the fair value of our own debt attributable to credit spreads compared with favourable movements of US$3.9bn in 2011. This variance of US$9.1bn was partially offset by an increase of US$7.5bn in respect of gains from the disposal of businesses, notably from the sale of the US Card and Retail Services business and the agreement to sell our stake in Ping An.

Underlying profit before tax was US$16.4bn, up US$2.5bn, mainly due to higher revenues and lower loan impairment charges and other credit risk provisions. These factors were partially offset by an increase in operating expenses, primarily reflecting the settlement of the investigations into past inadequate compliance with anti-money laundering and sanction laws and increased provisions for UK customer redress programmes.

Underlying revenues rose by 7%, led by Global Banking and Markets where the majority of our businesses grew, notably Credit and Rates in Europe, as spreads tightened and investor sentiment improved following stimuli by central banks globally. Commercial Banking also recorded revenue growth as customer loans and advances increased in all regions, with over half of this growth coming from our faster-growing regions of Hong Kong, Rest of Asia-Pacific and Latin America, driven by higher trade-related lending. Customer deposits also rose as we continued to attract deposits through Payments

Report of the Directors: Overview (continued)

and Cash Management products. In addition, Retail Banking and Wealth Management experienced revenue growth across all faster-growing regions, in particular Hong Kong and Latin America. These factors were partially offset by lower revenue in Global Private Banking, as we focused on repositioning our business model and target client base.

We achieved growth in reported loans and advances to customers of more than US$57bn during the year, notably in residential mortgages and term and trade-related lending. Customer deposits increased by over US$86bn, allowing us to maintain a strong ratio of customer advances to customer accounts of 74.4%.

Underlying costs were US$4.3bn higher than in 2011 including payments of US$1.9bn made as part of the settlement of the investigations into past inadequate compliance with anti-money laundering and sanctions laws, additional provisions in respect of UK customer redress programmes of US$1.4bn, and a credit in 2011 of US$0.6bn relating to defined benefit pension obligations in the UK which did not recur. 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.

The reported cost efficiency ratio deteriorated from 57.5% to 62.8% and from 63.4% to 66.0% on an underlying basis, as a result of higher notable cost items, as described above.

Return on equity was 8.4%, down from 10.9% in 2011, primarily reflecting the adverse movement in fair value of own debt attributable to movements in credit spreads, a higher tax charge and higher average shareholders equity. Similarly, the Group s pre-tax return on average risk-weighted assets (RoRWA) for 2012 was 1.8% or 1.5% on an underlying basis. Adjusting for the negative returns on US consumer finance business and legacy credit in Global Banking and Markets, the remainder of the Group achieved a RoRWA of 1.9% in 2012 and 2.1% in 2011.

The core tier 1 ratio increased during the year from 10.1% at the end of 2011 to 12.3%. This increase was driven by capital generation and a reduction in risk-weighted assets following business disposals.

The Basel III capital rules began their staged 6-10 year implementation in some parts of the world in January 2013. Nevertheless, the FSA has set our 2013 capital target calculation on a Basel III end point basis. This effectively accelerates our implementation of Basel III by several years relative to European regulations and other global banks. Consistent with this, we now operate to an internal capital target set on a Basel III end point basis of 9.5%-10.5%.

Profit attributable to ordinary shareholders was US$13.5bn, of which US$8.3bn was declared in dividends in respect of the year. This compared with US$2.9bn of variable pay awarded (net of tax) to our employees for 2012.

Dividends per ordinary share declared in respect of 2012 were US$0.45, an increase of 10% compared with 2011, with a fourth interim dividend for 2012 of US$0.18 per ordinary share.

Global standards

As a global organisation which trades on its international connectivity, we recognise that we have a responsibility to play a part in protecting the integrity of the financial system. In order to do this effectively, in April 2012 we committed to implementing industry-leading controls to increase our ability to combat financial crime.

The highest compliance standards are being adopted and enforced across HSBC and our Compliance function has already been strengthened considerably. More than 3,500 people are now employed globally to work on compliance and the cost of the Compliance function has approximately doubled since 2010 to more than US$500m. We have created and recruited externally for two new Compliance leadership roles Global Head of Regulatory Compliance and Head of Group Financial Crime Compliance and appointed a number of senior staff with extensive experience of handling relevant international legal and financial issues. A review of Know Your Customer files is under way across the entire Group and an enhanced global sanctions policy has been devised to ensure that we do not do business with key illicit actors anywhere, in any currency. In addition, we have moved to protect HSBC from the risks inherent in bearer shares by curtailing the ability of clients using bearer share companies to open accounts or transact with HSBC.

Table of Contents

Report of the Directors: Overview (continued)

We have also introduced a new filter, against which all existing and prospective clients and businesses are screened. This sixth filter focuses on financial crime risk. It means that where we cannot practically or economically apply the global standards to which we are committed we will stop writing business altogether or significantly restrict our activities. This policy is consistent with our commitments to adopt global standards, to simplify our business and operations, and to de-risk our business activities.

Implementing these standards will be a critical component of our work in 2013.

Outlook

Whilst the operating environment for financial institutions remains difficult, our core business will continue to reap the benefit of recovering economic growth in mainland China and its positive impact on other faster-growing regions. We expect the developing economies, led by mainland China, to continue to grow briskly at 5.4%, while developed economies should see more gradual growth of 1.0%. We forecast growth of 8.6% in mainland China in 2013.

The US economy should continue its gradual recovery, with continuing quantitative easing measures supporting a recovery in the housing market, although the recovery is still not strong enough to support a sustained reduction in unemployment. We expect higher growth in Latin America in 2013, due in part to a modest recovery in Brazil. The biggest risk to the world economy remains an uncharted shock from Europe and an exacerbation of the sovereign debt crisis. We remain cautious on the outlook for Europe due to weak demand, slow growth, and political and regulatory uncertainty.

Finally, I am pleased to report that the business had a good start to the year. Our results in 2013 will include a dilution gain of US$1.2bn on our investment in Industrial Bank, following its issue of additional share capital to third parties on 7 January. There was also a US$0.6bn net gain on the completion of the sale of our shares in Ping An, which offsets the adverse fair value movement on the forward contract included within our 2012 results. On 19 February 2013 we announced the sale of our operations in Panama for US$2.1bn.

S T Gulliver, *Group Chief Executive*

4 March 2013

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Overview (continued)

Our disclosure philosophy

HSBC strives to maintain the highest standards of disclosure in our reporting

It has long been our policy to provide disclosures that help investors and other stakeholders understand the Group s performance, financial position and changes thereto. In accordance with this policy, the information provided in the Notes on the Financial Statements and the Report of the Directors goes beyond the minimum levels required by accounting standards, statutory and regulatory requirements and listing rules. For this reason, we wholeheartedly supported the work of the Enhanced Disclosure Task Force (EDTF) in 2012.

Enhanced Disclosure Task Force

Following increased demands for enhanced risk disclosures, the Financial Stability Board established the EDTF in May 2012 with the goal of developing principles for enhancing risk disclosures by major banks, recommending disclosure improvements and identifying existing leading practice disclosures by global financial institutions, starting with December

2012 risk disclosures and continuing into 2013 and beyond.

The task force brought together senior officials and experts from financial institutions, investors and audit firms from around the world and, on 29 October 2012, the EDTF issued its report, Enhancing the Risk Disclosures of Banks .

Our approach

HSBC s *Annual Report and Accounts 2011* contained disclosures consistent with a majority of the report s recommendations, including some disclosures referenced in the report as leading practice . We have implemented the recommendations of the report in 2012 and will further enhance our risk disclosures in 2013.

Guide to the implementation of EDTF recommendations in this Report

Our response to selected EDTF disclosure recommendations of particular significance may be found on the following pages, and in HSBC s *Pillar 3 Disclosures 2012* report:

Type of risk	**Disclosure**	**Page**
General	Risks to which the business is exposed, risk appetite and stress testing.	124 to 128
	Top and emerging risks.	130 to 136
Risk Governance and risk management strategies/ business models		323 to 328
	Group Risk Committee.	20
	Diagram of risk exposures by global business.	

Capital adequacy and risk-weighted assets	Reconciliation of the accounting balance sheet to the regulatory balance sheet.	287
	Regulatory capital flow statement.	285
	Analysis of credit risk by Basel asset class.	*Pillar 3 Disclosures 2012* 23 to 28 and 32 to 38
	Risk-weighted assets flow statements for each risk-weighted asset type.	282 and 284
Liquidity	Liquid asset buffer.	206 to 207
Funding	Encumbrance.	211 to 214
	Maturity analysis by balance sheet line.	485 to 492
	Sources of funding and funding strategy.	209 to 211
Market risk	Relationship between the market risk measures for trading and non-trading portfolios and balance sheet classification.	218 to 219
Credit risk	Policies for impaired loans and reconciliation of movement in impaired loans.	162 and 254 to 259
	Loan forbearance policies.	257
	Credit risk mitigation and collateral.	163 to 168
Other risks	Quantified measures on the management of operational risk.	227 to 230

For a detailed list of all disclosure enhancements prepared in response to the recommendations of the EDTF, along with their locations, see page 119.

Table of Contents

Report of the Directors: Overview (continued)

HSBC s vision

For footnote, see page 120.

Principal activities

Our purpose is to enable businesses to thrive and economies to prosper, helping people fulfil their hopes and realise their ambitions.

HSBC is one of the largest banking and financial services organisations in the world, with a market capitalisation of US$194bn at 31 December 2012. We are headquartered in London.

Our products and services are delivered to clients through four global businesses, Retail Banking and Wealth Management (RBWM), Commercial Banking (CMB), Global Banking and Markets (GB&M) and Global Private Banking (GPB).

We operate through long-established businesses and have an international network of some 6,600 offices in 81 countries and territories in six geographical regions; Europe, Hong Kong, Rest of Asia-Pacific, Middle East and North Africa (MENA), North America and Latin America.

Taken together, our five largest customers do not account for more than 1% of our income. We have contractual and other arrangements with numerous third parties in support of our business activities. None of the arrangements is individually considered to be essential to the business of the Group.

Continuing the Group-wide review of our businesses, 26 disposals or closures of non-strategic and non core investments were announced in 2012 and a further four in 2013, taking the total to 47 since 2011. The most significant of these transactions which were completed in 2012 were the sale of the US Card and Retail Services business and

the upstate New York branches for a total gain of US$4.0bn. In December 2012, we announced an agreement to sell our entire shareholding in Ping An Insurance (Group) Company of China, Limited (Ping An), the sale of which was completed on 6 February 2013, generating a gain of US$3.0bn. For further information on all disposals, see page 27.

In 2012, we merged our operations in Oman with those of the Oman International Bank S.A.O.G. (OIB) and acquired the onshore retail and commercial banking businesses of Lloyds Banking Group in the United Arab Emirates (see page 470).

HSBC Values

Embedding global standards across HSBC in a consistent manner is a top priority and will shape the way we do business.

The role of HSBC Values in daily operating practice is fundamental to our culture in the context of the financial services sector and the wider economy.

This is particularly so in the light of developments and changes in regulatory policy, investor confidence and society s view of the role of banks. We expect our executives and employees to act with courageous integrity in the execution of their duties by being:

- dependable and doing the right thing;
- open to different ideas and cultures; and
- connected with our customers, communities, regulators and each other.

We continue to enhance our values-led culture by embedding HSBC Values into how we conduct our business and in the selection, assessment, recognition and training provided to staff.

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Overview (continued)

Ensuring our conduct matches our values

In line with our ambition to be recognised as the world s leading international bank, we aspire to lead the industry in our standards of conduct. 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.

Like any business, we greatly value our reputation. HSBC s success over the years is due in no small part to our reputation for trustworthiness and integrity. In April 2012, as part of this effort, we committed to adopting and enforcing the highest compliance standards across HSBC. Doing so will help us to achieve three key objectives:

- strengthen our capabilities to combat the ongoing threat of financial crime;
- make consistent and therefore simplify how we monitor and enforce high standards at HSBC; and
- ensure that we consistently apply our values so as to serve positively the customers and societies who entrust their financial needs to HSBC.

Under the supervision of HSBC s Global Standards Steering Committee, co-chaired by our Group Chief Risk Officer and our Chief Legal Officer, who report to the Group Chief Executive, we are already strengthening policies and processes in a number of important areas, described on the right.

We are also reinforcing the status of compliance and standards as an important element of how we assess and reward senior executives, and rolling out communication, training and assurance programmes to ensure that our staff understand and meet their responsibilities.

We have 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 it operates. We deal with tax authorities in an open and honest manner. We are strengthening our policies and controls with the objective of ensuring our services are not used by clients seeking to evade their tax obligations.

A new committee of the HSBC Holdings Board, the Financial System Vulnerabilities Committee, will provide governance, oversight and policy guidance over the framework of controls and procedures designed to identify areas where HSBC may become exposed and through that exposure, expose the financial system more broadly to financial crime or system abuse.

Global standards execution framework priority areas

Financial crime filter

Under the Group s strategy described on page 17, we analyse different markets against five financial filters to help us determine where to do business and the type of business we can do in line with our values and financial return objectives. In 2012, we added a sixth filter under which we also analyse all new and existing business to limit activity and client acquisition in jurisdictions with a high risk of financial crime.

Tax transparency

We are strengthening our policies and controls with the objective of ensuring that HSBC s services are not used by clients seeking to evade their tax obligations.

Sanctions

We have expanded our application of financial sanctions to ensure that the most demanding standards are enforced for all currencies and in all jurisdictions. Through application of these standards, we screen clients and all cross-border payments to prevent the use of HSBC s banking services for the benefit of blacklisted countries, companies and individuals.

Information sharing

We are extending the sharing of key compliance information between different parts of HSBC, to the extent permitted by law, for the purpose of managing our exposure to financial crime.

Customer due diligence

We are applying a globally consistent approach to the knowledge needed to accept or retain a customer relationship. When any customer or potential customer is considered an unacceptable reputational risk or otherwise does not meet our standards that determination will be applied globally.

Affiliates due diligence

We are building a single central repository holding all required due diligence information on each of our affiliates in order to facilitate seamlessly cross-border transactions on behalf of our clients.

Bearer shares

Shares not registered to any owner, but beneficially owned by the person who has physical possession of the share certificates, carry inherent risks relating to money laundering and tax evasion. We have set out minimum, highly restrictive standards, applicable in all markets, for dealing with customers who utilise bearer shares.

Business and operating models

Our business model is based on an international network connecting faster-growing and developed markets.

Our businesses are organised to serve a cohesive portfolio of markets, as tabulated below.

Business model

We take deposits from our customers and use these funds to make loans, either directly or through the capital markets. 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

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Overview (continued)

advances to companies secured on amounts owed to them by their customers. In addition, we offer a wide variety of products and financial services including broking, asset management, financial advisory, life insurance manufacturing, corporate finance, markets, securities services and alternative investments. We provide these products for clients ranging from governments to large and mid-market corporates, small and medium-sized enterprises (SME s), high net worth individuals and retail customers.

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; and
- net trading income income from trading activities primarily conducted in Global Markets, including Foreign Exchange, Credit, Rates and Equities trading.

At our Investor Day in May 2012, we outlined our geographical priorities where we expect future growth opportunities to be concentrated. We have defined the UK and Hong Kong as our home markets, and a further 20 countries as priority growth markets. These 22 markets accounted for over 90% of our profit before tax in 2012, and will be the primary focus of capital deployment. Network markets are markets with strong international relevance which serve to complement our international network, operating mainly through CMB and GB&M. 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. This structure is illustrated below.

HSBC s market structure

Operating model

HSBC has a matrix management structure which includes global businesses, geographical regions and global functions. Global businesses are responsible for setting globally consistent business strategies and operating models. Geographical regions execute business strategies set by the global businesses. Global functions, including HSBC Technology and Services, support and facilitate the execution of the strategy.

Holding company

HSBC Holdings plc, the holding company of the Group, is listed in London, Hong Kong, New York, Paris and Bermuda. HSBC Holdings is the primary provider of equity capital to 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 management and day-to-

Report of the Directors: Overview (continued)

day running of the Group, within the risk appetite set by the Board. The Board, through the 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 subsidiary, nor is a lender of last resort and does not carry out any banking business in its own right. HSBC has a legal entity-based Group structure, with subsidiaries operating under their own boards of directors as separately capitalised, ring-fenced entities, implementing Group strategy and delivering Group products and services, in most cases in the country or territory in which they are domiciled.

Global businesses

Our four global businesses 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 confines 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 businesses are summarised below. Further details are provided on page 60.

Main business activities by global business

For footnotes, see page 120.

Geographical regions

The geographical regions share responsibility for executing the strategies set by the global businesses. They represent the Group to clients, regulators, employee groups and other stakeholders; allocate capital; manage risk appetite, liquidity and funding by legal entity; and are accountable for profit and loss performance in line with global business plans.

Within the geographical regions, the Group is structured as a network of regional banks and locally incorporated regulated banking entities. Each bank is separately capitalised in accordance with applicable prudential requirements and is required to consider its risk and maintain a capital buffer consistent with the Group s risk appetite for the relevant country or region. The banking entities manage their own funding and liquidity within parameters set centrally.

Global functions

Our global functions are Communications, Company Secretaries, Corporate Sustainability, Finance, Human Resources, Internal Audit, Legal, Risk (including Compliance), Strategy and Planning, Marketing, and HSBC Technology and Services, our global service delivery organisation. The global functions establish and manage all policies, processes and delivery platforms relevant to their activities, are fully accountable for their costs globally and are responsible for managing their headcount.

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Overview (continued)

Strategic direction

Our strategic objective is to become the world s leading international bank.

Our strategic direction is aligned to two long-term trends:

International trade and capital flows the world economy is becoming ever more connected. Growth in world trade and cross-border capital flows continues to outstrip growth in average gross domestic product. Financial flows between countries and regions are highly concentrated, and 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.

Economic development and wealth creation we expect economies currently deemed emerging to have increased five-fold in size by 2050, benefiting from demographics and urbanisation, by which time they will be larger than the developed world. By then, we expect 19 of the 30 largest economies will be markets that are currently described as emerging.

HSBC is one of the few truly international banks and our advantages lie in the extent to which our network corresponds with markets relevant to international financial flows, our access and exposure to high growth markets and businesses, and our strong balance sheet, which helps to generate a resilient stream of earnings.

Based on these long-term trends and our competitive position, our strategy has two parts:

Network of businesses connecting the world HSBC is well positioned to capture the growing international financial flows. Our global reach and range of services put us in a strong position to serve corporate clients as they grow from small enterprises into large and international corporates. Our access to local retail funding and our suite of international products allows us to offer distinctive solutions for these clients profitably. We will focus on South-South trade, connecting faster-growing economies with each other.

Wealth management and retail with local scale social mobility and wealth creation in the faster-growing markets in which we are positioned will generate demand for financial services which we will meet through our Wealth Management and GPB businesses. We will only invest in retail businesses in markets where we can achieve critical mass.

To implement this strategy we have set priorities across three areas to simplify, restructure and grow the Group, as described below.

Simplifying HSBC

We will continue to make HSBC easier to manage and control. This includes (i) running off legacy assets in the US and in GB&M, (ii) addressing fragmentation in our business portfolio through our six filters disposing of non-strategic businesses, and (iii) improving organisational efficiency.

In 2012, we added a sixth filter to the existing five strategic evaluation criteria used to assess our business (international connectivity, economic development, profitability, cost efficiency and liquidity). The sixth filter requires compliance with our global standards on financial crime and involves the assessment of existing and new client relationships and activities against those standards.

Run-off portfolios

Run-off portfolios comprise Consumer and Mortgage Lending portfolios and certain related treasury services in the US and, in GB&M, a legacy credit business. The latter comprises a separately identifiable, discretely managed business comprising Solitaire Funding Limited (Solitaire), securities investment conduits, asset-backed securities, trading portfolios and credit correlation portfolios, derivative transactions entered into with monoline insurers and certain structured credit transactions.

We continue to run off US legacy consumer assets and are actively analysing opportunities to reduce risk and improve returns.

Run-off of portfolio receivables in the US

For footnote, see page 120.

We have identified segments of the real estate portfolio in the US that represent a high risk and/or a high operational burden or may be sold on a capital

Report of the Directors: Overview (continued)

accretive basis. We have also identified the non-real estate portfolio for sale to reduce operational risk.

In GB&M, decisions to hold or sell legacy assets depend on whether the net present value of future cash flows from the assets (e.g. the terminal value net of funding and operational costs and the cost of capital) exceed the total of the expected loss on sale and the costs of the transaction.

Addressing fragmentation

Fragmentation of the business is being addressed using the six filters to guide strategic actions.

Using the six filters in decision-making

Since 2011 we have announced and completed a significant number of disposals:

Announced transactions[19]

For footnote, see page 120.

Improving organisational efficiency

We continued to make headway with the Four Programmes that we launched in May 2011 designed to simplify HSBC and make the Group easier to manage and control. The Four Programmes are

(i) implementing consistent business models;
(ii) re-engineering global functions;
(iii) re-engineering operational processes; and
(iv) streamlining IT.

Our approach to organisation, talent and values

Restructuring HSBC

We will restructure certain businesses to adapt to the new environment, including GB&M, our US franchise and GPB.

Global Banking and Markets

Product profitability for the industry as a whole is declining with client activity relatively subdued and regulatory changes reducing available capital and liquidity while, at the same time, posing significant challenges to some traditional business models. Overall, there is downward pressure on returns on capital.

GB&M is well positioned for the new business environment, with its deep and diversified client base, network of markets covering the majority of global financial flows, global product capabilities and diversified funding base.

GB&M is actively managing its legacy credit exposures. In 2012, risk-weighted assets (RWA s) decreased mainly because of downgrades to positions which resulted in a change from being risk-weighted to being deducted from capital. A clear economic framework has been put in place for decision-making over when and how to dispose of legacy investments.

With regard to its ongoing business activities, GB&M manages its RWAs comprehensively and pro-actively, which helps mitigate RWA growth arising from regulatory and model changes.

Our US businesses

Our US operations are being reshaped to focus on core activities, with the sale of the US Card and Retail Services business and the upstate New York

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Overview (continued)

branches and the repositioning of our activities towards international businesses.

- CMB is now focused on five hubs contributing over 50% of US corporate imports and exports, including the West Coast Southeast and Midwest.

- Global Banking serves top-tier multinationals and Global Markets (New York) provides a hub for international clients across America and globally, providing US dollar funding.

- RBWM and GPB target internationally mobile clients in large metropolitan centres on the West and East coasts.

Global Private Banking

The private banking industry faces challenges from stricter regulatory requirements, particularly to its international banking model, and increasing competition to capture new wealth inflows. To meet these challenges and better serve the needs of our clients, GPB is repositioning its business to focus on priority markets and improve its operational standards in the following ways:

- *operational risk and compliance* GPB will adhere to the highest standards in the industry, and will continue to strengthen its compliance and risk framework, focusing on global standards and tax transparency;

- *integrated operating model* GPB has implemented a new global operating model that will provide better integration and coordination between geographical regions, and it will complete the roll-out of improved data security and compliance governance, systems and processes;

- *integration with the Group* GPB will intensify collaboration with CMB to access wealth created by entrepreneurs who already bank with HSBC on the business side. GPB will also contribute to a seamless Group wealth proposition for personal customers; and

- *capturing growth* GPB will focus investment on the most attractive developed and faster-growing wealth markets where it can build access to well established client franchises and strong local and international product capabilities.

Growing HSBC

We continue to position HSBC for growth. We also continue to benefit from the closer coordination and collaboration among our four global businesses to

capture significant revenue opportunities utilising, in particular, CMB s potential for increasing referrals and cross-selling with GB&M and GPB.

Faster-growing regions[20] *as a share of Group data*

For footnotes, see page 120.

We will actively deploy capital in our home and priority growth markets (see HSBC s market structure on page 15), access faster-growing markets and all major trade corridors and capture growth opportunities in trade finance as competitors deleverage.

Our aim in executing our strategy is to be regarded as the world s leading international bank. We have defined financial targets to achieve a return on equity of between 12% and 15% with a core tier 1 ratio of between 9.5% and 10.5%, and achieve a cost efficiency ratio of between 48% and 52%. We have also defined Key Performance Indicators to monitor the outcomes of actions across the three areas of capital deployment, cost efficiency and growth (see page 22).

Risk

As a provider of banking and financial services, risk is at the core of our day-to-day activities.

The chart below is designed to provide a high level guide to how HSBC s business activities are reflected in our risk measures and in our balance sheet.

The third party assets and liabilities shown provide a guide to the proportion of the Group s balance sheet which is contributed by each of them. In addition, we have used the regulatory RWAs to illustrate the relative size of the risks each of them incur.

Report of the Directors: Overview (continued)

Exposure to risks arising from the business activities of global businesses

For footnote, see page 120.

In carrying out its business activities, HSBC incurs a range of risks, some of which are measured and managed via capital, some by other mechanisms. For the former, we use both regulatory and economic capital. Currently, the Group s risk appetite is most affected by the regulatory capital dimension as it exceeds economic capital. The table above shows the Pillar 1 regulatory capital demand for those risks and is represented by RWAs. Under this regulatory capital framework, the capital invested in our Insurance business is deducted from regulatory capital; as at 31 December 2012, the capital invested in our Insurance business was US$10.1bn. HSBC is also exposed to other risks as shown in the table above. The regulatory capital required against these other risks is covered within the total capital that HSBC holds.

We have identified a comprehensive suite of risk factors which encompasses the broad range of risks we are exposed to, but may not necessarily be deemed as top or emerging risks. The risk factors inform our ongoing assessment of our top and emerging risks. This assessment may result in our risk appetite being revised.

Risk factors

Our businesses are exposed to a variety of risk factors that could potentially affect the results of our operations or financial condition. These 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 comply with certain regulatory requirements would have an adverse material effect on our results and operations.

We are subject to a number of legal and regulatory actions and investigations, the outcomes of which are inherently difficult to

Report of the Directors: Overview (continued)

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 significant adverse effect on our operations, financial condition and prospects.

The UK Government has proposed draft legislation for banking reforms based on the recommendations of the Independent Commission on Banking. Additional 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 including compliance

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.

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 assumptions and estimates which, if inaccurate, could cause material misstatement of the results and financial position of the Group.

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.

Risks related to our business

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 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.

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Overview (continued)

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, a difficult economic climate remains with continued pressures on household and corporate finances. During 2012, world economic growth slowed in all regions and growth is expected to remain well below its long-term potential in 2013. Mature economies are deleveraging and implementing austerity and structural reforms that are restricting economic activity in the short term. In emerging markets, growth was affected by lower overseas demand and cautious official policies even where domestic demand remained positive. Core difficulties remain in Europe, the US and Japan as economic growth is expected to resume at a very slow pace. In the US, the first quarter of 2013 will remain challenging as issues surrounding the fiscal policy and debt ceiling will have to be resolved. In the eurozone and in Japan, the ageing population, the structure of labour markets and the cost of the social welfare models are major concerns which are difficult to tackle without aggravating the sovereign debt crisis. In addition, mainland China experienced a slowdown in economic growth in 2011 and in 2012 and faces uncertainty over its future growth.

In the face of such economic uncertainty, markets have been very volatile throughout 2012 and are expected to remain so at least during the first half of 2013. The adverse 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 and the sovereign debt crisis in the eurozone;
- geopolitical risks might grow in different regions of the world, affecting directly the economies of these countries and their economic policies. An immediate cause for concern is Egypt, where the political situation is leading to a shortage of liquidity in the banking system;
- 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 continue to depress consumer and business confidence beyond expectations. If growth in the UK or the US remains subdued, for example, asset prices and payment patterns may be adversely affected, leading to increases in delinquencies, default rates, write-offs and loan impairment charges beyond our expectations.

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 been receding at the end of 2012, primarily as a result of the support given by the ECB and to the first steps taken to move towards fiscal union. This was however, obtained due in large part to the implementation of austerity measures in almost all countries in the eurozone and notably in the eurozone periphery. As a result, the region entered recession by mid-2012 and this recession is expected to continue during the first part of 2013. All European countries, including Germany and other Northern countries, are affected, by the lower demand and global deleveraging.

The risk of a vicious circle between economic recession and sovereign crisis throughout and beyond the eurozone remains significant. Although banks have reduced their exposure to sovereign debt issued by the weakest states, they are still vulnerable to a potential default or a significant widening of credit spreads. Although our direct exposure to peripheral eurozone economies is limited, we have substantial exposure to financial institutions and central banks in core European countries which may be affected by the ongoing crisis. For a further description of our exposures to selected eurozone

Report of the Directors: Overview (continued)

countries, eurozone banks and other financial institutions and corporates see Areas of special interest on page 128.

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 81 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, the Arab Spring continues to create political instability across the region, while strategic risks to regional security and global oil prices arising from Iran s nuclear programme are likely to intensify in 2013. In East Asia, tensions over a number of maritime sovereignty disputes involving mainland China have increased in 2012. Leadership changes in the region at the end of 2012, particularly in Japan and mainland China, may result in tensions rising in 2013 with a concomitantly higher risk of military escalation. A break-up of the eurozone or continued social unrest triggered by the ongoing economic crisis and related austerity programmes may result in political and social disruption throughout Europe.

