Statement of Directors' Responsibilities in relation to Financial Statements

The following statement, which should be read in conjunction with the Auditors' statement of their responsibilities set out in their report on pages 291 and 292, is made with a view to distinguishing for shareholders the respective responsibilities of the Directors and of the Auditors in relation to the financial statements.

The Directors are responsible for preparing the Annual Report, the consolidated financial statements of HSBC Holdings and its subsidiaries (the 'Group') and holding company financial statements for HSBC Holdings (the 'parent company') in accordance with applicable law and regulations.

Company law requires the Directors to prepare Group and parent company financial statements for each financial year. The Directors are required to prepare the Group financial statements in accordance with IFRSs as adopted by the EU and have elected to prepare the parent company financial statements on the same basis.

The Directors are also required to present additional information for US Shareholders. Accordingly these financial statements are framed to meet both UK and US requirements to give a consistent view to all shareholders.

The Group and parent company financial statements are required by law and IFRSs as adopted by the EU to present fairly the financial position of the Group and the parent company and the performance for that period; the Companies Act 1985 provides in relation to such financial statements that references in the relevant part of that Act to financial statements giving a true and fair view are references to their achieving a fair presentation.

In preparing each of the Group and parent company financial statements, the Directors are required to:

- select suitable accounting policies and then apply them consistently;
- make judgments and estimates that are reasonable and prudent; and
- state whether they have been prepared in accordance with IFRSs as adopted by the EU.

The Directors are required to prepare the financial statements on the going concern basis unless it is not appropriate. Since the Directors are satisfied that the Group has the resources to continue in business for the foreseeable future, the financial statements continue to be prepared on the going concern basis

The Directors have responsibility for ensuring that sufficient accounting records are kept that disclose with reasonable accuracy at any time the financial position of the parent company and enable them to ensure that its financial statements comply with the Companies Act 1985.

The Directors have general responsibility for taking such steps as are reasonably open to them to safeguard the assets of the Group and to prevent and detect fraud and other irregularities.

Under applicable law and regulations, the Directors also have responsibility for preparing a Directors' Report, Directors' Remuneration Report and the Corporate Governance statement on pages 248 to 289 that comply with that law and those regulations.

The Directors have responsibility for the maintenance and integrity of the Annual Report and Accounts as they appear on the company's website. Legislation in the UK governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

On behalf of the Board 5 March 2007

R G Barber, *Secretary*

Independent Auditor's Report to the Members of HSBC Holdings plc

We have audited the Group and parent company financial statements (the 'financial statements') of HSBC Holdings plc for the year ended 31 December 2006 which comprise the Group Income Statement, the Group and parent Company Balance Sheets, the Group and parent Cash Flow Statements, the Group Statement of Recognised Income and Expense, the Company Statement of Changes in Equity and the related notes. These financial statements have been prepared under the accounting policies set out therein. We have also audited the information in the Directors' Remuneration Report that is described as having been audited.

This report is made solely to the company's members, as a body, in accordance with section 235 of the Companies Act 1985. Our audit work has been undertaken so that we might state to the company's members those matters we are required to state to them in an auditor's report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the company and the company's members as a body, for our audit work, for this report, or for the opinions we have formed.

Respective responsibilities of directors and auditors

The directors' responsibilities for preparing the Annual Report, the Directors Remuneration Report and the financial statements in accordance with applicable law and International Financial Reporting Standards (IFRSs) as adopted by the EU are set out in the Statement of Directors' Responsibilities on page 290.

Our responsibility is to audit the financial statements and the part of the Directors' Remuneration Report to be audited in accordance with relevant legal and regulatory requirements and International Standards on Auditing (UK and Ireland).

We report to you our opinion as to whether the financial statements give a true and fair view and whether the financial statements and the part of the Directors' Remuneration Report to be audited have been properly prepared in accordance with the Companies Act 1985 and, as regards the group financial statements, Article 4 of the IAS Regulation. We also report to you whether in our opinion the information given in the Directors' Report is consistent with the financial statements.

In addition we report to you if, in our opinion, the company has not kept proper accounting records, if we have not received all the information and explanations we require for our audit, or if information specified by law regarding directors' remuneration and other transactions is not disclosed.

We review whether the Corporate Governance Statement reflects the company's compliance with the nine provisions of the 2003 Combined Code specified for our review by the Listing Rules of the Financial Services Authority, and we report if it does not. We are not required to consider whether the board's statements on internal control cover all risks and controls, or form an opinion on the effectiveness of the group's corporate governance procedures or its risk and control procedures.

We read the other information contained in the Annual Report and Accounts 2006 and consider whether it is consistent with the audited financial statements. We consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies with the financial statements. Our responsibilities do not extend to any other information.

Basis of audit opinion

We conducted our audit in accordance with International Standards on Auditing (UK and Ireland) issued by the Auditing Practices Board. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the financial statements and the part of the Directors' Remuneration Report to be audited. It also includes an assessment of the significant estimates and judgments made by the directors in the preparation of the financial statements, and of whether the accounting policies are appropriate to the group's and company's circumstances, consistently applied and adequately disclosed.

We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the financial statements and the part of the Directors' Remuneration Report to be audited are free from material misstatement, whether caused by fraud or other irregularity or error. In forming our opinion we also evaluated the overall adequacy of the presentation of information in the financial statements and the part of the Directors' Remuneration Report to be audited.

Independent Auditor's Report to the Members of HSBC Holdings plc (continued)

Opinion

In our opinion:

- the Group financial statements give a true and fair view, in accordance with IFRSs as adopted by the EU, of the state of the Group's affairs as at 31 December 2006 and of its profit for the year then ended;
- the parent company financial statements give a true and fair view, in accordance with IFRSs as adopted by the EU as applied in accordance with the provisions of the Companies Act 1985, of the state of the parent company's affairs as at 31 December 2006;
- the financial statements and the part of the Directors' Remuneration Report to be audited have been properly prepared in accordance with the Companies Act 1985 and, as regards the group financial statements, Article 4 of the IAS Regulation; and
- the information given in the Directors' Report is consistent with the financial statements.

KPMG Audit Plc
Chartered Accountants
Registered Auditor

5 March 2007

Financial Statements

Financial Statements (continued)

Consolidated income statement for the year ended 31 December 2006

	Notes	2006 US$m	2005 US$m	2004 US$m
Interest income		**75,879**	60,094	50,471
Interest expense		**(41,393)**	(28,760)	(19,372)
Net interest income		**34,486**	31,334	31,099
Fee income		**21,080**	17,486	15,902
Fee expense		**(3,898)**	(3,030)	(2,954)
Net fee income		**17,182**	14,456	12,948
Trading income excluding net interest income		**5,619**	3,656	2,786
Net interest income on trading activities		**2,603**	2,208	–
Net trading income		**8,222**	5,864	2,786
Net income from financial instruments designated at fair value	*3*	**657**	1,034	–
Net investment income on assets backing policyholders' liabilities		**–**	–	1,012
Gains less losses from financial investments		**969**	692	540
Dividend income		**340**	155	622
Net earned insurance premiums	*4*	**5,668**	5,436	5,368
Other operating income		**2,546**	2,733	1,613
Total operating income		**70,070**	61,704	55,988
Net insurance claims incurred and movement in policyholders' liabilities	*5*	**(4,704)**	(4,067)	(4,635)
Net operating income before loan impairment charges and other credit risk provisions		**65,366**	57,637	51,353
Loan impairment charges and other credit risk provisions		**(10,573)**	(7,801)	(6,191)
Net operating income	*6*	**54,793**	49,836	45,162
Employee compensation and benefits	*7*	**(18,500)**	(16,145)	(14,523)
General and administrative expenses	*8*	**(12,823)**	(11,183)	(9,739)
Depreciation and impairment of property, plant and equipment	*23*	**(1,514)**	(1,632)	(1,731)
Amortisation and impairment of intangible assets		**(716)**	(554)	(494)
Total operating expenses		**(33,553)**	(29,514)	(26,487)
Operating profit		**21,240**	20,322	18,675
Share of profit in associates and joint ventures	*20*	**846**	644	268
Profit before tax		**22,086**	20,966	18,943
Tax expense	*10*	**(5,215)**	(5,093)	(4,685)
Profit for the year		**16,871**	15,873	14,258
Profit attributable to shareholders of the parent company		**15,789**	15,081	12,918
Profit attributable to minority interests		**1,082**	792	1,340
		US$	US$	US$
Basic earnings per ordinary share	*12*	**1.40**	1.36	1.18
Diluted earnings per ordinary share	*12*	**1.39**	1.35	1.17
Dividends per ordinary share	*11*	**0.76**	0.69	0.63

The accompanying notes on pages 301 to 434, the audited sections of the 'Report of the Directors: The Management of Risk' on pages 165 to 247, and the 'Critical accounting policies' on pages 111 to 115 form an integral part of these financial statements.

Consolidated balance sheet at 31 December 2006

	Notes	2006 US$m	2005 US$m
ASSETS			
Cash and balances at central banks		**12,732**	13,712
Items in the course of collection from other banks		**14,144**	11,300
Hong Kong Government certificates of indebtedness		**13,165**	12,554
Trading assets	*15*	**328,147**	232,909
Financial assets designated at fair value	*16*	**20,573**	15,046
Derivatives	*17*	**103,702**	73,928
Loans and advances to banks	*33*	**185,205**	125,965
Loans and advances to customers	*33*	**868,133**	740,002
Financial investments	*18*	**204,806**	182,342
Interests in associates and joint ventures	*20*	**8,396**	7,249
Goodwill and intangible assets	*21*	**37,335**	33,200
Property, plant and equipment	*23*	**16,424**	15,206
Other assets	*25*	**33,444**	26,596
Prepayments and accrued income		**14,552**	11,961
Total assets		**1,860,758**	1,501,970
LIABILITIES AND EQUITY			
Liabilities			
Hong Kong currency notes in circulation		**13,165**	12,554
Deposits by banks	*33*	**99,694**	69,727
Customer accounts	*33*	**896,834**	739,419
Items in the course of transmission to other banks		**12,625**	7,022
Trading liabilities	*26*	**226,608**	174,365
Financial liabilities designated at fair value	*27*	**70,211**	61,829
Derivatives	*17*	**101,478**	74,036
Debt securities in issue	*28*	**230,325**	188,072
Retirement benefit liabilities	*7*	**5,555**	4,869
Other liabilities	*29*	**29,824**	26,515
Liabilities under insurance contracts	*30*	**17,670**	14,144
Accruals and deferred income		**16,310**	12,689
Provisions	*31*	**2,859**	1,966
Subordinated liabilities	*32*	**22,672**	16,537
Total liabilities		**1,745,830**	1,403,744
Equity			
Called up share capital	*38*	**5,786**	5,667
Share premium account	*39*	**7,789**	6,896
Other reserves	*39*	**29,380**	23,646
Retained earnings	*39*	**65,397**	56,223
Total shareholders' equity		**108,352**	92,432
Minority interests	*37*	**6,576**	5,794
Total equity		**114,928**	98,226
Total equity and liabilities		**1,860,758**	1,501,970

The accompanying notes on pages 301 to 434, the audited sections of the 'Report of the Directors: The Management of Risk' on pages 165 to 247, and the 'Critical accounting policies' on pages 111 to 115 form an integral part of these financial statements.

S K Green, *Group Chairman*

Financial Statements (continued)

Consolidated statement of recognised income and expense for the year ended 31 December 2006

	2006 US$m	2005 US$m	2004 US$m
Available-for-sale investments:			
– fair value gains/(losses) taken to equity	**1,582**	(400)	–
– fair value gains transferred to income statement on disposal or impairment	**(644)**	(240)	–
Cash flow hedges:			
– fair value gains/(losses) taken to equity	**1,554**	(92)	–
– fair value gains transferred to income statement	**(2,198)**	(106)	–
Share of changes in equity of associates and joint ventures	**20**	161	–
Exchange differences	**4,675**	(4,257)	3,720
Actuarial losses on defined benefit plans	**(78)**	(812)	(731)
	4,911	(5,746)	2,989
Tax on items taken directly to equity	**(44)**	437	319
Total income and expense taken to equity during the year	**4,867**	(5,309)	3,308
Profit for the year	**16,871**	15,873	14,258
Total recognised income and expense for the year	**21,738**	10,564	17,566
Effect of change in accounting policy			
IFRSs transition adjustment at 1 January 2005[1]	–	(8,824)	–
	21,738	1,740	17,566
Total recognised income and expense for the year attributable to:			
– shareholders of the parent company	**20,527**	9,912	15,743
– minority interests	**1,211**	652	1,823
	21,738	10,564	17,566

1 *For an explanation of the IFRSs transition adjustment at 1 January 2005, see Note 46 on the Financial Statements in the Annual Report and Accounts 2005.*

The accompanying notes on pages 301 to 434, the audited sections of the 'Report of the Directors: The Management of Risk' on pages 165 to 247, and the 'Critical accounting policies' on pages 111 to 115 form an integral part of these financial statements.

Consolidated cash flow statement for the year ended 31 December 2006

	Notes	2006 US$m	2005 US$m	2004 US$m
Cash flows from operating activities				
Profit before tax		**22,086**	20,966	18,943
Adjustments for:				
– non-cash items included in profit before tax	40	**14,956**	11,404	11,406
– change in operating assets	40	**(173,269)**	(91,753)	(133,143)
– change in operating liabilities	40	**237,378**	72,212	175,503
– elimination of exchange differences[1]		**(12,114)**	2,580	(7,783)
– net gain from investing activities		**(2,014)**	(692)	(540)
– share of profits in associates and joint ventures		**(846)**	(644)	(268)
– dividends received from associates		**97**	114	127
– contribution paid to defined benefit pension schemes		**(547)**	(2,547)	(564)
– tax paid		**(4,946)**	(4,619)	(3,784)
Net cash from operating activities		**80,781**	7,021	59,897
Cash flows from investing activities				
Purchase of financial investments		**(286,316)**	(378,103)	(330,917)
Proceeds from the sale of financial investments		**273,774**	368,696	315,437
Purchase of property, plant and equipment		**(2,400)**	(2,887)	(2,830)
Proceeds from the sale of property, plant and equipment		**2,504**	620	371
Net purchase of intangible assets		**(852)**	(849)	(108)
Net cash outflow from acquisition of and increase in stake of subsidiaries		**(1,185)**	(1,662)	(2,431)
Net cash inflow from disposal of subsidiaries		**62**	705	27
Net cash outflow from acquisition of and increase in stake of associates		**(585)**	(2,569)	(2,122)
Proceeds from disposal of associates		**874**	422	212
Net cash used in investing activities		**(14,124)**	(15,627)	(22,361)
Cash flows from financing activities				
Issue of ordinary share capital		**1,010**	690	581
Issue of preference shares		**374**	1,298	–
Net purchases and sales of own shares for market-making and investment purposes		**46**	(55)	98
Purchases of own shares to meet share awards and share option awards		**(575)**	(766)	(345)
On exercise of share options		**173**	277	159
Increase in non-equity minority interests		**–**	–	1,480
Subordinated loan capital issued		**5,948**	2,093	6,021
Subordinated loan capital repaid		**(903)**	(1,121)	(1,740)
Dividends paid to shareholders of the parent company		**(5,927)**	(5,935)	(4,425)
Dividends paid to minority interests:				
– equity		**(710)**	(508)	(664)
– non-equity		**–**	–	(548)
Net cash used in financing activities		**(564)**	(4,027)	617
Net increase/(decrease) in cash and cash equivalents		**66,093**	(12,633)	38,153
Cash and cash equivalents at 1 January		**141,307**	160,956	117,558
Exchange differences in respect of cash and cash equivalents		**8,086**	(7,016)	5,245
Cash and cash equivalents at 31 December	40	**215,486**	141,307	160,956

1 *Adjustment to bring changes between opening and closing balance sheet amounts to average rates. This is not done on a line-by-line basis, as details cannot be determined without unreasonable expense.*

The accompanying notes on pages 301 to 434, the audited sections of the 'Report of the Directors: The Management of Risk' on pages 165 to 247, and the 'Critical accounting policies' on pages 111 to 115 form an integral part of these financial statements.

Financial Statements (continued)

HSBC Holdings balance sheet at 31 December 2006

	Notes	2006 US$m	2005 US$m
ASSETS			
Cash at bank and in hand:			
– balances with HSBC undertakings		**729**	756
Derivatives	*17*	**1,599**	968
Loans and advances to HSBC undertakings	*33*	**14,456**	14,092
Financial investments		**3,614**	3,517
Investments in subsidiaries	*24*	**62,356**	58,038
Property, plant and equipment		**1**	1
Other assets		**91**	171
Prepayments and accrued income		**41**	19
Total assets		**82,887**	77,562
LIABILITIES AND EQUITY			
Liabilities			
Amounts owed to HSBC undertakings	*33*	**3,100**	4,075
Financial liabilities designated at fair value	*27*	**14,070**	13,370
Derivatives	*17*	**177**	286
Other liabilities	*29*	**1,517**	1,203
Accruals and deferred income		**111**	95
Deferred tax	*31*	**–**	70
Subordinated liabilities	*32*	**8,423**	5,236
Total liabilities		**27,398**	24,335
Equity			
Called up share capital	*38*	**5,786**	5,667
Share premium account		**7,789**	6,896
Merger reserve and other reserves		**28,942**	28,942
Other reserves		**2,384**	2,221
Retained earnings		**10,588**	9,501
Total equity		**55,489**	53,227
Total equity and liabilities		**82,887**	77,562

The accompanying notes on pages 301 to 434, the audited sections of the 'Report of the Directors: The Management of Risk' on pages 165 to 247, and the 'Critical accounting policies' on pages 111 to 115 form an integral part of these financial statements.

S K Green, *Group Chairman*

HSBC Holdings statement of changes in total equity for the year ended 31 December 2006

	2006 US$m	2005 US$m
Called up share capital		
At 1 January	**5,667**	5,587
Shares issued in connection with the early settlement of HSBC Finance 8.875 per cent Adjustable Conversion-Rate Equity Security Units	**2**	–
Shares issued under employee share plans	**38**	28
Shares issued in lieu of dividends	**79**	52
At 31 December	**5,786**	5,667
Share premium account		
At 1 January	**6,896**	4,881
Shares issued under employee share plans	**975**	662
Shares issued in lieu of dividends and amounts arising thereon	**(82)**	(52)
New share capital subscribed, net of costs	**–**	1,405
At 31 December	**7,789**	6,896
Merger reserve and other reserves		
At 1 January and 31 December	**28,942**	28,942
Other reserves		
Available-for-sale fair value reserve		
At 1 January	**337**	–
IFRSs transition adjustments at 1 January 2005[1]	**–**	464
Fair value changes taken to equity[2]	**(121)**	(184)
Tax on items taken directly to equity[2]	**30**	57
At 31 December	**246**	337
Share-based payment reserve		
At 1 January	**1,234**	1,329
Exercise of HSBC share options	**(381)**	(328)
Charge to the income statement in respect of equity settled share-based payment transactions	**58**	12
Shares/options granted to employees of subsidiaries under employee share awards	**293**	219
Other movements	**(2)**	2
At 31 December	**1,202**	1,234
Other paid-in capital		
At 1 January	**650**	411
Exercise of HSBC share options	**286**	239
At 31 December	**936**	650
Total other reserves at 31 December	**2,384**	2,221
Retained earnings		
At 1 January	**9,501**	8,959
IFRSs transition adjustments at 1 January 2005[1]	**–**	(317)
Profit for the year attributable to shareholders	**7,139**	6,816
Dividends to shareholders of the parent company	**(8,769)**	(7,750)
Amounts arising on shares in lieu of dividends	**2,528**	1,811
Own shares adjustments	**157**	87
Tax on share based payments	**9**	–
Exchange differences and other movements[2]	**23**	(105)
At 31 December[3]	**10,588**	9,501

1 *For an explanation of the IFRSs transition adjustment at 1 January 2005, see Note 46 on the Financial Statements in the* Annual Report and Accounts 2005.

2 *The total net expense taken directly to equity during the year was US$59 million (2005: US$232 million).*

3 *Retained earnings include 35,639,856 (US$544 million) of own shares held to fund employee share plans (2005: 49,217,589, US$701 million).*

The accompanying notes on pages 301 to 434, the audited sections of the 'Report of the Directors: The Management of Risk' on pages 165 to 247, and the 'Critical accounting policies' on pages 111 to 115 form an integral part of these financial statements.

Financial Statements (continued)

HSBC Holdings cash flow statement for the year ended 31 December 2006

	Notes	2006 US$m	2005 US$m
Cash flows from operating activities			
Profit before tax		**6,974**	6,541
Adjustments for:			
– non-cash items included in profit before tax	*40*	**58**	13
– change in operating assets	*40*	**(1,827)**	3,563
– change in operating liabilities	*40*	**1,056**	(4,400)
– elimination of exchange differences[1]		**(29)**	(123)
– net gain from investing activities		**(8)**	–
– tax received		**219**	158
Net cash from operating activities		**6,443**	5,752
Cash flows from investing activities			
Proceeds from the sale of financial investments		**–**	303
Net cash outflow from acquisition of and increase in stake of subsidiaries		**(4,440)**	(4,093)
Net cash inflow from disposal of subsidiaries		**–**	1,063
Net cash used in investing activities		**(4,440)**	(2,727)
Cash flows from financing activities			
Issue of ordinary share capital		**1,010**	690
Issue of preference shares		**–**	1,405
Purchases of own shares to meet share awards and share option awards		**(46)**	(39)
On exercise of share options		**127**	67
Subordinated loan capital issued		**2,806**	1,647
Subordinated loan capital repaid		**–**	(350)
Dividends paid		**(5,927)**	(5,935)
Net cash (used in)/from financing activities		**(2,030)**	(2,515)
Net increase/(decrease) in cash and cash equivalents		**(27)**	510
Cash and cash equivalents at 1 January		**756**	246
Cash and cash equivalents at 31 December	*40*	**729**	756

1 *Adjustment to bring changes between opening and closing balance sheet amounts to average rates. This is not done on a line-by-line basis, as details cannot be determined without unreasonable expense.*

The accompanying notes on pages 301 to 434, the audited sections of the 'Report of the Directors: The Management of Risk' on pages 165 to 247, and the 'Critical accounting policies' on pages 111 to 115 form an integral part of these financial statements.

1 Basis of preparation

(a) Compliance with International Financial Reporting Standards

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

IFRSs comprise accounting standards issued by the IASB and its predecessor body and interpretations issued by the International Financial Reporting Interpretations Committee ('IFRIC') and its predecessor body.

The significant accounting policies applied in the preparation of these financial statements are set out below. They have been applied consistently, except for:

- IAS 32 'Financial Instruments: Presentation' ('IAS 32'), IAS 39 'Financial Instruments: Recognition and Measurement' ('IAS 39') and IFRS 4 'Insurance Contracts' ('IFRS 4') have been applied for the first time from 1 January 2005. Where disclosed, the 2004 comparative information has been prepared on the basis of HSBC's previous accounting policies disclosed in Note 46g on the Financial Statements in the *Annual Report and Accounts 2005*;
- HSBC has adopted 'Amendment to IAS 39: The Fair Value Option', 'Amendment to IAS 19 Employee Benefits: Actuarial Gains and Losses, Group Plans and Disclosures', 'Amendment to IAS 1 Presentation of Financial Statements: Capital Disclosures' and IFRIC 4 'Determining whether an Arrangement contains a Lease' with effect from 1 January 2005;
- No comparative information for disclosures required by IFRS 7 'Financial Instruments: Disclosures' has been presented for 2004 as permitted for entities applying the standard for annual periods beginning before 1 January 2006; and
- During 2006, HSBC changed how certain of its geographical operating segments are managed and their performance assessed. As a result, a new segment, Latin America and the Caribbean ('Latin America'), was formed from the Group's businesses previously reported under South America, and those in Mexico and Panama which had been previously reported as part of the North America geographical segment. All prior period comparative data have been restated to conform to the current year presentation.

On 1 January 2006, HSBC adopted 'Amendments to IAS 39 and IFRS 4 – Financial Guarantee Contracts', 'Amendment to IAS 21 The Effects of Changes in Foreign Exchange Rates – Net Investment in a Foreign Operation', and 'Amendment to IAS 39 – Cash Flow Hedge Accounting of Forecast Intragroup Transactions'. The application of these amendments had no significant effect on the consolidated or separate financial statements.

On 1 January 2006, HSBC adopted 'IFRIC 7: Applying the Restatement Approach under IAS 29 Financial Reporting in Hyperinflationary Economies', 'IFRIC 8 Scope of IFRS 2' and 'IFRIC 9 Reassessment of Embedded Derivatives' ahead of their effective dates. The application of these interpretations had no significant effect on the consolidated or separate financial statements.

(b) Differences between IFRSs and US GAAP, and Hong Kong Financial Reporting Standards

A discussion of the significant differences between IFRSs and US GAAP and a reconciliation to US GAAP of certain amounts is contained in Note 47. As stated in Note 46, there are no significant differences between IFRSs and Hong Kong Financial Reporting Standards. The Notes on the Financial Statements, taken together with the Report of the Directors, include the aggregate of all disclosures necessary to satisfy IFRSs, Hong Kong and US reporting requirements.

