

HSBC HOLDINGS PLC  
Form 20-F  
March 12, 2013  
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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

b **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**

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(Exact name of Registrant as specified in its charter)

<p><b>N/A</b> (Translation of Registrant's name into English)</p>	<p><b>United Kingdom</b> (Jurisdiction of incorporation or organisation)</p>
	8 Canada Square
	London E14 5HQ
	United Kingdom
	(Address of principal executive offices)
	Russell C Picot
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	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 Depositary Shares, each representing 5	New York Stock Exchange
Ordinary Shares of nominal value US\$0.50 each. 6.20% Non-Cumulative Dollar Preference Shares,	New York Stock Exchange*
Series A American Depositary Shares, each representing one-	New York Stock Exchange
fortieth of a Share of 6.20% Non-Cumulative Dollar	
Preference Shares, Series A	
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

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6.100% Senior Unsecured Notes due 2042  
8.125% Perpetual Subordinated Capital Securities

New York Stock Exchange  
New York Stock Exchange

Exchangeable at the Issuer's Option into Non-

Cumulative Dollar Preference Shares  
8.00% Perpetual Subordinated Capital Securities

New York Stock Exchange

Exchangeable at the Issuer's Option into Non-

Cumulative Dollar Preference Shares, Series 2  
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.

Yes  No

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

Yes  No

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

Yes  No

Indicate by check mark whether the registrant 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  Accelerated filer  Non-accelerated filer   
Indicate by check mark which basis of accounting the registrant has used to prepare the financial statements included in this filing:

U.S. GAAP  International Financial Reporting Standards as issued by the International Accounting Standards Board  Other

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

Item 17  Item 18

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

Yes  No

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

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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.*

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<sup>1</sup> Detailed contents are provided on the referenced pages.

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### **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.

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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.



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HSBC HOLDINGS PLC

**Report of the Directors: Overview**

**Financial highlights**

**Earnings per share**

US\$0.74 *down 20%*

2011: US\$0.92

2010: US\$0.73

**Dividends per ordinary share<sup>1</sup>**

US\$0.41

2011: US\$0.39

2010: US\$0.34

**Net assets per share**

US\$9.09 *up 7%*

2011: US\$8.48

2010: US\$7.94

**For the year**

**Profit before taxation**

US\$20,649m *down 6%*

2011: US\$21,872m

2010: US\$19,037m

**Underlying profit before taxation**

US\$16,385m *up 18%*

2011: US\$13,861m

**Total operating income**

US\$82,545m *down 1%*

2011: US\$83,461m

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

2011: US\$72,280m

2010: US\$12,746m

2010: US\$68,247m

**At the year-end**

**Loans and advances**

**to customers**

US\$998bn *up 6%*

2011: US\$940bn

2010: US\$958bn

**Total equity**

US\$183bn *up 10%*

2011: US\$166bn

2010: US\$155bn

**Capital ratios**

**Core tier 1 ratio**

12.3%

2011: 10.1%

2010: 10.5%

**Customer accounts**

US\$1,340bn *up 7%*

2011: US\$1,254bn

2010: US\$1,228bn

**Average total shareholders**

**equity to average total assets**

6.2%

2011: 5.6%

2010: 5.5%

**Tier 1 ratio**

13.4%

2011: 11.5%

2010: 12.1%

**Ratio of customer advances**

**to customer accounts**

74.4%

2011: 75.0%

2010: 78.1%

**Risk-weighted assets**

US\$1,124bn *down 7%*

2011: US\$1,210bn

2010: US\$1,103bn

**Total capital ratio**

16.1%

2011: 14.1%

2010: 15.2%



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HSBC HOLDINGS PLC

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

**Performance ratios**

Credit coverage ratios

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

<b>Return on average ordinary shareholders equity</b>	<b>Return on average invested capital<sup>3</sup></b>	<b>Post-tax return on average total assets</b>	<b>Pre-tax return on average risk-weighted assets</b>
<b>8.4%</b>	<b>8.0%</b>	<b>0.6%</b>	<b>1.8%</b>
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

<b>Cost efficiency ratio<sup>4</sup></b>	<b>Net interest income to total operating income</b>	<b>Net fee income to total operating income</b>	<b>Net trading income to total operating income</b>

62.8%

45.6%

19.9%

8.6%

2011: 57.5%

2010: 55.2%

2011: 48.7%

2010: 49.3%

2011: 20.6%

2010: 21.7%

2011: 7.8%

2010: 9.0%

**Share information at the year-end**

US\$0.50 ordinary shares in issue	Market capitalisation	Closing market price		
		London	Hong Kong	American Depositary Share <sup>5</sup>
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
		Over 1 year	Total shareholder return <sup>6</sup> Over 3 years	Over 5 years
<b>To 31 December 2012</b>		<b>139</b>	<b>104</b>	<b>113</b>
Benchmarks:				
FTSE 100		110	121	111
MSCI World		117	124	97
MSCI Bank		128	106	68

*For footnotes, see page 120.*

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HSBC HOLDINGS PLC

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

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**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 other 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

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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.