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 comply with certain regulatory requirements would have an adverse material effect on our results and operations.

In December 2012, HSBC reached agreement with US authorities in relation to investigations regarding inadequate compliance with anti-money laundering, the US Bank Secrecy Act and sanctions law. This

includes a DPA with the US Department of Justice (DoJ). We also reached agreement to achieve a resolution with all other US government agencies that have investigated our past conduct related to these issues, and finalised an undertaking with the FSA to comply with certain forward-looking obligations with respect to anti-money laundering and sanctions requirements over a five-year term. Under these agreements, we made payments totalling US$1,921m to US authorities and take further action to strengthen our compliance policies and procedures. Over the five-year term of the agreement with the DoJ and the FSA, an independent monitor (who will, for FSA purposes, be a skilled person under section 166 of the Financial Services and Markets Act (FSMA)) will evaluate and assess our progress in fully implementing these and other measures it recommends and will produce regular assessment of the effectiveness of our Compliance function.

Additionally and as reflected in the agreement entered into with the Office of the Comptroller of the Currency (OCC) in December 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 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. 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 the Gramm-Leach Bliley Act (GLB Act). Similar consequences could result for subsidiaries of HSBC Bank USA that engage in financial activities in reliance on expanded powers provided for in the GLB Act. Any such divestiture or termination of activities would have a material adverse effect on our business, prospects, financial condition and results of operation.

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Overview (continued)

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. 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.

More stringent regulatory requirements governing the development of parameters applied and controls around models used for measuring risk can give rise to changes, 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 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 ICB ring-fencing proposals, recovery and resolution plans, the Volcker Rule and the Foreign Account Tax Compliance Act (FATCA), 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

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Overview (continued)

expropriation, nationalisation, confiscation of assets and changes in legislation or regulations relating to foreign ownership.

The FSA supervises HSBC on a consolidated basis but the UK financial services regulatory structure is currently in the process of substantial reform. Legislation has been passed to abolish the FSA and establish three new regulatory bodies from 1 April 2013. These three bodies will comprise 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 will inherit the majority of the FSA s existing functions as the micro-prudential supervisors. Some subsidiaries such as HSBC Bank will be dual-regulated firms, subject to prudential regulation by the PRA and to conduct regulation by the FCA. These reforms will endow the new regulatory bodies with additional powers. For example, under certain circumstances, the PRA and the FCA will be able to issue directions to unregulated qualifying parent undertakings such as HSBC Holdings plc. The FPC will have 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, new 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. These developments are expected to continue to change the way in which we are regulated and supervised.

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) which will require the Group to meet higher capital standards at least 2.5% above the Basel III minimum core equity requirement of 7%, although the implications for capital management of our locally incorporated banks and branch operations are unclear. The rules for G-SIBS also provide a framework for more intensive supervision of these firms.

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 many of the details, impact and timing 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 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 with a two-year conformance period ending in full implementation in July 2014. This could affect our various businesses widely, and geographically beyond North America, although the initial draft rules are being revised. In addition, in December 2012, the Federal Reserve Board issued draft proposals to apply enhanced supervisory standards to large foreign banking organisations such as HSBC. These are subject to comment and amendment and the possible effect on HSBC is unclear.

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. The UK and EU proposals on recovery and resolution could lead to changes in the structure of the Group and relationships between underlying legal entities. In addition, at an EU level, the initiatives include the EU s implementation of the Basel III proposals (CRD IV), the proposed Recovery and Resolution Directive (RRD) and the implementation of The European Markets Infrastructure Regulation (EMIR) and the revised Markets in Financial Instruments Directive (MiFID). Although the target implementation date for the Basel III capital framework was 1 January 2013, CRD IV has not yet been finalised and increased capital requirements and changes to what is defined to constitute capital may constrain the Group s planned activities and could increase costs and contribute to adverse impacts on the Group s earnings. Additionally, during periods of market dislocation, increasing the Group s capital resources in order to meet targets may prove more difficult or costly.

At a national level in the UK, other relevant regulatory initiatives include the FSA s Retail Distribution and Mortgage Market Reviews and an ever greater focus 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.

Report of the Directors: Overview (continued)

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 mis-selling of payment protection insurance and of interest rate derivative products to SME.

The UK and other regulators may identify future industry-wide mis-selling 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); 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 proposed draft legislation for banking reforms based on the recommendations of the Independent Commission on Banking. Additional proposals are being considered in France and the EU and any resulting structural changes could have a material adverse effect on us

The UK 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 and greater primary loss absorbing capacity. The ICB further recommends that the first £85,000 of an eligible person s deposits in a bank are proposed to be made preferred debts, so that in the event of an insolvency they will rank ahead of other creditors.

The UK Government subsequently undertook consultation on the ICB proposals during 2012. In October 2012, draft primary legislation was presented to the UK s Parliamentary Commission on Banking Standards for pre-legislative scrutiny and the UK Government is now considering whether its original proposal should be adjusted in the light of these deliberations. The draft legislation did not incorporate some of the details set out in the final

report from the ICB or adjustments arising from the subsequent consultations. These details will be reflected in secondary legislation and underlying rules from supervisory authorities. The UK Chancellor announced in February 2013 that if banks attempt to game or flout the rules establishing the ring-fence, they could be subject to full legal separation.

The UK Government has proposed a deadline of May 2015 (the end of the current session of Parliament) for the Banking Reform Bill and all relevant secondary legislation to be completed. The UK Government has also indicated that it will follow the ICB s preferred deadline of 1 January 2019 for the implementation of the ring-fencing reforms and the introduction of depositor preference.

In respect of UK universal banks, including HSBC s major UK banking subsidiary, HSBC Bank, the ICB has proposed a separation of the UK retail and wholesale banking operations through the creation of a ring-fenced retail bank. A requirement is that all deposits and overdrafts of UK personal customers and smaller companies and payments services would be provided by this ring-fenced bank, but it could also include banking services for larger customers. The UK Government also proposed that some simpler hedging activities could be undertaken within this bank.

In addition, the ICB proposed that large UK-headquartered groups (which would include HSBC) should have primary loss-absorbing capacity (PLAC) equal to at least 17% of risk-weighted assets (RWA s) calculated under Basel III. This capacity should be satisfied by the issuance of additional equity and/or debt that is loss-absorbing at the point of non-viability. The UK supervisor would retain the power to increase this minimum loss-absorbing capacity if it had concerns about the ability of the bank to restructure or liquidate at the point of failure.

The UK Government has indicated that if a large UK-headquartered group has non-UK subsidiaries which are demonstrably resolvable without an adverse effect on UK financial stability, they would be excluded from the calculation of the PLAC requirement.

The ICB also recommended that a large ring-fenced bank should be required to maintain an equity ring-fence buffer of at least 10% of RWAs, and the minimum leverage ratio of equity-to-total assets should be adjusted to 4.06% for larger banks, including HSBC Bank. The UK Government has however proposed that the leverage ratio should

Report of the Directors: Overview (continued)

remain at the minimum of 3% as set out in the Basel III proposals.

If the proposals described above regarding ICB are adopted substantially in the form described, major changes to our corporate structure and business activities conducted in the UK through HSBC Bank might be required. The changes would include separating the ring-fenced bank from the existing UK incorporated universal bank. The proposals would take an extended period of time to implement and would significantly increase our costs, both from implementation and from running our operations as restructured.

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 Liikanen Group presented its recommendations on 2 October 2012, which included 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, changes to banks capital requirements, particularly relating to trading assets and real estate-related loans as well as a number of other recommendations. The European Commission has held a consultation on the recommendations and may make its own proposals during 2013. A summary of responses to the consultation were published on 21 December 2012, which state that the proposal for mandatory separation of bank trading activities was subject to the most comment and controversy. The Commission has indicated in January 2013 that it intended to publish a directive or a regulation on the reform of the structure of EU banks in the third quarter of 2013.

The French Government has also made legislative proposals to prohibit a limited range of trading activities within banks and these are now being subjected to parliamentary scrutiny. The relationship between the ICB proposals in the UK, the French proposals and the Liikanen proposals at the EU level has still to be clarified.

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 including compliance

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. Any such divestiture or termination of activities would 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

Report of the Directors: Overview (continued)

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. Any such divestiture or termination of activities would have a material adverse effect on our business, prospects, financial condition and results of operation.

Our operations are subject to disruption from the external environment

HSBC operates in many geographic 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 have an economic impact on us. Any such divestiture or termination of activities would have a material adverse effect on our business, prospects, financial condition and results of operation.

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 its 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. Any such divestiture or termination of activities would have a material adverse effect on our business, prospects, financial condition and results of operation.

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. During 2012, a major payment systems outage experienced by another UK Bank demonstrated the potential damage, in particular to its reputation, associated with a prolonged systems outage.

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 2012, we were subjected to six denial of service attacks on our external facing websites across Latin America, Asia and North America. A denial of service attack is the attempt to intentionally paralyse a computer network by flooding it with data sent simultaneously from many individual computers.

One of these attacks affected several geographical regions and lasted 15 hours; there was limited effect from the five other attacks with services maintained. We did not experience any loss of data as a result of these attacks.

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

Report of the Directors: Overview (continued)

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 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, 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 assumptions and estimates which, if inaccurate, could cause material misstatement of the results and financial position of the Group

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 and assumptions 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 and provision for liabilities, which are discussed in detail in Critical accounting policies on page 54.

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 it is possible that the results of operations and the financial position of the Group could be materially misstated if the estimates and assumptions used prove to be inaccurate. For further details, see Critical accounting policies on page 54.

If the judgement, estimates and assumptions we use in preparing our consolidated financial statements are subsequently found to be incorrect, this could materially 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 for money laundering. A major focus of US governmental policy relating to financial institutions in recent years has been combating money laundering and enforcing compliance with US economic sanctions, and this prioritisation is evidenced by our agreements with US authorities relating to various investigations regarding inadequate compliance with anti-money laundering and sanctions law including DPAs with the US DoJ 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 Federal Reserve Board which requires the implementation of improvements to compliance procedures regarding obligations under the US Bank Secrecy Act (the BSA) and anti-money laundering (AML) rules. These consent orders do not preclude additional enforcement actions by bank regulatory,

21h

Report of the Directors: Overview (continued)

governmental or law enforcement agencies or private litigation.

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 (and our relevant counterparties) knowledge. If we are associated with, or even accused of being associated with, or become a party to, money laundering, our reputation could suffer and we could become subject to fines, sanctions and/or legal enforcement (including being added to any blacklists that would prohibit certain parties from engaging in transactions with us), any one of which 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 DPA relates are intended to ensure that the Group s businesses are better protected in respect of these risks. These actions are listed in the DPA. It will, however, take time to complete these remedial actions. Breach of the DPA 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 DPA.

We may not achieve all the expected benefits of our strategic initiatives

In 2011 we developed and presented a new strategy for the Group (see Strategic direction on page 17). Our strategy 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 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. Where 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 a change in the law could affect our ability to forecast on collateral or otherwise enforce contractual rights.

This risk that collateral cannot be realised includes situations where this arises by change of law that may impact our ability to foreclose on collateral or otherwise enforce contractual rights.

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 impacts on 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

21i

adjustments or fair value changes may have a material adverse effect and 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 have a significant impact on 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 impact 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. 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. We continued to have good access to debt capital markets in 2012. Our cost of issuing new debt fell significantly, principally in the second half of the year. However, 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 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.

Report of the Directors: Overview (continued)

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. In 2012, HSBC Holdings long-term credit ratings were downgraded by Moody s (to AA2) and Fitch (to AA-) due to Moody s global review of bank credit ratings and Fitch s reassessment of HSBC s financial strengths. We experienced no change in market demand or the cost of issuing liabilities and negligible changes in our collateral requirements arising from these changes in rating. Further 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 estimate that HSBC could be required to post additional collateral of up to US$1.5bn (2011: US$3.0bn) in the event of a one notch downgrade in credit ratings, which would increase to US$2.5bn (2011:US$3.8bn) in the event of a two notch downgrade.

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.

Our general insurance businesses are exposed to the risk of uncertain insurance claim rates. For example, extreme weather conditions can result in high property damage claims, higher levels of theft can increase claims on home insurance and changes to unemployment levels can increase claims on loan protection insurance. These claims rates may differ from business assumptions and negative developments may materially adversely affect our financial condition and results of operations.

HSBC Holdings is a holding company and as a result, is dependent on 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 profits and other funds in order to be able to pay

Report of the Directors: Overview (continued)

obligations to shareholders and debt holders as they fall due. The ability of HSBC Holdings subsidiaries and affiliates to pay dividends could be restricted by changes in official banking measures, exchange controls and other requirements.

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 affect on our business, prospects, financial condition and/or results of operations.

Report of the Directors: Overview (continued)

Top and emerging risks

We classify certain risks as top or emerging . 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 one-year horizon. We consider an emerging risk to be one which has large uncertain outcomes which may form and crystallise beyond a one-year horizon and, if it were to crystallise, could have a material effect on our long-term strategy.

Our approach to identifying and monitoring top and emerging risks is informed by the risk factors.

All of our activities involve, to varying degrees, the measurement, evaluation, acceptance and management of risk or combinations of risks which we assess on a Group-wide basis. Top and emerging risks fall under the following three broad categories:

- macroeconomic and geopolitical risk;
- macro-prudential, regulatory and legal risks to our business model; and
- risks related to our business operations, governance and internal control systems.

During 2012, our senior management paid particular attention to a number of top and emerging risks. The current list is summarised below:

Macroeconomic and geopolitical risk

- Emerging markets slow down.
- Macroeconomic risks within developed economies.
- Increased geopolitical risk in certain regions.

Macro-prudential, regulatory and legal risks to our business model

- Regulatory developments affecting our business model and Group profitability.

Regulatory investigations, fines, sanctions and requirements relating to conduct of business and financial crime negatively affecting our results and brand.

Dispute risk.

Risks related to our business operations, governance and internal control systems

Regulatory commitments and consent orders including under the Deferred Prosecution Agreements.

Challenges to achieving our strategy in a downturn.

Internet crime and fraud.

Level of change creating operational complexity and heightened operational risk.

Information security risk.

Model risk.

A detailed account of these risks is provided on page 131. All of them are regarded as top risks. Further comments on expected risks and uncertainties are made throughout the *Annual Report and Accounts 2012*, particularly in the section on Risk, pages 123 to 249.

Risk appetite

Risk appetite is a key component of our management of risk and describes the types and level of risk we are prepared to accept in delivering our strategy. Our risk appetite is set out in the Group s Risk Appetite Statement and is central to the annual planning process. Global businesses, geographical regions and global functions are required to articulate their risk appetite statements. They are discussed further on page 126.

Our risk appetite may be revised in response to the top and emerging risks we have identified.

Key performance indicators

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

From time to time the Group reviews its key performance indicators (KPIs) in light of its strategic objectives and may in the future adopt new or refined measures, or modify or adjust existing targets, to better align the KPIs to our strategic objectives.

The GMB remains focused on improving our capital deployment to support the achievement of our medium-term target for return on equity of between 12% and 15%, utilising the six filter analysis across our portfolio of businesses. We will continue to evaluate our businesses in 2013 using this methodology.

Employee engagement has been monitored through annual Global People Surveys. In 2012, quarterly Pulse Surveys were introduced, and the Global People Surveys scheduled biennially. The next Global People Survey will be in 2013. As the Pulse Surveys were not designed to report employee engagement information comparable with that derived from the Global People Surveys, we have not disclosed this KPI in 2012.

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Overview (continued)

Strategy Restructuring HSBC improving the way we deploy capital

Return on average ordinary shareholders equity[2]

Measure: (percentage) profit attributable to ordinary shareholders divided by average ordinary shareholders equity.

Target: to maintain a return in the medium term of between 12% and 15%.

Outcome: return on average ordinary shareholders equity remained outside our target range and was 2.5 percentage points below 2011. The latter primarily reflected adverse fair value movements on own debt attributable to credit spreads, compared with favourable movements in 2011, a higher tax charge and higher average shareholders equity.

Core tier 1 capital ratio[10]

Measure: (percentage) ratio of core tier 1 capital comprising shareholders equity and related non-controlling interests less regulatory deductions and adjustments to total risk-weighted assets.

Target: to maintain a strong capital base to support the development of the business and meet regulatory capital requirements at all times.

Outcome: the increase in core tier 1 capital ratio to 12.3% was driven by capital generation and a reduction in RWAs following business disposals, notably the disposal of the US Card and Retail Services business and derecognition of Ping An as an associate.

Advances to core funding ratio[23]

Measure: 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.

Target: to maintain an advances to core funding ratio below limits set for each entity.

Outcome: The operating entities reported remained inside their advances to core funding limits of between 70% and 115% during 2012, except for one operating entity reported within the total of HSBC s other principal entities which operated with a limit of 125% during the year. This limit has been reduced to 115% for 2013.

Strategy Simplifying HSBC a lean and values-driven organisation

Cost efficiency

(2012: underlying cost efficiency 66.0%)

Measure: (percentage) total operating expenses divided by net operating income before loan impairment and other credit risk provisions.

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

Basic earnings

per ordinary share

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

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

growth.

Outcome: the ratio remained outside the target range. On a reported basis, revenues decreased primarily due to adverse fair value movements on own debt attributable to credit spreads, coupled with higher costs in part reflecting a charge in respect of fines and penalties as part of the settlement of investigations into HSBC s past inadequate compliance with anti-money laundering and sanctions laws as well as an increase in provisions relating to UK customer redress programmes. On an underlying basis, revenue growth was more than offset by the increase in costs.

Outcome: Earnings per share decreased in 2012 reflecting adverse fair value movements on own debt attributable to credit spreads, compared with favourable movements in 2011, and a higher tax charge which resulted in a decrease in reported profits.

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Overview (continued)

Growing HSBC continuing to position ourselves for growth **Strategy**

Risk-adjusted revenue growth

(2012: underlying growth 13%)

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

Target: to deliver consistent growth in risk adjusted revenues.

Outcome: reported risk-adjusted revenue was broadly in line with 2011. On an underlying basis, there was an increase due to revenue growth, notably in GB&M and CMB, and lower loan impairment charges, notably in North America.

Dividends per ordinary share growth

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

Target: to deliver sustained dividend per share growth.

Outcome: dividends per share increased by 10%.

Customer recommendation

Measure: we measure our customer satisfaction through an independent market research survey of retail banking customers in selected countries, using a specific customer recommendation index (CRI) to score performance. We benchmark our performance against key competitors in each market and set targets relative to our peer group of banks.

Target: the Group target is for 75% of all the markets (based on their weighted revenue) to meet their CRI targets.

Outcome: RBWM failed to make its target of 75% as a consequence of reputational issues in certain of our major developed markets that adversely affected customers perception of the bank in the third quarter of 2012. We saw a good recovery in the fourth quarter but, taking the overall averaged annual position into account, we only met our target in 38% of our weighted revenue. 55% of the weighted revenue target was within two points (from a 100-point scale).

Brand value

Measure: in 2011, we moved our brand measure to the Brand Finance valuation method as reported in *The Banker Magazine*. This is our second year of using this benchmark. The Brand Finance methodology gives us a more complete measure of the strength of the brand and its impact across all business lines and customer groups. It is a wholly independent measure and is publicly reported.

Target: a top three position in the banking peer group.

Outcome: The HSBC brand moved from first to third in the Brand Finance ranking and suffered a substantial reduction in value. We achieved our target of a top three position but, in consultation with the Brand Finance organisation, we have seen reputational issues cited as a major factor in our reduced performance in 2012.

For CMB, we changed our measures in 2012 for customer satisfaction to reflect the strategic focus of the business. Previously, we only surveyed small business customers in a limited number of markets and measured customer recommendation. For 2012, we introduced a new measure of our performance through a client engagement survey conducted for us by a third party. This provides a more complete perspective for our performance across all our CMB segments and will give us a competitive benchmark in 13 of our top markets. In 2012, therefore, we set benchmarks but not targets. We will set targets for 2013 and report results in the future.

For footnotes, see page 120.

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Operating and Financial Review

Financial summary

The management commentary included in the Report of the Directors: Overview and Operating and Financial Review , together with the Employees and Corporate sustainability sections of Corporate Governance and the Directors Remuneration Report is presented in compliance with the IFRS 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 372. There are times when we measure our performance internally, using financial measures which have been derived from our reported results, in order to eliminate factors which distort year-on-year comparisons so we can view our results on a more like-for-like basis; these are considered non-GAAP measures. Constant currency and underlying performance are non-GAAP measures that we use throughout our Operating and 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 2012 with reported results for 2011 retranslated at 2012 exchange rates. Except where stated otherwise, commentaries are on a constant currency basis, as reconciled in the table overleaf.

The foreign currency translation differences reflect the movements of the US dollar against most major currencies during 2012.

We exclude the translation differences when monitoring progress against operating plans and past results because management believes the like-for-like basis of constant currency financial measures more appropriately reflects changes due to operating performance.

Constant currency

Constant currency comparatives for 2011 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 2011 at the average rates of exchange for 2012; and

- the balance sheet at 31 December 2011 at the prevailing rates of exchange on 31 December 2012.

Constant currency comparatives for 2010 referred to in the 2011 commentaries are computed on the same basis, by applying average rates of exchange for 2011 to the 2010 income statement and rates of exchange on 31 December 2011 to the balance sheet at 31 December 2010.

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

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Operating and Financial Review

Reconciliation of reported and constant currency profit before tax

	2012 compared with 2011					
			2011			
	2011 as reported	Currency translation adjustment[24]	at 2012 exchange rates	2012 as reported	Reported change[25]	Constant currency change[25]
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[26]	3,933	(35)	3,898	(5,215)		
Gains on disposal of US branch network, US cards business and Ping An				7,024		
Other income[27]	10,525	(446)	10,079	12,419	18	23
Net operating income[21]	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[28]						
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[28]						
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 120.

Underlying performance

Underlying performance:

- adjusts for the year-on-year effects of foreign currency translation;

- eliminates 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 (see footnote 26 on page 120); and

- adjusts for acquisitions, disposals and changes of ownership levels of subsidiaries, associates and businesses (see footnote 29 on page 120).

For disposals, acquisitions and changes of ownership levels of subsidiaries, associates and businesses, we eliminate the gain or loss on disposal in the period incurred and remove the operating profit or loss of the acquired and disposed of businesses from all periods presented. Previously, this adjustment for the results of operations was effected by removing the time-equivalent component of operating profit or loss from the comparative period. During 2012 we changed this adjustment to better reflect the results of the ongoing business. Had we maintained our previous approach, underlying profit before tax would have been US$1.7bn higher in 2012. This was mainly due to the elimination of the US Card and Retail Services business.

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

We use underlying performance when monitoring progress against operating plans and past results because we believe that this basis more appropriately reflects operating performance. We use underlying performance in our commentaries to explain year-on-year changes when the effect of fair

value movements on own debt, acquisitions, disposals or dilution is significant.

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 Financial Services (Middle East) Limited s disposal of majority stake in HSBC Private Equity Middle East Limited	Jun 2011	**(7)**
Dilution gain on our holding in Ping An following the issue of share capital to a third party	Jun 2011	**181**
Grupo Financiero HSBC, S.A. de C.V. s disposal of HSBC Afore S.A. de C.V.[30]	Aug 2011	**83**
Dilution gain as a result of the merger between HSBC Saudi Arabia Limited and SABB Securities Limited	Dec 2011	**27**
HSBC Bank Canada s disposal of HSBC Securities (Canada) Inc s full service retail brokerage business[30]	Jan 2012	**83**
The Hongkong and Shanghai Banking Corporation Limited s disposal of RBWM operations in Thailand[30]	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[30]	May 2012	**3,148**
HSBC Bank USA, N.A. s disposal of 138 non-strategic branches[30]	May 2012	**661**
HSBC Argentina Holdings S.A. s disposal of its general insurance manufacturing subsidiary[30]	May 2012	**102**
The Hongkong and Shanghai Banking Corporation Limited s disposal of its private banking business in Japan[30]	Jun 2012	**67**
The Hongkong and Shanghai Banking Corporation Limited s disposal of its shareholding in a property company in the Philippines	Jun 2012	**130**
HSBC Bank USA, N.A. s disposal of 57 non-strategic branches[30]	Aug 2012	**203**
Hang Seng Bank Limited s disposal of its general insurance manufacturing subsidiary[30]	Jul 2012	**46**
HSBC Asia Holdings B.V. s investment loss on a subsidiary[30]	Aug 2012	**(85)**
HSBC Bank plc s disposal of HSBC Securities SA	Aug 2012	**(11)**
HSBC Europe (Netherlands) B.V. s disposal of HSBC Credit Zrt	Aug 2012	**(2)**
HSBC Europe (Netherlands) B.V. s disposal of HSBC Insurance (Ireland) Limited	Oct 2012	**(12)**
HSBC Europe (Netherlands) B.V. s disposal of HSBC Reinsurance Limited	Oct 2012	**7**
HSBC Private Bank (UK) Limited s disposal of Property Vision Holdings Limited	Oct 2012	**(1)**
HSBC Investment Bank Holdings Limited s disposal of its stake in Havas Havalimanlari Yer Hizmetleri Yatirim Holding Anonim Sirketi	Oct 2012	**18**
HSBC Insurance (Asia) Limited s disposal of its general insurance portfolios[30]	Nov 2012	**117**
HSBC Bank plc s disposal of HSBC Shipping Services Limited	Nov 2012	**(2)**
HSBC Bank (Panama) S.A. s disposal of its operations in Costa Rica, El Salvador and Honduras[30]	Dec 2012	**(62)**
HSBC Insurance Holdings Limited and The Hongkong and Shanghai Banking Corporation Limited s disposal of their shares in Ping An[30]	Dec 2012	**3,012**
	Dec 2012	**212**

The Hongkong and Shanghai Banking Corporation Limited s disposal of its shareholding in Global Payments Asia-Pacific Limited[30]

For footnote, see page 120.

Acquisition gains/(losses) affecting the underlying performance

	Date	Fair value gain on acquisition US$m
Our share of the loss recorded by Ping An on re-measurement of its previously held equity interest in Ping An bank (formerly known as Shenzhen Development Bank) when Ping An took control and fully consolidated Ping An Bank	Jul 2011	**(48)**
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**

27

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

The following table reconciles our reported revenue, loan impairment charges, operating expenses and profit before tax for 2012 and 2011 to an underlying basis. Throughout this *Annual Report and Accounts*, we reconcile other reported results to underlying results when doing so results in a more useful discussion of operating performance. 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

	2012 US$m	2011 US$m	Change[25] %
Revenue[21]			
Reported revenue	**68,330**	72,280	(5)
Currency translation adjustment[24]		(2,033)	
Own credit spread[26]	**5,215**	(3,933)	
Acquisitions, disposals and dilutions	**(10,048)**	(6,976)	
Underlying revenue	**63,497**	59,338	7
Loan impairment charges and other credit risk provisions (LIC s)			
Reported LICs	**(8,311)**	(12,127)	31
Currency translation adjustment[24]		277	
Acquisitions, disposals and dilutions	**338**	1,619	
Underlying LICs	**(7,973)**	(10,231)	22
Operating expenses			
Reported operating expenses	**(42,927)**	(41,545)	(3)
Currency translation adjustment[24]		1,273	
Acquisitions, disposals and dilutions	**1,004**	2,666	
Underlying operating expenses	**(41,923)**	(37,606)	(11)
Underlying cost efficiency ratio	**66.0%**	63.4%	
Profit before tax			
Reported profit before tax	**20,649**	21,872	(6)
Currency translation adjustment[24]		(428)	
Own credit spread[26]	**5,215**	(3,933)	
Acquisitions, disposals and dilutions	**(9,479)**	(3,650)	
Underlying profit before tax	**16,385**	13,861	18
By global business[28]			
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[28]			
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 120.