(c) Presentation of information

Disclosures under IFRS 4 and IFRS 7 relating to the nature and extent of risks have been included in the audited sections of the 'Report of the Directors: The Management of Risk' on pages 165 to 247.

Notes on the Financial Statements (continued)

Note 1

Capital disclosures under IAS 1 'Presentation of Financial Statements' have been included in the audited sections of 'Capital management and allocation' on pages 243 to 247.

As a result of the Companies (Disclosure of Auditor Remuneration) Regulations 2005 coming into force, the presentation and the level of detail of the information disclosed in Note 8 has changed compared with the prior year. Comparative information has been provided on a consistent basis with the current year presentation as required by IAS 1 'Presentation of Financial Statements'.

In publishing the parent company financial statements here together with the Group financial statements, HSBC Holdings has taken advantage of the exemption in section 230 of the Companies Act 1985 not to present its individual income statement and related notes that form a part of these financial statements.

HSBC has taken advantage of the exemption under Regulation 7 of the Partnerships and Unlimited Companies (Accounts) Regulations 1993 from certain partnerships that are consolidated by HSBC presenting their own individual financial statements under IFRSs.

The functional currency of HSBC Holdings plc is US dollars, which is also the presentational currency of the consolidated financial statements of HSBC.

(d) Comparative information

As required by US GAAP, these consolidated financial statements include two years of comparative information for the consolidated income statement, consolidated cash flow statement, consolidated statement of recognised income and expense, and related notes on the financial statements, with certain exceptions in respect of the 2004 comparative information, as explained in (a) Compliance with International Financial Reporting Standards above.

(e) Use of estimates and assumptions

The preparation of financial information requires the use of estimates and assumptions about future conditions. Use of available information and application of judgement are inherent in the formation of estimates. Actual results in the future may differ from those reported. In this regard, management believes that the critical accounting policies where judgement is necessarily applied are those which relate to loan impairment, goodwill impairment and the valuation of financial instruments (see Critical Accounting Policies on pages 111 to 115).

Further information about key assumptions concerning the future, and other key sources of estimation uncertainty, are set out in the notes on these financial statements.

(f) Consolidation

The consolidated financial statements of HSBC comprise the financial statements of HSBC Holdings and its subsidiaries made up to 31 December, with the exception of the banking and insurance subsidiaries of HSBC Bank Argentina, whose financial statements are made up to 30 June annually to comply with local regulations. Accordingly, HSBC uses their audited interim financial statements, drawn up to 31 December annually.

Newly acquired subsidiaries are consolidated from the date that HSBC gains control. The purchase method of accounting is used to account for the acquisition of subsidiaries by HSBC. The cost of an acquisition is measured at the fair value of the consideration given at the date of exchange, together with costs directly attributable to that acquisition. The acquired identifiable assets, liabilities and contingent liabilities are measured at their fair values at the date of acquisition. Any excess of the cost of acquisition over the fair value of HSBC's share of the identifiable assets, liabilities and contingent liabilities acquired is recorded as goodwill. If the cost of acquisition is less than the fair value of HSBC's share of the identifiable assets, liabilities and contingent liabilities of the business acquired, the difference is recognised immediately in the income statement.

Entities that are controlled by HSBC are consolidated until the date that control ceases.

In the context of Special Purpose Entities ('SPEs'), the following circumstances may indicate a relationship in which, in substance, HSBC controls and, consequently, consolidates an SPE:

- the activities of the SPE are being conducted on behalf of HSBC according to its specific business needs so that HSBC obtains benefits from the SPE's operation;
- HSBC has the decision-making powers to obtain the majority of the benefits of the activities of the SPE or,

by setting up an ‘autopilot’ mechanism, HSBC has delegated these decision-making powers;

- HSBC has rights to obtain the majority of the benefits of the SPE and therefore may be exposed to risks incident to the activities of the SPE; or
- HSBC retains the majority of the residual or ownership risks related to the SPE or its assets in order to obtain benefits from its activities.

All intra-HSBC transactions are eliminated on consolidation.

The consolidated financial statements of HSBC also include the attributable share of the results and reserves of joint ventures and associates. These are based on financial statements made up to 31 December, with the exception of the Bank of Communications Limited, Ping An Insurance (Group) Company of China, Limited, and Industrial Bank Company Limited which are included on the basis of financial statements made up for the twelve months to 30 September. These are equity accounted three months in arrears in order to meet the requirements of the Group’s reporting timetable. HSBC has taken into account changes in the period from 1 October to 31 December that would have materially affected its results.

(g) Future accounting developments

IFRSs

At 31 December 2006, HSBC had adopted all IFRSs and Interpretations that had been issued by the IASB and IFRIC, and endorsed by the EU. There are currently no IFRSs or Interpretations that have been issued by the IASB and endorsed by the EU which become effective after 31 December 2006 that have not been adopted by HSBC.

Standards and Interpretations issued by the IASB but not endorsed by the EU

IFRS 8 ‘Operating Segments’ (‘IFRS 8’), which replaces IAS 14 ‘Segment Reporting’ (‘IAS 14’), was issued on 30 November 2006 and is effective for annual periods beginning on or after 1 January 2009. This standard specifies how an entity should report information about its operating segments, based on information about the components of the entity that management uses to make operating decisions. HSBC currently presents two sets of segments in accordance with IAS 14, one geographical and one based on customer groups, which reflect the way the businesses of the Group are managed. HSBC currently expects to adopt IFRS 8 with effect from 1 January 2009, and will accordingly present segmental information which reflects the operating segments used to make operating decisions at that time.

IFRIC 10 ‘Interim Financial Reporting and Impairment’ (‘IFRIC 10’) was issued on 20 July 2006 and is effective for annual periods beginning on or after 1 November 2006. IFRIC 10 states that any impairment losses recognised in an interim financial statement in respect of goodwill under IAS 36 ‘Impairment of Assets’, or certain financial assets under IAS 39 ‘Financial Instruments: Recognition & Measurement’ must not be reversed in subsequent interim or annual financial statements. HSBC will adopt IFRIC 10 from 1 January 2007, though it is not expected to have a significant effect.

IFRIC 11 ‘Group and Treasury Share Transactions’ (‘IFRIC 11’) was issued on 30 November 2006 and is effective for annual periods beginning on or after 1 March 2007. IFRIC 11 requires a share-based payment arrangement in which an entity receives goods or services as consideration for its own equity-instruments to be accounted for as an equity-settled share-based payment transaction, regardless of how the equity instruments required are obtained. The Interpretation also provides guidance on whether share-based payment arrangements in which suppliers of goods or services of an entity are provided with equity instruments of the entity’s parent, should be accounted for as cash-settled or equity-settled in the entity’s financial statements. HSBC applies IFRS 2 ‘Share-based Payment’ in the same manner as set out in IFRIC 11, therefore there will be no impact for HSBC.

IFRIC 12 ‘Service Concession Arrangements’ (‘IFRIC 12’) was issued on 30 November 2006 and is effective for annual periods beginning on or after 1 January 2008. IFRIC 12 provides guidance on service concession arrangements by which a government or other public sector entity grants contracts for the supply of public services to private sector operators. IFRIC 12 addresses how service concession operators should apply existing IFRSs to account for the obligations they undertake and the rights they receive in service concession arrangements. IFRIC 12 is unlikely to have a material effect on HSBC.

US GAAP

Future accounting developments in respect of US GAAP are set out on page 433.

2 Summary of significant accounting policies

(a) Interest income and expense

Interest income and expense for all financial instruments except for those classified as held for trading or designated at fair value (other than debt securities issued by HSBC and derivatives managed in conjunction with such debt securities issued) are recognised in 'Interest income' and 'Interest expense' in the income statement using the effective interest method. The effective interest method is a way of calculating the amortised cost of a financial asset or a financial liability (or groups of financial assets or financial liabilities) and of allocating the interest income or interest expense over the relevant period.

The effective interest rate is the rate that exactly discounts estimated future cash receipts or payments through the expected life of the financial instrument or, where appropriate, a shorter period, to the net carrying amount of the financial asset or financial liability. When calculating the effective interest rate, HSBC estimates cash flows considering all contractual terms of the financial instrument but not future credit losses. The calculation includes all amounts paid or received by HSBC that are an integral part of the effective interest rate of a financial instrument, including transaction costs and all other premiums or discounts.

Interest on impaired financial assets is calculated by applying the original effective interest rate of the financial asset to the carrying amount as reduced by any allowance for impairment.

(b) Non interest income

Fee income

HSBC earns fee income from a diverse range of services provided to its customers. Fee income is accounted for as follows:

- income earned on the execution of a significant act is recognised as revenue when the act is completed (for example, fees arising from negotiating, or participating in the negotiation of, a transaction for a third party, such as the arrangement for the acquisition of shares or other securities);
- income earned from the provision of services is recognised as revenue as the services are provided (for example, asset management, portfolio and other management advisory and service fees); and
- income which forms an integral part of the effective interest rate of a financial instrument is recognised as an adjustment to the effective interest rate (for example, certain loan commitment fees) and recorded in 'Interest income' (Note 2a).

Net trading income

Net trading income comprises all gains and losses from changes in the fair value of financial assets and financial liabilities held for trading, together with related interest income, expense and dividends.

Net income from financial instruments designated at fair value

'Net income from financial instruments designated at fair value' includes all gains and losses from changes in the fair value of financial assets and financial liabilities designated at fair value through profit or loss. Interest income and expense and dividend income arising on these financial instruments are also included, except for debt securities issued and derivatives managed in conjunction with debt securities issued. Interest on these instruments is presented in 'Interest expense'.

Dividend income

Dividend income is recognised when the right to receive payment is established. This is the ex-dividend date for equity securities.

(c) Segment reporting

HSBC is organised into five geographical regions, Europe, Hong Kong, Rest of Asia-Pacific, North America and Latin America, and manages its business through four customer groups: Personal Financial Services; Commercial Banking, Corporate, Investment Banking and Markets; and Private Banking. The main items reported in the 'Other' segment are the income and expenses of wholesale insurance operations, certain property activities, unallocated investment activities including hsbc.com, centrally held investment companies and HSBC's holding company and financing operations. Segment income and expenses include transfers between geographical regions and transfers between customer groups. These transfers are conducted on arm's length terms and conditions.

(d) Determination of fair value

All financial instruments are recognised initially at fair value. The fair value of a financial instrument on initial recognition is normally the transaction price, i.e. the fair value of the consideration given or received. In certain circumstances, however, the initial fair value may be based on other observable current market transactions in the same instrument, without modification or repackaging, or on a valuation technique whose variables include only data from observable markets.

Subsequent to initial recognition, the fair values of financial instruments measured at fair value that are quoted in active markets are based on bid prices for assets held and offer prices for liabilities issued. When independent prices are not available, fair values are determined by using valuation techniques which refer to observable market data. These include comparison with similar instruments where market observable prices exist, discounted cash flow analysis, option pricing models and other valuation techniques commonly used by market participants.

For certain derivatives, fair values may be determined in whole or in part using valuation techniques based on assumptions that are not supported by prices from current market transactions or observable market data.

A number of factors such as bid-offer spread, credit profile and model uncertainty are taken into account, as appropriate, when fair values are calculated using valuation techniques.

If the fair value of a financial asset measured at fair value becomes negative, it is recorded as a financial liability until its fair value becomes positive, at which time it is recorded as a financial asset, or it is extinguished.

(e) Loans and advances to banks and customers

Loans and advances to banks and customers include loans and advances originated by HSBC which are not classified either as held for trading or designated at fair value. Loans and advances are recognised when cash is advanced to borrowers. They are derecognised when either borrowers repay their obligations, or the loans are sold or written off, or substantially all the risks and rewards of ownership are transferred. They are initially recorded at fair value plus any directly attributable transaction costs and are subsequently measured at amortised cost using the effective interest method, less impairment losses.

(f) Loan impairment

Losses for impaired loans are recognised promptly when there is objective evidence that impairment of a loan or portfolio of loans has occurred. Impairment losses are calculated on individual loans and on loans assessed collectively. Losses expected from future events, no matter how likely, are not recognised.

Individually assessed loans

At each balance sheet date, HSBC assesses on a case-by-case basis whether there is any objective evidence that a loan is impaired. This procedure is applied to all accounts that are considered individually significant. In determining impairment losses on these loans, the following factors are considered:

- HSBC's aggregate exposure to the customer;
- the viability of the customer's business model and their capability to trade successfully out of financial difficulties and generate sufficient cash flow to service debt obligations;
- the amount and timing of expected receipts and recoveries;

– the likely dividend available on liquidation or bankruptcy;
– the extent of other creditors' commitments ranking ahead of, or *pari passu* with, HSBC and the likelihood of other creditors continuing to support the company;
– the complexity of determining the aggregate amount and ranking of all creditor claims and the extent to which legal and insurance uncertainties are evident;
– the realisable value of security (or other credit mitigants) and likelihood of successful repossession;
– the likely deduction of any costs involved in recovery of amounts outstanding;
– the ability of the borrower to obtain, and make payments in, the currency of the loan if not denominated in local currency; and
– when available, the secondary market price of the debt.

Impairment losses are calculated by discounting the expected future cash flows of a loan at its original effective interest rate, and comparing the resultant present value with the loan's current carrying amount. Any loss is charged in the income statement. The carrying amount of impaired loans on the balance sheet is reduced through the use of an allowance account.

Collectively assessed loans

Impairment is assessed on a collective basis in two circumstances:

– to cover losses which have been incurred but have not yet been identified on loans subject to individual assessment; and
– for homogeneous groups of loans that are not considered individually significant.

Incurred but not yet identified impairment

Individually assessed loans for which no evidence of loss has been specifically identified on an individual basis are grouped together according to their credit risk characteristics for the purpose of calculating an estimated collective loss. This reflects impairment losses incurred at the balance sheet date which will only be individually identified in the future.

The collective impairment allowance is determined after taking into account:

– historical loss experience in portfolios of similar credit risk characteristics (for example, by industry sector, loan grade or product);
– the estimated period between impairment occurring and the loss being identified and evidenced by the establishment of an appropriate allowance against the individual loan; and
– management's experienced judgement as to whether current economic and credit conditions are such that the actual level of inherent losses is likely to be greater or less than that suggested by historical experience.

The period between a loss occurring and its identification is estimated by local management for each identified portfolio.

Homogeneous groups of loans

For homogeneous groups of loans that are not considered individually significant, two alternative methods are used to calculate allowances on a portfolio basis:

– When appropriate empirical information is available, HSBC utilises roll rate methodology. This methodology employs statistical analyses of historical trends of delinquency and default to estimate the likelihood that loans will progress through the various stages of delinquency and ultimately prove irrecoverable. The estimated loss is the difference between the present value of expected future cash flows, discounted at the original effective interest rate of the portfolio, and the carrying amount of the portfolio. Current economic conditions are also evaluated when calculating the appropriate level of allowance required to cover inherent loss. In certain highly developed markets, sophisticated models also take into account behavioural and account management trends as revealed in, for example, bankruptcy and rescheduling statistics.

- In other cases, when the portfolio size is small or when information is insufficient or not reliable enough to adopt a roll rate methodology, HSBC adopts a formulaic approach which allocates progressively higher percentage loss rates the longer a customer's loan is overdue. Loss rates are calculated from the discounted expected future cash flows from a portfolio.

In normal circumstances, historical experience provides the most objective and relevant information from which to assess inherent loss within each portfolio. In certain circumstances, historical loss experience provides less relevant information about the inherent loss in a given portfolio at the balance sheet date, for example, where there have been changes in economic, regulatory or behavioural conditions, such that the most recent trends in the portfolio risk factors are not fully reflected in the statistical models. In these circumstances, such risk factors are taken into account when calculating the appropriate level of impairment allowances by adjusting the impairment allowances derived solely from historical loss experience.

Roll rates, loss rates and the expected timing of future recoveries are regularly benchmarked against actual outcomes to ensure they remain appropriate.

Loan write-offs

Loans (and the related impairment allowance accounts) are normally written off, either partially or in full, when there is no realistic prospect of recovery of these amounts and, for collateralised loans, when the proceeds from realising the security have been received.

Reversals of impairment

If the amount of an impairment loss decreases in a subsequent period, and the decrease can be related objectively to an event occurring after the impairment was recognised, the excess is written back by reducing the loan impairment allowance account accordingly. The reversal is recognised in the income statement.

Assets acquired in exchange for loans

Non-financial assets acquired in exchange for loans as part of an orderly realisation are recorded as assets held for sale and reported in 'Other assets'. The asset acquired is recorded at the lower of its fair value (less costs to sell) and the carrying amount of the loan (net of impairment allowance) at the date of exchange. No depreciation is charged in respect of assets held for sale. Any subsequent write-down of the acquired asset to fair value less costs to sell is recognised in the income statement, in 'Other operating income'. Any subsequent increase in the fair value less costs to sell, to the extent this does not exceed the cumulative write down, is also recognised in 'Other operating income', together with any realised gains or losses on disposal.

Renegotiated loans

The impairment of personal loans is generally subject to collective assessment. Personal loans whose terms have been renegotiated are no longer considered past due but are treated as new loans only after the minimum required number of payments required under the new arrangements has been received.

Loans subject to individual impairment assessment, whose terms have been renegotiated, are subject to ongoing review to determine whether they remain impaired or should be considered past due.

(g) Trading assets and trading liabilities

Treasury bills, debt securities, equity shares and short positions in securities are classified as held for trading if they have been acquired principally for the purpose of selling or repurchasing in the near term, or they form part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent pattern of short-term profit-taking. These financial assets or financial liabilities are recognised on trade date, when HSBC enters into contractual arrangements with counterparties to purchase or sell securities, and are normally derecognised when either sold (assets) or extinguished (liabilities). Measurement is initially at fair value, with transaction costs taken to the income statement. Subsequently, their fair values are remeasured, and all gains and losses from changes therein are recognised in the income statement in 'Net trading income' as they arise.

(h) Financial instruments designated at fair value

Financial instruments, other than those held for trading, are classified in this category if they meet one or more of the criteria set out below, and are so designated by management. HSBC may designate financial instruments at fair value when the designation:

– eliminates or significantly reduces valuation or recognition inconsistencies that would otherwise arise from measuring financial assets or financial liabilities, or recognising gains and losses on them, on different bases. Under this criterion, the main classes of financial instruments designated by HSBC are:

  Long-term debt issues – The interest payable on certain fixed rate long-term debt securities issued has been matched with the interest on 'receive fixed/pay variable' interest rate swaps as part of a documented interest rate risk management strategy. An accounting mismatch would arise if the debt securities issued were accounted for at amortised cost, because the related derivatives are measured at fair value with changes in the fair value recognised in the income statement. By designating the long-term debt at fair value, the movement in the fair value of the long-term debt will also be recognised in the income statement.

  Financial assets and financial liabilities under investment contracts – Liabilities to customers under linked contracts are determined based on the fair value of the assets held in the linked funds, with changes recognised in the income statement. Liabilities to customers under other types of investment contracts would be measured at amortised cost. If no designation was made for the assets relating to the customer liabilities they would be classified as available-for-sale and the changes in fair value would be recorded directly in equity. These financial instruments are managed on a fair value basis and management information is also prepared on this basis.

  Designation at fair value of the financial assets and liabilities under investment contracts allows the changes in fair values to be recorded in the income statement and presented in the same line.

– applies to groups of financial assets, financial liabilities or combinations thereof that are managed, and their performance evaluated, on a fair value basis in accordance with a documented risk management or investment strategy, and where information about the groups of financial instruments is reported to management on that basis. Under this criterion, certain financial assets held to meet liabilities under insurance contracts are the main class of financial instrument so designated. HSBC has documented risk management and investment strategies designed to manage such assets at fair value, taking into consideration the relationship of assets to liabilities in a way that mitigates market risks. Reports are provided to management on the fair value of the assets. Fair value measurement is also consistent with the regulatory reporting requirements under the appropriate regulations for these insurance operations.

– relates to financial instruments containing one or more embedded derivatives that significantly modify the cash flows resulting from those financial instruments, including certain debt issues and debt securities held.

The fair value designation, once made, is irrevocable. Designated financial assets and financial liabilities are recognised when HSBC enters into the contractual provisions of the arrangements with counterparties, which is generally on trade date, and are normally derecognised when sold (assets) or extinguished (liabilities). Measurement is initially at fair value, with transaction costs taken directly to the income statement. Subsequently, the fair values are remeasured, and gains and losses from changes therein are recognised in 'Net income from financial instruments designated at fair value'. The amount of change during the period, and cumulatively, in the fair value of designated financial liabilities and loans and advances that is attributable to changes in their credit risk is determined as the amount of change in the fair value that is not attributable to changes in market conditions that give rise to market risk.

(i) Financial investments

Treasury bills, debt securities and equity shares intended to be held on a continuing basis, other than those designated at fair value (Note 2h), are classified as 'available-for-sale' or 'held-to-maturity'. Financial investments are recognised on trade date, when HSBC enters into contractual arrangements with counterparties to purchase securities, and are normally derecognised when either the securities are sold or the borrowers repay their obligations.

(i) Available-for-sale securities are initially measured at fair value plus direct and incremental transaction costs. They are subsequently remeasured at fair value, and changes therein are recognised in equity in the

'Available-for-sale reserve' (Note 39) until the securities are either sold or impaired. When available-for-sale securities are sold, cumulative gains or losses previously recognised in equity are recognised in the income statement as 'Gains less losses from financial investments'.

Interest income is recognised on available-for-sale securities using the effective interest rate method, calculated over the asset's expected life. Premiums and/or discounts arising on the purchase of dated investment securities are included in the calculation of their effective interest rates. Dividends are recognised in the income statement when the right to receive payment has been established.

At each balance sheet date an assessment is made of whether there is any objective evidence of impairment in the value of a financial asset or group of assets. This usually arises when circumstances are such that an adverse effect on future cash flows from the asset or group of assets can be reliably estimated. If an available-for-sale security is impaired, the cumulative loss (measured as the difference between the asset's acquisition cost (net of any principal repayments and amortisation) and its current fair value, less any impairment loss on that asset previously recognised in the income statement) is removed from equity and recognised in the income statement. Reversals of impairment losses are subject to contrasting treatments depending on the nature of the instrument concerned:

– if the fair value of a debt instrument classified as available-for-sale increases in a subsequent period, and the increase can be objectively related to an event occurring after the impairment loss was recognised in the income statement, the impairment loss is reversed through the income statement;

– impairment losses recognised in the income statement on equity instruments are not reversed through the income statement.

(ii) Held-to-maturity investments are non-derivative financial assets with fixed or determinable payments and fixed maturities that HSBC positively intends, and is able, to hold until maturity. Held-to-maturity investments are initially recorded at fair value plus any directly attributable transaction costs, and are subsequently measured at amortised cost using the effective interest rate method, less any impairment losses.

(j) Sale and repurchase agreements (including stock lending and borrowing)

When securities are sold subject to a commitment to repurchase them at a predetermined price ('repos'), they remain on the balance sheet and a liability is recorded in respect of the consideration received. Securities purchased under commitments to sell ('reverse repos') are not recognised on the balance sheet and the consideration paid is recorded in 'Loans and advances to banks' or 'Loans and advances to customers' as appropriate. The difference between the sale and repurchase price is treated as interest and recognised over the life of the agreement.

Securities lending and borrowing transactions are generally secured, with collateral taking the form of securities or cash advanced or received. The transfer of securities to counterparties is not normally reflected on the balance sheet. Cash collateral advanced or received is recorded as an asset or a liability respectively.

Securities borrowed are not recognised on the balance sheet. If they are sold on to third parties, an obligation to return the securities is recorded as a trading liability and measured at fair value, and any gains or losses are included in 'Net trading income'.

(k) Derivatives and hedge accounting

Derivatives are recognised initially, and are subsequently remeasured, at fair value. Fair values of exchange-traded derivatives are obtained from quoted market prices. Fair values of over-the-counter derivatives are obtained using valuation techniques, including discounted cash flow models and option pricing models.

In the normal course of business, the fair value of a derivative on initial recognition is the transaction price (that is, the fair value of the consideration given or received). In certain circumstances, however, the fair value will be based on other observable current market transactions in the same instrument, without modification or repackaging, or on a valuation technique whose variables include only data from observable markets, such as interest rate yield curves, option volatilities and currency rates. When such evidence exists, HSBC recognises a trading gain or loss on inception of the derivative. When unobservable market data have a significant impact on the valuation of derivatives, the entire initial difference in fair value indicated by the valuation model from the transaction price is not recognised immediately in the income statement but is recognised over the life of the transaction on an appropriate basis, or when the inputs become observable, or the transaction matures or is closed out.

Derivatives may be embedded in other financial instruments, for example, a convertible bond with an embedded conversion option. Embedded derivatives are treated as separate derivatives when their economic characteristics and risks are not clearly and closely related to those of the host contract; the terms of the embedded derivative are the same as those of a stand-alone derivative; and the combined contract is not held for trading or designated at fair value. These embedded derivatives are measured at fair value with changes therein recognised in the income statement.

Derivatives are classified as assets when their fair value is positive, or as liabilities when their fair value is negative. Derivative assets and liabilities arising from different transactions are only offset if the transactions are with the same counterparty, a legal right of offset exists, and the parties intend to settle the cash flows on a net basis.