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HSBC HOLDINGS PLC

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

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**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**



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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,

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### **Report of the Directors: Overview** (continued)

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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

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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

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### **Report of the Directors: Overview** (continued)

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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**

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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

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HSBC HOLDINGS PLC

### **Report of the Directors: Overview** (continued)

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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

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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

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**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.



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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.

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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.

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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

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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.

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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.

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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

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**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.	

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

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



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## **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.

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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.

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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**

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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

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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 (SMEs), 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

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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-

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### **Report of the Directors: Overview** (continued)

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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

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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.



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### **Report of the Directors: Overview** (continued)

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#### **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.

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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

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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*<sup>19</sup>

*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

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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<sup>20</sup> 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.

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*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.

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



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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.

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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.

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**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

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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

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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 depository 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.

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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:

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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

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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.

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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) 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.

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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

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

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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

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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

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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

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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

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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

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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,

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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.

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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

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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.

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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.

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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.

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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

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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.

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#### **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.



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**Strategy**

Restructuring HSBC – improving the way we deploy capital

**Return on average ordinary shareholders' equity**

**Core tier 1 capital ratio<sup>10</sup>**

**Advances to core funding ratio<sup>23</sup>**

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

**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.

**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 a return in the medium term of between 12% and 15%.

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

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

**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.

**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.

**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**

**Basic earnings**

(2012: underlying cost efficiency 66.0%)

**per ordinary share**

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

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

**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

**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.

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Growing HSBC <b>Risk-adjusted revenue growth</b>	continuing to position ourselves for growth <b>Dividends per ordinary share growth</b>	<b>Strategy</b>
(2012: underlying growth 13%)		
<b>Measure:</b> (percentage) increase in reported net operating income after loan impairment and other credit risk charges since last year.	<b>Measure:</b> (percentage) increase in dividends per share since last year, based on dividends paid in respect of the year to which the dividend relates.	
<b>Target:</b> to deliver consistent growth in risk adjusted revenues.	<b>Target:</b> to deliver sustained dividend per share growth.	
<b>Outcome:</b> 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.	<b>Outcome:</b> dividends per share increased by 10%.	
<b>Customer recommendation</b>	<b>Brand value</b>	
<b>Measure:</b> 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.	<b>Measure:</b> in 2011, we moved our brand measure to the Brand Finance valuation method as reported in <i>The Banker Magazine</i> . 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.	
<b>Target:</b> the Group target is for 75% of all the markets (based on their weighted revenue) to meet their CRI targets.	<b>Target:</b> a top three position in the banking peer group.	
<b>Outcome:</b> 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).	<b>Outcome:</b> 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.*



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*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

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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.

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**Report of the Directors: Operating and Financial Review***Reconciliation of reported and constant currency profit before tax*

	2012 compared with 2011					
	2011 as reported		2012 as reported		Reported change <sup>25</sup>	Constant currency change <sup>25</sup>
	US\$m	Currency translation adjustment <sup>24</sup> US\$m	at 2012 exchange rates US\$m	US\$m	%	%
<b>HSBC</b>						
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 <sup>26</sup>	3,933	(35)	3,898	(5,215)		
Gains on disposal of US branch network, US cards business and Ping An				7,024		
Other income <sup>27</sup>	10,525	(446)	10,079	12,419	18	23
<b>Net operating income<sup>21</sup></b>	<b>72,280</b>	<b>(2,068)</b>	<b>70,212</b>	<b>68,330</b>	<b>(5)</b>	<b>(3)</b>
Loan impairment charges and other credit risk provisions	(12,127)	277	(11,850)	(8,311)	31	30
<b>Net operating income</b>	<b>60,153</b>	<b>(1,791)</b>	<b>58,362</b>	<b>60,019</b>		<b>3</b>
Operating expenses	(41,545)	1,273	(40,272)	(42,927)	(3)	(7)
<b>Operating profit</b>	<b>18,608</b>	<b>(518)</b>	<b>18,090</b>	<b>17,092</b>	<b>(8)</b>	<b>(6)</b>
Share of profit in associates and joint ventures	3,264	55	3,319	3,557	9	7
<b>Profit before tax</b>	<b>21,872</b>	<b>(463)</b>	<b>21,409</b>	<b>20,649</b>	<b>(6)</b>	<b>(4)</b>
<b>By global business<sup>28</sup></b>						
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)
<b>By geographical region<sup>28</sup></b>						
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.