Table of Contents

HSBC HOLDINGS PLC

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

Consolidated income statement

Five-year summary consolidated income statement

	2012	2011	2010	2009	2008
	US$m	US$m	US$m	US$m	US$m
Net interest income	**37,672**	40,662	39,441	40,730	42,563
Net fee income	**16,430**	17,160	17,355	17,664	20,024
Net trading income	**7,091**	6,506	7,210	9,863	6,560
Net income/(expense) from financial instruments designated at fair value	**(2,226)**	3,439	1,220	(3,531)	3,852
Gains less losses from financial investments	**1,189**	907	968	520	197
Dividend income	**221**	149	112	126	272
Net earned insurance premiums	**13,044**	12,872	11,146	10,471	10,850
Gains on disposal of French regional banks					2,445
Gains on disposal of US branch network, US cards business and Ping An	**7,024**				
Other operating income	**2,100**	1,766	2,562	2,788	1,808
Gains arising from dilution of interests in associates and joint ventures		208	188		
Other	**2,100**	1,558	2,374	2,788	1,808
Total operating income	**82,545**	83,461	80,014	78,631	88,571
Net insurance claims incurred and movement in liabilities to policyholders	**(14,215)**	(11,181)	(11,767)	(12,450)	(6,889)
Net operating income before loan impairment charges and other credit risk provisions	**68,330**	72,280	68,247	66,181	81,682
Loan impairment charges and other credit risk provisions	**(8,311)**	(12,127)	(14,039)	(26,488)	(24,937)
Net operating income	**60,019**	60,153	54,208	39,693	56,745
Total operating expenses[34]	**(42,927)**	(41,545)	(37,688)	(34,395)	(49,099)
Operating profit	**17,092**	18,608	16,520	5,298	7,646
Share of profit in associates and joint ventures	**3,557**	3,264	2,517	1,781	1,661
Profit before tax	**20,649**	21,872	19,037	7,079	9,307
Tax expense	**(5,315)**	(3,928)	(4,846)	(385)	(2,809)
Profit for the year	**15,334**	17,944	14,191	6,694	6,498
Profit attributable to shareholders of the parent company	**14,027**	16,797	13,159	5,834	5,728
Profit attributable to non-controlling interests	**1,307**	1,147	1,032	860	770

Five-year financial information

	US$	US$	US$	US$	US$
Basic earnings per share[35]	**0.74**	0.92	0.73	0.34	0.41
Diluted earnings per share[35]	**0.74**	0.91	0.72	0.34	0.41
Basic earnings excluding goodwill impairment per share[34,35]	**0.74**	0.92	0.73	0.34	1.19
Dividends per ordinary share[1]	**0.41**	0.39	0.34	0.34	0.93

	%	%	%	%	%
Dividend payout ratio[36]					
reported	**55.4**	42.4	46.6	100.0	226.8
excluding goodwill impairment[34]	**55.4**	42.4	46.6	100.0	78.2
Post-tax return on average total assets	**0.6**	0.65	0.57	0.27	0.26
Return on average ordinary shareholders equity	**8.4**	10.9	9.5	5.1	4.7
Average foreign exchange translation rates to US$:					
US$1: £	**0.631**	0.624	0.648	0.641	0.545
US$1:	**0.778**	0.719	0.755	0.719	0.684

For footnotes, see page 120.

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

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 (see Note 26 on the Financial Statements), 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 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. The difference between reported and underlying results is explained and reconciled on page 26.

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

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

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.

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.

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
2012							
Non-qualifying hedges	**(51)**	**(31)**	**(20)**		**(194)**		**(296)**
Ping An contingent forward sale contract[37]			**(553)**				**(553)**
Gain on sale of non-core investments in India		**314**					**314**
Loss recognised following the classification of businesses to held for sale						**(96)**	**(96)**
2011							
Non-qualifying hedges	(291)	(14)	(20)		(1,067)		(1,392)
Refinement of PVIF calculation	95	135	11			2	243
2010							
Non-qualifying hedges	(691)	(17)	4		(353)		(1,057)

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
2012						
Non-qualifying hedges	**(193)**		**(42)**	**4**	**(65)**	**(296)**
Ping An contingent forward sale contract[37]					**(553)**	**(553)**
Gain on sale of non-core investments in India					**314**	**314**
Loss recognised following the classification of businesses to held for sale	**(26)**	**(35)**	**(27)**		**(8)**	**(96)**
2011						
Non-qualifying hedges	(1,038)		90	(5)	(439)	(1,392)
Refinement of PVIF calculation	181	62				243
2010						
Non-qualifying hedges	(310)		(309)	1	(439)	(1,057)

For footnote, see page 120.

31

Table of Contents

HSBC HOLDINGS PLC

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

Notable cost items by geographical region[38]

	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
2012							
Restructuring and other related costs	**299**	**31**	**131**	**27**	**221**	**167**	**876**
UK customer redress programmes	**2,338**						**2,338**
UK bank levy	**472**						**472**
Fines and penalties for inadequate compliance with anti-money laundering and sanction laws	**375**				**1,546**		**1,921**
US mortgage foreclosure and servicing costs					**104**		**104**
2011							
Restructuring and other related costs	404	68	45	31	236	338	1,122
UK customer redress programmes	898						898
UK bank levy	570						570
UK pension credit	(587)						(587)
Payroll tax	(13)						(13)
US mortgage foreclosure and servicing costs					257		257
2010							
Restructuring and other related costs	87	15	36		13	3	154
UK customer redress programmes	78						78
US accounting gain on change in staff benefits					(148)		(148)
Payroll tax	324						324

Notable cost items by global business[38]

	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
2012						
Restructuring and other related costs	**266**	**62**	**63**	**58**	**427**	**876**
UK customer redress programmes	**1,751**	**258**	**331**	**(2)**		**2,338**
UK bank levy					**472**	**472**
Fines and penalties for inadequate compliance with anti-money laundering and sanction laws					**1,921**	**1,921**
US mortgage foreclosure and servicing costs	**104**					**104**
2011						
Restructuring and other related costs	405	122	158	38	399	1,122
UK customer redress programmes	875	23				898
UK bank levy					570	570

UK pension credit	(264)	(212)	(111)			(587)
Payroll tax			(13)			(13)
US mortgage foreclosure and servicing costs	257					257
2010						
Restructuring and other related costs	22	1	4		127	154
UK customer redress programmes	78					78
US accounting gain on change in staff benefits	(99)	(16)	(19)	(5)	(9)	(148)
Payroll tax	5	3	307	9		324

For footnote, see page 120.

32

Table of Contents

HSBC HOLDINGS PLC

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

Group performance by income and expense item

Net interest income

	2012 US$m	2011 US$m	2010 US$m
Interest income	**56,702**	63,005	58,345
Interest expense	**(19,030)**	(22,343)	(18,904)
Net interest income[39]	**37,672**	40,662	39,441
Average interest-earning assets	**1,625,068**	1,622,658	1,472,294
Gross interest yield[40]	**3.49%**	3.88%	3.96%
Less: cost of funds	**(1.36%)**	(1.56%)	(1.41%)
Net interest spread[41]	**2.13%**	2.32%	2.55%
Net interest margin[42]	**2.32%**	2.51%	2.68%

Summary of interest income by type of asset

	2012 Average balance US$m	2012 Interest income US$m	2012 Yield %	2011 Average balance US$m	2011 Interest income US$m	2011 Yield %	2010 Average balance US$m	2010 Interest income US$m	2010 Yield %
Short-term funds and loans and advances to banks	**275,979**	**4,307**	**1.56**	261,749	5,860	2.24	236,742	4,555	1.92
Loans and advances to customers	**934,656**	**41,043**	**4.39**	945,288	45,250	4.79	858,499	44,186	5.15
Financial investments	**387,329**	**9,078**	**2.34**	384,059	10,229	2.66	378,971	9,375	2.47
Other interest-earning assets[43]	**27,104**	**2,274**	**8.39**	31,562	1,666	5.28	(1,918)	229	(11.94)
Total interest-earning assets	**1,625,068**	**56,702**	**3.49**	1,622,658	63,005	3.88	1,472,294	58,345	3.96
Trading assets and financial assets designated at fair value[44,45]	**368,406**	**6,931**	**1.88**	410,038	8,671	2.11	385,203	7,060	1.83
Impairment provisions	**(17,421)**			(18,738)			(22,905)		
Non-interest-earning assets	**730,901**			752,965			664,308		
Total assets and interest income	**2,706,954**	**63,633**	**2.35**	2,766,923	71,676	2.59	2,498,900	65,405	2.62

Summary of interest expense by type of liability and equity

	2012 Average	2012 Interest	2012 Cost	2011 Average	2011 Interest	2011 Cost	2010 Average	2010 Interest	2010 Cost

	balance	expense	%	balance	expense	%	balance	expense	%
	US$m	US$m		US$m	US$m		US$m	US$m	
Deposits by banks[46]	**92,803**	**1,160**	**1.25**	106,099	1,591	1.50	111,443	1,136	1.02
Financial liabilities designated at fair value own debt issued[47]	**75,016**	**1,325**	**1.77**	73,635	1,313	1.78	66,706	1,271	1.91
Customer accounts[48]	**1,052,812**	**10,878**	**1.03**	1,058,326	13,456	1.27	962,613	10,778	1.12
Debt securities in issue	**161,348**	**4,755**	**2.95**	181,482	5,260	2.90	189,898	4,931	2.60
Other interest-bearing liabilities	**19,275**	**912**	**4.73**	14,024	723	5.16	8,730	788	9.03
Total interest-bearing liabilities	**1,401,254**	**19,030**	**1.36**	1,433,566	22,343	1.56	1,339,390	18,904	1.41
Trading liabilities and financial liabilities designated at fair value (excluding own debt issued)	**318,883**	**3,445**	**1.08**	355,345	4,564	1.28	275,804	3,780	1.37
Non-interest bearing current accounts	**177,085**			162,369			142,579		
Total equity and other non-interest bearing liabilities	**809,732**			815,643			741,127		
Total equity and liabilities	**2,706,954**	**22,475**	**0.83**	2,766,923	26,907	0.97	2,498,900	22,684	0.91

For footnotes, see page 120.

33

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

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 (see page 29) 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 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 .

Table of Contents

HSBC HOLDINGS PLC

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

Net fee income

	2012 US$m	2011 US$m	2010 US$m
Account services	**3,563**	3,670	3,632
Cards	**3,030**	3,955	3,801
Funds under management	**2,561**	2,753	2,511
Credit facilities	**1,761**	1,749	1,635
Broking income	**1,350**	1,711	1,789
Imports/exports	**1,196**	1,103	991
Remittances	**819**	770	680
Unit trusts	**739**	657	560
Underwriting	**739**	578	623
Global custody	**737**	751	700
Insurance	**696**	1,052	1,147
Corporate finance	**370**	441	440
Trust income	**283**	294	291
Investment contracts	**141**	136	109
Mortgage servicing	**86**	109	118
Taxpayer financial services		2	73
Maintenance income on operating leases			99
Other	**2,078**	1,766	1,918
Fee income	**20,149**	21,497	21,117
Less: fee expense	**(3,719)**	(4,337)	(3,762)
Net fee income	**16,430**	17,160	17,355

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 listed on page 29 (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.

Table of Contents

HSBC HOLDINGS PLC

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

Net trading income

	2012	2011	2010
	US$m	US$m	US$m
Trading activities	5,249	4,873	5,708
Ping An contingent forward sale contract[37]	(553)		
Net interest income on trading activities	2,683	3,223	2,530
Other trading income hedge ineffectiveness:			
on cash flow hedges	35	26	(9)
on fair value hedges	(27)	(224)	38
Non-qualifying hedges	(296)	(1,392)	(1,057)
Net trading income[49,50]	7,091	6,506	7,210

For footnotes, see page 120.

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.

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 (see page 441).

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

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

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 (see page 472).

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

	2012	2011	2010
	US$m	US$m	US$m
Net income/(expense) arising from:			
financial assets held to meet liabilities under insurance and investment contracts	**2,980**	(933)	2,349
liabilities to customers under investment contracts	**(996)**	231	(946)
HSBC s long-term debt issued and related derivatives	**(4,327)**	4,161	(258)
Change in own credit spread on long-term debt	**(5,215)**	3,933	(63)
Other changes in fair value[51]	**888**	228	(195)
other instruments designated at fair value and related derivatives	**117**	(20)	75
Net income/(expense) from financial instruments designated at fair value	**(2,226)**	3,439	1,220

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

	2012	2011	2010
	US$m	US$m	US$m
Financial assets designated at fair value at 31 December	**33,582**	30,856	37,011
Financial liabilities designated at fair value at 31 December	**87,720**	85,724	88,133
Including:			
Financial assets held to meet liabilities under:			
insurance contracts and investment contracts with DPF[52]	**8,376**	7,221	7,167
unit-linked insurance and other insurance and investment contracts	**23,655**	20,033	19,725
Long-term debt issues designated at fair value	**74,768**	73,808	69,906

For footnotes, see page 120.

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

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

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.

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

	2012	2011	2010
	US$m	US$m	US$m
Net gains/(losses) from disposal of:			
debt securities	**781**	712	564
equity securities	**823**	360	516
other financial investments	**5**	12	(7)
	1,609	1,084	1,073
Impairment of available-for-sale equity securities	**(420)**	(177)	(105)
Gains less losses from financial investments	**1,189**	907	968

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 (see page 18), 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

	2012	2011	2010
	US$m	US$m	US$m
Gross insurance premium income	**13,602**	13,338	11,609
Reinsurance premiums	**(558)**	(466)	(463)
Net earned insurance premiums	**13,044**	12,872	11,146

Table of Contents

HSBC HOLDINGS PLC

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

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

	2012	2011	2010
	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	**3,012**		
Total	**7,024**		

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 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 (see page 472). Our remaining shareholding has been classified as a financial investment.

Other operating income

	2012	2011	2010
	US$m	US$m	US$m
Rent received	**210**	217	535
Gains/(losses) recognised on assets held for sale	**485**	55	(263)
Valuation gains on investment properties	**72**	118	93
Gain on disposal of property, plant and equipment, intangible assets and non-financial investments	**187**	57	701
Gains arising from dilution of interests in associates and joint ventures		208	188
Change in present value of in-force long-term insurance business	**737**	726	705
Other	**409**	385	603
Other operating income	**2,100**	1,766	2,562

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

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

	2012	2011	2010
	US$m	US$m	US$m
Value of new business	**1,027**	943	737
Expected return	**(420)**	(428)	(85)
Assumption changes and experience variances	**69**	(30)	59
Other adjustments	**61**	241	(6)
Change in present value of in-force long-term insurance business	**737**	726	705

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 (see page 28). 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

	2012	2011	2010
	US$m	US$m	US$m
Insurance claims incurred and movement in liabilities to policyholders:			
gross	**14,529**	11,631	11,969
reinsurers share	**(314)**	(450)	(202)
net[53]	**14,215**	11,181	11,767

For footnote, see page 120.

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

40

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

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 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

	2012	2011	2010
	US$m	US$m	US$m
Loan impairment charges			
New allowances net of allowance releases	**9,306**	12,931	14,568
Recoveries of amounts previously written off	**(1,146)**	(1,426)	(1,020)
	8,160	11,505	13,548
Individually assessed allowances	**2,139**	1,915	2,625
Collectively assessed allowances	**6,021**	9,590	10,923
Impairment of available-for-sale debt securities	**99**	631	472
Other credit risk provisions/(recoveries)	**52**	(9)	19
Loan impairment charges and other credit risk provisions	**8,311**	12,127	14,039

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

Table of Contents

HSBC HOLDINGS PLC

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

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. Further information on our exposures to countries in the eurozone is provided on page 192. 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 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

	2012	2011	2010
	US$m	US$m	US$m
By expense category			
Employee compensation and benefits	**20,491**	21,166	19,836
Premises and equipment (excluding depreciation and impairment)	**4,326**	4,503	4,348
General and administrative expenses	**15,657**	12,956	10,808
Administrative expenses	**40,474**	38,625	34,992
Depreciation and impairment of property, plant and equipment	**1,484**	1,570	1,713

Amortisation and impairment of intangible assets	**969**	1,350	983
Operating expenses	**42,927**	41,545	37,688

Staff numbers (full-time equivalents)

	At 31 December		
	2012	2011	2010
Europe	**70,061**	74,892	75,698
Hong Kong	**27,742**	28,984	29,171
Rest of Asia-Pacific	**85,024**	91,051	91,607
Middle East and North Africa	**8,765**	8,373	8,676
North America	**22,443**	30,981	33,865
Latin America	**46,556**	54,035	56,044
Staff numbers	**260,591**	288,316	295,061

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

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, HSBC North America Holdings Inc. (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).

Cost efficiency ratios[4]

	2012	2011	2010
	%	%	%
HSBC	**62.8**	57.5	55.2
Geographical regions			
Europe	**108.4**	70.4	67.9
Hong Kong	**39.0**	44.5	43.4
Rest of Asia-Pacific	**42.7**	54.2	55.7
Middle East and North Africa	**48.0**	44.5	44.7
North America	**60.8**	55.7	48.8
Latin America	**58.7**	63.3	65.7

Global businesses			
Retail Banking and Wealth Management	**58.4**	63.2	58.1
Commercial Banking	**45.9**	46.3	49.4
Global Banking and Markets	**54.2**	57.0	48.8
Global Private Banking	**67.6**	68.8	65.8

For footnote, see page 120.

Share of profit in associates and joint ventures

	2012	2011	2010
	US$m	US$m	US$m
Associates			
Bank of Communications Co., Limited	**1,670**	1,370	987
Ping An Insurance (Group) Company of China, Ltd	**763**	946	848
Industrial Bank Co., Limited	**670**	471	327
The Saudi British Bank	**346**	308	161
Other	**72**	126	156
Share of profit in associates	**3,521**	3,221	2,479
Share of profit in joint ventures	**36**	43	38
Share of profit in associates and joint ventures	**3,557**	3,264	2,517

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

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 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 (see page 39 for details of this transaction).

Tax expense

	2012	2011	2010
	US$m	US$m	US$m
Profit before tax	**20,649**	21,872	19,037
Tax expense	**(5,315)**	(3,928)	(4,846)
Profit after tax	**15,334**	17,944	14,191
Effective tax rate	**25.7%**	18.0%	25.5%

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).

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

2011 compared with 2010

Reconciliation of reported and underlying profit before tax[31]

	2011 compared with 2010								
HSBC	2010 as reported US$m	2010 adjust-ments[32] US$m	Currency translation adjustment[24] US$m	2010 at 2011 exchange rates[33] US$m	2011 as reported US$m	2011 adjust-ments[32] US$m	2011 under-lying US$m	Re-ported change[25] %	Under-lying change[25] %
Net interest income	39,441	48	781	40,270	40,662		40,662	3	1
Net fee income	17,355	(55)	349	17,649	17,160		17,160	(1)	(3)
Own credit spread[26]	(63)	63			3,933	(3,933)			
Other income[27]	11,514	(847)	284	10,951	10,525	(291)	10,234	(9)	(7)
Net operating income[21]	68,247	(791)	1,414	68,870	72,280	(4,224)	68,056	6	(1)
Loan impairment charges and other credit risk provisions	(14,039)		(206)	(14,245)	(12,127)		(12,127)	14	15
Net operating income	54,208	(791)	1,208	54,625	60,153	(4,224)	55,929	11	2
Operating expenses	(37,688)	220	(842)	(38,310)	(41,545)		(41,545)	(10)	(8)
Operating profit	16,520	(571)	366	16,315	18,608	(4,224)	14,384	13	(12)
Income from associates	2,517		93	2,610	3,264	48	3,312	30	27
Profit before tax	19,037	(571)	459	18,925	21,872	(4,176)	17,696	15	(6)
By geographical region									
Europe	4,302	(88)	167	4,381	4,671	(2,947)	1,724	9	(61)
Hong Kong	5,692	(130)	(10)	5,552	5,823		5,823	2	5
Rest of Asia-Pacific	5,902	(187)	227	5,942	7,471	(135)	7,336	27	23
Middle East and North Africa	892	42	(10)	924	1,492	(41)	1,451	67	57
North America	454	(208)	39	285	100	(970)	(870)	(78)	
Latin America	1,795		46	1,841	2,315	(83)	2,232	29	21
Profit before tax	19,037	(571)	459	18,925	21,872	(4,176)	17,696	15	(6)
By global business									
Retail Banking and Wealth Management	3,839	(3)	126	3,962	4,270	(83)	4,187	11	6
Commercial Banking	6,090	(119)	126	6,097	7,947		7,947	30	30
Global Banking and Markets	9,215	(262)	198	9,151	7,049		7,049	(24)	(23)
Global Private Banking	1,054		6	1,060	944		944	(10)	(11)
Other	(1,161)	(187)	3	(1,345)	1,662	(4,093)	(2,431)		(81)
Profit before tax	19,037	(571)	459	18,925	21,872	(4,176)	17,696	15	(6)

For footnotes, see page 120.

Consolidated income statement

Reported profit before tax of US$21.9bn in 2011 was US$2.8bn higher than in 2010, primarily due to US$3.9bn of favourable fair value movements on own debt attributable to credit spreads compared with a negative movement of US$63m in 2010. On an underlying basis, profit before tax was 6% lower than in 2010 due to increased operating expenses which were partly offset by lower loan impairment charges and other credit risk provisions.

The results of the Group continued to be adversely affected by the losses in the US consumer

finance business, which were US$2.4bn in 2011 and US$2.2bn in 2010. We have agreed to sell the profitable US Card and Retail Services portfolio, with the remainder of the loss-making US consumer finance business being run down. We expect the sale of this business to have a significant impact on both revenue and profitability in North America for the foreseeable future.

The difference between reported and underlying results is explained on page 26. Except where stated otherwise, the commentaries in the Financial Summary are on an underlying basis and references to HSBC Finance Corporation (HSBC Finance) and

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

HSBC Bank USA N.A. (HSBC Bank USA) are on a management basis, rather than a legal entity basis.

Net operating income before loan impairment charges and other credit risk provisions (revenue) was broadly in line with 2010, due to the adverse effect on GB&M revenue in Europe of the turmoil in the eurozone sovereign debt market and a decline in lending balances in RBWM in North America being offset by revenue growth in faster-growing regions. The eurozone turmoil resulted in lower trading income from our Credit and Rates businesses as problems escalated, particularly in the second half of 2011. Our GB&M performance was also affected by lower revenues in Balance Sheet Management, as higher yielding positions matured and interest rates remained low, and in our legacy credit portfolio. In North America, we continued to reposition our business and we remained focused on managing down our run-off portfolios. As a consequence, revenue fell, reflecting declining customer loan balances in the run-off portfolios and in the Card and Retail Services businesses.

These factors were broadly offset by increased net interest income in CMB as a result of strong balance sheet growth in 2010 which continued into 2011, albeit at a slower pace during the latter part of the year. Revenue also benefited from balance sheet growth in RBWM in Rest of Asia-Pacific and Latin America. There were also strong performances in over half of our business lines in GB&M, including Global Banking, Foreign Exchange and Equities, particularly in the faster growing regions of Rest of Asia-Pacific and Latin America.

Loan impairment charges and other credit risk provisions were considerably lower than in 2010, with decreases across all regions except Latin America and Hong Kong. The most significant decline in loan impairment charges was in RBWM in North America, reflecting lower balances in our consumer finance portfolios and lower lending balances and improved credit quality in Card and Retail Services. There was also a notable decline in loan impairment charges in Europe, due to successful initiatives taken to mitigate risk within RBWM which resulted in a reduction in delinquency rates in personal lending in the UK. Loan impairment charges and other credit risk provisions fell in the Middle East in GB&M due to the non-recurrence of restructuring activity for a small number of large customers. In Latin America, loan impairment charges and other credit risk provisions increased as a result of strong lending growth in RBWM and CMB, along with a rise in delinquency rates in Brazil during the second half of 2011.

Operating expenses were higher than in 2010, reflecting an increase in notable items and higher staff costs in faster-growing regions. Notable items included restructuring costs of US$1.1bn, a bank levy introduced by the UK government of US$570m, higher provisions relating to customer redress programmes of US$898m and US mortgage servicing costs of US$257m. The restructuring costs were incurred as a result of actions taken following the review of our capital deployment and operational effectiveness. This led to a reduction of more than 7,600 FTEs during the second half of 2011 and sustainable savings of US$0.9bn. These notable items were partially offset by a credit of US$587m resulting from a change in the inflation measure used to calculate the defined benefit obligation of the HSBC Bank plc (HSBC Bank) UK defined benefit plan for deferred pensions.

Income from associates increased, mainly driven by strong results in our mainland China associates. The contribution from Bank of Communications Co., Limited (BoCom) rose due to loan growth, wider deposit spreads and higher fee income. Our share of profits from Industrial Bank Co. Limited (Industrial Bank) rose due to strong growth in customer lending and an increase in fee-based revenue.

The reported profit after tax was US$3.8bn or 26% higher, due to the increase in taxable profits, primarily from movements on the fair value of own debt and a lower tax expense. This reflected the inclusion in 2011 of a deferred tax benefit now eligible to be recognised in respect of foreign tax credits. In addition, the tax charge in 2010 included US$1.2bn attributable to a taxable gain from an internal reorganisation in North America. As a result of these factors, the effective tax rate for 2011 was 18% compared with 25.5% in 2010.

Group performance by income and expense item

Net interest income

Net interest income was US$40.7bn, 3% higher than in 2010. On an underlying basis, net interest income was broadly in line with the previous year, as the benefit to income from continued strong growth in average interest-earning balances was largely offset by a decline in spreads.

Average loans and advances to customers grew strongly in 2011, reflecting targeted lending growth during 2010 and the first half of 2011 in CMB and GB&M, as well as strong mortgage lending growth in our RBWM businesses in the UK, Hong Kong and Rest of Asia-Pacific throughout both years. During the year, we announced the sale of 195 non-strategic

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

branches and our Cards and Retail Services business in the US, and reclassified the related loans and advances to customers to other assets held for sale, reported within Other interest-earning assets . This, together with the continued decline in the consumer finance portfolios in run-off, partly offset the rise in average lending balances in other regions.

The benefit to interest income of the strong customer lending volume growth was offset in part by a reduction in gross yields from loans and advances to customers. This reflected the transfer of balances to assets held for sale, including higher yielding unsecured lending, the continued decline within the US consumer finance portfolios and the repositioning of RBWM towards higher quality secured lending, particularly mortgages, together with intense competition in certain markets.

Interest income from short-term funds and loans and advances to banks also increased, attributable to higher average balances with central banks. This reflected higher deposit requirements by central banks in certain markets, together with the placement of excess liquidity in Asia with central banks. Interest income from short-term funds and loans and advances to banks, as well as financial investments, also benefited from higher yields as interest rates rose, particularly in mainland China, India and Brazil.

Interest income from other interest earning assets rose as a result of the reclassification of assets held for sale and the related income.

The rise in interest income was largely offset by higher interest expense. This was driven by a significant increase in average customer account balances in Hong Kong, Rest of Asia-Pacific and Europe as a result of targeted deposit campaigns. The cost of funds also rose as a result of base rate increases, notably in mainland China, India and Brazil, and competitive pricing to attract and retain deposits in many markets.

The increase in interest expense on deposits by banks was driven by a rise in the cost of funds in Europe, reflecting the maturity of derivatives used to hedge interest rate risk and their replacement at lower prevailing interest rates.

The interest expense on own debt designated at fair value also rose, reflecting the volume of new issuances during the year. Although the average balance of debt securities in issue declined due to maturities not being replaced in North America and Europe, the related interest expense increased as a result of a general widening of credit spreads in the financial sector.

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 these assets rose due to the increase in average trading assets during the year. In reporting our global business results, this cost is included within Net trading income .

The decrease in the net interest spread compared with 2010 was attributable to lower yields on loans and advances to customers as we continued to target higher quality assets, coupled with a rising cost of funds on customer accounts. Our net interest margin also fell, but by a lesser amount, due to the benefit from net free funds. This benefit rose as a result of the increase in the Group s cost of funds, coupled with higher third party funding of our trading book, in line with the growth of trading assets.

Net fee income

Reported net fee income was broadly in line with 2010. Reported results in 2010 included revenue from Eversholt Rail Group and HSBC Insurance Brokers Ltd. These items are excluded from our underlying results which declined by 3%. This was mainly due to increased fee expenses in North America and the impact of discontinuing certain business operations.

Fee expenses increased in North America, reflecting higher revenue-share payments to our credit card partners as improved portfolio performance resulted in increased cash flows. Fee expenses also rose in Latin America, reflecting increased transaction volumes, and in Europe, notably in GB&M, which benefited from higher recoveries from the securities investment conduits in 2010.

Card-related income was higher, led by growth in Hong Kong due to higher transaction volumes, driven by increased retail spending and customer promotions, and in Europe due to increased interchange commissions from higher volumes and rates.

Fee income from unit trusts increased due to higher transaction volumes, notably in Hong Kong, reflecting increased product offerings, competitive pricing and successful sales activity as clients sought to maximise returns in the low interest rate environment. However, broking income was lower, primarily in Hong Kong due to increased competition in the territory during the second half of the year.

Remittances and trade-related fee income increased, notably in the Rest of Asia-Pacific region, due to higher trade and transaction volumes as we targeted asset growth and trade activity in the region, supported by marketing activities, customer acquisition and a rise in transactions from existing customers.

The negligible income from Taxpayer Financial Services in the US during 2011 resulted from the decision to exit the business.

We expect the sale of the Card and Retail Services business to have a significant impact on both fee income related to cards and insurance, and fee expenses.

Net trading income

Reported net trading income was US$6.5bn, 10% lower than in 2010. On an underlying basis, net trading income declined by 15%, driven by significantly lower net income from trading activities in GB&M as turmoil in eurozone sovereign debt markets escalated, particularly in the second half of 2011. Increased risk aversion and limited client activity led to a significant widening of spreads on certain eurozone sovereign and corporate bonds, resulting in trading losses in our European Credit and Rates businesses.