The method of recognising fair value gains and losses depends on whether derivatives are held for trading or are designated as hedging instruments, and if the latter, the nature of the risks being hedged. All gains and losses from changes in the fair value of derivatives held for trading are recognised in the income statement. When derivatives are designated as hedges, HSBC classifies them as either: (i) hedges of the change in fair value of recognised assets or liabilities or firm commitments ('fair value hedges'); (ii) hedges of the variability in highly probable future cash flows attributable to a recognised asset or liability, or a forecast transaction ('cash flow hedges'); or (iii) hedges of net investments in a foreign operation ('net investment hedges'). Hedge accounting is applied to derivatives designated as hedging instruments in a fair value, cash flow or net investment hedge provided certain criteria are met.

Hedge accounting

At the inception of a hedging relationship, HSBC documents the relationship between the hedging instruments and the hedged items, its risk management objective and its strategy for undertaking the hedge. HSBC also requires a documented assessment, both at hedge inception and on an ongoing basis, of whether or not the hedging instruments, primarily derivatives, that are used in hedging transactions are highly effective in offsetting the changes attributable to the hedged risks in the fair values or cash flows of the hedged items. Interest on designated qualifying hedges is included in 'Net interest income'.

Fair value hedge

Changes in the fair value of derivatives that are designated and qualify as fair value hedging instruments are recorded in the income statement, along with changes in the fair value of the hedged assets, liabilities or group thereof that are attributable to the hedged risk.

If a hedging relationship no longer meets the criteria for hedge accounting, the cumulative adjustment to the carrying amount of the hedged item is amortised to the income statement based on a recalculated effective interest rate over the residual period to maturity, unless the hedged item has been derecognised, in which case, it is released to the income statement immediately.

Cash flow hedge

The effective portion of changes in the fair value of derivatives that are designated and qualify as cash flow hedges is recognised in equity within the cash flow hedging reserve. Any gain or loss in fair value relating to an ineffective portion is recognised immediately in the income statement.

Amounts accumulated in equity are recycled to the income statement in the periods in which the hedged item will affect profit or loss. However, when the forecast transaction that is hedged results in the recognition of a non-financial asset or a non-financial liability, the gains and losses previously deferred in equity are transferred from equity and included in the initial measurement of the cost of the asset or liability.

When a hedging instrument expires or is sold, or when a hedge no longer meets the criteria for hedge accounting, any cumulative gain or loss existing in equity at that time remains in equity until the forecast transaction is eventually recognised in the income statement. When a forecast transaction is no longer expected to occur, the cumulative gain or loss that was reported in equity is immediately transferred to the income statement.

Net investment hedge

Hedges of net investments in foreign operations are accounted for in a similar way to cash flow hedges. A gain or loss on the effective portion of the hedging instrument is recognised in equity; a gain or loss on the ineffective portion is recognised immediately in the income statement. Gains and losses accumulated in equity are included in the income statement on the disposal of the foreign operation.

Hedge effectiveness testing

To qualify for hedge accounting, HSBC requires that at the inception of the hedge and throughout its life, each hedge must be expected to be highly effective (prospective effectiveness), and demonstrate actual effectiveness (retrospective effectiveness) on an ongoing basis.

The documentation of each hedging relationship sets out how the effectiveness of the hedge is assessed. The method an HSBC entity adopts for assessing hedge effectiveness will depend on its risk management strategy.

For prospective effectiveness, the hedging instrument must be expected to be highly effective in offsetting changes in fair value or cash flows attributable to the hedged risk during the period for which the hedge is designated. For actual effectiveness to be achieved, the changes in fair value or cash flows must offset each other in the range of 80 per cent to 125 per cent.

Hedge ineffectiveness is recognised in the income statement in 'Net trading income'.

Derivatives that do not qualify for hedge accounting

All gains and losses from changes in the fair values of derivatives that do not qualify for hedge accounting are recognised immediately in the income statement. These gains and losses are reported in 'Net trading income', except where derivatives are managed in conjunction with financial instruments designated at fair value (other than derivatives managed in conjunction with debt securities issued by the Group), in which case gains and losses are reported in 'Net income from financial instruments designated at fair value'. The interest on derivatives managed in conjunction with debt securities issued by the Group which are designated at fair value is recognised in 'Interest expense'. All other gains and losses on these derivatives are reported in 'Net income from financial instruments designated at fair value'.

(l) Derecognition of financial assets and liabilities

Financial assets are derecognised when the right to receive cash flows from the assets has expired; or when HSBC has transferred its contractual right to receive the cash flows of the financial assets, and either

– substantially all the risks and rewards of ownership have been transferred; or

– substantially all the risks and rewards have neither been retained nor transferred but control is not retained.

Financial liabilities are derecognised when they are extinguished, that is when the obligation is discharged, cancelled or expires.

(m) Offsetting financial assets and financial liabilities

Financial assets and financial liabilities are offset and the net amount reported in the balance sheet when there is a legally enforceable right to offset the recognised amounts and there is an intention to settle on a net basis, or realise the asset and settle the liability simultaneously.

(n) Subsidiaries, associates and joint ventures

HSBC Holdings' investments in subsidiaries are stated at cost less any impairment losses. Reversals of impairment losses are recognised in the income statement if there has been a change in the estimates used to determine the recoverable amount of the investment.

Investments in associates and interests in joint ventures are recognised using the equity method, initially stated at cost, including attributable goodwill, and are adjusted thereafter for the post-acquisition change in HSBC's share of net assets.

Profits on transactions between HSBC and its associates and joint ventures are eliminated to the extent of HSBC's interest in the respective associates or joint ventures. Losses are also eliminated to the extent of HSBC's interest in the associates or joint ventures unless the transaction provides evidence of an impairment of the asset transferred.

(o) Goodwill and intangible assets

(i) Goodwill arises on business combinations, including the acquisition of subsidiaries, and interests in joint ventures and associates, when the cost of acquisition exceeds the fair value of HSBC's share of the identifiable assets, liabilities and contingent liabilities acquired. By contrast, if HSBC's interest in the fair value of the identifiable assets, liabilities and contingent liabilities of an acquired business is greater than the cost of acquisition, the excess is recognised immediately in the income statement.

Intangible assets are recognised separately from goodwill when they are separable or arise from contractual or other legal rights, and their fair value can be measured reliably.

Goodwill is allocated to cash-generating units for the purpose of impairment testing, which is undertaken at the lowest level at which goodwill is monitored for internal management purposes. Impairment testing is performed at least annually by comparing the present value of the expected future cash flows from a business with the carrying amount of its net assets, including attributable goodwill. Goodwill is stated at cost less accumulated impairment losses which are charged to the income statement.

Goodwill on acquisitions of interests in joint ventures and associates is included in 'Interests in associates and joint ventures'.

At the date of disposal of a business, attributable goodwill is included in HSBC's share of net assets in the calculation of the gain or loss on disposal.

(ii) Intangible assets include the value of in-force long-term insurance business, computer software, trade names, mortgage servicing rights, customer lists, core deposit relationships, credit card customer relationships and merchant or other loan relationships. Intangible assets are subject to impairment review if there are events or changes in circumstances that indicate that the carrying amount may not be recoverable.

- Intangible assets that have an indefinite useful life, or are not yet ready for use, are tested for impairment annually. This impairment test may be performed at any time during the year, provided it is performed at the same time every year. An intangible asset recognised during the current period is tested before the end of the current year.
- Intangible assets that have a finite useful life, except for the value of in-force long-term insurance business, are stated at cost less amortisation and accumulated impairment losses and are amortised over their estimated useful lives. Estimated useful life is the lower of legal duration and expected useful life. The amortisation of mortgage servicing rights is included within 'Net fee income'.

For the accounting policy governing the value of in-force long-term insurance business see Note 2(x).

(iii) Intangible assets are amortised over their finite useful lives, generally on a straight line basis, as follows:

Trade names	10 years
Mortgage servicing rights	between 5 and 30 years
Purchased software	between 3 and 5 years
Internally generated software	between 3 and 5 years
Customer/merchant relationships	between 3 and 10 years
Other	generally 10 years

(p) Property, plant and equipment

Land and buildings are stated at historical cost, or fair value at the date of transition to IFRSs ('deemed cost'), less any impairment losses and depreciation calculated to write off the assets over their estimated useful lives as follows:

- freehold land is not depreciated;
- freehold buildings are depreciated at the greater of two per cent per annum on a straight-line basis or over their remaining useful lives; and

– leasehold buildings are depreciated over the unexpired terms of the leases, or over their remaining useful lives.

Equipment, fixtures and fittings (including equipment on operating leases where HSBC is the lessor) are stated at cost less any impairment losses and depreciation calculated on a straight-line basis to write off the assets over their useful lives, which run to a maximum of 35 years but are generally between five years and 20 years.

Property, plant and equipment is subject to an impairment review if there are events or changes in circumstances which indicate that the carrying amount may not be recoverable.

HSBC holds certain properties as investments to earn rentals or for capital appreciation, or both. Investment properties are included in the balance sheet at fair value with changes therein recognised in the income statement in the period of change. Fair values are determined by independent professional valuers who apply recognised valuation techniques.

(q) Finance and operating leases

Agreements which transfer to counterparties substantially all the risks and rewards incidental to the ownership of assets, but not necessarily legal title, are classified as finance leases. When HSBC is a lessor under finance leases the amounts due under the leases, after deduction of unearned charges, are included in 'Loans and advances to banks' or 'Loans and advances to customers' as appropriate. Finance income receivable is recognised in 'Net interest income' over the periods of the leases so as to give a constant rate of return on the net investment in the leases.

When HSBC is a lessee under finance leases, the leased assets are capitalised and included in 'Property, plant and equipment' and the corresponding liability to the lessor is included in 'Other liabilities'. A finance lease and its corresponding liability are recognised initially at the fair value of the asset or, if lower, the present value of the minimum lease payments. Finance charges payable are recognised in 'Net interest income' over the period of the lease based on the interest rate implicit in the lease so as to give a constant rate of interest on the remaining balance of the liability.

All other leases are classified as operating leases. When acting as lessor, HSBC includes the assets subject to operating leases in 'Property, plant and equipment' and accounts for them accordingly. Impairment losses are recognised to the extent that residual values are not fully recoverable and the carrying value of the equipment is thereby impaired. When HSBC is the lessee, leased assets are not recognised on the balance sheet. Rentals payable and receivable under operating leases are accounted for on a straight-line basis over the periods of the leases and are included in 'General and administrative expenses' and 'Other operating income' respectively.

(r) Income tax

Income tax on the profit or loss for the year comprises current tax and deferred tax. Income tax is recognised in the income statement except to the extent that it relates to items recognised directly in shareholders' equity, in which case it is recognised in shareholders' equity.

Current tax is the tax expected to be payable on the taxable profit for the year, calculated using tax rates enacted or substantively enacted by the balance sheet date, and any adjustment to tax payable in respect of previous years. Current tax assets and liabilities are offset when HSBC intends to settle on a net basis and the legal right to offset exists.

Deferred tax is recognised on temporary differences between the carrying amounts of assets and liabilities in the balance sheet and the amounts attributed to such assets and liabilities for tax purposes. Deferred tax liabilities are generally recognised for all taxable temporary differences and deferred tax assets are recognised to the extent that it is probable that future taxable profits will be available against which deductible temporary differences can be utilised.

Deferred tax is calculated using the tax rates expected to apply in the periods in which the assets will be realised or the liabilities settled, based on tax rates and laws enacted, or substantively enacted, by the balance sheet date. Deferred tax assets and liabilities are offset when they arise in the same tax reporting group and relate to income taxes levied by the same taxation authority, and when a legal right to offset exists in the entity.

Deferred tax relating to actuarial gains and losses on post-employment benefits is recognised directly in equity. From 1 January 2005, deferred tax relating to fair value remeasurement of available-for-sale investments and cash flow hedging instruments which are charged or credited directly to equity, is also credited or charged directly to equity and is subsequently recognised in the income statement when the deferred fair value gain or loss is recognised in the income statement.

(s) Pension and other post-employment benefits

HSBC operates a number of pension and other post-employment benefit plans throughout the world. These plans include both defined benefit and defined contribution plans and various other post-employment benefits such as post-employment health-care.

Payments to defined contribution plans and state-managed retirement benefit plans, where HSBC's obligations under the plans are equivalent to a defined contribution plan, are charged as an expense as they fall due.

The costs recognised for funding defined benefit plans are determined using the Projected Unit Credit Method, with annual actuarial valuations performed on each plan. Actuarial differences that arise are recognised in shareholders' equity and presented in the Statement of Recognised Income and Expense in the period in which they arise. Past service costs are recognised immediately to the extent that the benefits have vested, and are otherwise recognised on a straight-line basis over the average period until the benefits vest. Current service costs and any past service costs, together with the unwinding of the discount on plan liabilities less the expected return on plan assets, are charged to operating expenses.

The defined benefit liability recognised in the balance sheet represents the present value of defined benefit obligations adjusted for unrecognised past service costs and reduced by the fair value of plan assets. Any net defined benefit surplus is limited to unrecognised past service costs plus the present value of available refunds and reductions in future contributions to the plan.

The costs of providing other defined post-employment benefits, such as post-employment health-care, are accounted for on the same basis as defined benefit pension plans.

(t) Equity compensation plans

Shares awarded to an employee on joining HSBC that are made available immediately, with no vesting period attached to the award, are expensed immediately. When an inducement is awarded to an employee on commencement of employment with HSBC, and the employee must complete a specified period of service before the inducement vests, the expense is spread over the period to vesting.

The expense of share options is recognised over the vesting period, and is determined by reference to the fair value of the options on grant date, and the effect of any non-market vesting conditions such as option lapses. An option may lapse if, for example, an employee ceases to be employed by HSBC before the end of the vesting period. Estimates of future such employee departures are taken into account when accruing the cost during the service period.

The expense relating to shares awarded as bonuses in respect of past service, by which an employee is required to complete a specified period of future service to be entitled to the award, is spread over the period of service rendered to the vesting date.

The compensation expense charged to the income statement is credited to the share-based payment reserve over the vesting period of the shares and options. If awards of shares and options lapse during the vesting period due to an employee leaving employment with HSBC, the charge to date is reversed to the income statement. If an award lapses due to an employee leaving a plan but not employment with HSBC or due to HSBC cancelling or modifying a plan, this is accounted for as an acceleration of vesting with full immediate recognition of the outstanding charge in the income statement. If awards of shares or options lapse after they have fully vested, the amount in respect of the award charged to the share-based payment reserve is transferred to retained earnings.

(u) Foreign currencies

Items included in the financial statements of each of HSBC's entities are measured using the currency of the primary economic environment in which the entity operates ('the functional currency'). The consolidated financial statements of HSBC are presented in US dollars, which is the Group's presentation currency.

Transactions in foreign currencies are recorded in the functional currency at the rate of exchange prevailing on the date of the transaction. Monetary assets and liabilities denominated in foreign currencies are translated into the functional currency at the rate of exchange ruling at the balance sheet date. Any resulting exchange differences are included in the income statement. Non-monetary assets and liabilities that are measured at historical cost in a foreign currency are translated into the functional currency using the rate of exchange at the date of the initial transaction. Non-monetary assets and liabilities measured at fair value in a foreign currency are translated into the functional currency using the rate of exchange at the date the fair value was determined. Any exchange component of a gain or loss on a non-monetary item is recognised directly in equity if the gain or loss on the non-monetary item is recognised directly in equity. Any exchange component of a gain or loss on a non-monetary item is recognised directly in the income statement if the gain or loss on the non-monetary item is recognised in the income statement.

In the consolidated financial statements, the assets, including related goodwill where applicable, and liabilities of branches, subsidiaries, joint ventures and associates whose functional currency is not US dollars, are translated into the Group's presentation currency at the rate of exchange ruling at the balance sheet date. The results of branches, subsidiaries, joint ventures and associates whose functional currency is not US dollars are translated into US dollars at the average rates of exchange for the reporting period. Exchange differences arising from the retranslation of opening foreign currency net investments, and exchange differences arising from retranslation of the result for the reporting period from the average rate to the exchange rate prevailing at the period end, are recognised in equity in the 'foreign exchange reserve'. Exchange differences on a monetary item that is part of a net investment in a foreign operation are recognised in the income statement of the separate financial statements. In consolidated financial statements these exchange differences are recognised in the foreign exchange reserve in shareholders' equity. On disposal of a foreign operation, exchange differences relating thereto and previously recognised in reserves are recognised in the income statement.

(v) Provisions

Provisions are recognised when it is probable that an outflow of economic benefits will be required to settle a current legal or constructive obligation as a result of past events, and a reliable estimate can be made of the amount of the obligation.

Contingent liabilities, which include certain guarantees and letters of credit pledged as collateral security, are possible obligations that arise from past events whose existence will be confirmed only by the occurrence, or non-occurrence, of one or more uncertain future events not wholly within the control of HSBC. Contingent liabilities are not recognised in the financial statements but are disclosed unless they are remote.

(w) Financial guarantee contracts

Liabilities under financial guarantees contracts which are not classified as insurance contracts, are recorded initially at their fair value, which is generally the fee received or receivable. Subsequently, the financial guarantee liabilities are measured at the higher of the initial fair value, less cumulative amortisation, and the best estimate of the expenditure required to settle the obligations.

HSBC Holdings has issued financial guarantees to other Group entities. Where these guarantees have been classified as insurance contracts, they are measured consistently with insurance liabilities.

(x) Insurance contracts

Through its insurance subsidiaries, HSBC issues contracts to customers that contain insurance risk, financial risk or a combination thereof. A contract under which HSBC accepts significant insurance risk from another party by agreeing to compensate that party on the occurrence of a specified uncertain future event, is classified as an insurance contract. An insurance contract may also transfer financial risk, but is accounted for as an insurance contract if the insurance risk is significant.

Insurance contracts are accounted for as follows:

Premiums

Gross insurance premiums for non-life insurance business are reported as income over the term of the insurance contracts based on the proportion of risks borne during the accounting period. The unearned premium (the proportion of the business underwritten in the accounting year relating to the period of risk after the balance sheet date) is calculated on a daily or monthly pro rata basis.

Premiums for life insurance contracts are accounted for when receivable, except in unit-linked insurance contracts where premiums are accounted for when liabilities are established.

Reinsurance premiums are accounted for in the same accounting period as the premiums for the direct insurance contracts to which they relate.

Claims and reinsurance recoveries

Gross insurance claims for non-life insurance contracts include paid claims and movements in outstanding claims liabilities.

Gross insurance claims for life insurance contracts reflect the total cost of claims arising during the year, including claim handling costs and any policyholder bonuses allocated in anticipation of a bonus declaration. Claims arising during the year include maturities, surrenders and death claims.

Maturity claims are recognised when due for payment. Surrenders are recognised when paid or at an earlier date on which, following notification, the policy ceases to be included within the calculation of the related insurance liabilities. Death claims are recognised when notified.

Reinsurance recoveries are accounted for in the same period as the related claim.

Liabilities under insurance contracts

Outstanding claims liabilities for non-life insurance contracts are based on the estimated ultimate cost of all claims incurred but not settled at the balance sheet date, whether reported or not, together with related claim-handling costs and a reduction for the expected value of salvage and other recoveries. Liabilities for claims incurred but not reported are made on an estimated basis, using appropriate statistical techniques.

Liabilities under non-linked life insurance contracts are calculated by each life insurance operation based on local actuarial principles.

Liabilities under unit-linked life insurance contracts are at least equivalent to the surrender or transfer value which is calculated by reference to the value of the relevant underlying funds or indices.

Present value of in-force long-term insurance business

The value placed on insurance contracts that are classified as long-term insurance business and are in force at the balance sheet date is recognised as an asset.

The present value of in-force long-term insurance business is determined by discounting future cash flows expected to emerge from business currently in force using appropriate assumptions in assessing factors such as future mortality, lapse rates and levels of expenses and a risk discount rate that reflects the risk premium attributable to the respective long-term insurance business. Movements in the present value of in-force long-term insurance business are included in ‘Other operating income’ on a gross of tax basis.

(y) Investment contracts

Customer liabilities under non-linked and unit-linked investment contracts and the linked financial assets are designated at fair value, and the movements in fair value are recognised in the income statement in ‘Net income from financial investments designated at fair value’. Premiums receivable and amounts withdrawn are accounted for as increases or decreases in the liability recorded in respect of investment contracts.

Liabilities under unit-linked investment contracts are at least equivalent to the surrender or transfer value which is calculated by reference to the value of the relevant underlying funds or indices.

Investment management fees receivable are recognised in the income statement over the period of the provision of the investment management services, in ‘Net fee income’.

The incremental costs directly related to the acquisition of new investment contracts or renewing existing investment contracts are deferred and amortised over the period during which the investment management services are provided.

(z) Debt securities issued and deposits by customers and banks

Financial liabilities are recognised when HSBC enters into the contractual provisions of the arrangements with counterparties, which is generally on trade date, and initially measured at fair value, which is normally the consideration received net of directly attributable transaction costs incurred. Subsequent measurement of financial liabilities, other than those measured at fair value through profit or loss and financial guarantees, is at amortised cost, using the effective interest rate method to amortise the difference between proceeds net of directly attributable transaction costs and the redemption amount over the expected life of the debt.

(aa) Share capital

Shares are classified as equity when there is no contractual obligation to transfer cash or other financial assets. Incremental costs directly attributable to the issue of equity instruments are shown in equity as a deduction from the proceeds, net of tax.

HSBC Holdings plc shares held by HSBC are recognised in 'Total shareholders' equity' as a deduction from retained earnings until they are cancelled. When such shares are subsequently sold, reissued or otherwise disposed of, any consideration received is included in 'Total shareholders' equity', net of any directly attributable incremental transaction costs and related income tax effects.

(ab) Cash and cash equivalents

For the purpose of the cash flow statement, cash and cash equivalents include highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of change in value. Such investments are normally those with less than three months' maturity from the date of acquisition, and include cash and balances at central banks, treasury bills and other eligible bills, loans and advances to banks, items in the course of collection from or in transmission to other banks, and certificates of deposit.

3 Net income from financial instruments designated at fair value

Net income from financial instruments designated at fair value includes:

- all gains and losses from changes in the fair value of financial assets and liabilities designated at fair value, including liabilities under investment contracts;
- all gains and losses from changes in the fair value of derivatives that are managed in conjunction with financial assets and liabilities designated at fair value; and
- interest income, interest expense and dividend income in respect of:
  - financial assets and liabilities designated at fair value; and
  - derivatives managed in conjunction with the above,

  except for interest expense arising on HSBC's issued debt securities, together with the interest element of derivatives managed in conjunction with them, which are recognised in 'Interest expense'.