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**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. <sup>30</sup>	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 <sup>28</sup>	Jan 2012	83
The Hongkong and Shanghai Banking Corporation Limited's disposal of RBWM operations in Thailand <sup>29</sup>	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 <sup>30</sup>	May 2012	3,148
HSBC Bank USA, N.A.'s disposal of 138 non-strategic branches <sup>30</sup>	May 2012	661
HSBC Argentina Holdings S.A.'s disposal of its general insurance manufacturing subsidiary <sup>30</sup>	May 2012	102
The Hongkong and Shanghai Banking Corporation Limited's disposal of its private banking business in Japan <sup>29</sup>	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 <sup>30</sup>	Aug 2012	203
Hang Seng Bank Limited's disposal of its general insurance manufacturing subsidiary <sup>30</sup>	Jul 2012	46
HSBC Asia Holdings B.V.'s investment loss on a subsidiary <sup>30</sup>	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 portfolio <sup>30</sup>	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 <sup>30</sup>	Dec 2012	(62)
HSBC Insurance Holdings Limited and The Hongkong and Shanghai Banking Corporation Limited's disposal of their shares in Ping An <sup>30</sup>	Dec 2012	3,012
	Dec 2012	212

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The Hongkong and Shanghai Banking Corporation Limited's disposal of its shareholding in Global Payments Asia-Pacific Limited<sup>30</sup>

For footnote, see page 120.

*Acquisition gains/(losses) affecting the underlying performance*

	<b>Fair value gain on acquisition US\$m</b>
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

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**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 <sup>25</sup> %
<b>Revenue<sup>21</sup></b>			
Reported revenue	68,330	72,280	(5)
Currency translation adjustment <sup>24</sup>		(2,033)	
Own credit spread <sup>26</sup>	5,215	(3,933)	
Acquisitions, disposals and dilutions	(10,048)	(6,976)	
Underlying revenue	63,497	59,338	7
<b>Loan impairment charges and other credit risk provisions ( LIC s)</b>			
Reported LICs	(8,311)	(12,127)	31
Currency translation adjustment <sup>24</sup>		277	
Acquisitions, disposals and dilutions	338	1,619	
Underlying LICs	(7,973)	(10,231)	22
<b>Operating expenses</b>			
Reported operating expenses	(42,927)	(41,545)	(3)
Currency translation adjustment <sup>24</sup>		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%	
<b>Profit before tax</b>			
Reported profit before tax	20,649	21,872	(6)
Currency translation adjustment <sup>24</sup>		(428)	
Own credit spread <sup>26</sup>	5,215	(3,933)	
Acquisitions, disposals and dilutions	(9,479)	(3,650)	
Underlying profit before tax	16,385	13,861	18
<b>By global business<sup>28</sup></b>			
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
<b>By geographical region<sup>28</sup></b>			
Europe	699	1,629	(57)

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Hong Kong	<b>7,162</b>	5,761	24
Rest of Asia-Pacific	<b>6,403</b>	6,249	2
Middle East and North Africa	<b>1,380</b>	1,417	(3)
North America	<b>(1,499)</b>	(3,076)	51
Latin America	<b>2,240</b>	1,881	19
Underlying profit before tax	<b>16,385</b>	13,861	18
<i>For footnotes, see page 120.</i>			



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HSBC HOLDINGS PLC

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

	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
<b>Total operating income</b>	<b>82,545</b>	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)
<b>Net operating income before loan impairment charges and other credit risk provisions</b>	<b>68,330</b>	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)
<b>Net operating income</b>	<b>60,019</b>	60,153	54,208	39,693	56,745
Total operating expenses <sup>34</sup>	(42,927)	(41,545)	(37,688)	(34,395)	(49,099)
<b>Operating profit</b>	<b>17,092</b>	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
<b>Profit before tax</b>	<b>20,649</b>	21,872	19,037	7,079	9,307
Tax expense	(5,315)	(3,928)	(4,846)	(385)	(2,809)
<b>Profit for the year</b>	<b>15,334</b>	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 <sup>35</sup>	0.74	0.92	0.73	0.34	0.41
Diluted earnings per share <sup>35</sup>	0.74	0.91	0.72	0.34	0.41
Basic earnings excluding goodwill impairment per share <sup>34,35</sup>	0.74	0.92	0.73	0.34	1.19
Dividends per ordinary share <sup>1</sup>	0.41	0.39	0.34	0.34	0.93

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

*For footnotes, see page 120.*

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

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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.

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*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

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**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*

	Rest of					Total US\$m
	Europe US\$m	Hong Kong US\$m	Asia- Pacific US\$m	MENA US\$m	North America US\$m	
<b>2012</b>						
Non-qualifying hedges	(51)	(31)	(20)		(194)	(296)
Ping An contingent forward sale contract <sup>37</sup>			(553)			(553)
Gain on sale of non-core investments in India		314				