Net trading income also declined from our legacy credit portfolio, a separately identifiable, discretely managed business comprising Solitaire Funding Limited, the securities investment conduits, the asset-backed securities trading portfolios and credit correlation portfolios, derivative transactions entered into directly with monoline insurers, and certain other structured credit transactions. This reflected the non-recurrence of the price appreciation during the previous year and lower holdings as a result of maturities and disposals aimed at reducing capital consumption, coupled with the non-recurrence of an US$89m gain from a 2010 legal settlement relating to certain loans previously purchased for resale from a third party.

In addition, lower favourable foreign exchange movements were reported on trading assets held as economic hedges of foreign currency debt designated at fair value. These offset lower adverse foreign exchange movements on the foreign currency debt which are reported in Net expense from financial instruments designated at fair value .

Notwithstanding the difficult trading conditions, there were strong performances across other parts of GB&M. Rates trading revenues in Hong Kong, North America and Latin America remained resilient as client flows increased. Fair value gains on structured liabilities also increased, mainly in Rates, as credit spreads widened more significantly than in

2010, resulting in a gain of US$458m compared with US$23m in 2010.

Our Foreign Exchange business benefited from increased activity from both Global Banking and CMB customers, particularly in Hong Kong, Rest of Asia-Pacific, North America and Latin America, coupled with an improved trading environment compared with 2010. The latter reflected market volatility caused by geopolitical tensions, ongoing eurozone sovereign debt concerns and interventions by central banks. Equities revenues also rose as investment in platforms improved our competitive positioning and helped capture increased client flows, notably in the first half of the year in Europe and Hong Kong.

In addition to the decline in net income from trading activities in GB&M, we reported adverse fair value movements on derivatives relating to certain legacy provident funds in Hong Kong as long-term investment returns fell. This was offset in part by a reduction in the loss provisions for mortgage loan repurchase obligations associated with loans previously sold in RBWM in North America, which decreased by US$341m to US$92m.

There were adverse fair value movements on non-qualifying hedges. These are derivatives entered into as part of a documented interest rate management strategy for which hedge accounting was not, or could not be, applied. They are principally cross-currency and interest rate swaps used to economically hedge fixed rate debt issued by HSBC Holdings and floating rate debt issued by HSBC Finance. The size and direction of the changes in 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. The adverse fair value movement on non-qualifying hedges in North America was higher in 2011 as long-term US interest rates declined to a greater extent than in 2010. This was partly offset by lower adverse fair value movements on these instruments in Europe.

Ineffectiveness in the hedging of available-for-sale investment portfolios resulted in adverse movements on fair value hedges. This was due to growth in the underlying investment portfolio in Europe as a result of new purchases and a more pronounced decline in yield curves in North America than in 2010.

Net interest income earned on trading activities rose by 23%, driven by an increase in average holdings and higher yields on our trading portfolio. This was partly offset by higher interest expense on trading liabilities reflecting an increase in funding requirements in line with the growth in average trading assets. The cost of internally funding these assets also rose, but this interest expense is reported within Net interest income .

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

We reported net income from financial instruments designated at fair value of US$3.4bn in 2011 compared with US$1.2bn in 2010. This included the credit spread-related movements in the fair value of our own long-term debt, on which we reported favourable fair value movements of US$3.9bn in 2011 and adverse movements of US$63m in 2010. These favourable fair value movements arose in 2011 as credit spreads widened, in comparison with smaller favourable fair value movements in North America and adverse fair value movements in Europe, both in 2010.

On an underlying basis, which excludes credit spread-related movements in the fair value of our own long-term debt, the equivalent figures were net expense of US$494m in 2011 and net income of US$1.3bn in 2010. Net expense arising from financial assets held to meet liabilities under insurance and investment contracts reflected net investment losses in 2011 as a result of adverse movements in equity markets, primarily in Europe and Hong Kong, compared with net investment gains experienced during 2010. 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 resulted 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 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 lower adverse foreign exchange movements than in 2010 on foreign currency debt designated at fair value issued as part of our overall funding strategy, with an offset from trading assets held as economic hedges reported in Net trading income .

Gains less losses from financial investments

Reported gains less losses from financial investments decreased by US$61m to US$907m. On an underlying basis, excluding an accounting gain of US$62m arising from the reclassification of Bao Viet as an associate in 2010, they declined by 4%.

The reduction was principally driven by lower net gains from the disposal of available-for-sale equity securities, as deterioration in market confidence resulted in fewer disposal opportunities and lower gains from the sale of private equity investments, notably in Europe. We also recognised a gain on disposal in 2010 of an equity investment in a Singaporean property company which did not recur.

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

This was partly offset by a gain on sale of shares in a Mexican listed company.

Impairments of available-for-sale equity securities rose, due to write downs of our equity investments in real estate companies, reflecting a decline in property values in 2011.

Net gains from the disposal of available-for-sale debt securities increased in Europe and North America following sales of government bonds and mortgage-backed securities by Balance Sheet Management as part of normal portfolio management activities. However, this was offset in part by lower net gains in Hong Kong and Rest of Asia-Pacific on the disposal of government debt securities in 2011.

Net earned insurance premiums

Net earned insurance premiums which relate to insurance and investment contracts with DPF increased by 15% on a reported basis and by 13% on an underlying basis, primarily driven by strong sales in the Hong Kong life insurance business and also in Latin America. This reflected the strategic focus of the Group on wealth management, of which insurance is a key part.

In Hong Kong, sales of deferred annuities, unit-linked products and a universal life product targeted at high net worth individuals all rose, coupled with higher levels of renewals from a larger in-force book of business due to an increased demand for wealth products. Sales of a universal life insurance product targeted at high net worth individuals were also higher in Rest of Asia-Pacific, notably in Singapore, driven by successful sales initiatives.

In Latin America, net earned premiums also grew strongly due to a rise in contributions from unit-linked, life and credit protection products in Brazil, reflecting investment in the distribution network. This was supported by higher premiums from the motor insurance business in Argentina as a result of volume growth and repricing initiatives.

In Europe, net earned premiums decreased resulting from the non-renewal and transfer to third parties of certain contracts in our Irish business as well as the continued run-off and subsequent disposal of the motor business in the UK during 2011.

This was partly offset by premium growth in both France, on investment contracts with DPF as a result of targeted sales campaigns aimed at high net worth clients, and the UK, on unit-linked products due to increased distribution channels.

Other operating income

Reported other operating income of US$1.8bn decreased by US$796m in 2011. Reported results 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, our Mexican pension administration business. We also reported a dilution gain of US$27m as a result of the reduction in our holding in HSBC Saudi Arabia Limited following its merger with SABB Securities Limited. Income in 2010 included a gain of US$188m following the dilution of our holding in Ping An along with gains from the sale of HSBC Insurance Brokers (US$107m), the Wells Fargo HSBC Trade Bank (US$66m), Eversholt Rail Group (US$255m) and HSBC Private Equity (Asia) Ltd (US$74m), partly offset by a loss of US$42m on the disposal of our shareholding in British Arab Commercial Bank plc.

On an underlying basis, excluding the items referred to above, other operating income decreased by US$71m compared with 2010. Lower losses on assets held for sale driven by the non-recurrence of the US$207m loss on the sale of the US vehicle finance servicing operation in 2010 and associated loan portfolio were more than offset by the non-recurrence of gains of US$250m on the sale and leaseback of our Paris and New York headquarters in 2010, which exceeded gains recorded in 2011 on the sale of buildings including US$61m from the sale and leaseback of branches in Mexico.

Favourable net movements in the present value of in-force (PVIF) long-term insurance business compared with 2010 were driven by a one-off gain of US$243m recognised upon the refinement of the calculation of the PVIF asset to bring greater comparability and consistency across our insurance operations, and strong sales of life insurance products, notably in Hong Kong and Singapore. Largely offsetting this was a net decrease from experience and assumption updates and a higher unwind of cash flows from the growing in-force book.

Net insurance claims incurred and movement in liabilities to policyholders

Net insurance claims incurred and movement in liabilities to policyholders decreased by 5% on a reported basis and by 7% on an underlying basis, driven by investment losses on insurance assets, notably in Europe and Hong Kong.

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

In France, the UK and Hong Kong we experienced a reduction in the movement in liabilities to policyholders resulting from a fall in fair value of the assets held to support policyholder funds, particularly in relation to unit-linked insurance contracts and investment and insurance contracts with DPF, as a result of equity market falls.

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

Further declines in the movement in liabilities to policyholders resulted from the non-renewal and transfer to third parties of certain contracts in our Irish businesses as well as the continued run-off and subsequent sale of the motor business in the UK during 2011.

Reductions in the movement in liabilities to policyholders were partly offset by additional liabilities established for new business premiums written, notably in Hong Kong, Brazil, France, the UK and Singapore, which are consistent with increases in net earned premiums.

Loan impairment charges and other credit risk provisions

Loan impairment charges and other credit risk provisions were US$12.1bn, a decline of 14% compared with 2010 on a reported basis and 15% on an underlying basis.

At 31 December 2011, the aggregate balance of customer loan impairment allowances was US$17.5bn, representing 1.9% of gross loans and advances to customers (net of reverse repos and settlement accounts) compared with 2.2% at 31 December 2010.

In 2011, loan impairment charges and other credit risk provisions declined in all regions except Latin America and Hong Kong. The reduction was most significant in our consumer finance portfolios in HSBC Finance in North America, which contributed 66% of the reduction, reflecting lower lending balances in the run-off portfolio along with a reduction in lending balances and lower delinquency rates as our Card and Retail Services customers focused on repayments. In Latin America, principally Brazil, and also in Hong Kong, collective loan impairment allowances rose as we grew our lending book on the back of strong economic growth and increased customer demand.

During 2011, we reported US$631m of impairments related to available-for-sale debt

securities, compared with US$472m in 2010. In 2011, we recognised a charge of US$212m to write down to market value available-for-sale Greek sovereign debt now judged to be impaired following the deterioration in Greece s fiscal position. This was partly offset as losses arising in underlying collateral pools generated lower charges on asset-backed securities.

In our US run-off portfolios, loan impairment charges of US$5.0bn were 14% lower than in 2010. The decline was mainly in our Consumer and Mortgage Lending (CML) portfolio, driven by the reduction in customer lending balances, in part offset by higher loan impairment allowances reflecting a rise in the estimated cost to obtain collateral as well as delays in the timing of expected cash flows, both the result of the industry-wide delays in foreclosure processing.

In the third quarter of 2011, loan impairment charges in the CML portfolio increased markedly as delinquency worsened compared with the first half of 2011. In addition, we increased our loan impairment allowances to reflect a rise in the expected cost to obtain and realise collateral following delays in foreclosure processing. Despite a decline in loan impairment charges in the fourth quarter, these factors contributed significantly to a rise in the Group s loan impairment charges in the second half of 2011 compared with the first half of the year.

In Card and Retail Services, loan impairment charges fell by 26% to US$1.6bn reflecting lower lending balances and improved delinquency rates as customer repayment rates remained strong during 2011.

In CMB, loan impairment charges and other credit risk provisions in North America declined in both Canada and the US reflecting improved credit quality, and in Canada this was also due to lower lending balances. These declines were partly offset by a loan impairment charge on a commercial real estate lending exposure.

The reduction in loan impairment charges and other credit risk provisions in North America was partly offset by an increase in GB&M, reflecting lower releases of collective loan impairment allowances compared with 2010. In addition, 2011 included a loan impairment charge associated with a corporate lending relationship.

Loan impairment charges and other credit risk provisions in Europe fell by 20% to US$2.5bn, notably in the UK. The reduction was mainly in our RBWM business where loan impairment charges declined by 53% to US$596m despite the difficult

Table of Contents

HSBC HOLDINGS PLC

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

economic climate and continued pressures on households finances. Delinquency rates declined across both the secured and unsecured lending portfolios, reflecting improvement in portfolio quality and the continued low interest rate environment as well as successful actions taken to mitigate credit risk and proactive account management. In CMB, loan impairment charges and other credit risk provisions were 7% lower, mainly in the UK. This was partly offset by an increase in individually assessed loan impairment charges in Greece as economic conditions worsened.

In GB&M in Europe, loan impairment charges and other credit risk provisions increased by 8% as we recorded an impairment of US$145m to write down to market value available-for-sale Greek sovereign debt now judged to be impaired following the deterioration in Greece s fiscal position.

In the Middle East and North Africa, loan impairment charges and other credit risk provisions fell by 53% to US$293m, primarily due to a marked decline in loan impairment charges and other credit risk provisions in our GB&M business. This reflected the non-recurrence of individually assessed loan impairment charges recorded in the first half of 2010 related to restructuring activity for a small number of large corporate customers in the United Arab Emirates (UAE). In RBWM, loan impairment charges declined by 45%, due to significantly improved delinquency rates reflecting a repositioning of the loan book towards higher quality lending as we continued to manage down unsecured lending, together with impaired collections practices.

In Rest of Asia-Pacific, loan impairment charges and other credit risk provisions declined by 42% to US$267m, driven by reductions in India and Singapore. The marked decline in India reflected an improvement in delinquency, particularly in the unsecured portfolios as lending balances were managed down. In GB&M, loan impairment charges and other credit risk provisions declined by 58%, mainly in Singapore, due to a reduction in individually assessed loan impairment charges.

In Latin America, loan impairment charges increased by 17% to US$1.9bn. In Brazil, loan impairment charges and other credit risk provisions rose by 43% to US$1.4bn due to a rise in collective loan impairment allowances in both RBWM and CMB following the strong growth in our customer lending balances and a rise in delinquency rates in the second half of 2011. In addition, we recognised a significant individually assessed loan impairment charge related to a commercial customer. The increase in Brazil was partly offset by a 28% decline in

loan impairment charges and other credit risk provisions in Mexico. This was mainly in our RBWM business due to lower balances in our credit card portfolio as certain higher risk portfolios were run-down and both credit quality and collections improved.

In Hong Kong, loan impairment charges and other credit risk provisions increased by 36% to US$156m. In CMB, higher loan impairment charges included a specific impairment charge related to a single customer, as well as higher collectively assessed charges reflecting growth in lending balances. In GPB, loan impairment charges and other credit risk provisions also increased, reflecting an impairment of available-for-sale Greek sovereign debt.

Operating expenses

Operating expenses increased by 10% to US$41.5bn on a reported basis. On an underlying basis, costs increased by 8% compared with 2010, driven by a higher amount of notable items in 2011 as listed in the table above and a rise in staff costs, primarily in faster growing regions. Notable items included restructuring costs, provisions relating to customer redress programmes in the UK, including a charge in respect of the possible mis-selling of Payment Protection Insurance (PPI) in previous years, the UK bank levy and a new provision for US mortgage foreclosure and servicing costs. These were partially offset by a credit resulting from a change in the inflation measure used to calculate the defined benefit obligation in the UK for deferred pensions and the non-recurrence of the 2010 payroll and bonus taxes in the UK and France.

Salaries and wages rose, primarily driven by wage inflation in Rest of Asia-Pacific and Hong Kong and union-agreed salary increases in Latin America.

The growth in business volumes, primarily in Hong Kong, Rest of Asia-Pacific and Latin America, was supported by a small rise in average staff numbers (expressed as FTEs) which grew marginally in 2011. Staff costs also rose due to higher amortisation charges for previous years restricted and performance share awards and an acceleration in the expense recognition for deferred bonus awards of US$163m, in line with regulatory and best practice guidance. Otherwise, performance-related costs were lower than in 2010, primarily in GB&M where net operating income declined.

During the year, we incurred US$1.1bn of restructuring costs including US$542m which were

Table of Contents

HSBC HOLDINGS PLC

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

staff related and US$325m of impairment of certain software projects now deferred or cancelled.

During 2011, we began a Group-wide review of our organisational effectiveness. We achieved US$0.9bn of sustainable savings in 2011, approximately one third of our objective of US$2.5bn to US$3.5bn over three years. We started implementing consistent business models in RBWM and CMB and undertook a detailed review of our head offices. In addition, we began the re-engineering of our global functions, we commenced the streamlining of our IT function including the consolidation of some data centres and other services, and we re-engineered a number of customer-facing and back-office processes leading to a more efficient use of our corporate real estate.

This resulted in a net reduction of staff numbers of more than 7,600 during the second half of 2011 despite continuing to recruit selectively in our target growth areas.

The savings achieved by delivering on these programmes enabled the funding of investment in strategic initiatives, including the development of Prime Services and equity market capabilities and the expansion of the Rates and Foreign Exchange e-commerce platforms in Europe, and the recruitment of additional front office staff in selected markets.

Costs increased due to a rise in compliance costs in GB&M and litigation expenses in RBWM, both predominantly in the US. However, marketing costs fell in North America and Latin America as discretionary costs were tightly controlled.

Share of profit in associates and joint ventures

The reported share of profit in associates and joint ventures was US$3.3bn, an increase of 30% compared with 2010. On an underlying basis, which excludes the re-measurement loss relating to Ping An s acquisition of Shenzhen Development Bank, the share of profits from associates increased by 27%. This was driven mainly by higher contributions from our mainland China associates.

Our share of profits from BoCom rose, driven by strong loan growth, wider spreads following benchmark interest rate rises by the People s Bank of China and effective re-pricing. Fee-based income also increased due to the continued development of investment banking services as well as increased credit card spending. The contribution from Industrial Bank rose as a result of continued growth in customer lending, higher fee income and a fall in loan impairment charges.

Profits from Saudi British Bank increased, driven by a decline in loan impairment charges as the credit environment improved in Saudi Arabia and due to good cost control.

Higher profits from Ping An resulted from strong growth in sales in the insurance business and higher income from the banking business following the acquisition of Shenzhen Development Bank in July 2011.

Tax expense

Our reported tax expense decreased by US$0.9bn compared with 2010. The lower tax charge reflected the benefit of a deferred tax credit of US$0.9bn now eligible to be recognised in respect of foreign tax credits in the US. In addition, the tax charge in 2010 included US$1.2bn attributable to a taxable gain from an internal reorganisation in our North American operations. The resulting reported effective tax rate for 2011 was 18% compared with 25.5% in 2010.

Economic profit

Our internal performance measures include economic profit/(loss), a calculation which compares the return on financial capital invested in HSBC by our shareholders with the cost of that capital. We price our cost of capital internally and the difference between that cost and the post-tax profit attributable to ordinary shareholders represents the amount of economic profit/(loss) generated. In order to concentrate on external factors rather than measurement bases, we emphasise the trend in economic profit/(loss) ahead of absolute amounts.

Our long-term cost of capital is reviewed annually and is 11% for 2011; this remains unchanged from 2010. The following commentary is on a reported basis.

The return on invested capital increased by 1.5 percentage points to 10.2%, which was 0.8 percentage points lower than our benchmark cost of capital. Our economic loss was US$1.3bn, US$2.0bn less than the loss at 31 December 2010, reflecting an increase in profit attributable to shareholders. This was predominantly driven by a significant increase in the fair value of own debt and a lower tax charge.

The increase in average invested capital reflected higher retained earnings and an increase in average foreign exchange reserves, primarily due to the effect of euro and sterling exchange rate movements on our underlying assets.

Table of Contents

HSBC HOLDINGS PLC

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

Recent events

On 5 March 2013, we announced an agreement to sell HSBC Finance s non-real estate personal loan portfolio to SpringCastle Acquisition LLC, a Delaware-based company owned by Springleaf Finance, Inc, and Newcastle Investment Corp for expected cash consideration of US$3.2bn, adjusted for cash received from the loan portfolio and agreed funding and servicing costs of the portfolio between

31 December 2012 and the completion date. The sale is scheduled for completion in the second quarter of 2013 and is subject to customary closing conditions. We expect to record a loss of US$250m based on the cash consideration of US$3.2bn. The ultimate gain or loss on disposal will be based on the net cash consideration received after adjustments as described above. The portfolio was classified as Asset held for sale as at 31 December 2012 with a carrying amount of US$3.4bn.

Table of Contents

HSBC HOLDINGS PLC

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

Consolidated balance sheet

Five-year summary consolidated balance sheet and selected financial information

	At 31 December				
	2012	2011	2010	2009	2008
	US$m	US$m	US$m	US$m	US$m
ASSETS					
Cash and balances at central banks	**141,532**	129,902	57,383	60,655	52,396
Trading assets	**408,811**	330,451	385,052	421,381	427,329
Financial assets designated at fair value	**33,582**	30,856	37,011	37,181	28,533
Derivatives	**357,450**	346,379	260,757	250,886	494,876
Loans and advances to banks	**152,546**	180,987	208,271	179,781	153,766
Loans and advances to customers[54]	**997,623**	940,429	958,366	896,231	932,868
Financial investments	**421,101**	400,044	400,755	369,158	300,235
Assets held for sale	**19,269**	39,558	1,991	3,118	2,075
Other assets	**160,624**	156,973	145,103	146,061	135,387
Total assets	**2,692,538**	2,555,579	2,454,689	2,364,452	2,527,465
LIABILITIES AND EQUITY					
Liabilities					
Deposits by banks	**107,429**	112,822	110,584	124,872	130,084
Customer accounts	**1,340,014**	1,253,925	1,227,725	1,159,034	1,115,327
Trading liabilities	**304,563**	265,192	300,703	268,130	247,652
Financial liabilities designated at fair value	**87,720**	85,724	88,133	80,092	74,587
Derivatives	**358,886**	345,380	258,665	247,646	487,060
Debt securities in issue	**119,461**	131,013	145,401	146,896	179,693
Liabilities under insurance contracts	**68,195**	61,259	58,609	53,707	43,683
Liabilities of disposal groups held for sale	**5,018**	22,200	86	3	
Other liabilities	**118,123**	111,971	109,868	148,411	149,150
Total liabilities	**2,509,409**	2,389,486	2,299,774	2,228,791	2,427,236
Equity					
Total shareholders equity	**175,242**	158,725	147,667	128,299	93,591
Non-controlling interests	**7,887**	7,368	7,248	7,362	6,638
Total equity	**183,129**	166,093	154,915	135,661	100,229
Total equity and liabilities	**2,692,538**	2,555,579	2,454,689	2,364,452	2,527,465
Five-year selected financial information					
Called up share capital	**9,238**	8,934	8,843	8,705	6,053
Capital resources[55,56]	**180,806**	170,334	167,555	155,729	131,460
Undated subordinated loan capital	**2,778**	2,779	2,781	2,785	2,843
Preferred securities and dated subordinated loan capital[57]	**48,260**	49,438	54,421	52,126	50,307
Risk-weighted assets and capital ratios[55]					
Risk-weighted assets	**1,123,943**	1,209,514	1,103,113	1,133,168	1,147,974

	%	%	%	%	%
Core tier 1 ratio	**12.3**	10.1	10.5	9.4	7.0
Total capital ratio	**16.1**	14.1	15.2	13.7	11.4
Financial statistics					
Loans and advances to customers as a percentage of customer accounts	**74.4**	75.0	78.1	77.3	83.6
Average total shareholders equity to average total assets	**6.16**	5.64	5.53	4.72	4.87
Net asset value per ordinary share at year-end[58] (US$)	**9.09**	8.48	7.94	7.17	7.44
Number of US$0.50 ordinary shares in issue (millions)	**18,476**	17,868	17,686	17,408	12,105
Closing foreign exchange translation rates to US$:					
US$1: £	**0.619**	0.646	0.644	0.616	0.686
US$1:	**0.758**	0.773	0.748	0.694	0.717

For footnotes, see page 120.

A more detailed consolidated balance sheet is contained in the Financial Statements on page 374.

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

Movement in 2012

Total reported assets were US$2.7 trillion, 5% higher than at 31 December 2011. Excluding the effect of currency movements, total assets increased by 4%, as shown on page 48.

Our business model (see page 14) and our approach to managing the Group balance sheet contributed to our strong liquidity position. Customer deposits increased by over US$65bn in 2012, which enabled us to continue to support our customers borrowing requirements. Loans and advances to customers grew by more than US$39bn during the year, notably in residential mortgages and term and trade-related lending to corporate and commercial customers. Higher customer activity also led to a rise in trading assets.

We have made significant progress in simplifying and re-shaping our balance sheet to improve our capital deployment. We completed a significant number of business disposals during the year, most notably the Card and Retail Services business and non-strategic branches in the US. This led to a significant reduction in Assets held for sale with further transactions due to complete in 2013.

Assets

Cash and balances at central banks rose by 7% as we placed a greater portion of our surplus liquidity in Hong Kong, Europe and Rest of Asia-Pacific with central banks, reflecting both our risk profile and growth in customer deposits. This was partly offset by a reduction in North America as liquidity was redeployed into highly-rated financial investments.

Trading assets increased by 21%. At the end of 2011, client activity fell as eurozone debt concerns dominated the global economy and, as a result, we reduced our holdings of debt and equity securities and did not replace maturities in our reverse repo book. In 2012, client activity increased from these subdued levels which resulted in a rise in reverse repo and securities borrowing balances, together with higher holdings of equity securities. Notwithstanding the rise in year-end balances, we actively managed the trading inventory in GB&M and the average balance for the year declined by 9%.

Financial assets designated at fair value rose by 8%. Holdings of equity securities in our insurance businesses in Hong Kong and Europe increased, reflecting favourable market movements. Portfolio growth was also partly attributable to net premiums received in the year.

Derivative assets remained broadly in line with December 2011 levels. Downward movements in

yield curves in major currencies led to a rise in the fair value of interest rate contracts, largely in Europe and, to a lesser extent, the US. This was partly offset by a decline in the fair value of credit derivative contracts in Europe and the US, as spreads tightened, and foreign exchange contracts in Europe reflecting lower volumes of open trades. In addition, netting increased from an increase in trading through clearing houses and a rise in the fair value of interest rate contracts.

Loans and advances to banks declined by 16%, driven by a reduction in reverse repo balances in Europe, in part reflecting the redeployment of liquidity to central banks, together with maturities and repayments in Hong Kong and Rest of Asia-Pacific.

Loans and advances to customers increased by 4%. Residential mortgage balances continued to grow strongly, following the success of marketing campaigns and competitive pricing in the UK, the continued strength in the property market in Hong Kong and expansion of the distribution network in Rest of Asia-Pacific. Our focus on corporate and commercial customers that trade internationally led to a rise in term and trade-related lending in Hong Kong and Rest of Asia-Pacific. Lending to CMB customers also increased in Europe, notably in the UK despite muted demand for credit, and in North America, reflecting our focus on target segments in the US. In the Middle East and North Africa, the rise in term lending balances followed the completion of the merger of our operations in Oman with OIB and the acquisition of the onshore retail and commercial banking business of Lloyds Banking Group in the UAE. Corporate overdraft balances which did not meet netting criteria also increased in the UK, with a corresponding rise in related customer accounts. The above movements were partly offset by a reduction in residential mortgage balances in North America as a result of repayments and write-offs on the run-off portfolio. Lending to GB&M customers in Europe also declined as we reduced our exposure to certain sectors and disposed of selected positions, and clients chose to re-finance through the capital markets. Reverse repo balances also declined, mainly in Europe.

During 2012 we reclassified to Assets held for sale loans and advances to customers relating to the planned disposals of non-strategic RBWM banking operations in Rest of Asia-Pacific and businesses in Latin America and Middle East and North Africa. In addition, loans and advances to customers, net of customer allowances, relating to the planned disposal of non-real estate personal loan balances

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

in the CML run-off portfolio in North America were reclassified as Assets held for sale .

Financial investments rose by 4% as excess liquidity was deployed into available-for-sale investments, notably treasury bills in Hong Kong and highly rated debt securities in North America.

Assets held for sale declined by 51% following the completion of the US disposals. This was partly offset by the reclassification to Assets held for sale during the year of the non-real estate personal loan balances in North America, our shareholdings in Ping An and Bao Viet Holdings and other non-strategic businesses.

Liabilities

Deposits by banks declined by 6% due to lower placements by, and repo activity with, other financial institutions in Europe. This was partly offset by higher short-term placements in North America and Hong Kong.

Customer accounts rose by 5%. This was driven in part by a significant rise in Hong Kong, where RBWM customers adopted a more conservative approach to managing their assets. CMB benefited from increased liquidity in the market, higher Payments and Cash Management balances and a rise in deposits from Business Banking customers. There was also strong deposit growth in CMB and GB&M in Europe, which benefited from higher balances in Payments and Cash Management, while growth in RBWM in Europe reflected the success of deposit gathering campaigns. The increase in current accounts in GB&M in the UK was also related to the rise in overdrafts which did not meet netting criteria. These movements were partly offset by a decrease in Brazil due to both a managed reduction in term deposits and the continued transformation of our funding base, substituting wholesale customer deposits for medium-term notes. Customer account balances in North America also fell as short-term deposits in the US placed at the end of 2011 were withdrawn. In addition, we reduced rates offered to customers as our funding requirements diminished following the business disposals and the continued decline of the consumer finance portfolios in run-off.