	2006	2005
	US$m	US$m
Net income/(expense) arising on:		
– financial assets held to meet liabilities under insurance and investment contracts	**1,552**	1,760
– other financial assets designated at fair value	**217**	90
– derivatives managed in conjunction with financial assets designated at fair value	**57**	17
	1,826	1,867
– liabilities to customers under investment contracts	**(1,008)**	(1,126)
– HSBC's issued debt securities[1]	**(277)**	1,795
– derivatives managed in conjunction with HSBC's issued debt securities	**242**	(1,392)
– other financial liabilities designated at fair value	**(125)**	(112)
– derivatives managed in conjunction with other financial liabilities designated at fair value	**(1)**	2
	(1,169)	(833)
Net income from financial instruments designated at fair value	**657**	1,034

Notes on the Financial Statements (continued)

Notes 4, 5 and 6

1 *Gains and losses from changes in the fair value of HSBC's issued debt securities may arise from changes in HSBC's own credit risk. In 2006, HSBC recognised a US$388 million loss on changes in the fair value of these instruments arising from changes in HSBC's own credit risk (2005: loss US$70 million).*

4 Net earned insurance premiums

	Non-life insurance US$m	Life insurance (non-linked) US$m	Life insurance (linked) US$m	Investment contracts with discretionary participation features US$m	Total US$m
2006					
Gross written premiums	**1,824**	**3,640**	**848**	**8**	**6,320**
Movement in unearned premiums	**122**	**14**	**(1)**	**–**	**135**
Gross earned premiums	**1,946**	**3,654**	**847**	**8**	**6,455**
Gross written premiums ceded to reinsurers	**(451)**	**(274)**	**(14)**	**–**	**(739)**
Reinsurers' share of movement in unearned premiums	**(48)**	**–**	**–**	**–**	**(48)**
Reinsurers' share of gross earned premiums	**(499)**	**(274)**	**(14)**	**–**	**(787)**
Net earned insurance premiums	**1,447**	**3,380**	**833**	**8**	**5,668**
2005					
Gross written premiums	2,364	3,441	768	12	6,585
Movement in unearned premiums	(225)	2	(210)	–	(433)
Gross earned premiums	2,139	3,443	558	12	6,152
Gross written premiums ceded to reinsurers	(479)	(277)	(20)	–	(776)
Reinsurers' share of movement in unearned premiums	60	–	–	–	60
Reinsurers' share of gross earned premiums	(419)	(277)	(20)	–	(716)
Net earned insurance premiums	1,720	3,166	538	12	5,436

5 Net insurance claims incurred and movement in policyholders' liabilities

	Non-life insurance US$m	Life insurance (non-linked) US$m	Life insurance (linked) US$m	Investment contracts with discretionary participation features US$m	Total US$m
2006					
Claims, benefits and surrenders paid	**889**	**814**	**495**	**–**	**2,198**
Movement in liabilities	**10**	**2,207**	**651**	**6**	**2,874**
Gross claims incurred and movement in liabilities	**899**	**3,021**	**1,146**	**6**	**5,072**
Reinsurers' share of claims, benefits and surrenders paid	**(228)**	**(154)**	**(9)**	**–**	**(391)**
Reinsurers' share of movement in liabilities	**57**	**(54)**	**20**	**–**	**23**
Reinsurers' share of claims incurred and movement in liabilities	**(171)**	**(208)**	**11**	**–**	**(368)**
Net insurance claims incurred and movement in policyholders' liabilities	**728**	**2,813**	**1,157**	**6**	**4,704**

	Non-life insurance US$m	Life insurance (non-linked) US$m	Life insurance (linked) US$m	Investment contracts with discretionary participation features US$m	Total US$m
2005					
Claims, benefits and surrenders paid	966	621	357	–	1,944
Movement in liabilities	72	1,683	445	9	2,209
Gross claims incurred and movement in liabilities	1,038	2,304	802	9	4,153
Reinsurers' share of claims, benefits and surrenders paid	(146)	(111)	(11)	–	(268)
Reinsurers' share of movement in liabilities	2	191	(11)	–	182
Reinsurers' share of claims incurred and movement in liabilities	(144)	80	(22)	–	(86)
Net insurance claims incurred and movement in policyholders' liabilities	894	2,384	780	9	4,067

6 Net operating income

Net operating income is stated after the following items of income, expense, gains and losses:

	2006 US$m	2005 US$m
Income		
Interest recognised on impaired financial assets	**284**	120
Fees earned on financial assets or liabilities not held for trading nor designated at fair value, other than fees included in effective interest rate calculations on these types of assets and liabilities	**11,182**	9,077
Fees earned on trust and other fiduciary activities where HSBC holds or invests assets on behalf of its customers	**2,909**	2,912
Income from listed investments[1]	**7,304**	6,819
Income from unlisted investments[2]	**9,192**	5,001
Expense		
Interest on financial instruments, excluding interest on financial liabilities held for trading or designated at fair value	**(38,158)**	(26,627)
Fees payable on financial assets or liabilities not held for trading nor designated at fair value, other than fees included in effective interest rate calculations on these types of assets and liabilities	**(1,826)**	(1,357)
Fees payable relating to trust and other fiduciary activities where HSBC holds or invests assets on behalf of its customers	**(103)**	(238)
Gains/(losses)		
Gain /(loss) on disposal or settlement of loans and advances	**24**	(12)
Net impairment loss on loans and advances	**(10,547)**	(7,860)
Net (charge)/reversal of impairment allowances in respect of available-for-sale financial investments	**(21)**	42
Gains on disposal of property, plant and equipment and non-financial investments	**781**	703

1 *Income from listed investments at 31 December 2004 was US$5,166 million.*
2 *Income from unlisted investments at 31 December 2004 was US$3,521 million.*

Notes on the Financial Statements (continued)

Note 7

7 Employee compensation and benefits

	2006 US$m	2005 US$m	2004 US$m
Wages and salaries	**16,186**	14,008	12,374
Social security costs	**1,194**	1,072	973
Post-employment benefits	**1,120**	1,065	1,176
	18,500	16,145	14,523

The average number of persons employed by HSBC during the year was as follows:

	2006	2005 *(restated[1])*	2004 *(restated[1])*
Europe	**84,170**	82,638	80,930
Hong Kong	**27,328**	25,699	25,070
Rest of Asia-Pacific	**68,182**	50,605	37,211
North America	**57,654**	51,518	49,832
Latin America	**58,863**	54,825	51,684
Total	**296,197**	265,285	244,727

1 *In 2006, Mexico and Panama were reclassified from the North America segment to the Latin America segment. Comparative information has been restated accordingly. See Note 13.*

Post-employment benefit plans

HSBC pension plans

HSBC operates some 166 pension plans throughout the world, covering 76 per cent of HSBC's employees, with a total pension cost of US$1,058 million (2005: US$1,007 million; 2004: US$1,111 million), of which US$668 million (2005: US$546 million; 2004: US$485 million) relates to plans outside the UK.

Progressively, HSBC has been moving to defined contribution plans for all new employees. The pension cost for defined contribution plans, which cover 35 per cent of HSBC's employees, was US$456 million (2005: US$389 million; 2004: US$351 million).

Both HSBC's and, where relevant and appropriate, the trustees' long-term investment objectives for defined benefit plans are:

- to limit the risk of the assets failing to meet the liability of the plans over the long-term; and
- to maximise returns consistent with an acceptable level of risk so as to control the long-term costs of the defined benefit plans.

Both HSBC and, where relevant and appropriate, the trustees, consider that the investment policy should be consistent with meeting their mutual overall long-term investment objectives. In pursuit of these long-term objectives, an overall benchmark is established for the allocation of the defined benefit plan assets between asset classes. In addition, each permitted asset class has its own benchmarks, such as stock market or property valuation indices and desired levels of out-performance where relevant. This is intended to be reviewed at least triennially within 18 months of the date at which the actuarial valuation is made, or more frequently if circumstances or local legislation so require. The process generally involves an extensive asset and liability review.

The Group's defined benefit plans, which cover 41 per cent of HSBC's employees, are predominantly funded plans with assets which, in the case of most of the larger plans, are held in trust or similar funds separate from HSBC. The plans are reviewed at least annually or in accordance with local practice and regulations by qualified actuaries. The actuarial assumptions used to calculate the defined benefit obligations and related current service costs vary according to the economic conditions of the countries in which they are situated.

The largest plan exists in the UK, where the HSBC Bank (UK) Pension Scheme covers employees of HSBC Bank plc and certain other employees of HSBC. This plan comprises a funded defined benefit plan ('the principal plan') which is closed, and a defined contribution plan which was established on 1 July 1996 for new employees. In 2006, HSBC and the Trustee of the principal plan agreed to change the investment strategy in order to reduce the investment risk. This involved switching from a largely equity-based strategy to a strategy largely based on holding bonds together with a more diverse range of investments. At the same time the principal plan entered into swap arrangements whereby the principal plan is committed to making LIBOR related interest payments in exchange for cash flows paid into the plan, based on a projection of the future benefit payments from the principal plan. The asset allocation for the new strategy is:

	%
Equities	12.5
Bonds	50.0
Alternative assets[1]	12.5
Property	10.0
Cash	15.0
	100.0

1 *Alternative assets include emerging market bonds, loans, and infrastructure assets*.

At 31 December 2006, significant progress had been made towards the new strategy and swap arrangements were in place.

The latest actuarial investigation of the principal plan was made at 31 December 2005, by C G Singer, Fellow of the Institute of Actuaries, of Watson Wyatt Limited. At that date, the market value of the HSBC Bank (UK) Pension Scheme's assets was US$18,072 million (including assets relating to the defined benefit plan, the defined contribution plan, and additional voluntary contributions). The market value of the plan assets represented 89 per cent of the amount expected to be required, on the basis of the assumptions adopted, to provide the benefits accrued to members after allowing for expected future increases in earnings, and the resulting deficit amounted to US$2,065 million. The method adopted for this investigation was the projected unit method. The expected cash flows from the plan were projected by reference to the Retail Price Index ('RPI') swap break-even curve at 31 December 2005. Salary increases were assumed to be 1 per cent per annum above RPI and inflationary pension increases, subject to a minimum of 0 per cent and a maximum of 5 per cent, were assumed to be in line with RPI. The projected cash flows were discounted at the LIBOR swap curve at 31 December 2005 plus a margin for the expected return on the investment strategy of 110 basis points per annum. The mortality experience of the plan's pensioners over the three year period since the previous valuation was analysed and the mortality assumption set on the basis of this with allowances for medium cohort improvements on the PA92 series of tables from the valuation date.

In anticipation of the results of the 2005 investigation, on 22 December 2005 HSBC Bank plc made an additional contribution of US$1,746 million to the principal plan in order to reduce the deficit of the plan. Following receipt of the valuation results, HSBC agreed with the Trustee to meet a schedule of additional future funding payments, as set out below:

	US$m
2007	589
2012	913
2013	913
2014	913

HSBC considers that the contributions set out above are sufficient to meet the deficit as at 31 December 2005 over the agreed period.

HSBC also decided to make ongoing contributions to the principal plan in respect of the accrual of benefits of defined benefit section members at the rate of 36 per cent of pensionable salaries from 1 January 2007, until the completion of the next actuarial valuation, due at 31 December 2008. During 2006 HSBC paid contributions at the rate of 20 per cent of pensionable salaries. A further 2 per cent of pensionable salaries is being paid over the period 1 January 2007 to 31 December 2014 to make good the difference in contributions during 2006.

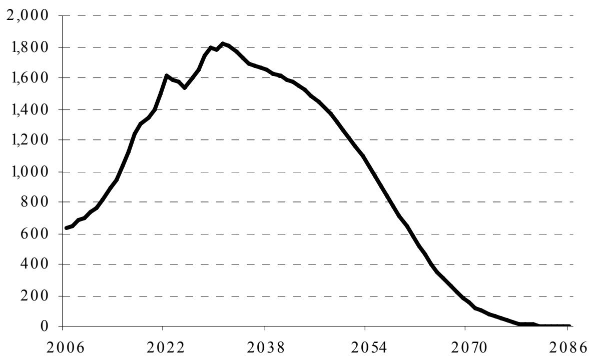
As part of the 31 December 2005 valuation, calculations were also carried out as to the amount of assets that might be needed to meet the liabilities if the plan was discontinued and the members' benefits bought out with an insurance company (although in practice this may not be possible for a plan of this size) or the Trustee continued to run the plan without the support of HSBC. The amount required under this approach is estimated to be US$26,700 million as at 31 December 2005. In estimating the solvency position for this purpose, a more prudent assumption about future mortality was made than for the assessment of the ongoing position and it was assumed that the Trustee would alter the investment strategy to be an appropriately matched portfolio of cash and interest and inflation swaps. An explicit allowance for expenses was also included.

Notes on the Financial Statements (continued)

Note 7

The benefits payable from the defined benefit plan are expected to be as shown in the chart below:

Benefit payments (US$m)



In Hong Kong, the HSBC Group Hong Kong Local Staff Retirement Benefit Scheme covers employees of The Hongkong and Shanghai Banking Corporation and certain other employees of HSBC. The plan comprises a funded defined benefit plan (which provides a lump sum on retirement but which is now closed to new members) and a defined contribution plan. The latter was established on 1 January 1999 for new employees. The latest valuation of the defined benefit plan was made at 31 December 2004 and was performed by E Chiu, Fellow of the Society of Actuaries of the United States of America, of HSBC Life (International) HSBC Holdings. At that date, the market value of the defined benefit plan's assets was US$942 million. On an ongoing basis, the actuarial value of the plan's assets represented 115 per cent of the benefits accrued to members, after allowing for expected future increases in salaries, and the resulting surplus amounted to US$121 million. On a wind-up basis, the actuarial value of the plan's assets represented 128 per cent of the members' vested benefits, based on current salaries, and the resulting surplus amounted to US$206 million. The actuarial method used was the projected unit credit method and the main assumptions used in this valuation were a discount rate of 4 per cent per annum and long-term salary increases of 3 per cent per annum (with short-term deviation from 2005 to 2008).

The HSBC North America (U.S.) Retirement Income Plan was formed with effect from the close of business on 31 December 2004 by the merger of the HSBC Bank USA Pension Plan and the Household International Retirement Income Plan. This plan covers employees of HSBC Bank USA, HSBC Finance, and certain other employees of HSBC. It comprises a final average pay plan (now closed to new participants) and a cash balance plan. All new employees participate in the cash balance plan. The first full actuarial valuation of the merged plan was made at 1 January 2005 by Pedro Nebres, Fellow of the Society of Actuaries and Dan Kutliroff, Enrolled Actuary, of Mercer Human Resource Consulting. Both are members of the American Academy of Actuaries. At that date, the market value of the merged plan's assets was US$2,305 million. The actuarial value of the assets represented 137 per cent of the benefits accrued to members, after allowing for expected future increases in earnings. The resulting surplus amounted to US$622 million. The method employed for this valuation was the projected unit credit method and the main assumptions used were a discount rate of 8 per cent per annum and average salary increases of 3.75 per cent per annum. The Internal Revenue Service granted formal approval for changes in funding method due to the merger of pension plans on 23 August 2006.

The HSBC Bank (UK) Pension Scheme, The HSBC Group Hong Kong Local Staff Retirement Benefit Scheme, and the HSBC North America (U.S.) Retirement Income Plan cover 37 per cent of HSBC's employees.

HSBC healthcare benefits plans

HSBC also provides post-employment healthcare benefits under plans in the UK, the US, Canada, Mexico, France and Brazil, the majority of which are unfunded. Post-employment healthcare benefits plans are accounted for in the same manner as defined benefit pension plans. The plans are reviewed at least annually or in accordance with local practice and regulations by qualified actuaries. The actuarial assumptions used to calculate the defined benefit obligation and related current service cost vary according to the economic conditions of the countries in which they are situated. Total healthcare cost was US$62 million (2005: US$58 million; 2004: US$65 million).

Post-employment defined benefit plans' principal actuarial financial assumptions

The principal actuarial financial assumptions used to calculate the Group's obligations under its defined benefit pension and post-employment healthcare plans at 31 December 2006, were as follows. These assumptions will also form the basis for measuring periodic costs under the plans in 2007:

					Healthcare cost trend		
	Discount rate %	**Inflation rate %**	**Rate of increase for pensions[1] %**	**Rate of pay increase %**	**Initial rate %**	**Ultimate rate %**	**Year of ultimate rate**
UK	**5.1**	**3.0**	**3.0**	**4.0**	**7.0**	**7.0**	**n/a**
Hong Kong	**3.75**	**n/a**	**n/a**	**3.0**	**n/a**	**n/a**	**n/a**
US	**5.9**	**2.5**	**n/a**	**3.75**	**10.5**	**5.0**	**2014**
Jersey	**5.1**	**3.0**	**3.0**	**4.75**	**n/a**	**n/a**	**n/a**
Mexico	**8.0**	**3.5**	**2.0**	**4.0**	**6.75**	**6.75**	**n/a**
Brazil	**10.75**	**4.5**	**4.5**	**4.5**	**11.0**	**5.5**	**2016**
France	**4.5**	**2.0**	**2.0**	**3.0**	**6.0**	**6.0**	**n/a**
Canada	**5.19**	**2.5**	**n/a**	**3.47**	**9.9**	**4.9**	**2012**
Switzerland	**2.25**	**1.5**	**n/a**	**2.25**	**n/a**	**n/a**	**n/a**
Germany	**4.5**	**2.0**	**2.0**	**3.0**	**n/a**	**n/a**	**n/a**

1 *Rate of increase for pensions in payment and deferred pension.*

The principal actuarial financial assumptions used to calculate the Group's obligations under its defined benefit pension and post-employment healthcare plans at 31 December 2005, were as follows. These assumptions also formed the basis for measuring periodic costs under the plans in 2006:

					Healthcare cost trend		
	Discount rate %	Inflation rate %	Rate of increase for pensions[1] %	Rate of pay increase %	Initial rate %	Ultimate rate %	Year of ultimate rate
UK	4.75	2.7	2.7	3.7[2]	6.7	6.7	n/a
Hong Kong	4.2	n/a	n/a	5.0	n/a	n/a	n/a
US	5.7	2.5	n/a	3.75	10.4	5.0	2013
Jersey	4.75	2.7	2.7	4.45	n/a	n/a	n/a
Mexico	8.90	3.75	3.75	4.5	7.3	7.3	n/a
Brazil	11.75	5.5	5.5	5.5	12.5	6.5	2016
France	4.1	2.0	2.0	3.0	6.0	6.0	n/a
Canada	5.25	2.5	n/a	3.0	7.3	4.5	2009
Switzerland	2.25	1.5	n/a	2.25	n/a	n/a	n/a
Germany	4.0	2.0	2.0	3.0	n/a	n/a	n/a

1 *Rate of increase for pensions in payment and deferred pension.*
2 *The 2005 and 2004 rate of pay increase assumptions disclosed have been increased from 3.2 per cent to 3.7 per cent to reflect an age-related promotional salary scale that was included in the obligation calculation but not in the disclosed assumption.*

HSBC determines the discount rates to be applied to its obligations in consultation with the plans' local actuaries, on the basis of current average yields of high quality (AA rated or equivalent) debt instruments, with maturities consistent with those of the defined benefit obligations. The expected rate of return on plan assets is based on historical market returns adjusted for additional factors such as the current rate of inflation and interest rates.

The principal actuarial financial assumptions used to calculate the Group's obligations under its defined benefit pension and post-employment healthcare plans at 31 December 2004, which formed the basis for measuring the 2005 periodic costs, were as follows:

Notes on the Financial Statements (continued)

Note 7

	Discount rate %	Inflation rate %	Rate of increase for pensions[1] %	Rate of pay increase %	Healthcare cost trend: Initial rate %	Healthcare cost trend: Ultimate rate %	Healthcare cost trend: Year of ultimate rate
UK	5.3	2.7	2.7	3.7[2]	7.7	7.7	n/a
Hong Kong	4.0	n/a	n/a	5.0	n/a	n/a	n/a
US	6.0	2.5	n/a	3.75	11.6	5.9	2009
Jersey	5.3	2.7	2.7	4.45	n/a	n/a	n/a
Mexico	10.75	5.0	5.0	6.50	8.68	8.68	n/a
Brazil	11.75	5.0	5.0	5.0	10.5	6.0	2015
France	4.5	2.0	2.0	3.5	6.0	6.0	n/a
Canada	6.0	2.5	n/a	3.0	7.7	4.6	2009
Switzerland	3.25	1.5	n/a	2.25	n/a	n/a	n/a
Germany	4.5	1.5	1.5	2.5	n/a	n/a	n/a

1 *Rate of increase for pensions in payment and deferred pension.*
2 *The 2005 and 2004 rate of pay increase assumptions disclosed have been increased from 3.2 per cent to 3.7 per cent to reflect an age-related promotional salary scale that was included in the obligation calculation but not in the disclosed assumption.*

Mortality assumptions are increasingly significant in measuring the Group's obligations under its defined benefit pension and post-employment healthcare plans, particularly given the maturity of the plans. The mortality tables and average life expectancy at 65 used at 31 December 2006 were as follows:

	Mortality table	**Life expectancy at age 65 for a male member currently:**		**Life expectancy at age 65 for a female member currently:**	
		Aged 65	**Aged 45**	**Aged 65**	**Aged 45**
UK	PA92[1]	**20.3**	**21.6**	**23.3**	**24.6**
Hong Kong	n/a	**n/a**	**n/a**	**n/a**	**n/a**
US	RP 2000 projected to 2005	**18.7**	**18.7**	**20.9**	**20.9**
Jersey	PA92[1]	**20.3**	**21.6**	**23.3**	**24.6**
Mexico	GAM83	**16.6**	**16.6**	**16.6**	**16.6**
Brazil	RP 2000 imp 2006	**18.9**	**20.5**	**21.0**	**21.9**
France	TG 05	**22.8**	**25.6**	**26.3**	**29.1**
Canada pension plans	Between UP94 C2015 and UP94 C2027	**19.0 and 20.0**	**19.0 and 20.0**	**21.6 and 22.1**	**21.6 and 22.1**
Canada healthcare plan	UP94 C2025	**19.8**	**19.8**	**22.0**	**22.0**
Switzerland	EVK2000 and BVG2000	**17.6 and 17.8**	**17.6 and 17.8**	**20.4 and 21.1**	**20.4 and 21.1**
Germany	Heubeck 2005 G	**18.1**	**20.8**	**22.2**	**24.9**

1 *PA92 with standard improvements to 2005 and medium cohort improvements thereafter.*

The mortality tables and average life expectancy at 65 used at 31 December 2005 were as follows:

	Mortality table	Life expectancy at age 65 for a male member currently:		Life expectancy at age 65 for a female member currently:	
		Aged 65	Aged 45	Aged 65	Aged 45
UK	PA92U2005	19.53	20.89	22.57	23.86
Hong Kong	n/a	n/a	n/a	n/a	n/a
US	RP 2000 imp 2005	17.90	17.90	20.25	20.25
Jersey	PA92C2036	20.83	20.83	23.75	23.75
Mexico	GAM83	16.56	16.56	16.56	16.56
Brazil	AT83	18.51	18.51	21.89	21.89
France	TPG93	23.02	25.32	23.02	25.32
Canada pension plans	UP94 C2012 and UP94 C2027	18.65 and 19.84	18.65 and 19.84	21.37 and 22.00	21.37 and 22.00
Canada healthcare plan	GAM94M/F	17.88	17.88	21.32	21.32
Switzerland	EVK2000	17.6	17.6	20.4	20.4
Germany	Heubeck 2005 G	18.06	20.84	22.20	24.85

Actuarial assumption sensitivities

The discount rate is sensitive to changes in market conditions arising during the reporting period. The mortality rates used are sensitive to experience from the plan member profile. The following table shows the effect of changes in these and the other key assumptions on the principal plan:

	HSBC Bank (UK) Pension Scheme US$m
Discount rate	
Change in pension obligation at 31 December 2006 from a 25bps increase	**(1,086)**
Change in pension obligation at 31 December 2006 from a 25bps decrease	**1,147**
Change in 2007 pension cost from a 25bps increase	**(20)**
Change in 2007 pension cost from a 25bps decrease	**22**
Rate of inflation	
Change in pension obligation at 31 December 2006 from a 25bps increase	**1,147**
Change in pension obligation at 31 December 2006 from a 25bps decrease	**(1,086)**
Change in 2007 pension cost from a 25bps increase	**88**
Change in 2007 pension cost from a 25bps decrease	**(77)**
Rate of increase for pensions in payment and deferred pensions	
Change in pension obligation at 31 December 2006 from a 25bps increase	**909**
Change in pension obligation at 31 December 2006 from a 25bps decrease	**(872)**
Change in 2007 pension cost from a 25bps increase	**57**
Change in 2007 pension cost from a 25bps decrease	**(55)**
Rate of pay increase	
Change in pension obligation at 31 December 2006 from a 25bps increase	**287**
Change in pension obligation at 31 December 2006 from a 25bps decrease	**(275)**
Change in 2007 pension cost from a 25bps increase	**31**
Change in 2007 pension cost from a 25bps decrease	**(27)**
Mortality	
Change in pension obligation from each additional year of longevity assumed	**756**

The following table shows the effect of changes in the discount rate and in mortality rates on plans other than the principal plan:

	Other plans US$m
Change in pension obligations at 31 December 2006 from a 25bps increase in discount rate	**(276)**
Change in 2007 pension cost from a 25bps increase in discount rate	**(5)**
Increase in pension obligation from each additional year of longevity assumed	**167**

Notes on the Financial Statements (continued)

Note 7

Defined benefit pension plans

The calculation of the net liability under the Group's defined benefit pension plans is set out below together with the expected rates of return and plan assets used to measure the net defined benefit pension costs in each subsequent year.

	At 31 December 2006			
	HSBC Bank (UK) Pension Scheme		Other plans	
	Expected rates of return %	Value US$m	Expected rates of return %	Value US$m
Equities	**8.0**	**5,046**	**8.1**	**3,209**
Bonds	**5.3**	**12,189**	**5.7**	**3,302**
Property	**7.0**	**2,056**	**7.0**	**138**
Other	**4.3**	**1,296**	**4.6**	**467**
Fair value of plan assets		**20,587**		**7,116**
Present value of funded obligations		**(24,332)**		**(7,534)**
Present value of unfunded obligations		**–**		**(382)**
Defined benefit obligation		**(24,332)**		**(7,916)**
Effect of limit on plan surpluses		**–**		**(9)**
Unrecognised past service cost		**–**		**1**
Net liability		**(3,745)**		**(808)**

	At 31 December 2005			
	HSBC Bank (UK) Pension Scheme		Other plans	
	Expected rates of return %	Value US$m	Expected rates of return %	Value US$m
Equities	8.0	8,181	8.6	2,749
Bonds	4.3	5,234	5.2	2,539
Property	6.5	1,540	6.5	97
Other	3.6	2,441	4.6	971
Fair value of plan assets		17,396		6,356
Present value of funded obligations		(20,587)		(6,687)
Present value of unfunded obligations		–		(415)
Defined benefit obligation		(20,587)		(7,102)
Effect of limit on plan surpluses		–		(7)
Unrecognised past service cost		–		3
Net liability		(3,191)		(750)

Plan assets include US$87 million (2005: US$80 million) of equities issued by HSBC and US$188 million (2005: US$53 million) of other assets issued by HSBC. Additionally, the fair value of plan assets include derivatives entered into with the HSBC Bank (UK) Pension Scheme with a negative fair value of US$273 million at 31 December 2006 (2005: nil).