Trading liabilities increased by 12%, due to higher repo activity, notably in the US and in Europe, which we used to fund the rise in trading assets resulting from higher client activity.

Financial liabilities designated at fair value remained broadly in line with December 2011 levels. A net increase in Europe due to new issuances was largely offset by a net reduction in North America as maturities were not replaced, reflecting the decrease in funding requirements in the US.

The increase 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 declined by 10% as maturing debt was not replaced in North America due to the decline in funding requirements there.

Liabilities under insurance contracts rose by 11%, largely due to higher investment returns which resulted in a rise in the fair value of assets held to support unit-linked insurance contracts and investment and insurance contracts with DPF, together with the related liabilities to policyholders. In addition, liabilities to policyholders were established for new business written in Hong Kong, Europe and Latin America. This was offset in part by a reduction in liabilities under insurance contracts reflecting disposals of general insurance businesses in Hong Kong, Rest of Asia-Pacific, Latin America and Europe, together with the reclassification to Liabilities of disposal groups held for sale of general insurance liabilities in North America and life insurance liabilities in Rest of Asia-Pacific.

Liabilities of disposal groups held for sale declined by 77% following the completion of the US disposals. This was partly offset by the transfer to this classification of other non-strategic businesses.

Other liabilities rose by 5%, reflecting higher provisions for customer redress programmes in the UK together with a rise in amounts owed to clearing houses as trading activity conducted through them increased.

Equity

Total shareholders equity rose by 9%, driven in part by profits generated in the year. In addition, there was a favourable movement on the available-for-sale reserve from a negative balance of US$3.3bn at 31 December 2011 to a positive balance of US$1.6bn at 31 December 2012, reflecting an improvement in the fair value of these assets.

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

Reconciliation of reported and constant currency assets and liabilities

	31 December 2012 compared with 31 December 2011					
	31 Dec 11 as reported	Currency translation adjustment[59]	31 Dec 11 at 31 Dec 12 exchange rates	31 Dec 12 as reported	Reported change	Constant currency change
HSBC	**US$m**	**US$m**	**US$m**	**US$m**	**%**	**%**
Cash and balances at central banks	129,902	2,011	131,913	141,532	9	7
Trading assets	330,451	7,317	337,768	408,811	24	21
Financial assets designated at fair value	30,856	147	31,003	33,582	9	8
Derivative assets	346,379	9,519	355,898	357,450	3	
Loans and advances to banks	180,987	1,436	182,423	152,546	(16)	(16)
Loans and advances to customers	940,429	18,175	958,604	997,623	6	4
Financial investments	400,044	4,772	404,816	421,101	5	4
Assets held for sale	39,558	(175)	39,383	19,269	(51)	(51)
Other assets	156,973	719	157,692	160,624	2	2
Total assets	2,555,579	43,921	2,599,500	2,692,538	5	4
Deposits by banks	112,822	1,809	114,631	107,429	(5)	(6)
Customer accounts	1,253,925	20,233	1,274,158	1,340,014	7	5
Trading liabilities	265,192	6,262	271,454	304,563	15	12
Financial liabilities designated at fair value	85,724	1,782	87,506	87,720	2	
Derivative liabilities	345,380	9,566	354,946	358,886	4	1
Debt securities in issue	131,013	2,053	133,066	119,461	(9)	(10)
Liabilities under insurance contracts	61,259	145	61,404	68,195	11	11
Liabilities of disposal groups held for sale	22,200	(486)	21,714	5,018	(77)	(77)
Other liabilities	111,971	693	112,664	118,123	5	5
Total liabilities	2,389,486	42,057	2,431,543	2,509,409	5	3
Total shareholders equity	158,725	1,821	160,546	175,242	10	9
Non-controlling interests	7,368	43	7,411	7,887	7	6
Total equity	166,093	1,864	167,957	183,129	10	9
Total equity and liabilities	2,555,579	43,921	2,599,500	2,692,538	5	4

For footnote, see page 120.

Table of Contents

HSBC HOLDINGS PLC

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

In implementing our strategy, we have agreed to sell a number of businesses across the Group. Assets and liabilities of businesses which, it is highly probable, will be sold are reported as held for sale on the balance sheet until the sale is closed. We include loans and advances to customers and customer

account balances reported as held for sale in our combined view of customer lending and customer accounts. We consider the combined view more accurately reflects the size of our lending and deposit books and growth thereof.

Combined view of customer lending and customer deposits

	2012	2011	Change
	US$m	US$m	%
Loans and advances to customers	**997,623**	940,429	6
Loans and advances to customers reported in assets held for sale[60]	**6,124**	35,105	(83)
Card and Retail Services		29,137	(100)
US branches		2,441	(100)
Other	**6,124**	3,527	74
Combined customer lending	**1,003,747**	975,534	3
Customer accounts	**1,340,014**	1,253,925	7
Customer accounts reported in assets held for sale[62]	**2,990**	20,138	(85)
US branches		15,144	(100)
Other	**2,990**	4,994	(40)
Combined customer deposits	**1,343,004**	1,274,063	5

For footnote, see page 120.

Financial investments

	At 31 December 2012		
	Equity securities	**Debt securities**	**Total**
	US$bn	**US$bn**	**US$bn**
Balance Sheet Management		**293.4**	**293.4**

Insurance entities		**43.4**	**43.4**
Special purpose entities		**24.7**	**24.7**
Principal investments	**2.9**		**2.9**
Other	**2.9**	**53.8**	**56.7**
	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 223) for a description of the activities and an analysis of third party assets in balance sheet management.

Risk management of insurance operations (page 232) includes a discussion and further analysis of the use of financial investments within our insurance operations.

Special purpose entities (page 502) 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 222) 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.

Table of Contents

HSBC HOLDINGS PLC

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

Average balance sheet

Average balance sheet and net interest income

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

within Other interest-earning assets and Other interest-bearing liabilities as appropriate and the elimination entries are included within Other operations in those two categories.

Net interest margin numbers are calculated by dividing net interest income as reported in the income statement by the average interest-earning assets from which interest income is reported within the Net interest income line of the income statement. 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

	2012			2011			2010		
	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)	**1,625,068**	**56,702**	**3.49**	1,622,658	63,005	3.88	1,472,294	58,345	3.96
Trading assets and financial assets designated at fair value[90,91]	**368,406**	**6,931**	**1.88**	410,038	8,671	2.11	385,203	7,060	1.83
Impairment provisions	**(17,421)**			(18,738)			(22,905)		
Non-interest-earning assets	**730,901**			752,965			664,308		
Total assets and interest income	**2,706,954**	**63,633**	**2.35**	2,766,923	71,676	2.59	2,498,900	65,405	2.62
Average yield on all interest-earning assets			**3.19**			3.53			3.52

Short-term funds and loans and advances to banks										
Europe	HSBC Bank	**86,496**	**1,040**	**1.20**	62,489	1,186	1.90	47,741	1,290	2.70
	HSBC Private Banking Holdings (Suisse)	**2,072**	**9**	**0.43**	1,886	14	0.74	2,603	15	0.58
	HSBC France	**33,199**	**176**	**0.53**	36,023	477	1.32	47,094	337	0.72
Hong Kong	Hang Seng Bank	**16,396**	**283**	**1.73**	17,761	334	1.88	14,884	222	1.49
	The Hongkong and Shanghai Banking Corporation	**18,379**	**224**	**1.22**	22,033	233	1.06	16,544	117	0.71
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	**42,814**	**805**	**1.88**	41,692	920	2.21	30,288	464	1.53
	HSBC Bank Malaysia	**5,375**	**157**	**2.92**	6,049	174	2.88	5,113	126	2.46
MENA	HSBC Bank Middle East	**5,922**	**41**	**0.69**	4,467	42	0.94	5,335	60	1.12
North America	HSBC Bank USA	**23,768**	**106**	**0.45**	27,495	97	0.35	28,653	103	0.36
	HSBC Bank Canada	**1,677**	**17**	**1.01**	2,886	23	0.80	3,823	16	0.42
Latin America	HSBC Mexico	**3,053**	**119**	**3.90**	3,383	130	3.84	3,238	129	3.98
	Brazilian operations[92]	**14,610**	**1,155**	**7.91**	18,954	2,036	10.74	16,102	1,525	9.47
	HSBC Bank Panama	**410**	**5**	**1.22**	1,138	10	0.88	959	8	0.83
	HSBC Bank Argentina	**396**	**45**	**11.36**	341	33	9.68	169	20	11.83
Other operations		**21,412**	**125**	**0.58**	15,152	151	1.00	14,196	123	0.87
		275,979	**4,307**	**1.56**	261,749	5,860	2.24	236,742	4,555	1.92

Table of Contents

HSBC HOLDINGS PLC

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

		2012 Average balance US$m	2012 Interest income US$m	2012 Yield %	2011 Average balance US$m	2011 Interest income US$m	2011 Yield %	2010 Average balance US$m	2010 Interest income US$m	2010 Yield %
Loans and advances to customers										
Europe	HSBC Bank	**289,586**	**10,596**	**3.66**	299,775	10,225	3.41	265,163	9,761	3.68
	HSBC Private Banking Holdings (Suisse)	**12,591**	**199**	**1.58**	14,631	255	1.74	11,987	191	1.59
	HSBC France	**69,021**	**1,713**	**2.48**	75,033	2,087	2.78	66,910	1,684	2.52
	HSBC Finance	**886**	**42**	**4.74**	1,486	98	6.59	2,251	198	8.80
Hong Kong	Hang Seng Bank	**64,907**	**1,895**	**2.92**	63,198	1,569	2.48	51,028	1,313	2.57
	The Hongkong and Shanghai Banking Corporation	**100,203**	**2,410**	**2.41**	91,209	1,975	2.17	65,226	1,755	2.69
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	**109,298**	**5,231**	**4.79**	99,683	4,863	4.88	81,080	3,928	4.84
	HSBC Bank Malaysia	**13,456**	**707**	**5.25**	12,118	657	5.42	9,614	531	5.52
MENA	HSBC Bank Middle East	**24,012**	**1,214**	**5.06**	22,494	1,296	5.76	21,193	1,303	6.15
North America	HSBC Bank USA	**59,806**	**1,742**	**2.91**	67,817	3,226	4.76	78,556	4,582	5.83
	HSBC Finance	**43,887**	**3,904**	**8.90**	59,857	5,842	9.76	78,105	7,741	9.91
	HSBC Bank Canada	**44,673**	**1,588**	**3.55**	44,512	1,683	3.78	46,360	1,643	3.54
Latin America	HSBC Mexico	**14,411**	**1,613**	**11.19**	14,290	1,630	11.41	12,309	1,571	12.76
	Brazilian operations[92]	**27,621**	**5,468**	**19.80**	30,212	6,584	21.79	23,366	5,118	21.90
	HSBC Bank Panama	**5,691**	**395**	**6.94**	10,346	833	8.05	9,348	815	8.72
	HSBC Bank Argentina	**3,644**	**718**	**19.70**	3,320	524	15.78	2,460	367	14.92
Other operations		**50,963**	**1,608**	**3.16**	35,307	1,903	5.39	33,543	1,685	5.02
		934,656	**41,043**	**4.39**	945,288	45,250	4.79	858,499	44,186	5.15
Financial investments										
Europe	HSBC Bank	**80,475**	**1,275**	**1.58**	95,522	1,631	1.71	85,206	1,725	2.02
	HSBC Private Banking Holdings (Suisse)	**5,722**	**107**	**1.87**	13,521	247	1.83	17,013	287	1.69
	HSBC France	**11,208**	**130**	**1.16**	4,662	133	2.85	4,017	102	2.54
Hong Kong	Hang Seng Bank	**29,319**	**590**	**2.01**	26,095	596	2.28	30,334	541	1.78
	The Hongkong and Shanghai Banking Corporation	**48,695**	**320**	**0.66**	52,357	399	0.76	65,256	477	0.73
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	**46,095**	**1,501**	**3.26**	40,033	1,422	3.55	37,833	1,161	3.07
	HSBC Bank Malaysia	**1,798**	**59**	**3.28**	1,013	33	3.26	911	28	3.07
MENA	HSBC Bank Middle East	**10,266**	**113**	**1.10**	10,944	150	1.37	8,086	126	1.56
North America	HSBC Bank USA	**61,510**	**1,092**	**1.78**	50,357	1,250	2.48	38,541	1,156	3.00
	HSBC Finance	**941**	**67**	**7.12**	2,956	104	3.52	2,834	116	4.09
	HSBC Bank Canada	**21,179**	**297**	**1.40**	17,821	307	1.72	14,310	257	1.80
Latin America	HSBC Mexico	**8,021**	**379**	**4.73**	9,767	473	4.84	7,177	388	5.41
	Brazilian operations[92]	**9,527**	**1,019**	**10.70**	10,072	1,206	11.97	9,564	1,089	11.39
	HSBC Bank Panama	**585**	**20**	**3.42**	1,147	50	4.36	996	38	3.82
	HSBC Bank Argentina	**701**	**96**	**13.69**	651	99	15.21	370	58	15.68
Other operations		**51,287**	**2,013**	**3.92**	47,141	2,129	4.52	56,523	1,826	3.23

387,329	**9,078**	**2.34**	384,059	10,229	2.66	378,971	9,375	2.47

49b

Table of Contents

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

Assets (continued)

		2012 Average balance US$m	2012 Interest income US$m	2012 Yield %	2011 Average balance US$m	2011 Interest income US$m	2011 Yield %	2010 Average balance US$m	2010 Interest income US$m	2010 Yield %
Other interest-earning assets										
Europe	HSBC Bank	**119,175**	**153**	**0.13**	53,394	101	0.19	14,255	100	0.70
	HSBC Private Banking Holdings (Suisse)	**14,461**	**189**	**1.31**	19,568	262	1.34	17,738	241	1.36
	HSBC France	**13,107**	**121**	**0.92**	10,037	160	1.59	9,954	93	0.93
Hong Kong	Hang Seng Bank	**1,003**	**9**	**0.90**	854	9	1.05	1,077	13	1.21
	The Hongkong and Shanghai Banking Corporation	**43,871**	**441**	**1.01**	32,917	383	1.16	27,112	260	0.96
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	**15,320**	**40**	**0.26**	15,414	53	0.34	18,476	55	0.30
	HSBC Bank Malaysia	**553**	**4**	**0.72**	578	8	1.38	745	14	1.88
MENA	HSBC Bank Middle East	**1,914**	**72**	**3.76**	698	22	3.15	1,272	46	3.62
North America	HSBC Bank USA	**12,324**	**872**	**7.08**	15,187	903	5.95	3,467	58	1.67
	HSBC Finance	**7,723**	**656**	**8.49**	6,014	671	11.16	2,895	7	0.24
	HSBC Bank Canada	**2,340**	**69**	**2.95**	3,109	59	1.90	1,287	20	1.55
Latin America	HSBC Mexico	**614**	**39**	**6.35**	383	27	7.05	158	9	5.70
	Brazilian operations[92]	**1,338**	**100**	**7.47**	2,031	54	2.66	1,170	80	6.84
	HSBC Bank Panama	**4,647**	**348**	**7.49**	804	10	1.24	1,234	12	0.97
	HSBC Bank Argentina	**106**	**4**	**4**	88			87		
Other operations		**(211,392)**	**(843)**		(129,514)	(1,056)		(102,845)	(779)	
		27,104	**2,274**	**8.39**	31,562	1,666	5.28	(1,918)	229	(11.94)
Total interest-earning assets										
Europe	HSBC Bank	**575,732**	**13,064**	**2.27**	511,180	13,143	2.57	412,365	12,876	3.12
	HSBC Private Banking Holdings (Suisse)	**34,846**	**504**	**1.45**	49,606	778	1.57	49,341	734	1.49
	HSBC France	**126,535**	**2,140**	**1.69**	125,755	2,857	2.27	127,975	2,216	1.73
	HSBC Finance	**889**	**42**	**4.72**	1,486	98	6.59	2,251	198	8.80
Hong Kong	Hang Seng Bank	**111,625**	**2,777**	**2.49**	107,908	2,508	2.32	97,323	2,089	2.15
	The Hongkong and Shanghai Banking Corporation	**211,148**	**3,395**	**1.61**	198,516	2,990	1.51	174,138	2,609	1.50
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	**213,527**	**7,577**	**3.55**	196,822	7,258	3.69	167,677	5,608	3.34

	HSBC Bank Malaysia	**21,182**	**927**	**4.38**	19,758	872	4.41	16,383	699	4.27
MENA	HSBC Bank Middle East	**42,114**	**1,440**	**3.42**	38,603	1,510	3.91	35,886	1,535	4.28
North America	HSBC Bank USA	**157,408**	**3,812**	**2.42**	160,856	5,476	3.40	149,217	5,899	3.95
	HSBC Finance	**54,342**	**4,627**	**8.51**	68,827	6,617	9.61	83,834	7,864	9.38
	HSBC Bank Canada	**69,869**	**1,971**	**2.82**	68,328	2,072	3.03	65,780	1,936	2.94
Latin America	HSBC Mexico	**26,099**	**2,150**	**8.24**	27,823	2,260	8.12	22,882	2,097	9.16
	Brazilian operations[92]	**53,096**	**7,742**	**14.58**	61,269	9,880	16.13	50,202	7,812	15.56
	HSBC Bank Panama	**11,333**	**768**	**6.78**	13,435	903	6.72	12,537	873	6.96
	HSBC Bank Argentina	**4,847**	**863**	**17.80**	4,400	656	14.91	3,086	445	14.42
Other operations		**(89,524)**	**2,903**		(31,914)	3,127		1,417	2,855	
		1,625,068	**56,702**	**3.49**	1,622,658	63,005	3.88	1,472,294	58,345	3.96

For footnotes, see page 120.

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

Equity and liabilities

		2012 Average balance	2012 Interest expense	2012 Cost	2011 Average balance	2011 Interest expense	2011 Cost	2010 Average balance	2010 Interest expense	2010 Cost
		US$m	**US$m**	**%**	US$m	US$m	%	US$m	US$m	%
Summary										
Interest-bearing liabilities measured at amortised cost (itemised below)		**1,401,020**	**19,030**	**1.36**	1,433,566	22,343	1.56	1,339,390	18,904	1.41
Trading liabilities and financial liabilities designated at fair value (excluding own debt issued)		**318,883**	**3,445**	**1.08**	355,345	4,564	1.28	275,804	3,780	1.37
Non-interest bearing current accounts		**177,085**			162,369			142,579		
Total equity and other non-interest bearing liabilities		**809,876**			815,643			741,127		
Total equity and liabilities		**2,706,864**	**22,475**	**0.83**	2,766,923	26,907	0.97	2,498,900	22,684	0.91
Average cost on all interest-bearing liabilities				**1.31**			1.50			1.40
Deposits by banks[93]										
Europe	HSBC Bank	**27,738**	**435**	**1.57**	33,764	529	1.57	32,850	260	0.79
	HSBC Private Banking Holdings (Suisse)	**657**	**2**	**0.30**	874	2	0.23	964	2	0.21
	HSBC France	**26,026**	**171**	**0.66**	29,329	396	1.35	42,399	340	0.80
Hong Kong	Hang Seng Bank	**1,305**	**15**	**1.15**	1,903	7	0.37	1,456	4	0.27
	The Hongkong and Shanghai Banking Corporation	**7,648**	**12**	**0.16**	8,389	13	0.15	5,691	10	0.18
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	**10,668**	**159**	**1.49**	10,613	159	1.50	9,540	131	1.37
	HSBC Bank Malaysia	**961**	**20**	**2.08**	360	9	2.50	164	4	2.44
MENA	HSBC Bank Middle East	**1,588**	**6**	**0.38**	1,511	6	0.40	762	6	0.79
North America	HSBC Bank USA	**7,587**	**19**	**0.25**	7,730	18	0.23	8,693	26	0.30
	HSBC Bank Canada	**1,613**	**9**	**0.56**	760	15	1.97	946	5	0.53
Latin America	HSBC Mexico	**1,103**	**52**	**4.71**	1,167	62	5.31	1,002	51	5.09
	Brazilian operations[92]	**4,323**	**194**	**4.49**	6,433	331	5.15	3,610	247	6.84
	HSBC Bank Panama	**645**	**12**	**1.86**	802	18	2.24	612	18	2.94
	HSBC Bank Argentina	**44**	**3**	**6.82**	24	2	8.33	17	1	5.88
Other operations		**897**	**51**	**5.69**	2,440	24	0.98	2,737	31	1.13
		92,803	**1,160**	**1.25**	106,099	1,591	1.50	111,443	1,136	1.02
Financial liabilities designated at fair value own debt issued[94]										
Europe	HSBC Holdings	**23,864**	**446**	**1.87**	19,654	342	1.74	16,577	308	1.86
	HSBC Bank	**28,046**	**556**	**1.98**	26,504	462	1.74	15,169	270	1.78
	HSBC France	**7,147**	**118**	**1.65**	6,907	174	2.52	7,154	113	1.58

Hong Kong	Hang Seng Bank							63		
North America	HSBC Bank USA	**1,853**	**38**	**2.05**	1,642	38	2.31	1,721	25	1.45
	HSBC Finance	**12,147**	**184**	**1.51**	17,108	289	1.69	24,740	528	2.13
Other operations		**1,959**	**(17)**	**(0.87)**	1,820	8	0.44	1,282	27	2.11
		75,016	**1,325**	**1.77**	73,635	1,313	1.78	66,706	1,271	1.91

49d

Table of Contents

HSBC HOLDINGS PLC

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

Equity and liabilities (continued)

		2012 Average balance	2012 Interest expense	2012 Cost	2011 Average balance	2011 Interest expense	2011 Cost	2010 Average balance	2010 Interest expense	2010 Cost
		US$m	US$m	%	US$m	US$m	%	US$m	US$m	%
Customer accounts[95]										
Europe	HSBC Bank	**309,808**	**2,445**	**0.79**	306,060	2,387	0.78	275,153	2,042	0.74
	HSBC Private Banking Holdings (Suisse)	**15,926**	**84**	**0.53**	22,025	163	0.74	20,530	144	0.70
	HSBC France	**47,974**	**403**	**0.84**	49,363	650	1.32	50,096	377	0.75
Hong Kong	Hang Seng Bank	**85,425**	**365**	**0.43**	83,220	342	0.41	76,708	205	0.27
	The Hongkong and Shanghai Banking Corporation	**190,654**	**250**	**0.13**	177,336	231	0.13	160,794	146	0.09
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	**129,419**	**2,381**	**1.84**	121,237	2,277	1.88	104,648	1,696	1.62
	HSBC Bank Malaysia	**13,624**	**311**	**2.28**	13,326	299	2.24	11,213	220	1.96
MENA	HSBC Bank Middle East	**17,477**	**163**	**0.93**	17,484	237	1.36	15,906	284	1.79
North America	HSBC Bank USA	**68,134**	**224**	**0.33**	83,988	340	0.40	85,946	540	0.63
	HSBC Bank Canada	**45,116**	**344**	**0.76**	44,833	358	0.80	41,153	304	0.74
Latin America	HSBC Mexico	**17,735**	**528**	**2.98**	18,139	538	2.97	14,127	398	2.82
	Brazilian operations[92]	**30,352**	**2,411**	**7.94**	41,194	4,471	10.85	36,727	3,502	9.54
	HSBC Bank Panama	**4,303**	**96**	**2.23**	8,915	294	3.30	8,771	321	3.66
	HSBC Bank Argentina	**3,594**	**268**	**7.46**	3,149	200	6.35	2,538	97	3.82
Other operations		**73,271**	**605**	**0.83**	68,057	669	0.98	58,303	502	0.86
		1,052,812	**10,878**	**1.03**	1,058,326	13,456	1.27	962,613	10,778	1.12
Debt securities in issue										
Europe	HSBC Bank	**69,294**	**989**	**1.43**	79,670	982	1.23	62,735	1,130	1.80
	HSBC France	**14,801**	**118**	**0.80**	18,043	260	1.44	20,686	160	0.77
Hong Kong	Hang Seng Bank	**1,606**	**15**	**0.93**	1,424	13	0.91	1,034	13	1.26
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	**7,732**	**241**	**3.12**	7,918	263	3.32	5,558	218	3.92
	HSBC Bank Malaysia	**1,016**	**25**	**2.46**	568	18	3.17	389	15	3.86
MENA	HSBC Bank Middle East	**3,769**	**83**	**2.20**	3,870	77	1.99	3,940	63	1.60
North America	HSBC Bank USA	**12,738**	**390**	**3.06**	12,535	395	3.15	12,680	375	2.96
	HSBC Finance	**29,198**	**1,059**	**3.63**	40,629	1,413	3.48	48,561	1,766	3.64
	HSBC Bank Canada	**12,675**	**390**	**3.08**	12,061	392	3.25	13,205	343	2.60
Latin America	HSBC Mexico	**897**	**51**	**5.69**	1,074	57	5.31	922	51	5.53
	Brazilian operations[92]	**9,114**	**732**	**8.03**	6,825	708	10.37	2,112	151	7.15
	HSBC Bank Panama	**182**	**9**	**4.95**	601	29	4.83	771	40	5.19
	HSBC Bank Argentina	**121**	**20**	**16.53**	66	11	16.67	4		
Other operations		**(1,795)**	**633**	**(35.26)**	(3,802)	642	(16.89)	17,301	606	3.50

161,348	**4,755**	**2.95**	181,482	5,260	2.90	189,898	4,931	2.60

49e

Table of Contents

HSBC HOLDINGS PLC

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

		2012 Average balance US$m	2012 Interest expense US$m	2012 Cost %	2011 Average balance US$m	2011 Interest expense US$m	2011 Cost %	2010 Average balance US$m	2010 Interest expense US$m	2010 Cost %
Other interest-bearing liabilities										
Europe	HSBC Bank	**126,279**	**671**	**0.53**	66,449	595	0.90	28,269	434	1.54
	HSBC Private Banking Holdings (Suisse)	**4,195**	**4**	**0.10**	3,006	8	0.27	2,921	7	0.24
	HSBC France	**20,853**	**28**	**0.13**	20,294	170	0.84	16,668	78	0.47
	HSBC Finance	**303**	**2**	**0.66**	828	6	0.72	1,595	15	0.94
Hong Kong	Hang Seng Bank	**1,715**	**39**	**2.27**	1,422	25	1.76	829	5	0.60
	The Hongkong and Shanghai Banking Corporation	**11,213**	**71**	**0.63**	12,759	72	0.56	8,580	55	0.64
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	**40,827**	**406**	**0.99**	35,562	361	1.02	34,027	248	0.73
	HSBC Bank Malaysia	**1,069**	**16**	**1.50**	1,121	17	1.52	706	8	1.13
MENA	HSBC Bank Middle East	**1,681**	**76**	**4.52**	1,506	50	3.32	1,496	63	4.21
North America	HSBC Bank USA	**26,255**	**408**	**1.55**	23,431	820	3.50	14,669	609	4.15
	HSBC Finance	**3,196**	**162**	**5.07**	4,345	29	0.67	3,487	102	2.93
	HSBC Bank Canada	**772**	**4**	**0.52**	360	2	0.56	1,806	3	0.17
	HSBC Markets Inc	**1,202**	**36**	**3.00**	2,193	40	1.82	1,266	25	1.97
Latin America	HSBC Mexico	**1,305**	**19**	**1.46**	1,379	22	1.60	804	13	1.62
	Brazilian operations[92]	**4,705**	**362**	**7.69**	4,223	335	7.93	2,803	316	11.27
	HSBC Bank Panama	**3,722**	**113**	**3.04**	717	14	1.95	108	1	0.93
	HSBC Bank Argentina	**26**	**3**	**11.54**	15	1	6.67	4		
Other operations		**(230,043)**	**(1,508)**		(165,586)	(1,844)		(111,308)	(1,194)	
		19,275	**912**	**4.73**	14,024	723	5.16	8,730	788	9.03
Total interest-bearing liabilities										
Europe	HSBC Bank	**561,165**	**5,096**	**0.91**	512,447	4,955	0.97	414,176	4,136	1.00
	HSBC Private Banking Holdings (Suisse)	**20,778**	**90**	**0.43**	25,905	173	0.67	24,415	153	0.63
	HSBC France	**116,801**	**838**	**0.72**	123,936	1,650	1.33	137,003	1,068	0.78
	HSBC Finance	**303**	**2**	**0.66**	828	6	0.72	1,595	15	0.94
Hong Kong	Hang Seng Bank	**90,051**	**434**	**0.48**	87,969	387	0.44	80,090	227	0.28
	The Hongkong and Shanghai Banking Corporation	**209,515**	**333**	**0.16**	198,484	316	0.16	175,065	211	0.12
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	**188,646**	**3,187**	**1.69**	175,330	3,060	1.75	153,773	2,293	1.49
	HSBC Bank Malaysia	**16,670**	**372**	**2.23**	15,375	343	2.23	12,472	247	1.98
MENA	HSBC Bank Middle East	**24,515**	**328**	**1.34**	24,371	370	1.52	22,104	416	1.88
North America	HSBC Bank USA	**116,567**	**1,079**	**0.93**	129,326	1,611	1.25	123,709	1,575	1.27
	HSBC Finance	**44,541**	**1,405**	**3.15**	62,082	1,731	2.79	76,788	2,396	3.12

	HSBC Bank Canada	**60,176**	**747**	**1.24**	58,014	767	1.32	57,110	655	1.15
	HSBC Markets Inc	**1,202**	**36**	**3.00**	2,193	40	1.82	1,266	25	1.97
Latin America	HSBC Mexico	**21,040**	**650**	**3.09**	21,759	679	3.12	16,855	513	3.04
	Brazilian operations[92]	**48,494**	**3,699**	**7.63**	58,675	5,845	9.96	45,252	4,216	9.32
	HSBC Bank Panama	**8,852**	**230**	**2.64**	11,035	355	3.22	10,262	379	3.69
	HSBC Bank Argentina	**3,785**	**294**	**7.77**	3,254	217	6.67	2,563	98	3.82
Other operations		**(131,847)**	**210**		(77,417)	(162)		(15,108)	281	
		1,401,254	**19,030**	**1.36**	1,433,566	22,343	1.56	1,339,390	18,904	1.41

For footnotes, see page 120.

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

Net interest margin[96]

		2012	2011	2010
		%	%	%
Total		**2.32**	2.51	2.68
Europe	HSBC Bank	**1.38**	1.60	2.12
	HSBC Private Banking Holdings (Suisse)	**1.19**	1.22	1.18
	HSBC France	**1.03**	0.96	0.90
	HSBC Finance	**4.50**	6.19	8.13
Hong Kong	Hang Seng Bank	**2.10**	1.97	1.91
	The Hongkong and Shanghai Banking Corporation	**1.45**	1.35	1.38
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	**2.06**	2.13	1.98
	HSBC Bank Malaysia	**2.62**	2.68	2.76
MENA	HSBC Bank Middle East	**2.64**	2.95	3.12
North America	HSBC Bank USA	**1.74**	2.40	2.90
	HSBC Finance	**5.93**	7.10	6.52
	HSBC Bank Canada	**1.75**	1.91	1.95
Latin America	HSBC Mexico	**5.75**	5.68	6.92
	Brazilian operations[92]	**7.61**	6.59	7.16
	HSBC Bank Panama	**4.75**	4.08	3.94
	HSBC Bank Argentina	**11.74**	9.98	11.24

Distribution of average total assets

		2012	2011	2010
		%	%	%
Europe	HSBC Bank	**44.8**	41.5	37.5
	HSBC Private Banking Holdings (Suisse)	**1.7**	2.1	2.2
	HSBC France	**11.5**	10.3	12.9
	HSBC Finance		0.1	0.1
Hong Kong	Hang Seng Bank	**4.8**	4.5	4.5
	The Hongkong and Shanghai Banking Corporation	**12.0**	11.0	10.7
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	**11.3**	10.6	9.4
	HSBC Bank Malaysia	**1.0**	0.8	0.7
MENA	HSBC Bank Middle East	**1.8**	1.6	1.6
North America	HSBC Bank USA	**10.2**	9.7	9.7
	HSBC Finance	**2.1**	2.7	3.6
	HSBC Bank Canada	**3.2**	3.0	3.0
Latin America	HSBC Mexico	**1.5**	1.5	1.4
	Brazilian operations[92]	**2.7**	3.0	2.6
	HSBC Bank Panama	**0.5**	0.5	0.6
	HSBC Bank Argentina	**0.2**	0.2	0.2
Other operations (including consolidation adjustments)		**(9.3)**	(3.1)	(0.7)

	100.0	100.0	100.0

For footnotes, see page 120.

49g

Table of Contents

HSBC HOLDINGS PLC

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

Analysis of changes in net interest income and net interest expense

The following tables allocate changes in net interest income and net interest expense between volume and rate for 2012 compared with 2011, and for 2011 compared with 2010. We isolate volume variances and allocate any change arising from both volume and rate to rate.

Interest income

		2012	Increase/(decrease) in 2012 compared with 2011 Volume	Rate	2011	Increase/(decrease) in 2011 compared with 2010 Volume	Rate	2010
		US$m	US$m	US$m	US$m	US$m	US$m	US$m
Short-term funds and loans and advances to banks								
Europe	HSBC Bank	1,040	456	(602)	1,186	398	(502)	1,290
	HSBC Private Banking Holdings (Suisse)	9	1	(6)	14	(4)	3	15
	HSBC France	176	(37)	(264)	477	(80)	220	337
Hong Kong	Hang Seng Bank	283	(26)	(25)	334	43	69	222
	The Hongkong and Shanghai Banking Corporation	224	(39)	30	233	39	77	117
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	805	25	(140)	920	174	282	464
	HSBC Bank Malaysia	157	(19)	2	174	23	25	126
MENA	HSBC Bank Middle East	41	14	(15)	42	(10)	(8)	60
North America	HSBC Bank USA	106	(13)	22	97	(4)	(2)	103
	HSBC Bank Canada	17	(10)	4	23	(4)	11	16
Latin America	HSBC Mexico	119	(13)	2	130	6	(5)	129
	Brazilian operations[92]	1,155	(467)	(414)	2,036	270	241	1,525
	HSBC Bank Panama	5	(6)	1	10	1	1	8
	HSBC Bank Argentina	45	5	7	33	20	(7)	20
Other operations		125	63	(89)	151	8	20	123
		4,307	319	(1,872)	5,860	480	825	4,555
Loans and advances to customers								
Europe	HSBC Bank	10,596	(347)	718	10,225	1,274	(810)	9,761
	HSBC Private Banking Holdings (Suisse)	199	(35)	(21)	255	42	22	191
	HSBC France	1,713	(167)	(207)	2,087	205	198	1,684
	HSBC Finance	42	(40)	(16)	98	(67)	(33)	198
Hong Kong	Hang Seng Bank	1,895	42	284	1,569	313	(57)	1,313
	The Hongkong and Shanghai Banking Corporation	2,410	195	240	1,975	699	(479)	1,755
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	5,231	469	(101)	4,863	900	35	3,928
	HSBC Bank Malaysia	707	73	(23)	657	138	(12)	531
MENA	HSBC Bank Middle East	1,214	87	(169)	1,296	80	(87)	1,303
North America	HSBC Bank USA	1,742	(381)	(1,103)	3,226	(626)	(730)	4,582
	HSBC Finance	3,904	(1,559)	(379)	5,842	(1,808)	(91)	7,741
	HSBC Bank Canada	1,588	6	(101)	1,683	(65)	105	1,643

Latin America	HSBC Mexico	**1,613**	**14**	**(31)**	1,630	253	(194)	1,571
	Brazilian operations[92]	**5,468**	**(565)**	**(551)**	6,584	1,499	(33)	5,118
	HSBC Bank Panama	**395**	**(375)**	**(63)**	833	87	(69)	815
	HSBC Bank Argentina	**718**	**51**	**143**	524	128	29	367
Other operations		**1,608**	**844**	**(1,139)**	1,903	89	129	1,685
		41,043	**(509)**	**(3,698)**	45,250	4,470	(3,406)	44,186

49h

Table of Contents

HSBC HOLDINGS PLC

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

Interest income (continued)

		2012 US$m	Increase/(decrease) in 2012 compared with 2011 Volume US$m	Rate US$m	2011 US$m	Increase/(decrease) in 2011 compared with 2010 Volume US$m	Rate US$m	2010 US$m
Financial investments								
Europe	HSBC Bank	**1,275**	**(257)**	**(99)**	1,631	208	(302)	1,725
	HSBC Private Banking Holdings (Suisse)	**107**	**(143)**	**3**	247	(59)	19	287
	HSBC France	**130**	**187**	**(190)**	133	16	15	102
Hong Kong	Hang Seng Bank	**590**	**74**	**(80)**	596	(75)	130	541
	The Hongkong and Shanghai Banking Corporation	**320**	**(28)**	**(51)**	399	(94)	16	477
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	**1,501**	**215**	**(136)**	1,422	68	193	1,161
	HSBC Bank Malaysia	**59**	**26**		33	3	2	28
MENA	HSBC Bank Middle East	**113**	**(9)**	**(28)**	150	45	(21)	126
North America	HSBC Bank USA	**1,092**	**277**	**(435)**	1,250	354	(260)	1,156
	HSBC Finance	**67**	**(71)**	**34**	104	5	(17)	116
	HSBC Bank Canada	**297**	**58**	**(68)**	307	63	(13)	257
Latin America	HSBC Mexico	**379**	**(85)**	**(9)**	473	140	(55)	388
	Brazilian operations[92]	**1,019**	**(65)**	**(122)**	1,206	58	59	1,089
	HSBC Bank Panama	**20**	**(25)**	**(5)**	50	6	6	38
	HSBC Bank Argentina	**96**	**8**	**(11)**	99	44	(3)	58
Other operations		**2,013**	**187**	**(303)**	2,129	(303)	606	1,826
		9,078	**87**	**(1,238)**	10,229	126	728	9,375

For footnote, see page 120.

Interest expense

		2012 US$m	Increase/(decrease) in 2012 compared with 2011 Volume US$m	Rate US$m	2011 US$m	Increase/(decrease) in 2011 compared with 2010 Volume US$m	Rate US$m	2010 US$m
Deposits by banks								
Europe	HSBC Bank	**435**	**(95)**	**1**	529	7	262	260
	HSBC Private Banking Holdings (Suisse)	**2**			2			2
	HSBC France	**171**	**(45)**	**(180)**	396	(105)	161	340
Hong Kong	Hang Seng Bank	**15**	**(2)**	**10**	7	1	2	4

	The Hongkong and Shanghai Banking Corporation	**12**	**(1)**		13	5	(2)	10
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	**159**	**1**	**(1)**	159	15	13	131
	HSBC Bank Malaysia	**20**	**15**	**(4)**	9	5		4
MENA	HSBC Bank Middle East	**6**			6	6	(6)	6
North America	HSBC Bank USA	**19**		**1**	18	(3)	(5)	26
	HSBC Bank Canada	**9**	**17**	**(23)**	15	(1)	11	5
Latin America	HSBC Mexico	**52**	**(3)**	**(7)**	62	8	3	51
	Brazilian operations[92]	**194**	**(109)**	**(28)**	331	193	(109)	247
	HSBC Bank Panama	**12**	**(4)**	**(2)**	18	6	(6)	18
	HSBC Bank Argentina	**3**	**2**	**(1)**	2		1	1
Other operations		**51**	**(15)**	**42**	24	(3)	(4)	31
		1,160	**(199)**	**(232)**	1,591	(55)	510	1,136

49i

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

		2012	Increase/(decrease) in 2012 compared with 2011 Volume	Rate	2011	Increase/(decrease) in 2011 compared with 2010 Volume	Rate	2010
		US$m	US$m	US$m	US$m	US$m	US$m	US$m
Customer accounts								
Europe	HSBC Bank	**2,445**	**29**	**29**	2,387	229	116	2,042
	HSBC Private Banking Holdings (Suisse)	**84**	**(45)**	**(34)**	163	10	9	144
	HSBC France	**403**	**(18)**	**(229)**	650	(5)	278	377
Hong Kong	Hang Seng Bank	**365**	**9**	**14**	342	18	119	205
	The Hongkong and Shanghai Banking Corporation	**250**	**17**	**2**	231	15	70	146
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	**2,381**	**154**	**(50)**	2,277	269	312	1,696
	HSBC Bank Malaysia	**311**	**7**	**5**	299	41	38	220
MENA	HSBC Bank Middle East	**163**		**(74)**	237	28	(75)	284
North America	HSBC Bank USA	**224**	**(63)**	**(53)**	340	(12)	(188)	540
	HSBC Bank Canada	**344**	**2**	**(16)**	358	27	27	304
Latin America	HSBC Mexico	**528**	**(12)**	**2**	538	113	27	398
	Brazilian operations[92]	**2,411**	**(1,176)**	**(884)**	4,471	426	543	3,502
	HSBC Bank Panama	**96**	**(152)**	**(46)**	294	5	(32)	321
	HSBC Bank Argentina	**268**	**28**	**40**	200	23	80	97
Other operations		**605**	**51**	**(115)**	669	84	83	502
		10,878	**(70)**	**(2,508)**	13,456	1,072	1,606	10,778
Financial liabilities designated at fair value own debt issued		**1,325**	**25**	**(13)**	1,313	132	(90)	1,271
Debt securities in issue								
Europe	HSBC Bank	**989**	**(128)**	**135**	982	305	(453)	1,130
	HSBC France	**118**	**(47)**	**(95)**	260	(20)	120	160
Hong Kong	Hang Seng Bank	**15**	**2**		13	5	(5)	13
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	**241**	**(6)**	**(16)**	263	93	(48)	218
	HSBC Bank Malaysia	**25**	**14**	**(7)**	18	7	(4)	15
MENA	HSBC Bank Middle East	**83**	**(2)**	**8**	77	(1)	15	63
North America	HSBC Bank USA	**390**	**6**	**(11)**	395	(4)	24	375
	HSBC Finance	**1,059**	**(398)**	**44**	1,413	(289)	(64)	1,766
	HSBC Bank Canada	**390**	**20**	**(22)**	392	(30)	79	343
Latin America	HSBC Mexico	**51**	**(9)**	**3**	57	8	(2)	51
	Brazilian operations[92]	**732**	**237**	**(213)**	708	337	220	151
	HSBC Bank Panama	**9**	**(20)**		29	(9)	(2)	40
	HSBC Bank Argentina	**20**	**9**		11		11	
Other operations		**633**	**(339)**	**330**	642	(739)	775	606
		4,755	**(588)**	**83**	5,260	(219)	548	4,931

For footnote, see page 120.

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

Short-term borrowings

We include short-term borrowings within customer accounts, deposits by banks and debt securities in issue and do not show short-term borrowings separately on the balance sheet. Short-term borrowings are defined by the US Securities and Exchange Commission as Federal funds purchased and securities sold under agreements to repurchase, commercial paper and other short-term borrowings.

Our only significant short-term borrowings are securities sold under agreements to repurchase and certain debt securities in issue. 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

	2012	2011	2010
	US$m	US$m	US$m
Securities sold under agreements to repurchase			
Outstanding at 31 December	**170,790**	135,239	159,256
Average amount outstanding during the year	**206,352**	236,290	175,955
Maximum quarter-end balance outstanding during the year	**176,162**	202,305	193,319
Weighted average interest rate during the year	**0.4%**	0.6%	0.5%
Weighted average interest rate at the year-end	**0.5%**	1.0%	0.9%
Short-term bonds			
Outstanding at 31 December	**44,240**	35,415	44,152
Average amount outstanding during the year	**40,349**	40,679	37,981
Maximum quarter-end balance outstanding during the year	**44,240**	42,785	44,152
Weighted average interest rate during the year	**1.4%**	1.9%	2.9%
Weighted average interest rate at the year-end	**1.3%**	2.2%	4.5%

Contractual obligations

The table below provides details of our material contractual obligations as at 31 December 2012.

	Payments due by period				
		Less than			**More than**
	Total	**1 year**	**1 3 years**	**3 5 years**	**5 years**
	US$m	**US$m**	**US$m**	**US$m**	**US$m**
Long-term debt obligations	**218,443**	**64,015**	**42,968**	**45,240**	**66,220**
Term deposits and certificates of deposit	**159,410**	**142,975**	**13,669**	**1,687**	**1,079**

Capital (finance) lease obligations	**430**	**81**	**139**	**14**	**196**
Operating lease obligations	**5,730**	**965**	**1,476**	**1,042**	**2,247**
Purchase obligations	**607**	**433**	**1**	**173**	
Short positions in debt securities and equity shares	**60,974**	**45,702**	**2,435**	**4,487**	**8,350**
Current tax liability	**1,452**	**1,452**			
Pension/healthcare obligation	**16,658**	**1,371**	**2,820**	**3,089**	**9,378**
	463,704	**256,994**	**63,508**	**55,732**	**87,470**

49k

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

Loan maturity and interest sensitivity analysis

At 31 December 2012, 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	**41,233**	**20,445**	**43,234**	**8,764**	**13,398**	**13,206**	**140,280**
Commercial loans to customers							
Manufacturing and international trade and services	**89,674**	**33,623**	**42,058**	**10,039**	**8,549**	**14,188**	**198,131**
Real estate and other property related	**15,234**	**11,475**	**6,227**	**2,110**	**5,442**	**1,994**	**42,482**
Non-bank financial institutions	**46,817**	**3,646**	**3,242**	**274**	**7,025**	**1,034**	**62,038**
Governments	**1,414**	**1,523**	**855**	**1,501**	**684**	**1,082**	**7,059**
Other commercial	**31,765**	**3,468**	**10,631**	**2,935**	**3,790**	**3,440**	**56,029**
	184,904	**53,735**	**63,013**	**16,859**	**25,490**	**21,738**	**365,739**
Maturity after 1 year but within 5 years							
Loans and advances to banks	**3,644**	**2,062**	**1,322**	**434**	**67**	**822**	**8,351**
Commercial loans to customers							
Manufacturing and international trade and services	**29,211**	**9,848**	**8,771**	**2,100**	**11,530**	**6,382**	**67,842**
Real estate and other property related	**18,866**	**20,195**	**8,634**	**533**	**5,418**	**1,226**	**54,872**
Non-bank financial institutions	**7,652**	**856**	**1,013**	**698**	**2,971**	**449**	**13,639**
Governments	**399**	**758**	**215**	**81**	**75**	**199**	**1,727**
Other commercial	**13,924**	**5,627**	**5,185**	**1,253**	**4,243**	**2,887**	**33,119**
	70,052	**37,284**	**23,818**	**4,665**	**24,237**	**11,143**	**171,199**
Interest rate sensitivity of loans and advances to banks and commercial loans to customers							
Fixed interest rate	**14,551**	**116**	**1,267**	**1,159**	**5,535**	**3,417**	**26,045**
Variable interest rate	**59,145**	**39,230**	**23,873**	**3,940**	**18,769**	**8,548**	**153,505**
	73,696	**39,346**	**25,140**	**5,099**	**24,304**	**11,965**	**179,550**
Maturity after 5 years							
Loans and advances to banks	**443**	**993**	**36**			**2,500**	**3,972**
Commercial loans to customers							
Manufacturing and international trade and services	**8,759**	**715**	**701**	**349**	**3,071**	**1,970**	**15,565**
Real estate and other property related	**6,581**	**8,113**	**1,066**	**325**	**3,319**	**534**	**19,938**
Non-bank financial institutions	**1,263**	**44**		**224**	**3,939**	**111**	**5,581**
Governments	**580**	**557**	**66**	**80**	**15**	**701**	**1,999**
Other commercial	**10,348**	**3,297**	**896**	**1,146**	**1,947**	**987**	**18,621**
	27,531	**12,726**	**2,729**	**2,124**	**12,291**	**4,303**	**61,704**
Interest rate sensitivity of loans and advances to banks and commercial loans to customers							

Fixed interest rate	**7,286**	**968**	**68**	**616**	**3,319**	**934**	**13,191**
Variable interest rate	**20,688**	**12,751**	**2,697**	**1,508**	**8,972**	**5,869**	**52,485**
	27,974	**13,719**	**2,765**	**2,124**	**12,291**	**6,803**	**65,676**

491

Table of Contents

HSBC HOLDINGS PLC

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

Deposits

The following tables summarise the average amount of bank deposits, customer deposits and certificates of deposit (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

	2012 Average balance US$m	**2012** Average rate %	2011 Average balance US$m	2011 Average rate %	2010 Average balance US$m	2010 Average rate %
Europe	**64,497**		75,890		85,973	
Demand and other non-interest bearing	**9,377**		10,788		8,298	
Demand interest bearing	**8,988**	**0.4**	16,492	0.8	13,783	0.6
Time	**24,698**	**1.5**	19,893	2.2	28,337	0.9
Other	**21,434**	**1.1**	28,717	1.3	35,555	0.8
Hong Kong	**13,355**		13,222		10,000	
Demand and other non-interest bearing	**4,727**		3,047		2,860	
Demand interest bearing	**5,643**	**0.1**	6,052	0.1	4,787	0.2
Time	**2,013**	**0.4**	3,347	0.3	1,803	0.3
Other	**972**	**0.6**	776	0.1	550	0.7
Rest of Asia-Pacific	**14,485**		13,650		11,476	
Demand and other non-interest bearing	**2,495**		2,535		1,746	
Demand interest bearing	**6,190**	**1.1**	5,802	1.2	4,937	1.2
Time	**3,879**	**1.5**	4,218	1.6	3,626	1.5
Other	**1,921**	**3.1**	1,095	3.0	1,167	2.0
Middle East and North Africa	**1,892**		2,060		1,250	
Demand and other non-interest bearing	**301**		548		484	
Demand interest bearing	**8**	**6.5**	20		9	
Time	**1,543**	**0.4**	1,424	0.4	685	0.6
Other	**40**	**1.8**	68	1.6	72	1.2
North America	**13,695**		11,904		13,324	
Demand and other non-interest bearing	**4,470**		2,367		2,493	
Demand interest bearing	**2,996**	**0.1**	3,849	0.1	3,386	0.1

Time	**4,756**	**0.4**	4,797	0.4	4,716	0.4
Other	**1,473**	**0.5**	891	1.3	2,729	0.5
Latin America	**6,463**		8,819		5,523	
Demand and other non-interest bearing	**212**		161		222	
Demand interest bearing	**333**	**3.9**	545	3.7	322	4.3
Time	**3,665**	**3.7**	4,924	4.3	2,246	5.5
Other	**2,253**	**6.1**	3,189	6.0	2,733	6.6
Total	**114,385**		125,545		127,546	
Demand and other non-interest bearing	**21,582**		19,446		16,103	
Demand interest bearing	**24,157**	**0.5**	32,760	0.7	27,224	0.6
Time	**40,553**	**1.4**	38,603	2.0	41,413	1.1
Other	**28,093**	**1.7**	34,736	1.7	42,806	1.3

49m

Table of Contents

HSBC HOLDINGS PLC

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

Customer accounts

	2012		2011		2010	
	Average balance US$m	Average rate %	Average balance US$m	Average rate %	Average balance US$m	Average rate %
Europe	**467,472**		467,393		424,561	
Demand and other non-interest bearing	**71,342**		72,743		62,869	
Demand interest bearing	**242,769**	**0.4**	220,314	0.4	203,727	0.4
Savings	**62,626**	**1.8**	57,070	1.7	51,793	1.8
Time	**59,034**	**1.3**	67,499	1.5	60,140	1.2
Other	**31,701**	**0.5**	49,767	0.7	46,032	0.5
Hong Kong	**325,909**		307,513		280,733	
Demand and other non-interest bearing	**34,714**		31,694		27,412	
Demand interest bearing	**236,198**		219,581		202,330	
Savings	**39,752**	**0.8**	38,283	0.7	37,119	0.5
Time	**14,252**	**1.0**	16,910	1.0	12,793	0.7
Other	**993**	**0.3**	1,045	0.3	1,079	0.2
Rest of Asia-Pacific	**179,587**		170,008		142,807	
Demand and other non-interest bearing	**20,914**		19,283		16,418	
Demand interest bearing	**78,563**	**1.0**	74,636	1.1	63,033	1.0
Savings	**67,424**	**2.9**	63,500	2.8	51,757	2.4
Time	**12,381**	**1.0**	11,815	1.0	10,734	0.9
Other	**305**	**3.6**	774	2.2	865	2.2
Middle East and North Africa	**37,604**		36,105		32,747	
Demand and other non-interest bearing	**14,564**		13,016		11,873	
Demand interest bearing	**10,967**	**0.6**	9,887	0.6	6,315	1.5
Savings	**11,555**	**3.0**	12,596	3.2	13,774	2.8
Time	**452**	**2.2**	530	2.5	604	2.6
Other	**66**	**1.5**	76		181	0.1
North America	**153,057**		165,779		157,361	
Demand and other non-interest bearing	**28,403**		26,524		22,235	
Demand interest bearing	**38,419**	**0.3**	35,440	0.3	28,569	0.2
Savings	**68,039**	**0.7**	75,866	0.8	78,040	0.8
Time	**9,587**	**0.4**	13,835	0.4	17,975	0.8
Other	**8,609**	**0.2**	14,114	0.1	10,542	0.6
Latin America	**73,323**		89,603		77,618	
Demand and other non-interest bearing	**14,203**		14,815		12,407	
Demand interest bearing	**8,258**	**2.2**	8,374	1.7	6,270	1.2
Savings	**35,294**	**7.5**	47,197	9.8	41,784	8.5
Time	**13,095**	**4.0**	16,567	3.9	15,716	3.9
Other	**2,473**	**4.7**	2,650	7.2	1,441	7.5

Total	**1,236,953**		1,236,401		1,115,827	
Demand and other non-interest bearing	**184,140**		178,075		153,214	
Demand interest bearing	**615,175**	**0.4**	568,232	0.4	510,244	0.3
Savings	**284,690**	**2.4**	294,512	2.9	274,267	2.5
Time	**108,801**	**1.5**	127,156	1.6	117,962	1.4
Other	**44,147**	**0.7**	68,426	0.9	60,140	0.7

Table of Contents

HSBC HOLDINGS PLC

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

Customer accounts by country

	At 31 December	
	2012	2011
	US$m	US$m
Europe	**555,009**	493,404
UK	**426,144**	373,737
France[61]	**55,578**	55,278
Germany	**15,611**	8,738
Malta	**5,957**	5,695
Switzerland[62]	**20,211**	19,888
Turkey	**7,629**	6,809
Other	**23,879**	23,259
Hong Kong	**346,208**	315,345
Rest of Asia-Pacific	**183,621**	174,012
Australia	**20,430**	18,802
India	**10,415**	10,227
Indonesia	**6,512**	6,490
Mainland China	**35,572**	31,570
Malaysia	**17,641**	16,970
Singapore	**47,862**	44,447
Taiwan	**12,497**	11,659
Vietnam	**2,147**	1,834
Other	**30,545**	32,013
Middle East and North Africa		
(excluding Saudi Arabia)	**39,583**	36,422
Egypt	**7,548**	7,047
Qatar	**2,704**	2,796
UAE	**18,448**	18,172
Other	**10,883**	8,407
North America	**149,037**	155,982
US	**90,627**	97,542
Canada	**47,049**	45,510
Bermuda	**11,361**	12,930
Latin America	**66,556**	78,760
Argentina	**5,351**	4,878
Brazil	**30,144**	42,410
Mexico	**22,724**	21,772
Panama	**5,940**	5,463
Other	**2,397**	4,237

Total	**1,340,014**	1,253,925

For footnotes, see page 120.

Table of Contents

HSBC HOLDINGS PLC

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

Certificates of deposit and other money market instruments

	2012		2011		2010	
	Average balance US$m	**Average rate %**	Average balance US$m	Average rate %	Average balance US$m	Average rate %
Europe	**32,602**	**0.4**	46,641	0.6	57,018	0.4
Hong Kong	**1,458**	**0.9**	932	1.0	213	3.8
Rest of Asia-Pacific	**3,863**	**3.0**	3,951	3.4	3,529	3.4
Middle East and North Africa					68	0.5
North America	**9,339**	**0.6**	10,936	0.5	10,607	0.5
Latin America	**7,344**	**8.5**	5,499	9.2	1,126	4.0
	54,606	**1.8**	67,959	1.4	72,561	0.6

Certificates of deposit and other time deposits

The maturity analysis of certificates of deposit (CD s) 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 2012				
	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	**65,352**	**11,384**	**7,321**	**12,361**	**96,418**
Certificates of deposit	**14,205**	**4,689**	**869**		**19,763**
Time deposits:					
banks	**10,205**	**1,636**	**111**	**9,138**	**21,090**
customers	**40,942**	**5,059**	**6,341**	**3,223**	**55,565**
Hong Kong	**12,850**	**1,742**	**504**	**593**	**15,689**
Certificates of deposit	**50**	**637**	**319**	**537**	**1,543**
Time deposits:					
banks	**2,194**	**107**	**4**		**2,305**
customers	**10,606**	**998**	**181**	**56**	**11,841**
Rest of Asia-Pacific	**13,529**	**809**	**1,035**	**1,308**	**16,681**
Certificates of deposit	**1,120**	**78**	**771**	**687**	**2,656**
Time deposits:					
banks	**2,870**	**18**	**3**	**29**	**2,920**

customers	9,539	713	261	592	11,105
Middle East and North Africa	1,220	15	16	74	1,325
Time deposits:					
banks	975	10			985
customers	245	5	16	74	340
North America	11,670	924	1,106	416	14,116
Time deposits:					
banks	5,112	14	198		5,324
customers	6,558	910	908	416	8,792
Latin America	10,269	1,617	1,612	1,683	15,181
Certificates of deposit	43	255	261	107	666
Time deposits:					
banks	1,001	383	477	611	2,472
customers	9,225	979	874	965	12,043
Total	114,890	16,491	11,594	16,435	159,410
Certificates of deposit	15,418	5,659	2,220	1,331	24,628
Time deposits:					
banks	22,357	2,168	793	9,778	35,096
customers	77,115	8,664	8,581	5,326	99,686

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

Economic loss

Our internal performance measures include economic profit/(loss), a calculation which compares the return on financial capital invested in HSBC by our shareholders with the cost of that capital. We price our cost of capital internally and the difference between that cost and the post-tax profit attributable to ordinary shareholders represents the amount of economic profit/(loss) generated.