The principal plan holds a diversified portfolio of investments to meet future cash flow liabilities arising from accrued benefits as they fall due to be paid. The Trustee of the principal plan is required to produce a written statement of investment principles ('SIP'). The SIP sets out the principles governing how decisions about investments are made.

Changes in the present value of defined benefit obligations

	2006		2005	
	HSBC Bank (UK) Pension Scheme US$m	**Other plans US$m**	HSBC Bank (UK) Pension Scheme US$m	Other plans US$m
At 1 January	**20,587**	**7,102**	19,988	6,501
Current service cost	**456**	**304**	383	283
Interest cost	**1,055**	**366**	981	333
Contributions by employees	**–**	**28**	–	14
Actuarial losses	**30**	**211**	1,968	506
Benefits paid	**(696)**	**(386)**	(540)	(338)
Past service cost – vested immediately	**–**	**9**	–	(3)
Past service cost – unvested benefits	**–**	**–**	–	3
Acquisitions	**–**	**10**	84	–
Reduction in liabilities resulting from curtailments	**–**	**(5)**	–	(4)
Liabilities extinguished on settlements	**–**	**(21)**	–	(6)
Exchange differences	**2,900**	**298**	(2,277)	(187)
At 31 December	**24,332**	**7,916**	20,587	7,102

Changes in the fair value of plan assets

	2006		2005	
	HSBC Bank (UK) Pension Scheme US$m	**Other plans US$m**	HSBC Bank (UK) Pension Scheme US$m	Other plans US$m
At 1 January	**17,396**	**6,356**	15,105	5,823
Expected return on plan assets	**1,169**	**421**	954	401
Contributions by HSBC	**240**	**193**	1,986	448
– normal	**240**	**160**	240	156
– special	**–**	**33**	1,746	292
Contributions by employees	**–**	**28**	–	14
Experience gains	**–**	**203**	1,623	78
Benefits paid	**(696)**	**(343)**	(540)	(287)
Acquisitions	**–**	**–**	58	–
Assets distributed on curtailments	**–**	**(4)**	–	–
Assets distributed on settlements	**–**	**(14)**	–	(3)
Exchange differences	**2,478**	**276**	(1,790)	(118)
At 31 December	**20,587**	**7,116**	17,396	6,356

The actual return on plan assets for the year ended 31 December 2006 was US$1,793 million (2005: US$3,056 million). HSBC expects to make US$1,229 million of contributions to defined benefit pension plans during 2007. Benefits expected to be paid from the plans to retirees over each of the next five years, and in aggregate for the five years thereafter, are:

	2007 US$m	2008 US$m	2009 US$m	2010 US$m	2011 US$m	2012-2017 US$m
HSBC Bank (UK) Pension Scheme	662	693	707	750	779	4,865
Other significant plans	344	361	380	389	422	2,385

1,309

Notes on the Financial Statements (continued)

Note 7

Total expense recognised in the income statement in 'Employee compensation and benefits'

	2006		2005		2004	
	HSBC Bank (UK) Pension Scheme US$m	**Other plans US$m**	HSBC Bank (UK) Pension Scheme US$m	Other plans US$m	HSBC Bank (UK) Pension Scheme US$m	Other plans US$m
Current service cost	**456**	**304**	383	283	348	257
Interest cost	**1,055**	**366**	981	333	921	326
Expected return on plan assets	**(1,169)**	**(421)**	(954)	(401)	(927)	(382)
Past service cost	**–**	**11**	–	(3)	–	(8)
(Gains)/losses on curtailments	**–**	**–**	–	(4)	242	(17)
Total expense	**342**	**260**	410	208	584	176

Summary

	2006		2005		2004	
	HSBC Bank (UK) Pension Scheme US$m	**Other plans US$m**	HSBC Bank (UK) Pension Scheme US$m	Other plans US$m	HSBC Bank (UK) Pension Scheme US$m	Other plans US$m
Defined benefit obligation	**(24,332)**	**(7,916)**	(20,587)	(7,102)	(19,988)	(6,501)
Fair value of plan assets	**20,587**	**7,116**	17,396	6,356	15,105	5,823
Net deficit	**(3,745)**	**(800)**	(3,191)	(746)	(4,883)	(678)
Experience gains/(losses) on plan liabilities	**540**	**(167)**	70	(113)	401	(42)
Experience gains on plan assets	**–**	**203**	1,623	78	506	3
Losses from changes in actuarial assumptions	**(570)**	**(44)**	(2,038)	(393)	(1,357)	(243)
Total net actuarial gains/ (losses)	**(30)**	**(8)**	(345)	(428)	(450)	(282)

Actuarial gains and losses represent experience adjustments on plan assets and liabilities as well as adjustments arising from changes in actuarial assumptions. Total cumulative actuarial losses recognised in equity at 31 December 2006 were US$1,543 million (2005: US$1,505 million).

The total effect of the limit on plan surpluses recognised within actuarial losses in equity during 2006 was a US$2 million loss (2005: US$4 million gain).

Post-employment healthcare benefits plans

	2006		2005	
	Expected rates of return %	**Value US$m**	Expected rates of return %	Value US$m
Equities	**14.5**	**40**	12.0	32
Bonds	**8.5**	**93**	8.5	75
Fair value of plan assets		**133**		107
Present value of funded obligations		**(219)**		(178)
Present value of unfunded obligations		**(887)**		(826)
Defined benefit obligation		**(1,106)**		(1,004)
Unrecognised past service cost		**(29)**		(31)
Net liability		**(1,002)**		(928)

Changes in the present value of defined benefit obligations

	2006 US$m	2005 US$m
At 1 January	**1,004**	982
Current service cost	**19**	18
Interest cost	**64**	63
Contributions by employees	**2**	6
Actuarial losses	**37**	44
Benefits paid	**(52)**	(50)
Past service cost:		
– vested immediately	**1**	(13)
– unvested benefits	**–**	(29)
Reduction in liabilities resulting from curtailments	**(9)**	–
Liabilities extinguished on settlements	**(1)**	–
Exchange differences	**41**	(17)
At 31 December	**1,106**	1,004

Changes in the fair value of plan assets

	2006 US$m	2005 US$m
At 1 January	**107**	79
Expected return on plan assets	**11**	10
Contributions by HSBC	**39**	19
Experience gains/(losses)	**(1)**	1
Benefits paid	**(20)**	(7)
Assets distributed on curtailments	**(1)**	–
Exchange differences	**(2)**	5
At 31 December	**133**	107

The actual return on plan assets for the year ended 31 December 2006 was US$10 million (2005: US$11 million).

HSBC expects to make US$19 million of contributions to post-employment healthcare benefit plans during 2007. Benefits expected to be paid from the plans to retirees over each of the next five years, and in aggregate for the five years thereafter, are:

	2007 US$m	2008 US$m	2009 US$m	2010 US$m	2011 US$m	2012-2017 US$m
Significant plans	47	49	53	55	57	320

Total expense recognised in the income statement in 'Employee compensation and benefits'

	2006 US$m	2005 US$m	2004 US$m
Current service cost	**19**	18	17
Interest cost	**64**	63	58
Expected return on plan assets	**(11)**	(10)	(8)
Past service cost	**(1)**	(13)	(2)
Losses on curtailments	**(8)**	–	–
Losses on settlements	**(1)**	–	–
Total expense	**62**	58	65

Notes on the Financial Statements (continued)

Notes 7 and 8

Summary

	2006 US$m	2005 US$m	2004 US$m
Defined benefit obligation	(1,106)	(1,004)	(982)
Fair value of plan assets	133	107	79
Net deficit	(973)	(897)	(903)
Experience gains/(losses) on plan liabilities	(12)	19	(15)
Experience gains/(losses) on plan assets	(1)	1	–
Gains/(losses) from changes in actuarial assumptions	(25)	(63)	20
Total net actuarial gains/(losses)	(38)	(43)	5

Actuarial gains and losses represent experience adjustments on plan assets and liabilities as well as adjustments arising from changes in actuarial assumptions. Total cumulative net actuarial losses recognised in equity at 31 December 2006 were US$76 million (2005: US$38 million).

The actuarial assumptions of the healthcare cost trend rates have a significant effect on the amounts recognised. A one percentage point change in assumed healthcare cost trend rates would have the following effects on amounts recognised in 2006:

	1% increase US$m	1% decrease US$m
Increase/(decrease) of the aggregate of the current service cost and interest cost	8	(6)
Increase/(decrease) of defined benefit obligation	103	(111)

HSBC Holdings

Employee compensation and benefit expense in respect of HSBC Holdings' employees in 2006 amounted to US$193 million (2005: US$166 million). The average number of persons employed by HSBC Holdings during 2006 was 505 (2005: 433).

Employees of HSBC Holdings who are members of defined benefit pension plans are principally members of either the HSBC Bank (UK) Pension Scheme or the HSBC International Staff Retirement Benefit Scheme. There is no contractual or stated policy for charging the net defined benefit cost to HSBC Holdings, which is recognised in the consolidated accounts of HSBC in the note above. HSBC Holdings pays contributions to plans in accordance with schedules determined by the Trustees following consultation with qualified actuaries.

Directors' emoluments

The aggregate emoluments of the Directors of HSBC Holdings, computed in accordance with Part I of Schedule 6 of the Companies Act, were:

	2006 US$000	2005 US$000	2004 US$000
Fees	2,660	2,100	2,713
Salaries and other emoluments	7,774	12,869	9,721
Bonuses	10,705	13,264	17,288
	21,139	28,233	29,722
Gains on the exercise of share options	3	17	14,078
Vesting of Restricted Share Plan awards	18,975	24,221	9,598

In addition, there were payments under retirement benefit agreements with former Directors of US$1,045,448 (2005: US$996,098). The provision at 31 December 2006 in respect of unfunded pension obligations to former Directors amounted to US$17,759,454 (2005: US$16,458,975).

During the year, aggregate contributions to pension schemes in respect of Directors were US$889,241 (2005: US$4,819,759), including US$395,740 (2005: US$3,304,081) arising from a Director's waiver of bonus.

Discretionary bonuses for Directors are based on a combination of individual and corporate performance and are determined by the Remuneration Committee. Details of Directors' remuneration, share options and conditional awards under the Restricted Share Plan 2000 and The HSBC Share Plan are included in the 'Directors' Remuneration Report' on pages 280 to 289.

8 Auditors' remuneration

Auditors' remuneration in relation to statutory audit amounted to US$44.7 million (2005: US$47.0 million; 2004: US$41.7 million).

The following fees were payable by HSBC to the Group's principal auditor, KPMG Audit Plc and its associates (together 'KPMG'):

	2006 US$m	2005 US$m	2004 US$m
Audit fees for HSBC Holdings' statutory audit:			
– fees relating to current year	**2.7**	2.8	2.3
– fees relating to prior year	**–**	0.2	0.7
	2.7	3.0	3.0
Fees payable to KPMG for other services provided to HSBC:			
– audit of HSBC's subsidiaries, pursuant to legislation	**40.4**	42.5	36.6
– other services pursuant to legislation[1]	**15.4**	29.2	13.4
– tax services	**2.0**	2.6	6.2
– services relating to information technology	**0.6**	–	–
– services related to corporate finance transactions	**1.6**	0.3	1.6
– all other services	**4.1**	5.0	4.7
	64.1	79.6	62.5
Total fees payable	**66.8**	82.6	65.5

1 *Including fees paid to KPMG in respect of work relating to preparation for reporting under section 404 of the Sarbanes-Oxley Act of US$2.2 million (2005: US$11.7 million; 2004: US$4.1 million). Other accounting firms have been paid a total of US$8.3 million (2005: US$16.7 million; 2004: US$6.6 million) for work on this project.*

No fees were payable by HSBC to KPMG for the following types of services: internal audit services, valuation and actuarial services, services related to litigation, and services related to recruitment and remuneration.

'Audit fees for HSBC Holdings' statutory audit' are fees payable to KPMG Audit Plc for the statutory audit of the consolidated financial statements of HSBC and the separate financial statements of HSBC Holdings. They exclude amounts payable for the statutory audit of HSBC Holdings' subsidiaries which have been included in 'Fees payable to KPMG for other services provided to HSBC'.

The following is a description of the types of services included in 'Fees payable to KPMG for other services provided to HSBC':

Audit related services

– 'Audit of HSBC's subsidiaries pursuant to legislation' includes fees payable to KPMG for the statutory audit of HSBC's subsidiaries.

– 'Other services pursuant to legislation' include services for assurance and other services that are in relation to statutory and regulatory filings, including comfort letters and interim reviews.

Tax services

– 'Tax services' include tax compliance services and tax advisory services.

Other services

– 'Services relating to information technology' include advice on IT security and business continuity and performing agreed upon IT testing procedures.

– 'Services related to corporate finance transactions' include fees payable to KPMG for transaction-related work, including US debt issuances.

– 'All other services' include other assurance and advisory services such as translation services, ad-hoc accounting advice and review of financial models.

Notes on the Financial Statements (continued)

Notes 8 and 9

The following fees were payable by HSBC's associated pension schemes to KPMG:

	2006 US$'000	2005 US$'000	2004 US$'000
Audit fees	**581**	550	536
Tax services	**23**	17	11
All other services	**23**	5	5
Total fees payable	**627**	572	552

No fees were payable by HSBC's associated pension schemes to KPMG for the following types of services: other services pursuant to legislation, services relating to information technology, internal audit services, valuation and actuarial services, services related to litigation, services related to recruitment and remuneration, and services related to corporate finance transactions.

In addition to the above, KPMG estimate they have been paid fees of US$2.1 million (2005: US$4.5 million; 2004: US$4.0 million) by parties other than HSBC but where HSBC is connected with the contracting party and therefore may be involved in appointing KPMG. These fees arise from services such as auditing mutual funds managed by HSBC and reviewing the financial position of corporate concerns which borrow from HSBC.

Fees payable to KPMG for non-audit services for HSBC Holdings are not disclosed separately because such fees are disclosed on a consolidated basis for HSBC Group.

9 Share-based payments

During 2006, US$854 million was charged to the income statement in respect of equity-settled share-based payment transactions (2005: US$540 million; 2004: US$450 million). This expense was based on the fair value of the share-based payment transactions when contracted. All of the expense arose under employee share awards made within HSBC's reward structures.

Calculation of fair values

Fair values of share options/awards, measured at the date of grant of the option/award, are calculated using a binomial lattice model methodology that is based on the underlying assumptions of the Black-Scholes model. When modelling options/awards with vesting dependent on HSBC's Total Shareholder Return over a period, these performance targets are incorporated into the model using Monte Carlo simulation. The expected life of options depends on the behaviour of option holders, which is incorporated into the option model consistent with historic observable data. The fair values calculated are inherently subjective and uncertain due to the assumptions made and the limitations of the model used.

The significant weighted average assumptions used to estimate the fair value of the options granted were as follows:

	HSBC Holdings Group Share Option Plan	1-year Savings-Related Share Option Plan	3-year Savings-Related Share Option Plans	5-year Savings-Related Share Option Plans	The HSBC Share Plan
2006					
Risk-free interest rate[1] (%)	–	**4.7**	**4.8**	**4.7**	–
Expected life[2] (years)	–	**1**	**3**	**5**	–
Expected volatility[3] (%)	–	**17**	**17**	**17**	–
Share price at grant date (£)	–	**9.54**	**9.54**	**9.54**	–
2005					
Risk-free interest rate[1] (%)	4.6	–	4.3	4.3	4.3
Expected life[2] (years)	7.8	–	3	5	5
Expected volatility[3] (%)	20	–	20	20	20
Share price at grant date (£)	8.30	–	8.68	8.68	8.37

1 *The risk-free rate was determined from the UK gilts yield curve for the HSBC Holdings Group Share Option Plan awards and UK Savings-Related Share Option Plans. A similar yield curve was used for the International Savings-Related Share Option Plans.*
2 *Expected life is not a single input parameter but a function of various behavioural assumptions.*
3 *Expected volatility is estimated by considering both historic average share price volatility and implied volatility derived from traded options over HSBC shares of similar maturity to those of the employee options.*

Expected dividends have been incorporated into the valuation model for options and shares, where applicable. The expected US dollar denominated dividend growth was determined to be 9 per cent for the first year (2005: 12 per cent) and 8 per cent thereafter (2005: 8 per cent), consistent with consensus analyst forecasts.

The HSBC Share Plan

The HSBC Share Plan was adopted by HSBC Holdings in 2005. Under this Plan Performance Share awards, Restricted Share awards and Share Option awards may be made. The aim of The HSBC Share Plan is to align the interests of executives to the creation of shareholder value and recognise individual performance and potential. Awards are also made under this plan for recruitment and retention purposes.

Performance Share awards

Performance Share awards are made to executive Directors and other senior executives taking into account individual performance in the prior year. Performance Share awards are divided into two equal parts for testing attainment against pre-determined benchmarking. One half of the award is subject to a Total Shareholder Return measure, based on HSBC's ranking against a comparator group of 28 major banks. The other half of the award is subject to an earnings per share target. For each element of the award, shares would be released to the employee according to a sliding scale from 30 to 100 per cent of the award, dependent upon the scale of achievement against the benchmarks and provided that the minimum criteria for each performance measure has been met. Shares will be released after three years to the extent that the performance conditions are satisfied.

	2006 Number (000's)	2005 Number (000's)
Outstanding at 1 January	**5,077**	–
Additions during the year[1]	**5,312**	5,077
Forfeited in the year	**(22)**	–
Outstanding at 31 December	**10,367**	5,077

1 *Additions during the year include 1,413,650 shares awarded to employees of HSBC Holdings (2005: 3,453,884).*

The weighted average fair value of shares awarded by HSBC for Performance Share awards in 2006 was US$9.72 (2005: US$9.02).

Restricted Share awards

Restricted Share awards are made to other employees based on performance, potential and retention requirements, for recruitment or as part of deferral of annual bonus. The awards vest between one and three years from date of award.

	2006 Number (000's)	2005 Number (000's)
Outstanding at 1 January	**5,106**	–
Additions during the year[1]	**41,440**	5,285
Released in the year	**(1,685)**	(179)
Forfeited in the year	**(1,441)**	–
Outstanding at 31 December	**43,420**	5,106

1 *Additions during the year include 324,884 shares awarded to employees of HSBC Holdings (2005: 823).*

The weighted average fair value of shares awarded by HSBC for Restricted Share Awards in 2006 was US$17.65 (2005: US$16.66).

Notes on the Financial Statements (continued)

Note 9

Share options

Share options were granted in 2005 under the Rules of The HSBC Share Plan to employees in France based on their performance in the previous year. The share options are subject to the corporate performance condition, which consists of an absolute earnings per share measure and a Total Shareholder Return measure, based on HSBC Holdings' ranking against a comparator group of 28 major banks. The options vest after three years and are exercisable up to the tenth anniversary of the date of grant, after which they will lapse.

	2006		2005	
	Number (000's)	**Weighted average exercise price £**	Number (000's)	Weighted average exercise price £
Outstanding at 1 January	**628**	**8.84**	–	–
Granted in the year	**–**	**–**	628	8.84
Forfeited in the year	**–**	**–**	–	–
Outstanding at 31 December	**628**	**8.84**	628	8.84

The fair value of options granted in 2005 was US$2.29. No options were awarded in 2006. The weighted average remaining contractual life of options outstanding at the balance sheet date is 3.3 years (2005: 4.3 years). None of these options are exercisable at the balance sheet date.

Savings-related share option plans

The savings-related share option plans invite eligible employees to enter into savings contracts to save up to £250 per month (or equivalent in US dollars, Hong Kong dollars or euros), with the option to use the savings to acquire shares. The aim of the plan is to align the interests of all employees to the creation of shareholder value. The options are exercisable within three months following the first anniversary of the commencement of a one-year savings contract or within six months following either the third or the fifth anniversary of the commencement of three-year or five-year savings contracts. The exercise price is set at a 20 per cent (2005: 20 per cent) discount to the market value at the date of grant (except for the one-year options granted under the US sub-plan where a 15 per cent discount is applied).

	2006		2005	
	Number[1] (000's)	**Weighted average exercise price £**	Number[1] (000's)	Weighted average exercise price £
Outstanding at 1 January	**98,416**	**6.07**	109,722	5.92
Granted in the year	**22,627**	**7.63**	26,995	6.68
Exercised in the year	**(25,066)**	**5.61**	(29,693)	6.06
Forfeited in the year	**(7,307)**	**6.26**	(8,608)	6.06
Outstanding at 31 December	**88,670**	**6.58**	98,416	6.07

1 *The above includes HSBC Holdings employee options of 606,205 outstanding at 1 January 2006 (2005: 599,322), 112,181 options granted in the year (2005: 136,100) and 689,603 options outstanding at 31 December 2006 (2005: 606,205).*

The weighted average fair value of options granted in the year as at the date of grant was US$3.45 (2005: US$3.76). The exercise price range and weighted average remaining contractual life for options outstanding at the balance sheet date, were as follows:

	2006	2005
Exercise price range (£)	**5.35 – 8.07**	5.35 - 6.75
Weighted average remaining contractual life (years)	**1.76**	1.89
Of which exercisable:		
Number (000's)	**671**	772
Weighted average exercise price (£)	**5.35**	6.09

The weighted average share price at the date the share options were exercised was US$17.55 (2005: US$16.56).

HSBC Holdings Restricted Share Plan 2000

Performance Share awards made under the HSBC Holdings Restricted Share Plan 2000 (the 'Restricted Share Plan')

Performance Share awards under the Restricted Share Plan were granted to Senior Executives from 2000 to 2004. The aim of the plan was to align the interests of executives to the creation of shareholder value. This was achieved by setting certain Total Shareholder Return targets against a peer group of major banks which must normally be attained in order for the awards to vest. No further awards will be made under this Plan following adoption of The HSBC Share Plan in 2005 other than from reinvested scrip dividends.

	2006 Number (000's)	2005 Number (000's)
Outstanding at 1 January	**14,970**	17,044
Additions during the year[1]	**520**	710
Released in the year	**(3,050)**	(2,455)
Forfeited in the year	**(112)**	(329)
Outstanding at 31 December	**12,328**	14,970

1 *Additions during the year comprise reinvested scrip dividends, and include nil shares awarded to employees of HSBC Holdings (2005: 321,279).*

The weighted average remaining vesting period as at 31 December 2006 was 1.53 years (2005: 2.14 years).

Restricted share awards made under the HSBC Holdings Restricted Share Plan 2000

Restricted shares were awarded to eligible employees after taking into account the employee's performance in the prior year, potential and retention requirements. Restricted shares are also awarded as part deferral of annual bonus or for recruitment purposes. Shares are awarded without corporate performance conditions and are generally released to employees between one and three years after the award was made, providing the employees have remained continuously employed by HSBC for this period.

	2006 Number (000's)	2005 Number (000's)
Outstanding at 1 January	**58,427**	46,021
Additions during the year[1]	**1,499**	34,439
Released in the year	**(19,224)**	(21,007)
Forfeited in the year	**(2,032)**	(1,026)
Outstanding at 31 December	**38,670**	58,427

1 *Additions during the year comprise reinvested scrip dividends, and include 41,951 shares awarded to employees of HSBC Holdings (2005: 384,797).*

The weighted average fair value of shares awarded by HSBC for Restricted Share Awards in 2005 was US$15.88. No awards were made in 2006.

The weighted average remaining vesting period as at 31 December 2006 was 0.84 years (2005: 1.09 years).

HSBC Holdings Group Share Option Plan

The HSBC Holdings Group Share Option Plan was a long-term incentive plan under which certain HSBC employees between 2000 and 2005 were awarded share options. The aim of the plan was to align the interests of those higher performing employees to the creation of shareholder value. This was achieved by setting certain Total Shareholder Return targets which must normally be attained in order for the awards to vest. Options were granted at market value and are normally exercisable between the third and tenth anniversaries of the date of grant, subject to vesting conditions. Any options granted after May 2005 will be made under the Rules of The HSBC Share Plan.

Notes on the Financial Statements (continued)

Note 9

	2006		2005	
	Number[1] (000's)	**Weighted average exercise price £**	Number[1] (000's)	Weighted average exercise price £
Outstanding at 1 January	**209,982**	**8.06**	220,670	8.07
Granted in the year	**–**	**–**	7,470	8.36
Exercised in the year	**(38,469)**	**7.80**	(11,764)	8.49
Forfeited in the year	**(3,393)**	**8.29**	(6,394)	8.00
Outstanding at 31 December	**168,120**	**8.09**	209,982	8.06

1 *The above includes HSBC Holdings employee awards of 2,537,647 options outstanding at 1 January 2006 (2005: 2,624,133), zero options granted in the year (2005:3,775) and 2,189,156 options outstanding at 31 December 2006 (2005: 2,537,647).*

The weighted average fair value of options granted in 2006 was US$3.09. No options were granted in 2006. The number of options, weighted average exercise price, and the weighted average remaining contractual life for options outstanding at the balance sheet date, analysed by exercise price range, were as follows:

	2006		2005	
Exercise price range (£)	**6.00 – 8.00**	**8.01 – 10.00**	6.00 – 8.00	8.01 – 10.00
Number (000's)	**35,160**	**132,960**	53,242	156,741
Weighted average exercise price (£)	**6.92**	**8.40**	6.91	8.45
Weighted average remaining contractual life (years)	**4.74**	**7.17**	5.63	7.05
Of which exercisable:				
Number (000's)	**35,160**	**66,541**	411	84,145
Weighted average exercise price (£)	**6.92**	**8.58**	7.46	8.55

The weighted average share price at the date the share options were exercised was US$17.65 (2005: US$16.18).