Our long-term cost of capital is reviewed annually and is 11% for 2012; this remains unchanged from 2011. However, it has been revised to 10% for 2013, primarily due to a reduction in the risk-free rate, reflecting the continued intervention of central banks, quantitative easing and the flight to

quality, and greater banking sector stability through higher levels of capital and liquidity.

The following commentary is on a reported basis.

The return on invested capital fell by 2.2 percentage points to 8.0%, which was 3.0 percentage points lower than our benchmark cost of capital. Our economic loss was US$5.1bn, a deterioration of US$3.7bn compared with the loss in 2011. This reflected higher average invested capital and a decrease in profits attributable to ordinary shareholders, 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, an increase in notable cost items and a higher tax charge in 2012.

	2012		2011	
	US$m	**%[63]**	US$m	%[63]
Average total shareholders equity	**166,820**		156,129	
Adjusted by:				
Goodwill previously amortised or written off	**8,399**		8,123	
Property revaluation reserves	**(896)**		(914)	
Reserves representing unrealised losses on effective cash flow hedges	**55**		287	
Reserves representing unrealised losses on available-for-sale securities	**1,185**		3,379	
Preference shares and other equity instruments	**(7,256)**		(7,256)	
Average invested capital[64]	**168,307**		159,748	
Return on invested capital[65]	**13,454**	**8.0**	16,224	10.2
Benchmark cost of capital	**(18,514)**	**(11.0)**	(17,572)	(11.0)
Economic loss and spread	**(5,060)**	**(3.0)**	(1,348)	(0.8)

For footnotes, see page 120.

Table of Contents

HSBC HOLDINGS PLC

Report of the Directors: Operating and 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 26.

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 Card and Retail Services business which was sold in 2012.

The Card and Retail Services 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 pre-tax loss for Card and Retail Services in the table below 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)

	2012			2011		
	Pre-tax return	**Average RWAs[66]**	**RoRWA[66,67]**	Pre-tax return	Average RWAs[66]	RoRWA[66,67]
	US$m	**US$bn**	**%**	US$m	US$bn	%
Reported	**20,649**	**1,172**	**1.8**	21,872	1,154	1.9
Underlying[67]	**16,385**	**1,129**	**1.5**	13,861	1,077	1.3

Run-off portfolios	**(1,630)**	**167**	**(1.0)**	(4,901)	169	(2.9)
Legacy credit in GB&M	**(280)**	**45**	**(0.6)**	(429)	33	(1.3)
US CML and other[68]	**(1,350)**	**122**	**(1.1)**	(4,472)	136	(3.3)
Card and Retail Services	**(150)**	**5**	**(3.0)**			
Underlying (excluding run-off portfolios and Card and Retail Services)	**18,165**	**957**	**1.9**	18,762	908	2.1

For footnotes, see page 120.

Reconciliation of reported and underlying average risk-weighted assets

	Year ended 31 December		
	2012	2011	Change
	US$bn	US$bn	%
Average reported RWAs[66]	**1,172**	1,154	2
Currency translation adjustment[24]		(7)	
Acquisitions, disposals and dilutions	**(43)**	(70)	
Average underlying RWAs[66]	**1,129**	1,077	5

Disposals, held for sale and run-off portfolios

In implementing our strategy, we have sold or agreed to sell a number of businesses and investments across the Group. The sale of these businesses and investments will have a significant effect on both our revenue and profitability in the future. In addition, we have substantial portfolios which are being run down. We expect the losses on these portfolios to continue to affect the Group in the future.

The table below presents the contribution of these businesses and investments to the historical results of the Group. We do not expect the historical results to be indicative of future results because of disposals or run-offs. Fixed allocated costs, included in total operating costs, will not necessarily be removed upon disposal and have been separately identified.

Table of Contents

HSBC HOLDINGS PLC

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

Summary income statements for disposals, held for sale and run-off portfolios[69,70]

	2012					
				Held	Run-off portfolios	
	Card and Retail Services	Ping An	Other disposals	for sale excluding US CML	US CML and other[71]	Legacy credit in GB&M
	US$m	U$m	US$m	US$m	US$m	US$m
Net interest income/(expense)	1,267		352	303	2,561	(28)
Net fee income/(expense)	395		13	(35)	33	(17)
Net trading income/(expense)			67	22	(226)	99
Net income/(expense) from financial instruments designated at fair value			3	5	(785)	10
Gains less losses from financial investments			8	27		(72)
Dividend income					3	
Net earned insurance premiums			430	315		
Other operating income/(expense)	7		10	5	37	(3)
Total operating income/(expense)	1,669		883	642	1,623	(11)
Net insurance claims incurred and movement in liabilities to policyholders			(218)	(225)		
Net operating income/(expense)[21]	1,669		665	417	1,623	(11)
Loan impairment charges and other credit risk provisions	(322)		(16)	(77)	(2,569)	(168)
Net operating income/(expense)	1,347		649	340	(946)	(179)
Total operating expenses	(729)		(467)	(344)	(1,106)	(101)
Operating profit/(loss)	618		182	(4)	(2,052)	(280)
Share of profit in associates and joint ventures		763	12	9	2	
Profit/(loss) before tax	618	763	194	5	(2,050)	(280)
By global business						
Retail Banking and Wealth Management	618	622	99	(29)	(1,274)	
Commercial Banking		82	40	24	9	
Global Banking and Markets		59	65	28		(280)
Global Private Banking			(9)			
Other			(1)	(18)	(785)	
Profit/(loss) before tax	618	763	194	5	(2,050)	(280)
By geographical region						
Europe			(1)			(281)
Hong Kong			45			1
Rest of Asia-Pacific		763	(31)	22		(2)
Middle East and North Africa			46			
North America	618		25	(25)	(2,050)	2
Latin America			110	8		

Profit/(loss) before tax	**618**	**763**	**194**	**5**	**(2,050)**	**(280)**
Other information						
Gain on sale	**3,148**	**3,012**	**1,579**			
Fixed allocated costs included in total operating expenses	**188**		**77**	**52**	**230**	
	US$bn	**US$bn**	**US$bn**	**US$bn**	**US$bn**	**US$bn**
Reduction in RWAs on disposal[72]	**39.3**	**24.9**	**7.5**	**8.8**		
RWAs[72]				**9.3**	**107.1**	**38.6**
	%	**%**	**%**	**%**	**%**	**%**
Share of HSBC s profit before tax	**3.0**	**3.7**	**0.9**		**(10.0)**	**(1.4)**
Cost efficiency ratio	**43.7**		**70.2**	**82.5**	**68.1**	

For footnotes, see page 120.

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

Ratio of earnings to fixed charges[96]

	2012	2011	2010	2009	2008
Ratio of earnings to fixed charges					
excluding interest on deposits	**7.39**	7.34	7.10	2.99	3.17
including interest on deposits	**1.76**	1.68	1.73	1.22	1.14
Ratio of earnings to combined fixed charges and preference share dividends					
excluding interest on deposits	**5.79**	5.95	5.89	2.64	2.97
including interest on deposits	**1.71**	1.64	1.69	1.20	1.13

For footnote, see page 120.

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

Critical accounting policies

(Audited)

Introduction

The results of HSBC are sensitive to the accounting policies, assumptions and estimates that underlie the preparation of our consolidated financial statements. The significant accounting policies are described in Note 2 on the Financial Statements.

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 majority of the collectively assessed loan impairment allowances are in North America, where they were US$5.2bn, representing 54% (2011: US$6.8bn; 62%) of the Group s total collectively assessed loan impairment allowances and 32% of the Group s total impairment allowances. Of the North American collective impairment allowances approximately 86% (2011: 75%) 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 inherent 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.

In 2012, a portfolio risk factor adjustment of US$225m was made to increase the collective 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.

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 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

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

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. 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$0.5bn at 31 December 2012 (2011: US$0.7bn).

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 23 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 2012 (2011: 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.

During 2012, no impairment of goodwill was identified (2011: nil). In addition to the annual impairment test which was performed as at 1 July 2012, management reviewed the current and expected performance of the CGUs as at 31 December 2012 and determined that there was no indication of potential impairment of the goodwill allocated to them, except for the GB&M Europe CGU, which experienced significantly reduced profitability in the second half of 2012 compared with the first half of 2012. The reduced forecast profitability resulted in a reduction in the recoverable amount of the CGU over its carrying amount (headroom). Consequently, the results of the goodwill impairment testing for this CGU are more sensitive to key assumptions used. Management retested the goodwill

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

for this CGU and concluded that there was no impairment.

Note 23 on the Financial Statements includes details of the CGUs with significant balances of goodwill, states the key assumptions used to assess the goodwill in each of those CGUs for impairment and provides a discussion of the sensitivity of the carrying value of goodwill to changes in key assumptions.

Valuation of financial instruments

Our accounting policy for determining the fair value of financial instruments is described in Note 2d on the Financial Statements. The best evidence of fair value is a quoted price 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 market inputs that are unobservable. Valuation techniques that rely to a greater extent on unobservable inputs require a higher level of management judgement to calculate a fair value than those based wholly on observable inputs.

Valuation techniques used to calculate fair values are discussed in Note 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 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$718bn (2011: US$665bn) and US$622bn (2011: US$569bn), respectively, were determined using valuation techniques which represented 60% (2011: 61%) and 83% (2011: 82%), respectively, of financial assets and liabilities measured at fair value.

The methodology for estimating credit valuation adjustments (CVA) and debit valuation adjustments (DVA) has been revised as at 31 December 2012 as a result of changing market practices in response to regulatory and accounting changes, as well as general market developments.

A key input into the calculation of CVA is the probability of default (PD). Prior to the revision of the methodology, the PD was based on HSBC s internal credit rating for the counterparty. The revised methodology maximises the use of PD based on market-observable data, such as credit default swap (CDS) spreads. Where CDS spreads are not available, PDs are estimated having regard to market practice, considering relevant data including CDS indices and historical rating transition matrices. In addition, HSBC aligned its methodology for determining DVA to be consistent with that applied for CVA as at 31 December 2012. Historically, HSBC considered that a zero spread was appropriate in respect of own credit risk and consequently did not adjust derivative liabilities for its own credit risk.

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

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

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.

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$4.6bn or 61% (2011: US$5.2bn; 68%) 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 32 on the Financial Statements discloses the major categories of provisions recognised. The closing balance of provisions amounted to US$5.3bn (2011: US$3.3bn), of which US$1.7bn (2011: US$1.5bn) relates to legal proceedings and regulatory matters and US$2.4bn (2011: US$1.1bn) relates to customer remediation.

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 cases 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 2012 Financial Statements.

Report of the Directors: Operating and 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 79). 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 25) unless stated otherwise.

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 .

The 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 are included in the North America (US$1.5bn) and Europe (US$0.4bn) geographical regions, and in Other for the purposes of the segmentation by global business.

Profit/(loss) before tax

	2012		2011		2010	
	US$m	**%**	US$m	%	US$m	%
Retail Banking and Wealth Management	**9,575**	**46.4**	4,270	19.6	3,839	20.2
Commercial Banking	**8,535**	**41.3**	7,947	36.3	6,090	32.0
Global Banking and Markets	**8,520**	**41.3**	7,049	32.2	9,215	48.4
Global Private Banking	**1,009**	**4.9**	944	4.3	1,054	5.5
Other[73]	**(6,990)**	**(33.9)**	1,662	7.6	(1,161)	(6.1)
	20,649	**100.0**	21,872	100.0	19,037	100.0

Total assets[74]

	At 31 December			
	2012		2011	
	US$m	**%**	US$m	%
Retail Banking and Wealth Management	**536,244**	**19.9**	540,548	21.2
Commercial Banking	**363,659**	**13.5**	334,966	13.1
Global Banking and Markets	**1,942,470**	**72.1**	1,877,627	73.5
Global Private Banking	**118,440**	**4.4**	119,839	4.7
Other	**201,741**	**7.5**	180,126	7.0
Intra-HSBC items	**(470,016)**	**(17.4)**	(497,527)	(19.5)
	2,692,538	**100.0**	2,555,579	100.0

For footnotes, see page 120.

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

Risk-weighted assets

	At 31 December			
	2012		2011	
	US$bn	**%**	US$bn	%
Retail Banking and Wealth Management	**276.6**	**24.6**	351.2	29.0
Commercial Banking	**397.0**	**35.3**	382.9	31.7
Global Banking and Markets	**403.1**	**35.9**	423.0	35.0
Global Private Banking	**21.7**	**1.9**	22.5	1.9
Other	**25.5**	**2.3**	29.9	2.4
	1,123.9	**100.0**	1,209.5	100.0

Selected items included in profit before tax by global business

Acquisitions, disposals and dilutions[75]

	2012	2011	2010
	US$m	US$m	US$m
Retail Banking and Wealth Management	**5,574**	3,328	3
Commercial Banking	**594**	76	119
Global Banking and Markets	**149**	114	262
Global Private Banking	**55**	(9)	
Other[73]	**3,107**	141	250
	9,479	3,650	634

For footnotes, see page 120.

Table of Contents

HSBC HOLDINGS PLC

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

Products and services

Retail Banking and Wealth Management

RBWM serves over 54 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, Global 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.

Commercial Banking

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

We segment our CMB business into Corporate, to serve both corporate and mid-market companies with more sophisticated financial needs, and Business Banking, to serve SMEs, enabling differentiated coverage of our target customers. This allows us to provide continuous support to companies 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.

selected countries.

International 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.

HSBC HOLDINGS PLC

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

Global Banking and Markets

GB&M provides tailored financial solutions to major government, corporate and institutional clients and private investors worldwide. Managed as a global business, GB&M operates a long-term relationship management approach to build a full understanding of clients financial requirements. Sector-focused client service teams comprising relationship managers and product specialists develop financial solutions to meet individual client needs. With 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.

GB&M is managed as two principal business lines: Global Markets and Global Banking. This structure allows us to focus on relationships and sectors that best fit the Group s geographic reach and facilitate seamless delivery of our products and services to clients.

In addition, Balance Sheet Management is responsible for the management of liquidity and funding. It also manages structural interest rate positions within the Global Markets limit structure.

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

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

capital raising, advisory services, bilateral and syndicated lending, leveraged and acquisition finance, structured and project finance, lease finance and non-retail deposit taking;

international, regional and domestic payments and cash management services; and trade services for large corporate clients.

Global Private Banking

GPB provides investment management and trustee solutions to high net worth individuals and their families globally. We aim to meet the needs of our clients by providing excellent customer service, utilising our global reach 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, security 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.

Table of Contents

HSBC HOLDINGS PLC

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

Retail Banking and Wealth Management

RBWM provides banking and wealth management services for our personal customers to help them to manage their finances and protect and build their financial futures.

	2012 US$m	2011 US$m	2010 US$m
Net interest income	**20,298**	24,101	24,166
Net fee income	**7,205**	8,226	8,397
Other income	**6,358**	1,206	1,048
Net operating income[21]	**33,861**	33,533	33,611
LICs[76]	**(5,515)**	(9,319)	(11,259)
Net operating income	**28,346**	24,214	22,352
Total operating expenses	**(19,769)**	(21,202)	(19,539)
Operating profit	**8,577**	3,012	2,813
Income from associates[77]	**998**	1,258	1,026
Profit before tax	**9,575**	4,270	3,839
RoRWA[66]	**3.1%**	1.2%	1.1%

Underlying revenue growth

in all faster-growing regions

Announced

34

disposals or closures since

the start of 2011 and completed

12

in 2012

Best in Wealth Management

in Hong Kong

(The Asian Banker, March 2012)

Strategic direction

RBWM provides retail banking and wealth management services for personal customers in markets where we have, or can build, the scale 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.

For footnotes, see page 120.

The commentary is on a constant currency basis unless stated otherwise.

Review of performance

- RBWM reported profit before tax of US$9.6bn compared with US$4.3bn in 2011 (US$4.2bn on a constant currency basis). This included net gains resulting from a number of strategic transactions, including US$3.7bn from the disposals of the Card and Retail Services (CRS) business and non-strategic branches in the US.
- On an underlying basis, profit before tax increased by US$3.1bn, largely driven by lower loan impairment charges in the US run-off portfolio and higher insurance profits in Hong Kong and Brazil. These were partly offset by charges relating to the customer redress programmes in the UK of US$1.8bn, compared with US$868m in 2011 (US$875m as reported).

RBWM profit/(loss) before tax

	2012 US$m	2011 US$m	2010 US$m
RBWM excluding US CRS and US run-off portfolio	**7,083**	6,681	5,936
US CRS	**3,766**	2,061	1,979
US run-off portfolio	**(1,274)**	(4,472)	(4,076)
	9,575	4,270	3,839

- Loss before tax in the US run-off portfolio declined significantly, mainly due to lower loan impairment charges reflecting the decline in average lending balances. In addition, revenue benefited from lower adverse movements on the fair value of non-qualifying hedges in HSBC Finance of US$227m, compared with US$1.2bn in 2011. This was partly offset by a fall in net interest income largely driven by the continued reduction in lending balances.

Profit before tax for RBWM excluding US CRS and the US run-off portfolio increased by US$472m, with revenue growth in Hong Kong, Latin America and Rest of Asia-Pacific partly offset by a fall in profit in the UK due to a US$883m increase in customer redress provisions and the non-recurrence of a credit of US$256m (US$264m as reported) relating to defined benefit pension obligations.

Revenue grew by 13% in Hong Kong reflecting wider deposit spreads, higher lending and deposit balances and the gains on sale of the general insurance businesses and our shares in Global Payments Asia-Pacific Ltd. Insurance income also increased due to higher investment returns and strong sales and renewals of life insurance products. This was partly offset by the

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

non-recurrence of the implementation benefit from refining the PVIF asset calculation in 2011.

Revenue in Rest of Asia-Pacific increased by 3% due to the gain on sale of our operations in Thailand, partly offset by the loss of operating revenues associated with this disposal and the discontinuation of our HSBC Premier (Premier) service in Japan. Net interest income remained broadly in line with 2011. Mortgage and deposit balances grew, primarily in Singapore, mainland China, Australia and Malaysia, although the effect was offset by narrower asset and deposit spreads.

In Latin America, revenue grew by 6%, driven by higher insurance revenues from strong sales of unit-linked pension and term life products and the favourable effect of the recognition of a PVIF asset (US$144m) in Brazil. In addition, we reported a gain on sale of the general insurance business in Argentina. Net interest income increased due to growth in personal loans and deposit balances. Growth was partly offset by the loss on sale of certain businesses as well as the non-recurrence of gains on the sale and leaseback of branches and the sale of HSBC Afore, both in Mexico during 2011.

In Europe, revenue remained broadly in line with 2011. Revenue decreased in the UK, largely driven by deposit spread compression. This was partly offset by higher mortgage spreads and average balances in the UK and business expansion in Turkey, which led to higher net interest income following growth in personal lending and mortgage balances.

Loan impairment charges in RBWM excluding US CRS and the US run-off portfolio were broadly in line with 2011. Reductions in Europe, driven by lower delinquencies across both the secured and unsecured lending portfolios, particularly in the UK, were offset by higher impairments in Brazil, where delinquency rates increased as economic growth slowed in 2012.

Operating expenses in RBWM excluding US CRS and the US run-off portfolio increased only modestly, despite significantly higher customer redress provisions and the non-recurrence of a pension credit in the UK. Excluding these items, expenses decreased through both our organisational effectiveness programmes and the transactions undertaken as part of our portfolio management activities, detailed below. These led to a reduction of more than 13,500 FTEs, with all regions contributing to sustainable cost savings of more than US$350m.

Share of profit from associates and joint ventures decreased by 22%, mainly from Ping An due to market valuation losses on equity securities held by their insurance business, reflecting volatile domestic equity markets. Following the disposal of our associate, Ping An, our remaining shareholding has been classified as a financial investment.

Strategic imperatives

Developing a high standard of wealth management for retail customers

In 2012, we accelerated the transformation of the Wealth Management business in HSBC, investing significantly in infrastructure to improve customer experience and revenue generation, although further progress is required to achieve our strategic goals.

Wealth Management revenues increased by over US$550m in 2012 to US$6.4bn, primarily due to growth from insurance, mutual funds and foreign exchange. Wealth insurance revenues improved, driven by higher investment returns, notably in Hong Kong and France and strong sales of life insurance products in Hong Kong and Brazil. Mutual funds sales grew, with revenues increasing by 17% to US$935m. Revenues from foreign exchange transactions benefited from infrastructure investments, including the successful deployment of our web-enabled foreign currency Get Rate system across key markets in Europe and Asia towards the end of 2011.

Foreign exchange services are a core component of our wealth strategy, and we continue to invest in order to further enhance our customer offering. By 31 December 2012, over 220,000 of our customers were using our Global View and Global Transfer products, making cross-border transfers amounting to more than US$13bn in the year. We enhanced our international wire services by improving limits and pricing. We also completed the online launch of dual-currency deposits in Asian markets, and improved market access for foreign exchange trading.

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

Sales of our long-term fund products, including our managed solutions, continued to grow. We launched the HSBC Asia Focused Income Fund in May which grew to US$1bn by the end of 2012. World Selection and Premier Investment Management Services for retail customers continued to grow, with total net sales amounting to US$2bn during the year, resulting in a 20% increase to US$19bn in FuM related to these portfolios.

HSBC Global Asset Management s investment performance was strong in 2012, with over 70% of its Equity, Multi-Asset and Fixed Income funds by value ranking above median. As a result, 71% of eligible funds were in the top two quartiles over the three-year period to 31 December 2012.

We made significant investments to reinforce the wealth risk management framework, introducing enhanced risk profiling and strategic financial planning tools to enable more effective control of compliance and regulatory risks.

As part of the drive to enhance customer experience, we started the global roll-out of a new Wealth Dashboard, which allows customers easy access and analysis of personal holdings and enables ongoing comparison with reference portfolios. Additionally, in a number of markets we introduced a global insurance point-of-sale system which offers customers a faster, more integrated service.

Leveraging global expertise in retail banking

We continued to enhance our digital banking capabilities with the launch of the first mobile payment solution in Hong Kong enabling contactless credit card transactions through Visa payWave terminals, the first deployment of a global application platform in the US, and the roll-out of mortgage digital sales tools in the UK, India, UAE and Malaysia.

Our business re-engineering programme is driving cost reduction and efficiency improvements through standardisation. We used our global scale to improve cost controls and progressively standardised the design of our Contact Centres. In addition, we are successfully deploying enhanced analytical capabilities to improve customer experience.

Portfolio management to drive superior returns

Good progress was made in portfolio management activities with 17 disposals or closures announced in 2012 and a further four in 2013, following the 13 announced in 2011, and 12 transactions completed in 2012. During 2012, we completed the sale or closure of our retail businesses in Thailand, Honduras, El Salvador and Costa Rica, disposed of the Card and Retail Services business and upstate New York branches in the US and the full service retail brokerage business in Canada and recorded an investment loss on a subsidiary. Additionally, we announced the sale of our retail banking operations in Colombia, Peru, Uruguay, Paraguay and Pakistan and the closure of the consumer finance business in Canada. In December 2012 we disposed of our associate, Ping An, with our remaining shareholding classified as a financial investment, and also completed the sale of our shares in Global Payments Asia-Pacific Ltd. Following completion of all the announced transactions we will have refocused our business to 20 home and priority markets (representing 98% of 2012 profit before tax) and a limited number of network and small markets.

We are exiting the general insurance manufacturing business and focusing on life insurance manufacturing where we have scale. In 2012, we completed the sale of our general insurance businesses in Hong Kong, Singapore, Argentina and Ireland, announced the sale of our insurance manufacturing businesses in the US and Taiwan and reached an agreement to sell a portfolio of general insurance assets and liabilities in Mexico.

In October 2012, we completed the acquisition of the onshore retail banking business of Lloyds Banking Group in the UAE, following the merger in the second quarter of our Omani operations with OIB.

We remained focused on managing the run-off of balances in our CML portfolio, with year-end lending balances, including loans held for sale, declining by 14% from December 2011 to US$43bn. In the third quarter of 2012, we reclassified US$3.7bn of non-real estate personal loan balances, net of impairment allowances, from our consumer finance portfolio to Assets held for sale as we actively marketed the portfolio. We also identified real estate secured loan balances which we plan to actively market in multiple transactions over the next two years.

Table of Contents

HSBC HOLDINGS PLC

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

Commercial Banking

CMB offers a full range of commercial financial services and tailored solutions to more than three million customers ranging from small and medium-sized enterprises to publicly quoted companies in more than 60 countries.

	2012 US$m	2011 US$m	2010 US$m
Net interest income	**10,361**	9,931	8,487
Net fee income	**4,470**	4,291	3,964
Other income	**1,720**	1,389	1,383
Net operating income[21]	**16,551**	15,611	13,834
LICs[76]	**(2,099)**	(1,738)	(1,805)
Net operating income	**14,452**	13,873	12,029
Total operating expenses	**(7,598)**	(7,221)	(6,831)
Operating profit/(loss)	**6,854**	6,652	5,198
Income from associates[77]	**1,681**	1,295	892
Profit/(loss) before tax	**8,535**	7,947	6,090
RoRWA[66]	**2.2%**	2.2%	2.0%

Record reported profit before tax

US$8.5bn

9%

increase in customer deposits, driven by Payments

and Cash Management

Number one global trade finance

bank in the world

(Oliver Wyman Global Transaction Banking Survey 2012)

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 four strategic imperatives:

- focus on faster-growing markets while connecting revenue and investment flows with developed markets;
- capture growth in international SMEs and corporate businesses;
- enhance collaboration across all global businesses to provide our customers with access to the full range of the Group s services; and
- simplify processes and enhance risk management controls by adopting a global operating model.

For footnotes, see page 120.

The commentary is on a constant currency basis unless stated otherwise.

Review of performance

- CMB reported a record profit before tax of US$8.5bn in 2012, 7% higher than in 2011. On a constant currency basis, profit before tax increased by 10%. This included gains totalling US$468m mainly from the sale of branches in the US, the disposal of general insurance businesses in Argentina and Hong Kong and the sale of our shares in Global Payments Asia-Pacific Ltd in Hong Kong.
- On an underlying basis, profit before tax increased by 3%. This was driven by strong revenue growth and higher income from our associates, substantially offset by a rise in operating expenses which reflected the effect of notable cost items that included a customer redress provision of US$268m relating to interest rate protection products in the UK. Loan impairment charges also rose, driven by higher individually assessed provisions in Europe and Rest of Asia-Pacific, and a rise in collective charges in Latin America.
- *Revenue* grew by 10% in the year, with increases in all regions. This reflected strong net interest income growth, higher net fee income and a rise in other income driven by the gains on disposals.
- *Net interest income* increased by 8% as a result of average balance sheet growth. Customer loans and advances rose 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 higher trade-related lending as demand for export finance increased. In Europe, despite muted demand for credit, net interest income from lending activities also rose as a result of growth in average lending balances, notably in the UK. Net interest income from customer accounts rose as we continued to attract deposits through our Payments and Cash Management products. Net interest income from deposits also benefited from higher liability spreads in Hong Kong, reflecting an increase in short-term interest rates.
- *Net fee income* benefited from higher transaction volumes of Payments and Cash Management products, mainly in Europe, Latin America and Hong Kong. Net fee income from Global Trade and Receivables Finance products also rose in Hong Kong, due to continued demand for export finance as we captured international trade and capital flows, and in Europe as we continued to expand our Trade and Commodity and Structured Trade Finance offerings. In addition,

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

our collaboration with GB&M led to higher revenues generated primarily from sales of foreign exchange products.

Loan impairment charges and other credit risk provisions increased by US$442m, driven by higher individually assessed loan impairments in Europe, reflecting the challenging economic conditions in the UK, Greece, Spain and Turkey, and in Rest of Asia-Pacific in respect of a small number of customers in our Corporate segment. Collective impairment provisions also rose in Latin America, mainly in Brazil from increased delinquency in the Business Banking portfolio.

Operating expenses increased by 10%, primarily due to a US$268m customer redress provision relating to interest rate protection products in the UK (see page 32). The rise in costs also reflected the non-recurrence of a credit in 2011 of US$206m (US$212m as reported), arising from a change in the measurement of defined benefit pension obligations in the UK. In addition, we continued to invest in and strengthen our Risk and Compliance function as part of our global operating model. Operating expenses also increased in our faster-growing regions of Latin America and Rest of Asia-Pacific due to inflationary pressures and continued investment in front line and support staff.