After consideration of the performance and shareholder returns over the period between 2003 and 2005, the Remuneration Committee exercised its discretion to waive the Total Shareholder Return performance condition in respect of the awards made under this plan in 2003.

As a result, a charge of US$135 million was recognised in 2006, reflecting the incremental fair value granted measured at the date the performance condition was waived. This was measured using a binomial lattice model methodology that is based on the underlying assumptions of the Black-Scholes model, as described above in 'Calculation of fair values'. A risk-free interest rate of 4.3 per cent was used, with all other inputs to the model consistent with those used to value the other share options and awards made during 2006.

HSBC Holdings Executive Share Option Scheme

The HSBC Holdings Executive Share Option Scheme was a long-term incentive scheme under which certain senior HSBC employees were awarded share options before the adoption of the HSBC Holdings Group Share Option Plan in 2000. The aim of the plan was to align the interests of those higher performing senior employees to the creation of shareholder value. This was achieved by setting certain Total Shareholder Return targets to be attained in order for the awards to vest. Options were granted at market value and were exercisable between the third and tenth anniversaries of the date of grant, subject to vesting conditions. No awards have been made under this plan since 2000 and the remaining unexercised options are summarised below:

	2006		2005	
	Number[1] (000's)	**Weighted average exercise price £**	Number[1] (000's)	Weighted average exercise price £
Outstanding at 1 January	**32,255**	**6.78**	43,977	6.76
Exercised in the year	**(9,638)**	**6.69**	(11,206)	6.67
Forfeited in the year	**(146)**	**5.94**	(516)	7.31
Outstanding at 31 December	**22,471**	**6.82**	32,255	6.78

1 *The above includes HSBC Holdings employee awards of 712,922 options outstanding at 1 January 2006 (2005: 864,327) and 751,936 options outstanding at 31 December 2006 (2005: 712,922).*

The weighted average fair value of options as at the last date of grant during 2000 was US$5.26.

The weighted average share price at the date the share options were exercised was US$17.65 (2005: US$16.18).

The number of options, weighted average exercise price and the weighted average remaining contractual life for options outstanding at the balance sheet date, analysed by exercise price range, were as follows:

	2006		2005	
Exercise price range (£)	**2.17 – 6.00**	**6.01 – 7.87**	2.17 – 6.00	6.01 – 7.87
Number (000's)	**252**	**22,234**	781	31,474
Weighted average exercise price (£)	**5.02**	**6.84**	4.57	6.83
Weighted average remaining contractual life (years)	**–**	**2.64**	0.97	3.64
Of which exercisable:				
Number (000's)	**252**	**22.234**	781	31,474
Weighted average exercise price (£)	**5.02**	**6.84**	4.57	6.83

HSBC France and subsidiary company plans

Before its acquisition by HSBC in 2000, HSBC France and certain of its subsidiaries operated employee share plans under which share options were granted over their respective shares.

Options over HSBC France shares granted between 1994 and 1999 vested upon announcement of HSBC's intent to acquire HSBC France and were therefore included in the valuation of HSBC France.

HSBC France granted 909,000 options in 2000 after the public announcement of the acquisition and these options did not vest as a result of the change in control. The options were subject to continued employment and vested on 1 January 2002. The HSBC France shares obtained on exercise of the options are exchangeable for HSBC's ordinary shares of US$0.50 each in the same ratio as the Exchange Offer for Crédit Commercial de France shares (13 ordinary shares of US$0.50 for each HSBC France share). Options were granted at market value and are exercisable within 10 years of the date of grant.

	2006		2005	
	Number (000's)	**Exercise price €**	Number (000's)	Exercise price €
Outstanding at 1 January	**766**	**142.5**	860	142.5
Exercised in the year	**(120)**	**142.5**	(94)	142.5
Outstanding at 31 December	**646**	**142.5**	766	142.5

The remaining contractual life for options outstanding at the balance sheet date was 3.3 years (2005: 4.3 years).

The weighted average share price at the date the share options were exercised was US$17.64 (2005: US$16.18).

At the date of its acquisition in 2000, certain of HSBC France's subsidiary companies also operated employee share option plans under which options could be granted over their respective shares. On exercise of certain of these options, the subsidiary shares are exchanged for HSBC ordinary shares. The total number of HSBC ordinary shares exchanged under such arrangements in 2006 was 356,491 (2005: 821,466).

HSBC Finance Corporation

Upon acquisition, HSBC Finance Corporation share options previously granted were converted to share options over HSBC ordinary shares of US$0.50 each at a rate of 2.675 HSBC share options (the same ratio as the Exchange Offer for HSBC Finance Corporation) for each HSBC Finance Corporation share option. Options granted under HSBC Finance Corporation's own share option schemes prior to the announcement of the acquisition by HSBC in November 2002 vested as options over HSBC shares upon acquisition by HSBC. Options granted after the announcement of the acquisition in November 2002 but prior to its completion on 28 March 2003, generally vest equally over 4 years and expire 10 years from the date of grant.

Information with respect to share options granted under the HSBC Finance Corporation's pre-acquisition scheme was as follows:

Notes on the Financial Statements (continued)

Notes 9, 10, 11 and 12

	2006		2005	
	Number (000's)	**Exercise price US$**	Number (000's)	Exercise price US$
HSBC Finance Corporation share options outstanding at 1 January	**6,358**	**10.66**	7,112	10.66
Exercised in the year	**(3,219)**	**10.66**	(754)	10.66
Forfeited in the year	**(13)**	**10.66**	–	–
Outstanding at 31 December	**3,126**	**10.66**	6,358	10.66
Of which exercisable	**3,126**	**10.66**	5,520	10.66

The weighted average share price at the date the share options were exercised was US$17.65 (2005: US$16.18).

10 Tax expense

	2006 US$m	2005 US$m	2004 US$m
Current tax			
United Kingdom corporation tax charge – on current year profit	**772**	663	848
United Kingdom corporation tax charge – adjustments in respect of prior years	**(122)**	29	(132)
Overseas tax – on current year profit	**4,600**	4,103	2,877
Overseas tax – adjustments in respect of prior years	**(48)**	(110)	(21)
	5,202	4,685	3,572
Deferred tax			
Origination and reversal of temporary differences	**(51)**	506	1,204
Effect of changes in tax rates	**–**	8	(15)
Adjustments in respect of prior years	**64**	(106)	(76)
	13	408	1,113
Tax expense	**5,215**	5,093	4,685

The UK corporation tax rate applying to HSBC Holdings and its subsidiary undertakings was 30 per cent (2005: 30 per cent; 2004: 30 per cent). Overseas tax included Hong Kong profits tax of US$751 million (2005: US$639 million; 2004: US$539 million). Subsidiaries in Hong Kong provided for Hong Kong profits tax at the rate of 17.5 per cent (2005: 17.5 per cent; 2004: 17.5 per cent) on the profits for the year assessable in Hong Kong. Other overseas subsidiaries and overseas branches provided for taxation at the appropriate rates in the countries in which they operate.

The following table reconciles the tax expense which would apply if all profits had been taxed at the UK corporation tax rate:

	2006		2005		2004	
	US$m	**%**	US$m	%	US$m	%
Analysis of tax expense						
Taxation at UK corporation tax rate of 30% (2005 and 2004: 30%)	**6,626**	**30.0**	6,290	30.0	5,683	30.0
Effect of taxing overseas profits in principal locations at different rates	**(568)**	**(2.6)**	(342)	(1.6)	(347)	(1.8)
Tax-free gains	**(199)**	**(0.9)**	(220)	(1.0)	(64)	(0.3)
Adjustments in respect of prior period liabilities	**(106)**	**(0.5)**	(187)	(0.9)	(229)	(1.2)
Low income housing tax credits[1]	**(108)**	**(0.5)**	(110)	(0.5)	(95)	(0.5)
Other items	**(177)**	**(0.8)**	(145)	(0.8)	9	(0.1)
Deductible innovative tier 1 capital expense presented below profit before tax	**–**	**–**	–	–	(192)	(1.0)
Effect of profit in associates and joint ventures	**(253)**	**(1.1)**	(193)	(0.9)	(80)	(0.4)
Tax expense	**5,215**	**23.6**	5,093	24.3	4,685	24.7

1 *Low income housing tax credits arise in the US and are designed to encourage the provision of rental housing for low income households.*

In addition to the amount charged to the income statement, the aggregate amount of current and deferred tax, relating to items that are taken directly to equity, was a US$44 million reduction in equity (2005: US$437 million; 2004: US$319 million – both increases in equity).

11 Dividends

Dividends to shareholders of the parent company were as follows:

	2006			2005			2004		
	Per share US$	**Total US$m**	**Settled in scrip US$m**	Per share US$	Total US$m	Settled in scrip US$m	Per share US$	Total US$m	Settled in scrip US$m
Dividends declared on ordinary shares									
Fourth interim dividend in respect of previous year	**0.310**	**3,513**	**1,542**	0.270	3,007	431	–	–	–
First interim dividend in respect of current year	**0.150**	**1,712**	**248**	0.140	1,563	677	0.130	1,425	747
Second interim dividend in respect of current year	**0.150**	**1,724**	**515**	0.140	1,574	311	0.130	1,436	746
Third interim dividend in respect of current year	**0.150**	**1,730**	**223**	0.140	1,585	392	0.130	1,444	255
Third interim dividend in respect of previous year	–	–	–	–	–	–	0.240	2,627	346
	0.760	**8,679**	**2,528**	0.690	7,729	1,811	0.630	6,932	2,094
Quarterly dividends on preference share capital									
March dividend	**15.50**	**22**		–	–		–	–	
June dividend	**15.50**	**23**		–	–		–	–	
September dividend	**15.50**	**22**		–	–		–	–	
December dividend	**15.50**	**23**		14.29	21		–	–	
	62.00	**90**		14.29	21		–	–	

The Directors declared after the end of the year a fourth interim dividend in respect of the financial year ended 31 December 2006 of US$0.36 per ordinary share, a distribution of US$4,171 million. The fourth interim dividend will be payable on 10 May 2007 to shareholders on the Register at the close of business on 23 March 2007. No liability is recorded in the financial statements in respect of the fourth interim dividend.

12 Earnings per share

Basic earnings per ordinary share was calculated by dividing the earnings of US$15,699 million (2005: US$15,060 million; 2004: US$12,918 million) by the weighted average number of ordinary shares, excluding own shares held, outstanding in 2006 of 11,210 million (2005: 11,038 million; 2004: 10,907 million).

	2006 US$m	2005 US$m	2004 US$m
Profit attributable to shareholders of the parent company	**15,789**	15,081	12,918
Dividend payable on preference shares classified as equity	**(90)**	(21)	–
Profit attributable to the ordinary shareholders of the parent company	**15,699**	15,060	12,918

Diluted earnings per ordinary share was calculated by dividing the basic earnings, which require no adjustment for the effects of dilutive potential ordinary shares (including share options outstanding not yet exercised), by the weighted average number of ordinary shares outstanding, excluding own shares held, plus the weighted average number of ordinary shares that would be issued on ordinary conversion of dilutive potential ordinary shares in 2006 of 11,320 million (2005: 11,171 million; 2004: 11,054 million). The effect of dilutive share options and share awards on the weighted average number of ordinary shares in issue was as follows:

Notes on the Financial Statements (continued)

Note 13

	Number of shares (millions)		
	2006	2005	2004
Average number of shares in issue	**11,210**	11,038	10,907
Dilutive share options and share awards	**110**	133	147
– Savings-related Share Option Plan	**27**	22	38
– Executive Share Option Scheme	**10**	11	12
– Group Share Option Plan	**28**	14	13
– Restricted and performance share awards	**32**	70	63
– HSBC France share options	**8**	10	13
– HSBC Finance share options	**5**	6	8
Average number of shares in issue assuming dilution	**11,320**	11,171	11,054

Of the total number of employee share options and share awards existing at 31 December 2006, 20 million were anti-dilutive (2005: 121 million; 2004: 70 million).

13 Segment analysis

In the following segmental analysis, the benefit of shareholders' funds impacts the analysis only to the extent that these funds are actually allocated to businesses in the segment by way of intra-HSBC capital and funding structures.

By geographical region

Geographical information is classified by the location of the principal operations of the subsidiary undertaking, or, for The Hongkong and Shanghai Banking Corporation, HSBC Bank, HSBC Bank Middle East, HSBC Finance and HSBC Bank USA, by the location of the branch responsible for reporting the results or advancing the funds. Due to the nature of HSBC's structure, the analysis of profits shown below includes intra-HSBC items between geographical regions with the elimination shown in a separate column. The Rest of Asia-Pacific geographical segment includes the Middle East, India and Australasia. Shared costs are included in segments on the basis of the actual recharges made.

During 2006, HSBC changed how certain of its geographical segments are managed and their performance assessed. As a result, a new segment, Latin America and the Carribean ('Latin America'), was formed from the Group's businesses previously reported under South America, and those in Mexico and Panama which had been previously reported as part of the North America geographical segment. All prior period comparative data have been restated to conform to the current year presentation.

Total assets

	At 31 December 2006		At 31 December 2005 *(restated)*	
	US$m	**%**	US$m	%
Europe	**828,701**	**44.6**	636,703	42.4
Hong Kong	**272,428**	**14.6**	235,376	15.7
Rest of Asia-Pacific	**167,668**	**9.0**	142,014	9.4
North America	**511,190**	**27.5**	432,490	28.8
Latin America	**80,771**	**4.3**	53,387	3.7
	1,860,758	**100.0**	1,501,970	100.0

Total liabilities

	At 31 December 2006		At 31 December 2005 *(restated)*	
	US$m	**%**	US$m	%
Europe	**778,635**	**44.7**	594,953	42.4
Hong Kong	**258,028**	**14.8**	223,093	15.9
Rest of Asia-Pacific	**161,388**	**9.2**	136,892	9.8
North America	**477,310**	**27.3**	401,686	28.5
Latin America	**70,469**	**4.0**	47,120	3.4
	1,745,830	**100.0**	1,403,744	100.0

Profit before tax

	Year ended 31 December 2006						
	Europe US$m	Hong Kong US$m	Rest of Asia-Pacific US$m	North America US$m	Latin America US$m	Intra-HSBC items US$m	Total US$m
Interest income	25,249	11,097	7,693	27,959	7,289	(3,408)	75,879
Interest expense	(16,960)	(6,412)	(4,646)	(13,691)	(3,092)	3,408	(41,393)
Net interest income	8,289	4,685	3,047	14,268	4,197	–	34,486
Fee income	9,583	2,448	1,912	5,611	1,975	(449)	21,080
Fee expense	(2,475)	(392)	(290)	(845)	(345)	449	(3,898)
Net fee income	7,108	2,056	1,622	4,766	1,630	–	17,182
Trading income excluding net interest income	2,842	924	935	617	301	–	5,619
Net interest income/(expense) on trading activities	1,687	(307)	246	741	236	–	2,603
Net trading income	4,529	617	1,181	1,358	537	–	8,222
Net income/(expense) from financial instruments designated at fair value	144	260	79	(63)	237	–	657
Gains less losses from financial investments	624	162	41	58	84	–	969
Dividend income	183	61	5	85	6	–	340
Net earned insurance premiums	1,298	2,628	174	492	1,076	–	5,668
Other operating income	1,428	834	765	922	91	(1,494)	2,546
Total operating income	23,603	11,303	6,914	21,886	7,858	(1,494)	70,070
Net insurance claims incurred and movement in policyholders' liabilities	(531)	(2,699)	(192)	(259)	(1,023)	–	(4,704)
Net operating income before loan impairment charges and other credit risk provisions	23,072	8,604	6,722	21,627	6,835	(1,494)	65,366
Loan impairment charges and other credit risk provisions	(2,155)	(172)	(512)	(6,796)	(938)	–	(10,573)
Net operating income[1]	20,917	8,432	6,210	14,831	5,897	(1,494)	54,793
Total operating expenses (excluding depreciation and amortisation)	(12,811)	(3,002)	(3,412)	(9,669)	(3,923)	1,494	(31,323)
Depreciation of property, plant and equipment	(762)	(171)	(124)	(284)	(173)	–	(1,514)
Amortisation of intangible assets	(298)	(96)	(12)	(240)	(70)	–	(716)
Total operating expenses	(13,871)	(3,269)	(3,548)	(10,193)	(4,166)	1,494	(33,553)
Operating profit	7,046	5,163	2,662	4,638	1,731	–	21,240
Share of profit/(loss) in associates and joint ventures	(72)	19	865	30	4	–	846
Profit before tax	6,974	5,182	3,527	4,668	1,735	–	22,086
Other disclosures:							
Capital expenditure incurred[2]	1,508	324	235	899	2,017	–	4,983
Investment in associates and joint ventures	1,321	128	6,322	541	84	–	8,396

1 *Net operating income:*

External	*19,664*	*7,970*	*5,592*	*15,694*	*5,873*	*–*	*54,793*
Inter-segment	*1,253*	*462*	*618*	*(863)*	*24*	*(1,494)*	*–*

2 *Expenditure incurred on property, plant and equipment and intangible assets.*

Notes on the Financial Statements (continued)

Note 13

	Year ended 31 December 2005 *(restated)*						
	Europe US$m	Hong Kong US$m	Rest of Asia-Pacific US$m	North America US$m	Latin America US$m	Intra-HSBC items US$m	Total US$m
Interest income	21,023	7,419	5,673	22,189	6,133	(2,343)	60,094
Interest expense	(12,802)	(3,355)	(3,261)	(8,894)	(2,791)	2,343	(28,760)
Net interest income	8,221	4,064	2,412	13,295	3,342	–	31,334
Fee income	8,081	1,967	1,619	4,605	1,481	(267)	17,486
Fee expense	(1,782)	(293)	(279)	(653)	(290)	267	(3,030)
Net fee income	6,299	1,674	1,340	3,952	1,191	–	14,456
Trading income excluding net interest income	1,660	773	753	250	220	–	3,656
Net interest income/(expense) on trading activities	1,376	(227)	107	635	317	–	2,208
Net trading income	3,036	546	860	885	537	–	5,864
Net income/(expense) from financial instruments designated at fair value	362	(6)	58	434	186	–	1,034
Gains less losses from financial investments	439	108	18	47	80	–	692
Dividend income	63	41	5	41	5	–	155
Net earned insurance premiums	1,599	2,334	155	477	871	–	5,436
Other operating income	1,603	805	335	642	286	(938)	2,733
Total operating income	21,622	9,566	5,183	19,773	6,498	(938)	61,704
Net insurance claims incurred and movement in policyholders' liabilities	(818)	(2,059)	(166)	(232)	(792)	–	(4,067)
Net operating income before loan impairment charges and other credit risk provisions	20,804	7,507	5,017	19,541	5,706	(938)	57,637
Loan impairment charges and other credit risk provisions	(1,929)	(146)	(134)	(4,916)	(676)	–	(7,801)
Net operating income[1]	18,875	7,361	4,883	14,625	5,030	(938)	49,836
Total operating expenses (excluding depreciation and amortisation)	(11,493)	(2,586)	(2,648)	(8,276)	(3,263)	938	(27,328)
Depreciation of property, plant and equipment	(912)	(168)	(107)	(307)	(138)	–	(1,632)
Amortisation of intangible assets	(234)	(113)	(7)	(175)	(25)	–	(554)
Total operating expenses	(12,639)	(2,867)	(2,762)	(8,758)	(3,426)	938	(29,514)
Operating profit	6,236	4,494	2,121	5,867	1,604	–	20,322
Share of profit in associates and joint ventures	120	23	453	48	–	–	644
Profit before tax	6,356	4,517	2,574	5,915	1,604	–	20,966
Other disclosures:							
Capital expenditure incurred[2]	1,892	249	191	1,826	315	–	4,473
Investment in associates and joint ventures	1,733	108	5,362	43	3	–	7,249
1 *Net operating income:*							
External	*18,300*	*7,001*	*4,636*	*14,860*	*5,039*	*–*	*49,836*
Inter-segment	*575*	*360*	*247*	*(235)*	*(9)*	*(938)*	*–*

2 *Expenditure incurred on property, plant and equipment and intangible assets.*

	Year ended 31 December 2004 *(restated)*						
	Europe US$m	Hong Kong US$m	Rest of Asia-Pacific US$m	North America US$m	Latin America US$m	Intra-HSBC items US$m	Total US$m
Interest income	18,360	5,133	4,149	19,483	4,174	(828)	50,471
Interest expense	(9,262)	(1,495)	(2,089)	(5,696)	(1,658)	828	(19,372)
Net interest income	9,098	3,638	2,060	13,787	2,516	–	31,099
Fee income	7,546	1,964	1,287	4,115	1,226	(236)	15,902
Fee expense	(1,566)	(261)	(246)	(918)	(199)	236	(2,954)
Net fee income	5,980	1,703	1,041	3,197	1,027	–	12,948
Trading income	997	659	494	509	127	–	2,786
Net investment income on assets backing policyholders' liabilities	571	314	32	–	95	–	1,012
Gains less losses from financial investments	154	175	17	147	47	–	540
Dividend income	558	27	3	32	2	–	622
Net earned insurance premiums	1,875	2,247	97	450	699	–	5,368
Other operating income	1,175	536	146	341	46	(631)	1,613
Total operating income	20,408	9,299	3,890	18,463	4,559	(631)	55,988
Net insurance claims incurred and movement in policyholders' liabilities	(1,628)	(2,154)	(82)	(236)	(535)	–	(4,635)
Net operating income before loan impairment charges and other credit risk provisions	18,780	7,145	3,808	18,227	4,024	(631)	51,353
Loan impairment charges and other credit risk provisions	(1,033)	220	(89)	(5,036)	(253)	–	(6,191)
Net operating income[1]	17,747	7,365	3,719	13,191	3,771	(631)	45,162
Total operating expenses (excluding depreciation and amortisation)	(10,783)	(2,256)	(1,984)	(7,448)	(2,422)	631	(24,262)
Depreciation of property, plant and equipment	(1,095)	(168)	(99)	(266)	(103)	–	(1,731)
Amortisation of intangible assets	(150)	(134)	(4)	(201)	(5)	–	(494)
Total operating expenses	(12,028)	(2,558)	(2,087)	(7,915)	(2,530)	631	(26,487)
Operating profit	5,719	4,807	1,632	5,276	1,241	–	18,675
Share of profit/(loss) in associates and joint ventures	37	23	215	(8)	1	–	268
Profit before tax	5,756	4,830	1,847	5,268	1,242	–	18,943
Other disclosures:							
Capital expenditure incurred[2]	2,001	234	114	1,913	366	–	4,628
Investment in associates and joint ventures	896	97	2,392	46	9	–	3,440
1 *Net operating income:*							
External	*17,463*	*7,052*	*3,569*	*13,261*	*3,817*	*–*	*45,162*
Inter-segment	*284*	*313*	*150*	*(70)*	*(46)*	*(631)*	*–*

2 *Expenditure incurred on property, plant and equipment and intangible assets.*

Notes on the Financial Statements (continued)

Note 13

By customer group

HSBC's operations include a number of shared support services and head office functions. The costs of these functions are allocated to customer groups, where appropriate, on a systematic and consistent basis. In addition, a number of income and expense items include the effect of financial transactions entered into in the ordinary course of business between customer groups co-operating within the integrated HSBC Group. The following analysis includes inter-segment amounts within each customer group with the elimination shown in a separate column.

Total assets

	At 31 December 2006		At 31 December 2005	
	US$m	%	US$m	%
Personal Financial Services	**546,568**	**29.4**	484,314	32.2
Commercial Banking	**213,450**	**11.5**	175,120	11.7
Corporate, Investment Banking and Markets	**994,436**	**53.5**	755,056	50.3
Private Banking	**73,026**	**3.9**	59,827	4.0
Other	**33,278**	**1.7**	27,653	1.8
Total assets	**1,860,758**	**100.0**	1,501,970	100.0

Profit before tax

	Year ended 31 December 2006						
	Personal Financial Services US$m	Commercial Banking US$m	Corporate, Investment Banking & Markets US$m	Private Banking US$m	Other US$m	Intra-HSBC items US$m	Total US$m
Net interest income/(expense)	**26,076**	**7,514**	**3,168**	**1,011**	**(625)**	**(2,658)**	**34,486**
Net fee income	**8,762**	**3,207**	**3,718**	**1,323**	**172**	**–**	**17,182**
Trading income/(expense) excluding net interest income	**391**	**204**	**4,890**	**362**	**(228)**	**–**	**5,619**
Net interest income/(expense) on trading activities	**220**	**20**	**(379)**	**2**	**82**	**2,658**	**2,603**
Net trading income/(expense)	**611**	**224**	**4,511**	**364**	**(146)**	**2,658**	**8,222**
Net income/(expense) from financial instruments designated at fair value	**739**	**(22)**	**20**	**1**	**(81)**	**–**	**657**
Gains less losses from financial investments	**78**	**44**	**534**	**166**	**147**	**–**	**969**
Dividend income	**31**	**6**	**235**	**5**	**63**	**–**	**340**
Net earned insurance premiums	**5,130**	**258**	**73**	**–**	**207**	**–**	**5,668**
Other operating income	**782**	**250**	**1,378**	**61**	**3,254**	**(3,179)**	**2,546**
Total operating income	**42,209**	**11,481**	**13,637**	**2,931**	**2,991**	**(3,179)**	**70,070**
Net insurance claims incurred and movement in policyholders' liabilities	**(4,365)**	**(96)**	**(62)**	**–**	**(181)**	**–**	**(4,704)**
Net operating income[1]	**37,844**	**11,385**	**13,575**	**2,931**	**2,810**	**(3,179)**	**65,366**
Loan impairment (charges)/recoveries and other credit risk provisions	**(9,949)**	**(697)**	**119**	**(33)**	**(13)**	**–**	**(10,573)**
Net operating income[2]	**27,895**	**10,688**	**13,694**	**2,898**	**2,797**	**(3,179)**	**54,793**
Operating expenses	**(18,818)**	**(4,979)**	**(7,991)**	**(1,685)**	**(3,259)**	**3,179**	**(33,553)**
Operating profit/(loss)	**9,077**	**5,709**	**5,703**	**1,213**	**(462)**	**–**	**21,240**
Share of profit in associates and joint ventures	**380**	**288**	**103**	**1**	**74**	**–**	**846**
Profit/(loss) before tax	**9,457**	**5,997**	**5,806**	**1,214**	**(388)**	**–**	**22,086**
Capital expenditure incurred[3]	**2,150**	**1,083**	**1,021**	**45**	**684**	**–**	**4,983**

1 *Net operating income before loan impairment (charges)/recoveries and other credit risk provisions.*

2 *Net operating income:*

External	*23,238*	*9,692*	*20,034*	*1,661*	*168*	*–*	*54,793*
Inter-segment	*4,657*	*996*	*(6,340)*	*1,237*	*2,629*	*(3,179)*	*–*

3 *Expenditure incurred on property, plant and equipment and intangible assets.*

	Year ended 31 December 2005						
	Personal Financial Services US$m	Commercial Banking US$m	Corporate, Investment Banking & Markets US$m	Private Banking US$m	Other US$m	Intra-HSBC items US$m	Total US$m
Net interest income/(expense)	23,351	6,310	3,001	848	(472)	(1,704)	31,334
Net fee income	7,313	2,876	2,967	1,080	220	–	14,456
Trading income/(expense) excluding net interest income .	360	150	2,919	317	(90)	–	3,656
Net interest income/(expense) on trading activities	214	(3)	306	–	(13)	1,704	2,208
Net trading income/(expense)	574	147	3,225	317	(103)	1,704	5,864
Net income/(expense) from financial instruments designated at fair value	574	(12)	67	(1)	406	–	1,034
Gains less losses from financial investments	19	9	475	45	144	–	692
Dividend income	16	9	79	9	42	–	155
Net earned insurance premiums ..	4,864	236	76	–	260	–	5,436
Other operating income	729	327	1,621	68	2,634	(2,646)	2,733
Total operating income	37,440	9,902	11,511	2,366	3,131	(2,646)	61,704
Net insurance claims incurred and movement in policy-holders' liabilities	(3,716)	(118)	(54)	–	(179)	–	(4,067)
Net operating income[1]	33,724	9,784	11,457	2,366	2,952	(2,646)	57,637
Loan impairment (charges)/ recoveries and other credit risk provisions	(7,537)	(547)	272	12	(1)	–	(7,801)
Net operating income[2]	26,187	9,237	11,729	2,378	2,951	(2,646)	49,836
Operating expenses	(16,427)	(4,453)	(6,838)	(1,466)	(2,976)	2,646	(29,514)
Operating profit/(loss)	9,760	4,784	4,891	912	(25)	–	20,322
Share of profit in associates and joint ventures	144	177	272	–	51	–	644
Profit before tax	9,904	4,961	5,163	912	26	–	20,966
Capital expenditure incurred[3]	1,583	411	1,783	102	594	–	4,473

1 *Net operating income before loan impairment (charges)/recoveries and other credit risk provisions.*

2 *Net operating income:*

External	*25,000*	*8,258*	*13,998*	*1,668*	*912*	*–*	*49,836*
Inter-segment	*1,187*	*979*	*(2,269)*	*710*	*2,039*	*(2,646)*	*–*

3 *Expenditure incurred on property, plant and equipment and intangible assets.*

Notes on the Financial Statements (continued)

Notes 13 and 14

	Year ended 31 December 2004						
	Personal Financial Services US$m	Commercial Banking US$m	Corporate, Investment Banking & Markets US$m	Private Banking US$m	Other US$m	Intra-HSBC items US$m	Total US$m
Net interest income	21,422	4,875	3,994	718	90	–	31,099
Net fee income	6,406	2,645	2,764	962	171	–	12,948
Trading income	320	234	1,935	257	40	–	2,786
Net investment income on assets backing policy-holders' liabilities	635	324	9	–	44	–	1,012
Gains less losses from financial investments	79	6	197	39	219	–	540
Dividend income	16	37	548	5	16	–	622
Net earned insurance premiums	3,652	1,072	86	–	558	–	5,368
Other operating income	360	513	1,029	24	2,050	(2,363)	1,613
Total operating income	32,890	9,706	10,562	2,005	3,188	(2,363)	55,988
Net insurance claims incurred and movement in policyholders' liabilities	(2,953)	(1,264)	(59)	–	(359)	–	(4,635)
Net operating income[1]	29,937	8,442	10,503	2,005	2,829	(2,363)	51,353
Loan impairment (charges)/ recoveries and other credit risk provisions	(6,500)	(200)	499	11	(1)	–	(6,191)
Net operating income[2]	23,437	8,242	11,002	2,016	2,828	(2,363)	45,162
Operating expenses	(15,009)	(4,220)	(5,809)	(1,319)	(2,493)	2,363	(26,487)
Operating profit	8,428	4,022	5,193	697	335	–	18,675
Share of profit in associates and joint ventures	69	35	95	–	69	–	268
Profit before tax	8,497	4,057	5,288	697	404	–	18,943
Capital expenditure incurred[3]	1,415	614	1,919	142	538	–	4,628

1 *Net operating income before loan impairment (charges)/recoveries and other credit risk provisions.*
2 *Net operating income:*

External	*22,760*	*7,419*	*12,239*	*1,704*	*1,040*	*–*	*45,162*
Inter-segment	*677*	*823*	*(1,237)*	*312*	*1,788*	*(2,363)*	*–*

3 *Expenditure incurred on property, plant and equipment and intangible assets.*

14 Analysis of financial assets and liabilities by measurement basis

Financial assets and financial liabilities are measured on an ongoing basis either at fair value or at amortised cost. The summary of significant accounting policies in Note 2 describes how the classes of financial instruments are measured, and how income and expenses, including fair value gains and losses, are recognised. The following table analyses the carrying amounts of the financial assets and liabilities by category as defined in IAS 39 and by balance sheet heading.

	At 31 December 2006								
	Held for trading US$m	Designated at fair value US$m	Held-to-maturity securities US$m	Loans and receivables US$m	Available-for-sale securities US$m	Financial assets and liabilities at amortised cost US$m	Derivatives designated as fair value hedging instruments US$m	Derivatives designated as cash flow hedging instruments US$m	Total US$m
FINANCIAL ASSETS									
Cash and balances at central banks	–	–	–	–	–	12,732	–	–	12,732
Items in the course of collection from other banks	–	–	–	–	–	14,144	–	–	14,144
Hong Kong Government certificates of indebtedness	–	–	–	13,165	–	–	–	–	13,165
Trading assets	328,147	–	–	–	–	–	–	–	328,147
Financial assets designated at fair value	–	20,573	–	–	–	–	–	–	20,573
Derivatives	99,752	–	–	–	–	–	201	3,749	103,702
Loans and advances to banks	–	–	–	185,205	–	–	–	–	185,205
Loans and advances to customers	–	–	–	868,133	–	–	–	–	868,133
Financial investments	–	–	9,371	–	195,435	–	–	–	204,806
Other assets	–	–	–	–	–	23,305	–	–	23,305
Accrued income	–	–	–	–	–	12,735	–	–	12,735
Total financial assets	427,899	20,573	9,371	1,066,503	195,435	62,916	201	3,749	1,786,647
FINANCIAL LIABILITIES									
Hong Kong currency notes in circulation	–	–	–	13,165	–	–	–	–	13,165
Deposits by banks	–	–	–	–	–	99,694	–	–	99,694
Customer accounts	–	–	–	–	–	896,834	–	–	896,834
Items in the course of transmission to other banks	–	–	–	–	–	12,625	–	–	12,625
Trading liabilities	226,608	–	–	–	–	–	–	–	226,608
Financial liabilities designated at fair value	–	70,211	–	–	–	–	–	–	70,211
Derivatives	99,790	–	–	–	–	–	315	1,373	101,478
Debt securities in issue	–	–	–	–	–	230,325	–	–	230,325
Other liabilities	–	–	–	–	–	25,676	–	–	25,676
Accruals	–	–	–	–	–	15,057	–	–	15,057
Subordinated liabilities	–	–	–	–	–	22,672	–	–	22,672
Total financial liabilities	326,398	70,211	–	13,165	–	1,302,883	315	1,373	1,714,345

Notes on the Financial Statements (continued)

Note14

HSBC

	At 31 December 2005								
	Held for trading US$m	Designated at fair value US$m	Held-to-maturity securities US$m	Loans and receivables US$m	Available-for-sale securities US$m	Financial assets and liabilities at amortised cost US$m	Derivatives designated as fair value hedging instruments US$m	Derivatives designated as cash flow hedging instruments US$m	Total US$m
FINANCIAL ASSETS									
Cash and balances at central banks	–	–	–	–	–	13,712	–	–	13,712
Items in the course of collection from other banks	–	–	–	–	–	11,300	–	–	11,300
Hong Kong Government certificates of indebtedness	–	–	–	12,554	–	–	–	–	12,554
Trading assets	232,909	–	–	–	–	–	–	–	232,909
Financial assets designated at fair value	–	15,046	–	–	–	–	–	–	15,046
Derivatives	70,251	–	–	–	–	–	149	3,528	73,928
Loans and advances to banks	–	–	–	125,965	–	–	–	–	125,965
Loans and advances to customers	–	–	–	740,002	–	–	–	–	740,002
Financial investments	–	–	8,515	–	173,827	–	–	–	182,342
Other assets	–	–	–	–	–	26,596	–	–	26,596
Accrued income	–	–	–	–	–	11,961	–	–	11,961
Total financial assets	303,160	15,046	8,515	878,521	173,827	63,569	149	3,528	1,446,315
FINANCIAL LIABILITIES									
Hong Kong currency notes in circulation	–	–	–	12,554	–	–	–	–	12,554
Deposits by banks	–	–	–	–	–	69,727	–	–	69,727
Customer accounts	–	–	–	–	–	739,419	–	–	739,419
Items in the course of transmission to other banks	–	–	–	–	–	7,022	–	–	7,022
Trading liabilities	174,365	–	–	–	–	–	–	–	174,365
Financial liabilities designated at fair value	–	61,829	–	–	–	–	–	–	61,829
Derivatives	72,389	–	–	–	–	–	471	1,176	74,036
Debt securities in issue	–	–	–	–	–	188,072	–	–	188,072
Other liabilities	–	–	–	–	–	26,515	–	–	26,515
Accruals	–	–	–	–	–	12,689	–	–	12,689
Subordinated liabilities	–	–	–	–	–	16,537	–	–	16,537
Total financial liabilities	246,754	61,829	–	12,554	–	1,059,981	471	1,176	1,382,765

	At 31 December 2006					
	Held for trading US$m	**Designated at fair value US$m**	**Loans and receivables US$m**	**Available-for-sale securities US$m**	**Financial assets and liabilities at amortised cost US$m**	**Total US$m**
FINANCIAL ASSETS						
Cash at bank and in hand	**–**	**–**	**–**	**–**	**729**	**729**
Derivatives	**1,599**	**–**	**–**	**–**	**–**	**1,599**
Loans and advances to HSBC undertakings	**–**	**–**	**14,456**	**–**	**–**	**14,456**
Financial investments	**–**	**–**	**–**	**3,614**	**–**	**3,614**
Other assets	**–**	**–**	**–**	**–**	**25**	**25**
Total financial assets	**1,599**	**–**	**14,456**	**3,614**	**754**	**20,423**
FINANCIAL LIABILITIES						
Amounts owed to HSBC undertakings	**–**	**–**	**–**	**–**	**3,100**	**3,100**
Financial liabilities designated at fair value	**–**	**14,070**	**–**	**–**	**–**	**14,070**
Derivatives	**177**	**–**	**–**	**–**	**–**	**177**
Subordinated liabilities	**–**	**–**	**–**	**–**	**8,423**	**8,423**
Other liabilities	**–**	**–**	**–**	**–**	**1**	**1**
Accruals	**–**	**–**	**–**	**–**	**111**	**111**
Total financial liabilities	**177**	**14,070**	**–**	**–**	**11,635**	**25,882**

	At 31 December 2005					
	Held for trading US$m	Designated at fair value US$m	Loans and receivables US$m	Available-for-sale securities US$m	Financial assets and liabilities at amortised cost US$m	Total US$m
FINANCIAL ASSETS						
Cash at bank and in hand	–	–	–	–	756	756
Derivatives	968	–	–	–	–	968
Loans and advances to HSBC undertakings	–	–	14,092	–	–	14,092
Financial investments	–	–	–	3,517	–	3,517
Other assets	–	–	–	–	25	25
Total financial assets	968	–	14,092	3,517	781	19,358
FINANCIAL LIABILITIES						
Amounts owed to HSBC undertakings	–	–	–	–	4,075	4,075
Financial liabilities designated at fair value	–	13,370	–	–	–	13,370
Derivatives	286	–	–	–	–	286
Subordinated liabilities	–	–	–	–	5,236	5,236
Other liabilities	–	–	–	–	3	3
Accruals	–	–	–	–	95	95
Total financial liabilities	286	13,370	–	–	9,409	23,065

Notes on the Financial Statements (continued)

Notes 15 and 16

15 Trading assets

	2006 US$m	2005 US$m
Trading assets:		
– not subject to repledge or resale by counterparties	**273,507**	171,274
– which may be repledged or resold by counterparties	**54,640**	61,635
	328,147	232,909
Treasury and other eligible bills	**21,759**	12,746
Debt securities	**155,447**	117,659
Equity securities	**27,149**	20,203
	204,355	150,608
Loans and advances to banks	**52,006**	29,806
Loans and advances to customers	**71,786**	52,495
	328,147	232,909

The following table provides an analysis of trading securities which are valued at market value and the net gains/(losses) resulting from trading activities:

	2006		2005	
	Fair value US$m	Gains/ (losses) US$m	Fair value US$m	Gains/ (losses) US$m
US Treasury and US Government agencies	**8,348**	**91**	12,094	(21)
UK Government	**6,176**	**77**	3,225	2
Hong Kong Government	**8,759**	**4**	6,529	(16)
Other government	**70,747**	**232**	49,852	280
Asset-backed securities	**15,781**	**3**	3,361	(24)
Corporate debt and other securities	**67,395**	**(27)**	55,344	324
Equity securities	**27,149**	**(30)**	20,203	(117)
	204,355	**350**	150,608	428

*Included within the above figures are debt securities issued by banks and other financial institutions of US$*36,153 *million (2005:US$16,888 million).*

The following table analyses trading securities between those listed on a recognised exchange and those that are unlisted:

	Treasury and other eligible bills US$m	Debt securities US$m	Equity securities US$m	Total US$m
Fair value at 31 December 2006				
Listed on a recognised exchange[1]	**1,373**	**112,403**	**25,337**	**139,113**
Unlisted	**20,386**	**43,044**	**1,812**	**65,242**
	21,759	**155,447**	**27,149**	**204,355**
Fair value at 31 December 2005				
Listed on a recognised exchange[1]	7,174	95,994	17,728	120,896
Unlisted	5,572	21,665	2,475	29,712
	12,746	117,659	20,203	150,608

1 *Included within listed investments are US$4,309 million (2005: US$2,049 million) of investments listed in Hong Kong.*

The following table summarises HSBC's trading portfolios by valuation methodology:

	Assets		Liabilities	
	Trading securities	**Derivatives**	**Trading securities – short positions**	**Derivatives**
	%	**%**	**%**	**%**
At 31 December 2006				
Fair value based on:				
Quoted market prices	**82.2**	**1.9**	**93.2**	**2.6**
Internal models with significant observable market parameters	**17.8**	**96.3**	**6.8**	**96.5**
Internal models with significant unobservable market parameters	**–**	**1.8**	**–**	**0.9**
	100.0	**100.0**	**100.0**	**100.0**
At 31 December 2005				
Fair value based on:				
Quoted market prices	87.6	6.0	96.0	5.7
Internal models with significant observable market parameters	12.4	91.5	4.0	92.4
Internal models with significant unobservable market parameters	–	2.5	–	1.9
	100.0	100.0	100.0	100.0

16 Financial assets designated at fair value

	2006	2005
	US$m	US$m
Treasury and other eligible bills	**133**	53
Debt securities	**9,449**	5,705
Equity securities	**10,602**	8,533
Loans and advances to banks	**236**	124
Loans and advances to customers	**153**	631
	20,573	15,046

	Treasury and other eligible bills	**Debt securities**	**Equity securities**	**Total**
	US$m	**US$m**	**US$m**	**US$m**
Fair value at 31 December 2006				
Listed on a recognised exchange[1]	**133**	**4,939**	**9,212**	**14,284**
Unlisted	**–**	**4,510**	**1,390**	**5,900**
	133	**9,449**	**10,602**	**20,184**
Fair value at 31 December 2005				
Listed on a recognised exchange[1]	41	3,012	7,192	10,245
Unlisted	12	2,693	1,341	4,046
	53	5,705	8,533	14,291

1 *Included within listed investments are US$1,014 million of investments listed in Hong Kong (2005: US$932 million).*

Notes on the Financial Statements (continued)

The following table provides an analysis of securities designated at fair value:

	Market value	
	2006	2005
	US$m	US$m
US Treasury and US Government agencies	**92**	86
UK Government	**1,359**	1,164
Hong Kong Government	**216**	171
Other government	**2,131**	1,358
Asset-backed securities	**274**	193
Corporate debt and other securities	**5,510**	2,786
Equities	**10,602**	8,533
	20,184	14,291

Included within the above figures are debt securities issued by banks and other financial institutions of US$2,438 million (2005: US$1,703 million).

17 Derivatives

Fair values of derivatives by product contract type held by HSBC

	Assets			**Liabilities**		
	Trading	**Hedging**	**Total**	**Trading**	**Hedging**	**Total**
	US$m	**US$m**	**US$m**	**US$m**	**US$m**	**US$m**
At 31 December 2006						
Foreign exchange	**30,648**	**2,399**	**33,047**	**(28,837)**	**(394)**	**(29,231)**
Interest rate	**52,664**	**1,551**	**54,215**	**(52,927)**	**(1,287)**	**(54,214)**
Equities	**10,767**	**–**	**10,767**	**(11,647)**	**(7)**	**(11,654)**
Credit derivatives	**8,237**	**–**	**8,237**	**(8,611)**	**–**	**(8,611)**
Commodity and other	**1,304**	**–**	**1,304**	**(1,636)**	**–**	**(1,636)**
Gross total fair values	**103,620**	**3,950**	**107,570**	**(103,658)**	**(1,688)**	**(105,346)**
Netting			**(3,868)**			**3,868**
Total			**103,702**			**(101,478)**
At 31 December 2005						
Foreign exchange	21,082	263	21,345	(20,794)	(81)	(20,875)
Interest rate	44,323	3,414	47,737	(46,580)	(1,566)	(48,146)
Equities	4,833	–	4,833	(4,713)	–	(4,713)
Credit derivatives	3,585	–	3,585	(3,509)	–	(3,509)
Commodity and other	1,077	–	1,077	(1,442)	–	(1,442)
Gross total fair values	74,900	3,677	78,577	(77,038)	(1,647)	(78,685)
Netting			(4,649)			4,649
Total			73,928			(74,036)

Fair values of derivatives by product contract type held by HSBC Holdings with subsidiaries

	Year ended 31 December			
	2006		2005	
	Trading		Trading	
	Assets	**Liabilities**	Assets	Liabilities
	US$m	**US$m**	US$m	US$m
Foreign exchange	**1,557**	**–**	896	144
Interest rate	**42**	**177**	72	142
Gross total fair values	**1,599**	**177**	968	286

Derivatives are financial instruments that derive their value from the price of underlying items such as equities, bonds, interest rates, foreign exchange, credit spreads, commodities and equity or other indices. Derivatives enable users to increase, reduce or alter exposure to credit or market risks. HSBC makes markets in derivatives for its customers and uses derivatives to manage its exposure to credit and market risks.

Derivatives are carried at fair value and shown in the balance sheet as separate totals of assets and liabilities. Asset values represent the cost to HSBC of replacing all transactions with a fair value in HSBC's favour assuming that all

HSBC's relevant counterparties default at the same time, and that transactions can be replaced instantaneously. Liability values represent the cost to HSBC's counterparties of replacing all their transactions with HSBC with a fair value in their favour if HSBC were to default. Derivative assets and liabilities on different transactions are only set off if the transactions are with the same counterparty, a legal right of set-off exists and the cash flows are intended to be settled on a net basis.

Use of derivatives

HSBC transacts derivatives for three primary purposes: to create risk management solutions for clients, for proprietary trading purposes, and to manage and hedge HSBC's own risks. Derivatives (except for derivatives which are designated as effective hedging instruments as defined in IAS 39) are held for trading. The held for trading classification includes two types of derivatives: those used in sales and trading activities, and those used for risk management purposes but which for various reasons do not meet the qualifying criteria for hedge accounting. The second category includes derivatives managed in conjunction with financial instruments designated at fair value. These activities are described more fully below.

HSBC's derivative activities give rise to significant open positions in portfolios of derivatives. These positions are managed constantly to ensure that they remain within acceptable risk levels, with matching deals being utilised to achieve this where necessary. When entering into derivative transactions, HSBC employs the same credit risk management procedures to assess and approve potential credit exposures that are used for traditional lending.

Trading derivatives

Most of HSBC's derivative transactions relate to sales and trading activities. Sales activities include the structuring and marketing of derivative products to customers to enable them to take, transfer, modify or reduce current or expected risks. Trading activities in derivatives are entered into principally for the purpose of generating profits from short-term fluctuations in price or margin. Positions may be traded actively or be held over a period of time to benefit from expected changes in exchange rates, interest rates, equity prices or other market parameters. Trading includes market-making, positioning and arbitrage activities. Market-making entails quoting bid and offer prices to other market participants for the purpose of generating revenues based on spread and volume; positioning means managing market risk positions in the expectation of benefiting from favourable movements in prices, rates or indices; arbitrage involves identifying and profiting from price differentials between markets and products.

As mentioned above, other derivatives classified as held for trading include non-qualifying hedging derivatives, ineffective hedging derivatives and the components of hedging derivatives that are excluded from assessing hedge effectiveness. Non-qualifying hedging derivatives are entered into for risk management purposes but do not meet the criteria for hedge accounting. These include derivatives managed in conjunction with financial instruments designated at fair value.

Gains and losses from changes in the fair value of derivatives that do not qualify for hedge accounting are reported in 'Net trading income', except for derivatives managed in conjunction with financial instruments designated at fair value, where gains and losses are reported in 'Net income from financial instruments designated at fair value', together with the gains and losses on the hedged items. Changes in the fair values of trading derivatives are inclusive of contractual interest. Changes in the fair value of derivatives managed in conjunction with financial instruments designated at fair value are included in 'Net income from financial instruments designated at fair value' inclusive of contractual interest unless the derivatives are managed with debt securities in issue, in which case the contractual interest is shown in interest payable with the interest payable on the issued debt. Substantially all of HSBC Holdings' derivatives entered into with HSBC undertakings are managed in conjunction with financial liabilities designated at fair value.

Contract amounts of derivatives held for trading purposes by product type

	HSBC		HSBC Holdings	
	2006	2005	**2006**	2005
	US$m	US$m	**US$m**	US$m
Foreign exchange	**2,182,005**	1,721,456	**9,869**	10,224
Interest rate	**9,843,601**	6,731,721	**5,304**	5,304
Equities	**207,016**	101,364	**–**	–
Credit derivatives	**1,109,828**	511,741	**–**	–
Commodity and other	**30,532**	38,458	**–**	–
	13,372,982	9,104,740	**15,173**	15,528

Derivatives valued using models with unobservable inputs

The amount that has yet to be recognised in the consolidated income statement relating to the difference between the fair value at initial recognition (the transaction price) and the amount that would have arisen had valuation techniques used for subsequent measurement been applied at initial recognition, less subsequent releases, is as follows:

	2006	2005
	US$m	US$m
Unamortised balance at 1 January	**252**	73
Deferral on new transactions	**283**	340
Recognised in the income statement during the period:		
– amortisation	**(59)**	(56)
– subsequent to unobservable inputs becoming observable	**(226)**	(64)
– maturity or termination	**(53)**	(25)
Exchange differences	**17**	(16)
Unamortised balance at 31 December	**214**	252

Hedging Instruments

HSBC uses derivatives (principally interest rate swaps) for hedging purposes in the management of its own asset and liability portfolios and structural positions. This enables HSBC to optimise the overall cost to the Group of accessing debt capital markets, and to mitigate the market risk which would otherwise arise from structural imbalances in the maturity and other profiles of its assets and liabilities.