Income from associates grew by 28% as our associates in mainland China benefited from a rise in lending and associated fee income, reflecting continued economic growth.

Strategic imperatives

Focus on faster-growing markets while connecting with developed markets

We continued to position the business for growth, maintaining our investment in our faster-growing regions, where revenues rose by 12 percentage points from 2011 and represented over 54% of our revenues. Our top 20 markets contributed over 90% of our profit before tax in 2012, with 14 of these countries located in the faster-growing regions.

Our strong network helps connect customers with both developed and developing markets as they expand internationally. During 2012, we were the first bank to settle cross-border renminbi trade across six continents with our ability to provide related services in over 50 countries offering a competitive advantage to
our customers as the renminbi is positioned as a major global trade and investment currency. We have expanded our global network of dedicated China desks to cover our top markets, representing about half of the world s GDP. These are staffed by Mandarin-speaking experts who support mainland Chinese businesses to identify new opportunities to expand overseas.

As reported in the *Oliver Wyman Global Transaction Banking Survey 2012*, we maintained our position as the world s largest global trade finance bank with a market share of global trade finance revenue that increased from 9% in 2011 to 10% in the first half of 2012, in spite of a slowdown in world trade growth. Our Global Trade and Receivables Finance revenues increased by 11% as our network provided customers with access to over 75% of world trade flows. In addition, we continued to expand our Commodity and Structured Trade Finance offering across CMB and GB&M, establishing new teams in four countries, which brought the total to seven by the end of 2012. Our team of product specialists more than doubled from 31 at the end of 2011 to 78 across Europe, Hong Kong and Rest of Asia-Pacific, with plans for further expansion in Latin America, Middle East and North Africa, North America and additional countries in Rest of Asia-Pacific by the end of 2013.

International payments volumes in Payments and Cash Management have grown at twice the rate of the market globally since 2010 with year-on-year revenue increasing by 15% in 2012. This growth reflected new mandates and investments in new products such as HSBCnet mobile to improve our customers experience. Double digit revenue growth was reported in the UK, Brazil and Hong Kong, all of which are top markets for CMB, reflecting the strength of the franchise in both developed and developing markets. In 2012, HSBC was the first bank to be named Best Cash Management Bank globally for both Financial Institutions and Non-Financial Institutions in the same year by *Euromoney s* customer survey. Also in this poll, we were named Best Domestic Cash Management Provider in over 20 countries.

Capture growth in international businesses

Our strong international network offers a distinctive presence in key markets with major trade flows, facilitating growth for international businesses. Our international customer base generated around 40% of our revenues.

Table of Contents

HSBC HOLDINGS PLC

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

In Business Banking, we continued to attract and serve an increasing number of international SMEs and further differentiated our service offering to them by extending our global network of specialist International Relationship Managers (IRM s) who focus on high value international clients. During 2012, we added over 165 IRMs in France, Brazil and the UK and plan to expand the model into other key Business Banking markets in 2013.

We continued to support SMEs through the economic recovery, with a particular focus on those with international aspirations. In the first half of 2012, we launched an international SME fund in the UK to support UK 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 our 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. Similarly, in the UAE, we launched our third SME fund of AED1bn (US$272m) targeted at international trade customers.

Our global expertise helped connect our customers with new market opportunities. We held three Global Connections International Exchanges in Brazil, mainland China and Dubai in 2012, where we were joined by clients from all of our top 20 markets who were able to make contacts, share their specialist market knowledge and identify new business opportunities.

Strong partnership with global businesses

Our collaboration with GB&M has delivered nearly US$0.7bn in incremental gross revenue since 2010. Gross revenues from sales of GB&M products to CMB customers which are shared across the two global businesses grew by over US$0.1bn in 2012 or by 5%, mainly driven by sales of foreign exchange products.

We continued to benefit from GB&M s e-FX platform to deliver our standard foreign exchange products to customers more efficiently. We also addressed demand for
alternative sources of finance, providing our customers with access to debt and equity capital markets and offering specialised financing, such as Project and Export Finance, via GB&M.

Dedicated executives are now in place in both CMB and GPB to promote cross-business referral activities and support the collaboration between the businesses. For example, the Global Priority Clients initiative was launched in 2012 to service the Group s largest ultra-high net worth clients corporate and personal needs jointly.

In 2012, we launched our trade credit insurance offering in Hong Kong, Brazil and the UK. It will be rolled out to further markets in the first half of 2013, including Turkey, France, Singapore and Malaysia.

Simplify processes and enhance risk management controls by adopting a global operating model

The successful adoption of a global model has enabled us to deliver a number of benefits, notably simplified processes for our customers, enhanced governance and compliance oversight, and sustainable cost savings across the business.

We have made significant progress in simplifying and reducing the time to complete our credit renewal process, implementing improvements in 17 key markets with further countries in scope for the first quarter of 2013. In addition, we have deployed a consistent model for cross-border account opening to facilitate the on-boarding of new international customers.

The sustainable cost savings of over US$100m achieved through process re-engineering and organisational effectiveness have been reinvested in both front line staff and our Risk and Compliance function. We introduced enhanced consistent Know Your Customer procedures, a global product governance board and dedicated resources to improve governance oversight. This investment, combined with our values-based approach to relationship management, is helping to foster a disciplined and constructive culture of risk management in CMB while encouraging balanced and sustainable growth.

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

Global Banking and Markets

GB&M provides tailored financial solutions to major government, corporate and institutional clients worldwide.

	2012 US$m	2011 US$m	2010 US$m
Net interest income	**6,960**	7,263	7,343
Net fee income	**3,329**	3,227	3,664
Net trading income[78]	**5,690**	5,204	5,830
Other income	**2,294**	1,363	2,075
Net operating income[21]	**18,273**	17,057	18,912
LICs[76]	**(670)**	(984)	(990)
Net operating income	**17,603**	16,073	17,922
Total operating expenses	**(9,907)**	(9,722)	(9,228)
Operating profit	**7,696**	6,351	8,694
Income from associates[77]	**824**	698	521
Profit before tax	**8,520**	7,049	9,215
RoRWA[66]	**2.1%**	1.8%	2.5%

Record reported revenues from

corporate and institutional

debt issuance

77%

of profit before tax

from faster-growing regions

Most Innovative

Investment Bank of the Year

(The Banker Investment Banking Awards 2012)

Strategic direction

GB&M continues to pursue its well-established emerging markets-led and financing-focused strategy, with the objective of being a leading international wholesale bank. 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 strategic imperatives:

- reinforce client coverage and client-led solutions for major government, corporate and institutional clients;
- continue to selectively invest in the business to support the delivery of an integrated suite of products and services;
- enhance collaboration with other global businesses, particularly CMB, to appropriately service the needs of our international client base; and
- focus on business re-engineering to optimise operational efficiency and reduce costs.

For footnotes, see page 120.

The commentary is on a constant currency basis unless stated otherwise.

Review of performance

GB&M reported profit before tax of US$8.5bn, 21% higher than in 2011. On a constant currency basis, profit before tax increased by 24% despite a significant net charge relating to credit and debit derivative valuation adjustments. The rise in profit before tax was driven by strong revenue growth, notably in Rates and Credit, together with significantly lower credit risk provisions than in 2011, partly offset by higher operating expenses. GB&M is well positioned for growth in faster-growing regions with record reported revenues in Hong Kong (US$2.8bn), Rest of Asia-Pacific (US$4.0bn) and Latin America (US$1.8bn).

In the fourth quarter a net charge of US$385m was reported in net trading income as a result of a change in estimation methodology in respect of credit valuation adjustments on derivative assets of US$903m and debit valuation adjustments on derivative liabilities of US$518m to reflect evolving market practices (see Note 15 on the Financial Statements).

Notwithstanding the charge noted above, *revenues* rose by 10%, primarily due to significantly higher trading revenues in Rates and Credit, notably in Europe, as spreads tightened and investor sentiment improved following stimuli by central banks globally. Balance Sheet Management reported higher gains on the disposal of available-for-sale debt securities, largely in the UK, while Payments and Cash Management benefited from growth in average liability balances, increased transaction volumes and new mandates. These increases were partly offset by a fall in revenues from our Equities business due to lower client activity as market volumes declined. Revenues in 2012 also included adverse fair value movements from own credit spreads on structured liabilities of US$629m compared with a favourable fair value movement of US$458m reported in 2011.

Loan impairment charges and other credit risk provisions decreased by US$300m compared with 2011. Credit risk provisions declined significantly, from US$515m in 2011 to US$117m in 2012, driven by lower impairment charges on Greek sovereign debt, and on available-for-sale ABSs in our legacy portfolio reflecting an improvement in underlying asset prices. This was partly offset by a US$97m increase in loan impairment charges as a result of a small number of specific impairments in

Table of Contents

HSBC HOLDINGS PLC

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

Global Banking and on the legacy credit loans and receivables portfolio.

Operating expenses increased by US$393m to US$9.9bn, predominantly due to a customer redress provision of US$330m relating to interest rate protection products in the UK (see page 32). Performance costs rose, albeit at a lower rate of growth than net operating income, which resulted in a lower total compensation ratio than in 2011. 2011 also included a credit of US$108m (US$111m as reported) relating to defined benefit pension obligations in the UK, which did not recur.

Management view of total operating income

	2012 US$m	2011 US$m	2010 US$m
Global Markets[79]	**8,733**	8,098	9,173
Credit	**779**	335	1,649
Rates	**1,771**	1,341	2,052
Foreign Exchange	**3,215**	3,272	2,752
Equities	**679**	961	755
Securities Services	**1,663**	1,673	1,511
Asset and Structured Finance	**626**	516	454
Global Banking	**5,568**	5,401	4,621
Financing and Equity Capital Markets	**3,071**	3,233	2,852
Payments and Cash Management[80]	**1,744**	1,534	1,133
Other transaction services[81]	**753**	634	636
Balance Sheet Management[82]	**3,738**	3,488	4,102
Principal Investments	**125**	209	319
Debit valuation adjustment	**518**		
Other[83]	**(409)**	(139)	697
Total operating income	**18,273**	17,057	18,912

Balance Sheet Management revenues included a notional tax credit on income earned from tax-exempt investments of US$116m in 2012 (2011: US$85m; 2010: US$50m), which is offset above within Other.

For footnotes, see page 120.

Included in the table above are the following amounts in relation to the change in credit valuation adjustment estimation methodology:

	2012 US$m
Credit	**(52)**
Rates	**(837)**

Foreign Exchange	**(7)**
Equities	**(7)**
Total	**(903)**

Global Markets delivered a strong performance in an uncertain financial and economic environment, in part due to a US$444m increase in Rates revenues. This was despite significant adverse fair value movements from own credit spreads on structured liabilities as spreads tightened, compared with favourable movements reported in 2011, together with a credit valuation adjustment of US$837m in 2012. Revenues in Credit increased by US$453m due to strong trading income, mainly in Europe, as spreads tightened on corporate debt securities. Additionally, we achieved record reported revenues from primary market issuance, mainly within Credit, with revenues in Europe, Hong Kong and North America increasing as we enhanced regional coverage and actively captured growth in client demand for debt capital financing.

Foreign Exchange income was broadly in line with 2011, as higher revenues from enhanced collaboration between GB&M and CMB, and increased volumes from the improvement in our electronic pricing and distribution capabilities, offset the effect of less volatile markets in 2012. Notwithstanding the capture of higher market share within a number of our target emerging markets, Equities revenues decreased by 27%, driven by lower client activity as market volumes declined against the backdrop of economic and fiscal uncertainty in Europe and North America. This was coupled with adverse fair value movements on structured liabilities compared with favourable movements in 2011.

In Global Banking, Financing and Equity Capital Markets revenues were broadly unchanged compared with 2011 as lower advisory and underwriting fees, mainly in Europe, reflecting the challenging market environment, were partly offset by higher Project and Export Finance revenues, as deal volumes increased, and as we captured a higher market share of public and private sector investment in infrastructure development in emerging markets. Payments and Cash Management revenues increased by 15% due to higher average liability balances and an increase in transaction volumes. We increased our focus on cross-selling Payments and Cash Management products to selected international customers and saw a rise in new mandates.

In Other transaction services , revenues increased by 24% as the Global Trade and Receivables Finance business benefited from enhanced collaboration between Global Banking

69

Table of Contents

HSBC HOLDINGS PLC

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

relationship managers and specialist sales teams and the expansion of the Commodity and Structured Trade Finance offering leading to higher revenues in Europe and Rest of Asia-Pacific. Revenues in Rest of Asia-Pacific also increased as a result of growth in export lending and improved spreads.

Balance Sheet Management revenues rose by US$324m due to higher gains on the disposal of available-for-sale debt securities as part of structural interest rate risk management of the balance sheet, notably in Europe. Net interest income declined in Europe, however, as yield curves continued to flatten and liquidity 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. Higher net interest income was reported in Rest of Asia-Pacific due to higher yields and portfolio growth in mainland China, and in Latin America due to lower funding costs in Brazil as interest rates declined.

Principal Investments revenue declined by US$76m compared with 2011 owing to higher impairments, mainly on three available-for-sale equity securities, two of which were in our direct investment business in run-off. This was offset in part by higher realised gains on disposals.

Strategic imperatives

Reinforce client coverage and client-led solutions

Our multinational coverage teams continued to expand our offerings of cross-product solutions for our clients and delivered revenue growth, particularly in faster-growing regions as we successfully executed a number of notable cross-border transactions. This included providing financing and advisory services to clients through our Project and Export Financing business, which resulted in HSBC being awarded Best Project Finance House in Asia, the Middle East and Latin America in the *Euromoney Awards for Excellence 2012*.

To further strengthen client coverage and product expertise, we invested in selective recruitment in key strategic markets. In Rest of Asia-Pacific, we enhanced our advisory, debt capital markets and credit and lending businesses through a number of senior appointments in the Resources and Energy and the Financial Institutions groups. We also appointed a Co-Head of Global Banking in Brazil to drive strategic dialogue with key clients and develop our advisory business in Latin America.

We continued to develop our distinctive geographical franchise to enhance client coverage, particularly within debt capital markets. A number of successfully executed transactions, notably in emerging markets, demonstrated the benefit of partnering between regional and global product teams. These partnerships facilitated the delivery of innovative solutions and alternative funding opportunities for our clients. As a result, HSBC was awarded Best Global Emerging Market Debt House in the *Euromoney Awards for Excellence 2012*. Additionally, we increased our market share of, and maintained our leading position in, emerging markets debt issuance.

Enhance core product strengths and selectively develop new capabilities

We continued to develop cross-product capabilities in the growing renminbi market. Earlier in the year, we issued the first international renminbi bond outside Chinese sovereign territory. Since then, a number of significant transactions were supported by in-depth collaboration between regional teams, reinforcing HSBC s position as the leading house for international renminbi issuance. In recognition of these achievements, HSBC was awarded RMB House of the Year in the *2012 Asia Risk Awards*, along with Best for overall products/services and Most likely RMB products/services provider in the *2012 Asiamoney Offshore RMB Services* survey.

In Foreign Exchange, we remained focused on enhancing product offerings in our e-FX platforms for a broader client base, particularly for CMB and RBWM customers. This included the launch of our Dynamic Currency Conversion product within our transactional Foreign Exchange business in the UK in time for the Olympics, along with a real-time online foreign currency margin trading product in Hong Kong. Our strength in foreign exchange capabilities, particularly in emerging markets, was recognised by several awards during the year including Best Bank for Foreign Exchange in Asia-Pacific and Best Bank for Emerging Asian currencies in the *2012 FX Week Best Banks Awards*. Our innovation and achievements in the renminbi market contributed to HSBC also being awarded Foreign Exchange House of the Year in the *2012 Structured Products Asia Awards*.

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

As a result of recent investment in our equity execution platform and research capabilities in emerging markets, we progressed in repositioning the business for future growth and enhanced our ability to respond to client needs. We are now ranked in the top five of equities brokers in Hong Kong, while our ranking in the *Asiamoney 2012 Brokers Poll* for Asian Equity Research and Sales rose from fifth in 2011 to second in 2012.

In a challenging economic environment, our clients demand visibility and control of their intra-day cash positions. To facilitate this, we expanded the Global Liquidity Solutions platform within Payments and Cash Management, and it is now live in 27 countries. We were also the first foreign bank to gain approval to establish an automated, cross-border pooling structure in mainland China. The pilot scheme, which aims to centralise foreign currency management for multinational companies by connecting their onshore and offshore cash management structures, will enable our clients to manage their cash positions more efficiently.

We are actively managing our legacy credit exposures and exited from certain positions, including ABSs in the UK and certain structured credit positions and related hedges in the US during 2012. We will look to reduce the size of this portfolio further as opportunities arise, using the economic framework put in place in 2011 (see page 18).

Collaborate with other global businesses to deliver incremental revenues

We have worked closely with CMB to provide their clients with appropriate GB&M products and this has delivered nearly US$0.7bn in incremental gross revenue since 2010. Gross revenues, which are shared across the two global businesses, grew by over US$0.1bn in 2012, or by 5%, mainly driven by sales of foreign exchange products. A number of appointments during the year, including a new Head of Commercial Banking Coverage for Asia-Pacific in Global Banking, further strengthened collaboration efforts and enhanced our ability to meet the financing needs of our clients.

We continued to enhance collaboration across the Group through the Institutional Private Clients (IPC) initiative with GPB and the Premier referrals initiative with RBWM, leading to higher revenues and increased Premier account openings respectively, compared with 2011. We also appointed a Head of Coverage in Hong Kong to strengthen our Global Banking franchise and deliver on IPC initiatives in the region.

Strategic re-engineering to deliver sustainable cost savings

The successful implementation of the organisational design we announced in 2011, and our continued resource optimisation through re-engineering, delivered over US$200m of sustainable savings in 2012.

Table of Contents

HSBC HOLDINGS PLC

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

Global Private Banking

GPB serves high net worth individuals and families with complex and international needs.

	2012 US$m	2011 US$m	2010 US$m
Net interest income	**1,294**	1,439	1,345
Net fee income	**1,232**	1,382	1,299
Other income	**646**	471	449
Net operating income[21]	**3,172**	3,292	3,093
LIC (charges)/recoveries[76]	**(27)**	(86)	12
Net operating income	**3,145**	3,206	3,105
Total operating expenses	**(2,143)**	(2,266)	(2,035)
Operating profit	**1,002**	940	1,070
Income/(expense) from associates[77]	**7**	4	(16)
Profit before tax	**1,009**	944	1,054
RoRWA[66]	**4.6%**	3.9%	4.1%

Significant progress towards rationalising and

repositioning our business

Over US$70m

of sustainable cost savings

Outstanding Private Bank

in Asia-Pacific and in the Middle East

(Private Banker International Awards, 2012)

Strategic direction

GPB works with high net worth clients to manage and preserve their wealth while connecting them to global opportunities. We focus on three strategic imperatives:

- implementing a new operating model to manage the business globally and better service client needs, with an enhanced systems platform and adherence to the highest risk and compliance standards in the industry;

- intensifying collaboration within the Group, particularly with CMB, to access entrepreneur wealth creation; and

- capturing growth by focusing investment on the most attractive developed and faster-growing wealth markets, where GPB can access the Group s client franchise and its strong local and international product capabilities.

For footnotes, see page 120.

The commentary is on a constant currency basis unless stated otherwise.

Review of performance

- Reported profit before tax of US$1.0bn was 7% higher than in 2011 on a reported basis and 8% higher on a constant currency basis.

- On an underlying basis, which excludes the gain on the sale of our operations in Japan (US$67m) and associated operating results, profit before tax was broadly unchanged as lower operating expenses and decreased loan impairment charges and other credit risk provisions were largely offset by reduced revenues.

- *Revenue* declined by 3%, primarily due to lower fee income. Brokerage fees fell, reflecting a reduction in client transaction volumes due, in part, to lower volatility. Fees from assets under management and account service fees also declined as challenging market conditions in the latter half of 2011 led to a fall in average client assets in 2012, coupled with a reduction in client numbers as we repositioned our target client base. Net interest income was lower as higher yielding positions matured, opportunities for reinvestment were limited by lower prevailing yields and we selectively managed our exposures to eurozone sovereign debt. Narrower liability spreads and lower deposit balances in Switzerland and the sale of our operations in Japan also contributed to the fall in net interest income. These factors were partly offset by gains on the sale of our operations in Japan and our headquarters building in Switzerland of US$67m and US$53m, respectively.

- *Loan impairment charges and other credit risk provisions* reduced by 68% as a result of the non-recurrence of charges relating to available-for-sale Greek sovereign debt securities and lower individually assessed and collective impairments in the UK. These factors were partly offset by lower recoveries in the US.

- *Operating expenses* decreased by 4%, primarily due to a managed reduction in average staff numbers and lower performance costs. The decrease in staff costs was partly offset by higher customer redress provisions, costs relating to the merger of pension funds in Switzerland, and increased restructuring and other related costs.

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

Client assets[84]

	2012 US$bn	2011 US$bn
At 1 January	**377**	390
Net new money	**(7)**	13
Value change	**17**	(20)
Exchange and other	**11**	(6)
At 31 December	**398**	377

Client assets, which include FuM and cash deposits, increased by US$21bn, driven by the inclusion of custody assets in client assets and favourable market and foreign exchange movements, partly offset by negative net new money and the disposal of our operations in Japan. Negative net new money included a small number of large client withdrawals and reflected lower inflows as we became more selective in establishing new client relationships, as well as the adoption of more stringent compliance and tax transparency standards. We also stopped marketing in certain non-strategic countries. In addition, we implemented a redefined segmentation model to reposition our client base towards higher net worth international and domestic relationships. This programme, along with a review of certain client relationships with a view to reducing control risk, resulted in a reduction of around US$4.5bn of client assets in 2012.

Total client assets , which also include some non-financial assets held in client trusts, increased from US$496bn at 31 December 2011 to US$517bn at 31 December 2012 largely due to market movements partly offset by negative net new money as noted above.

Our return on assets, defined as the percentage of our revenues to our average client assets, was unchanged as the reduction in revenues corresponded with the fall in average client assets.

Strategic imperatives

2012 was a year of transition for GPB as we repositioned our business model and target client base to focus investment in selected priority markets, enhance our compliance and risk frameworks and encourage better alignment with the other global businesses. We are targeting higher net worth international and domestic customers and have built on existing product strengths and leveraged Group capabilities to meet their needs. We expect this period of transition and implementation to continue throughout 2013.

Implementing a more focused business model that better services client needs

We implemented a new target operating model based on six global markets (North Asia; South East Asia; North America; Latin America; Europe; and Middle East, North Africa and Turkey). This enables us to operate as an integrated global business rather than a federation of private banks and to provide our clients with globally consistent products and services and improved co-ordination of marketing and servicing activity.

We sold or closed a number of non-strategic, underperforming businesses in order to rationalise our business and focus on priority markets. Disposals included our operations in Japan, our UK property advisory business, a portfolio of non-strategic clients in Monaco, our domestic trust business in Malaysia and a branch of our UK business in Ireland.

Our compliance and risk framework was strengthened by the establishment of a GPB Global Standards Committee and a revised risk appetite framework. The implementation of ongoing workstreams including tax transparency and cross-border marketing will be accelerated in 2013.

We enhanced our global front office systems with the roll out of Global Vision in Switzerland, Global Client Relationship Management in the US and Global Private Wealth Solutions in the Channel Islands, which provide integrated databases to support effective client management. We will continue to roll these systems out to other locations during 2013.

Developing closer collaboration across the Group

We leveraged existing relationships across the Group in order to access wealth created by entrepreneurs who already bank with HSBC on the business side. Referral flows from other global businesses generated net new money of US$5.4bn. To further support referrals with CMB, a collaboration framework was put in place, dedicated executives appointed and referral targets agreed.

We worked with RBWM to define and promote a Group-wide wealth offering. GPB and RBWM now operate a systematic process for the review and referral of clients to ensure they receive the service most appropriate to their needs.

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

The Global Priority Clients initiative was launched with GB&M and CMB to service jointly the Group s largest ultra-high net worth clients with corporate and personal needs through a dedicated single point of contact. The framework has been defined, clients identified for joint coverage and investment specialists assigned, and we have begun to roll out a new credit advisory model to fund credit transactions.

Capturing growth in faster-growing and domestic markets

We continued to focus on faster-growing markets, and attracted positive net new money of US$1.9bn and US$0.5bn from clients in Asia and the Middle East, respectively.

Our product range was further developed during 2012; in particular, we made progress in strengthening our Alternatives platform, with four new real estate club deals and two private equity launches in the year raising more than US$1.3bn. Further launches are expected in 2013.

Other[73]

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.

	2012 US$m	2011 US$m	2010 US$m
Net interest expense	**(730)**	(911)	(998)
Net fee income	**194**	34	32
Net trading expense	**(537)**	(355)	(311)
Change in credit spread on long-term debt	**(4,327)**	4,161	(258)
Other changes in fair value	**(1,136)**	78	42
Net income/(expense) from financial instruments designated at fair value	**(5,463)**	4,239	(216)
Other income	**8,868**	6,138	6,153
Net operating income[21]	**2,332**	9,145	4,660
LIC recoveries[76]			3
Net operating income	**2,332**	9,145	4,663
Total operating expenses	**(9,369)**	(7,492)	(5,918)
Operating profit/(loss)	**(7,037)**	1,653	(1,255)
Income from associates[77]	**47**	9	94
Profit/(loss) before tax	**(6,990)**	1,662	(1,161)

For footnotes, see page 120.

The commentary is on a constant currency basis unless stated otherwise.

74

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

Notes

The reported loss before tax of US$7.0bn in 2012 compared with reported profit before tax of US$1.7bn in 2011. On a constant currency basis, pre-tax loss increased by US$8.7bn.

These results included adverse movements of US$5.2bn on the fair value of our own debt attributable to a tightening of our own credit spreads in 2012, notably in Europe and North America, compared with favourable movements of US$3.9bn in 2011. Reported results also included a number of gains and losses on disposal (see page 27). These included a gain of US$3.0bn on the disposal of our associate, Ping An. Our remaining shareholding has been classified as a financial investment (see Note 26 on the Financial Statements). In addition, we reported a gain on disposal of US$130m from the sale of our shareholding in a property company in the Philippines. Reported profits in 2011 included accounting gains of US$181m relating to the dilution of our shareholding in Ping An, partly offset by a remeasurement loss of US$48m relating to Ping An s consolidation of Ping An Bank (formerly known as Shenzhen Development Bank).

On an underlying basis, excluding the items noted above, the pre-tax loss increased by US$2.5bn, driven by higher operating expenses, notably the charge of US$1.9bn relating to US fines and penalties paid as part of the settlement of investigations into past inadequate compliance with anti-money laundering and sanctions laws. In addition, revenues declined due to adverse fair value movements of US$553m on the contingent forward sale contract relating to Ping An.

Net fee income increased by US$166m, due in part to fees received under the transition services agreement entered into following the sale of the Card and Retail Services business in North America.

Net trading expense increased from US$353m to US$537m, driven by adverse fair value movements on the contingent forward sale contract relating to Ping An. This was partly offset by lower adverse fair value movements on non-qualifying hedges in 2012. This was driven by non-qualifying hedges in HSBC Holdings, mainly related to cross-currency swaps used to economically hedge fixed rate long-term debt, on which there were favourable movements of US$122m in 2012 compared with adverse fair value movements of US$276m in 2011.

Gains less losses from financial investments included gains of US$314m on the sale of our non-strategic investments in four Indian banks.

Excluding the movements in the fair value of our own debt, *Net expense from financial instruments designated at fair value* of US$248m compared with net income of US$293m in 2011. This was due to adverse fair value movements in 2012 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 and North American subsidiaries, compared with favourable fair value movements in 2011.

We reported a gain of US$3.0bn on the disposal of our associate, Ping An. Our remaining shareholding has been classified as a financial investment.

Other operating income decreased by 9%, due to lower intra-group recharges from centralised operational activities due to divestments and on-going cost savings, notably in North America. This was partly offset by a gain of US$130m from the sale of our shareholding in a property company in the Philippines.

Operating expenses increased by 27% to US$9.4bn, primarily due to 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, of which US$1.5bn was attributed to and paid by HNAH and its subsidiaries and US$375m was paid by HSBC Holdings. In addition, there were inflationary pressures in certain of our Latin American and Asian markets. However, the charge relating to the UK bank levy declined as the current year charge of US$571m 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. Costs related to operational activities also fell due to divestments and on-going cost savings, notably in North America. These costs are recorded in Other and charged to global businesses through a recharge mechanism, with income reported in Other operating income .

Table of Contents

HSBC HOLDINGS PLC

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

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

Retail Banking and Wealth Management

2012 compared with 2011

	2011 as reported US$m	Currency translation adjustment[24] US$m	2011 at 2012 exchange rates US$m	**2012 as reported US$m**	**Reported change[25] %**	**Constant currency change[25] %**
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[27]	1,206	(100)	1,106	**2,623**	**117**	