The accounting treatment of hedge transactions varies according to the nature of the instrument hedged and the type of hedge transactions. Derivatives may qualify as hedges for accounting purposes if they are fair value hedges, cash flow hedges, or investment hedges. These are described under the relevant headings below:

Contract amounts of derivatives held for hedging purposes by product type

	At 31 December 2006		At 31 December 2005	
	Cash flow hedge	**Fair value hedge**	Cash flow hedge	Fair value hedge
	US$m	**US$m**	US$m	US$m
Foreign exchange	**21,765**	**2,985**	16,940	2,699
Interest rate	**201,635**	**24,279**	174,875	19,745
Equities	**–**	**30**	–	–
	223,400	**27,294**	191,815	22,444

With respect to exchange rate and interest rate contracts, the notional or contractual amounts of these instruments indicate the nominal value of transactions outstanding at the balance sheet date; they do not represent amounts at risk.

Fair value hedges

HSBC's fair value hedges principally consist of interest rate swaps that are used to protect against changes in the fair value of fixed-rate long-term financial instruments due to movements in market interest rates. For qualifying fair value hedges, all changes in the fair value of the derivative and in the fair value of the item in relation to the risk being hedged are recognised in income. If the hedge relationship is terminated, the fair value adjustment to the hedged item continues to be reported as part of the basis of the item and is amortised to income as a yield adjustment over the remainder of the hedging period.

The fair values of outstanding derivatives designated as fair value hedges at 31 December 2006 were assets of US$201 million (2005: US$149 million) and liabilities of US$315 million (2005: US$471 million).

Gains or losses arising from fair value hedges

	2006	2005
	US$m	US$m
Gains/(losses):		
– on hedging instruments	**8**	81
– on the hedged items attributable to the hedged risk	**8**	(67)
	16	14

Cash flow hedges

HSBC's cash flow hedges consist principally of interest rate and cross-currency swaps that are used to protect against exposures to variability in future interest cash flows on non-trading assets and liabilities which bear interest at variable rates or which are expected to be re-funded or reinvested in the future. The amounts and timing of future cash flows, representing both principal and interest flows, are projected for each portfolio of financial assets and liabilities on the basis of their contractual terms and other relevant factors, including estimates of prepayments and defaults. The aggregate principal balances and interest cash flows across all portfolios over time form the basis for identifying gains and losses on the effective portions of derivatives designated as cash flow hedges of forecast transactions. Gains and losses are initially recognised directly in equity, in the cash flow hedging reserve, and are transferred to the income statement when the forecast cash flows affect the income statement.

At 31 December 2006, the fair values of outstanding derivatives designated as cash flow hedges of forecast transactions were assets of US$3,749 million (2005: US$3,528 million) and liabilities of US$1,364 million (2005: US$1,062 million).

The schedule of forecast principal balances on which the expected interest cash flows arise as at 31 December 2006 is as follows:

	3 months or less	**More than 3 months but less than 1 year**	**5 years or less but more than 1 year**	**More than 5 years**
	US$m	**US$m**	**US$m**	**US$m**
At 31 December 2006				
Cash inflows from assets	**61,649**	**51,471**	**22,271**	**496**
Cash outflows from liabilities	**(96,852)**	**(91,868)**	**(60,712)**	**(8,093)**
Net cash outflows	**(35,203)**	**(40,397)**	**(38,441)**	**(7,597)**
At 31 December 2005				
Cash inflows from assets	54,355	37,270	31,664	1,474
Cash outflows from liabilities	(80,744)	(64,622)	(47,918)	(1,799)
Net cash outflows	(26,389)	(27,352)	(16,254)	(325)

This table reflects the interest rate refixing profile of the underlying hedged items and 2005 balances have been adjusted to ensure consistency with the 2006 balances for this disclosure.

The gains and losses on ineffective portions of such derivatives are recognised immediately in the income statement. During the year to 31 December 2006, a loss of US$122 million (2005: US$96 million) was recognised due to hedge ineffectiveness.

Hedges of net investments in foreign operations

HSBC's consolidated balance sheet is affected by exchange differences between the US dollar and all the non-US dollar functional currencies of subsidiaries. HSBC hedges structural foreign exchange exposures only in limited circumstances. Hedging is undertaken using forward foreign exchange contracts which are accounted for as hedges of a net investment in a foreign operation, or by financing with borrowings in the same currencies as the functional currencies involved.

Notes on the Financial Statements (continued)

At 31 December 2006, the fair values of outstanding financial instruments designated as hedges of net investments in foreign operations were liabilities of US$254 million (2005: US$114 million).

The ineffectiveness recognised in 'Net trading income' in the year ended 31 December 2006 that arose from hedges in foreign operations was nil (2005: nil).

Sensitivity of fair values to changing significant assumptions to reasonably possible alternatives

Fair values of certain derivatives recognised in the financial statements may be determined in whole or in part using valuation techniques based on assumptions that are not supported by prices from current market transactions or observable market data. In these instances, the net fair value recorded in the financial statements is the sum of three components:

– the value given by application of a valuation model, based upon HSBC's best estimate of the most appropriate model inputs;

– any fair value adjustments to account for market features not included within the valuation model (for example, bid-mid spreads, counterparty credit spreads and/or market data uncertainty); and

– inception profit, or an unamortised element thereof, not recognised immediately in the income statement in accordance with Note 2(k).

As the valuation models are based upon assumptions, changing the assumptions changes the resultant estimate of fair value. HSBC performs various sensitivity analyses on its valuation assumptions. The potential effect of using reasonably possible alternative assumptions in valuation models has been quantified as a reduction in assets of approximately US$72 million (2005: US$77 million) using less favourable assumptions, and an increase in assets of approximately US$69 million (2005: US$73 million) using more favourable assumptions. The ranges of reasonably possible alternative assumptions are established by application of professional judgement to an analysis of the data available to support each assumption.

The total amount of the change in fair value estimated using a valuation technique that was recognised in the year ended 31 December 2006 was a loss of US$195 million (2005: US$129 million).

18 Financial investments

HSBC

	2006 **US$m**	2005 US$m
Financial investments:		
– not subject to repledge or resale by counterparties	**197,055**	176,301
– which may be repledged or resold by counterparties	**7,751**	6,041
	204,806	182,342

	2006		2005	
	Carrying amount US$m	**Fair value US$m**	Carrying amount US$m	Fair value US$m
Treasury and other eligible bills	**25,313**	**25,313**	25,042	25,042
– available-for-sale	**25,268**	**25,268**	24,834	24,834
– held-to-maturity	**45**	**45**	208	208
Debt securities	**171,196**	**171,498**	149,781	149,962
– available-for-sale	**161,870**	**161,870**	141,699	141,699
– held-to-maturity	**9,326**	**9,628**	8,082	8,263
Equity securities	**8,297**	**8,297**	7,519	7,519
– available-for-sale	**8,297**	**8,297**	7,519	7,519
Total financial investments	**204,806**	**205,108**	182,342	182,523

	Amortised cost US$m	Gross unrealised gains US$m	Gross unrealised losses US$m	Fair value US$m
At 31 December 2006				
US Treasury	**10,219**	**5**	**(21)**	**10,203**
US Government agencies	**6,004**	**40**	**(76)**	**5,968**
US Government sponsored entities	**14,010**	**74**	**(285)**	**13,799**
UK Government	**7,515**	**10**	**(23)**	**7,502**
Hong Kong Government	**1,085**	**1**	**(6)**	**1,080**
Other government	**37,828**	**475**	**(105)**	**38,198**
Asset-backed securities	**26,752**	**9**	**(11)**	**26,750**
Corporate debt and other securities	**93,217**	**363**	**(269)**	**93,311**
Equities	**6,295**	**2,010**	**(8)**	**8,297**
	202,925	**2,987**	**(804)**	**205,108**
At 31 December 2005				
US Treasury	9,015	5	(23)	8,997
US Government agencies	4,173	52	(52)	4,173
US Government sponsored entities	16,099	82	(292)	15,889
UK Government	7,658	83	(1)	7,740
Hong Kong Government	4,429	2	(23)	4,408
Other government	34,623	317	(87)	34,853
Asset-backed securities	2,893	8	(12)	2,889
Corporate debt and other securities	96,018	452	(415)	96,055
Equities	6,414	1,111	(6)	7,519
	181,322	2,112	(911)	182,523
At 31 December 2004				
US Treasury	7,998	25	(22)	8,001
US Government agencies	9,657	91	(94)	9,654
US Government sponsored entities	10,093	133	(48)	10,178
UK Government	11,510	1	(2)	11,509
Hong Kong Government	5,274	88	–	5,362
Other government	36,393	543	(290)	36,646
Asset-backed securities	13,367	28	(6)	13,389
Corporate debt and other securities	84,477	1,061	(136)	85,402
Equities	6,563	1,136	(10)	7,689
	185,332	3,106	(608)	187,830

Included within the above figures are debt securities issued by banks and other financial institutions of US$86,649 million (2005: US$68,954 million). The fair value of these was US$86,596 million (2005: US$68,933 million).

	Treasury and other eligible bills available-for-sale US$m	Treasury and other eligible bills held-to-maturity US$m	Debt securities available-for-sale US$m	Debt securities held-to-maturity US$m	Equity securities US$m	Total US$m
Carrying amount at 31 December 2006						
Listed on a recognised exchange	**1,861**	**45**	**58,216**	**3,590**	**2,937**	**66,649**
Unlisted	**23,407**	**–**	**103,654**	**5,736**	**5,360**	**138,157**
	25,268	**45**	**161,870**	**9,326**	**8,297**	**204,806**
Carrying amount at 31 December 2005						
Listed on a recognised exchange	6,610	207	62,187	4,022	3,394	76,420
Unlisted	18,225	–	79,512	4,060	4,125	105,922
	24,835	207	141,699	8,082	7,519	182,342

The fair value of listed held-to-maturity debt securities as at 31 December 2006 was US$3,663 million (2005: US$4,143 million). Included within listed investments were US$1,179 million (2005: US$1,246 million) of investments listed in Hong Kong.

Notes on the Financial Statements (continued)

Notes 18 and 19

The maturities of investment securities at carrying value are analysed as follows:

	At 31 December	
	2006	2005
	US$m	US$m
Remaining contractual maturity of total debt securities:		
1 year or less	**63,932**	50,991
5 years or less but over 1 year	**55,145**	56,956
10 years or less but over 5 years	**12,015**	10,902
over 10 years	**40,104**	30,932
	171,196	149,781
Remaining contractual maturity of debt securities available for sale:		
1 year or less	**63,382**	50,559
5 years or less but over 1 year	**53,497**	55,531
10 years or less but over 5 years	**8,827**	8,636
over 10 years	**36,164**	26,973
	161,870	141,699
Remaining contractual maturity of debt securities held to maturity:		
1 year or less	**550**	432
5 years or less but over 1 year	**1,648**	1,425
10 years or less but over 5 years	**3,188**	2,266
over 10 years	**3,940**	3,959
	9,326	8,082

The following table provides an analysis of contractual maturities and weighted average yields of investment debt securities as at 31 December 2006:

	Within one year		After one year but within five years		After five years but within ten years		After ten years	
	Amount US$m	Yield %	Amount US$m	Yield %	Amount US$m	Yield %	Amount US$m	Yield %
Available-for-sale								
US Treasury agencies	199	3.95	1,463	3.65	125	4.38	22	4.97
US Government agencies	409	4.81	461	5.30	100	5.10	4,449	5.13
US Government-sponsored agencies	145	2.97	927	2.78	1,533	2.66	9,560	4.85
UK Government	769	3.87	1,324	5.26	–	–	–	–
Hong Kong Government	265	2.22	205	2.75	194	4.88	–	–
Other governments	11,790	4.06	11,907	8.00	2,175	7.07	1,274	7.54
Asset-backed securities	4,554	4.79	1,228	5.65	1,928	5.24	19,042	5.45
Corporate debt and other securities	44,875	3.93	36,046	5.41	2,512	4.53	2,487	5.18
Total amortised cost	63,006		53,561		8,567		36,834	
Total carrying value	63,382		53,497		8,827		36,164	
Held-to-maturity								
US Treasury agencies	3	5.88	3	5.06	26	4.23	77	5.11
US Government agencies	1	7.05	9	6.98	4	8.66	570	6.49
US Government-sponsored agencies	2	6.99	8	7.35	93	6.10	1,741	5.90
UK Government	–	–	–	–	–	–	–	–
Hong Kong Government	6	8.01	21	3.95	–	–	8	5.21
Other governments	126	4.20	135	5.95	130	4.84	594	4.94
Asset-backed securities	–	–	–	–	–	–	–	–
Corporate debt and other securities	412	3.96	1,472	4.73	2,935	4.83	950	4.92
Total amortised cost	550		1,648		3,188		3,940	
Total carrying value	550		1,648		3,188		3,940	

The maturity distributions of asset-backed securities are presented in the above table based upon contractual maturity dates. The weighted average yield for each range of maturities in the above table is calculated by dividing the annualised interest income for the year ended 31 December 2006 by the book amount of available-for-sale debt securities at that date. The yields do not include the effect of related derivatives.

19 Securitisations and other structured transactions

HSBC enters into transactions in the normal course of business by which it transfers recognised financial assets directly to third parties or to special purpose entities. These transfers may give rise to the full or partial derecognition of the financial assets concerned.

- Full derecognition occurs when HSBC transfers its contractual right to receive cash flows from the financial assets, or retains the right but assumes an obligation to pass on the cash flows from the asset, and transfers substantially all the risks and rewards of ownership. The risks include credit, interest rate, currency, prepayment and other price risks.
- Partial derecognition occurs when HSBC sells or otherwise transfers financial assets in such a way that some but not substantially all of the risks and rewards of ownership are transferred but control is retained. These financial assets are recognised on the balance sheet to the extent of HSBC's continuing involvement.

The majority of financial assets that do not qualify for derecognition are (i) debt securities held by counterparties as collateral under repurchase agreements or (ii) equity securities lent under securities lending agreements. The following table analyses the carrying amount of financial assets that did not qualify for derecognition during 2006 and 2005, and their associated financial liabilities:

	2006		2005	
	Carrying amount of transferred assets US$m	**Carrying amount of associated liabilities US$m**	Carrying amount of transferred assets[1] US$m	Carrying amount of associated Liabilities[1] US$m
Nature of transaction				
Repurchase agreements	**67,558**	**66,127**	62,663	62,880
Securities lending agreements	**12,908**	**12,469**	4,138	4,281
	80,466	**78,596**	66,801	67,161

1 *2005 amounts for repurchase agreements and securities lending agreements have been reclassified to ensure a consistent presentation with 2006 balances for this disclosure.*

A small proportion of financial assets that do not qualify for derecognition relate to loans, credit cards, debt securities and trade receivables that have been securitised under arrangements by which HSBC retains a continuing involvement in such transferred assets. Continuing involvement may entail retaining the rights to future cash flows arising from the assets after investors have received their contractual terms (for example, interest rate strips); providing subordinated interest; liquidity support; continuing to service the underlying asset; or entering into derivative transactions with the securitisation vehicles. As such, HSBC continues to be exposed to risks associated with these transactions.

The rights and obligations that HSBC retains from its continuing involvement in securitisations are initially recorded as an allocation of the fair value of the financial asset between the part that is derecognised and the part that continues to be recognised on the date of transfer. The following analyses the carrying amount of financial assets to the extent of HSBC's continuing involvement that qualified for partial derecognition during the year, and their associated liabilities:

	Carrying amount of assets (original) US$m	**Carrying amount of assets (currently recognised) US$m**	**Carrying amount of associated liabilities US$m**
Securitisations			
At 31 December 2006	**20,095**	**599**	**306**
At 31 December 2005	6,731	256	256

20 Interests in associates and joint ventures

Principal associates of HSBC

	At 31 December 2006		At 31 December 2005	
	Carrying amount US$m	**Fair value US$m**	Carrying amount US$m	Fair value US$m
Listed				
Bank of Communications Co., Limited	**2,710**	**11,065**	2,480	4,143
Ping An Insurance (Group) Company of China, Limited	**2,037**	**6,825**	1,837	2,274
The Saudi British Bank Limited	**978**	**4,700**	772	8,800
	5,725	**22,590**	5,089	15,217

	At 31 December 2006		
	Country of incorporation	**HSBC's interest in equity capital**	**Issued equity capital**
Listed			
Bank of Communications Co., Limited	PRC[1]	19.90%	RMB45,804m
Ping An Insurance (Group) Company of China, Limited	PRC[1]	19.90%	RMB6,195m
The Saudi British Bank Limited	Saudi Arabia	40.00%	SR3,750m
Unlisted			
Barrowgate Limited[2,3]	Hong Kong	24.64%	–
British Arab Commercial Bank Limited	England	46.51%	US$81m £32m fully paid £5m nil paid
Erisa S.A.	France	49.99%	€115m
Financiera Independencia S.A. de C.V.	Mexico	19.90%	MXP64m
Industrial Bank Company Limited[3,4]	PRC[1]	15.98%	RMB3,999m
Wells Fargo HSBC Trade Bank, N.A[5]	United States	20.00%	–

AEA Investors (Cayman) I LP[6,7]
HSBC PE European No. 2 LP[7,8]
Montagu III LP[7,8]
Ortigas & Company LP[9]
Private Equity Portfolio (Investment) LP Inc[7,8]

1 *People's Republic of China.*
2 *Issued equity capital is less than HK$1 million.*
3 *Investment held through Hang Seng Bank Limited, a 62.14 per cent owned subsidiary of HSBC.*
4 *Industrial Bank Company Limited listed on the Shanghai Stock Exchange on 5 February 2007.*
5 *Issued equity capital is less than US$1 million.*
6 *Venture Capital Limited partnership. Address of principal place of business is c/o Walkers SPV Limited, Walker House, 87 Mary Street, PO Box 908GT, George Town, Grand Cayman, Cayman Islands.*
7 *Limited partnership where the group owns more than 50 per cent but does not have control due to the limitations within these types of entities.*
8 *Limited partnership. Address of principal place of business is 68 Upper Thames Street, London EC4V 3PE.*
9 *Limited partnership. Address of principal place of business is 9/F Ortigas Building, Ortigas Avenue, Pasig City, Philippines.*

All the above investments in associates are owned by subsidiaries of HSBC Holdings. On 6 February 2006, HSBC disposed of its 21.16 per cent shareholding in the Cyprus Popular Bank Limited (trading as Laiki Group).

HSBC had US$4,747 million (2005: US$4,317 million) of investments in associates and joint ventures listed in Hong Kong.

For the year ended 31 December 2006, HSBC's share of associates and joint ventures tax on profit was US$279 million (2005: US$225 million), which is included within share of profit in associates and joint ventures in the income statement.

Summarised aggregate financial information on associates

	2006 US$m	2005 US$m
HSBC's share of:		
– assets	**83,096**	63,347
– liabilities	**77,446**	58,883
– revenues	**5,521**	3,330
– profit after tax	**823**	546

HSBC's share of associates' contingent liabilities amounted to US$13,824 million at 31 December 2006 (2005: US$7,818 million). No matters arose where HSBC was severally liable.

HSBC's 15.98 per cent investment in Industrial Bank Company Limited was equity accounted with effect from May 2004, reflecting HSBC's significant influence over this associate. HSBC's significant influence was established as a result of representation on the Board of Directors, and in accordance with the Technical Support and Assistance Agreements, HSBC is assisting in the development of financial and operating policies.

HSBC's 19.9 per cent investment in Ping An Insurance (Group) Company of China, Limited was equity accounted with effect from 31 August 2005, reflecting HSBC's significant influence over this associate. HSBC's significant influence was established as a result of the acquisition of an additional participation of 9.91 per cent on 31 August 2005, for a consideration of US$1,039 million.

HSBC's significant influence on Bank of Communications Co., Limited was established as a result of representation on the Board of Directors, and in accordance with the Technical Support and Assistance Agreements, HSBC is assisting in the development of financial and operating policies and a number of staff have been seconded to assist in this process.

The statutory accounting reference date of Bank of Communications Co., Limited, Ping An Insurance (Group) Company of China, Limited and Industrial Bank Company Limited is 31 December. For the year ended 31 December 2006, these companies were included on the basis of financial statements made up for the twelve months to 30 September 2006, taking into account changes in the subsequent period from 1 October 2006 to 31 December 2006 that would have materially affected their results.

HSBC also has a 100 per cent interest in the issued preferred stock (less than US$1 million) of Wells Fargo HSBC Trade Bank, N.A. HSBC has a 40 per cent economic interest in Wells Fargo HSBC Trade Bank, N.A. by virtue of the joint agreement under which HSBC's equity capital and preferred stock interests are being held.

HSBC acquired 19.9 per cent of Financiera Independencia S.A. de C.V. on 20 June 2006. The investment was equity accounted from that date, reflecting HSBC's significant influence over this associate.

Principal interests in joint ventures

	At 31 December 2006			
	Country of incorporation	**Principal activity**	**HSBC's interest in equity capital**	**Issued equity capital**
HSBC Saudi Arabia Limited	Saudi Arabia	Investment Banking	60%	SR50m

HSBC Saudi Arabia Limited has been established as a joint venture between HSBC and The Saudi British Bank, operating from July 2006. The ownership of HSBC Saudi Arabia Limited is split between HSBC, with 60 per cent, and The Saudi British Bank, with 40 per cent. The strategic financial and operating decisions of HSBC Saudi Arabia Limited require unanimous consent of HSBC and The Saudi British Bank.

Notes on the Financial Statements (continued)

Notes 20 and 21

Summarised aggregate financial information on joint ventures

	2006 US$m	2005 US$m
HSBC's share of:		
– current assets	**125**	95
– non-current assets	**107**	55
– current liabilities	**98**	34
– non-current liabilities	**87**	107
– income	**102**	118
– expenses	**79**	20

21 Goodwill and intangible assets

Goodwill and intangible assets includes goodwill arising on business combinations, the present value of in-force long-term insurance business, and other intangible assets.

Goodwill

	Europe US$m	Hong Kong US$m	Rest of Asia-Pacific US$m	North America US$m	Latin America US$m	Total US$m
Cost						
At 1 January 2006	**13,777**	**120**	**270**	**12,424**	**2,634**	**29,225**
Additions	**29**	**–**	**34**	**55**	**1,608**	**1,726**
Exchange differences	**1,428**	**4**	**25**	**–**	**20**	**1,477**
Other changes	**–**	**–**	**(4)**	**48**	**–**	**44**
At 31 December 2006	**15,234**	**124**	**325**	**12,527**	**4,262**	**32,472**
Cost *(restated)*						
At 1 January 2005	15,873	120	284	11,594	2,491	30,362
Additions	108	1	4	534	13	660
Disposals	(70)	–	–	(3)	–	(73)
Exchange differences	(2,137)	(1)	(17)	328	185	(1,642)
Other changes	3	–	(1)	(29)	(55)	(82)
At 31 December 2005	13,777	120	270	12,424	2,634	29,225

1 *In 2006, Mexico and Panama were reclassified from the North America segment to the Latin America segment. Comparative information has been restated accordingly. See Note 13.*

The addition to goodwill in Latin America related principally to the acquisition of Grupo Banistmo, S.A. on 23 November 2006.

The present value of in-force long-term insurance business ('PVIF')

Movement on the PVIF

	2006 US$m	2005 US$m
At 1 January	**1,400**	1,877
IFRSs transition adjustment at 1 January 2005[1]	**–**	(384)
Addition from current year new business	**254**	289
Movement from in-force business	**(203)**	(268)
Exchange differences and other movements	**98**	(114)
At 31 December	**1,549**	1,400

1 *For an explanation of the IFRSs transition adjustment at 1 January 2005, see Note 46 on the Financial Statements in the* Annual Report and Accounts 2005.

PVIF-specific assumptions

The key assumptions used in the computation of PVIF for HSBC's main life insurance operations were:

	2006		2005	
	UK	**Hong Kong**	UK	Hong Kong
	%	**%**	%	%
Risk free rate	**4.30**	**3.73**	3.90	4.19
Risk discount rate	**8.00**	**11.00**	8.00	11.00
Expenses inflation	**3.40**	**3.00**	3.20	3.00

The PVIF represents the value of the shareholder's interest in the in-force business of the life insurance operations. The calculation of the PVIF is based upon assumptions that take into account risk and uncertainty. To project these cash flows, a variety of assumptions regarding future experience is made by each insurance operation which reflect local market conditions and management's judgement of local future trends. Some of the Group's insurance operations incorporate risk margins separately into the projection assumptions for each product, while others incorporate risk margins into the overall discount rate. This is reflected in the wide range of risk discount rates applied.

Other intangible assets

The analysis of the movement of intangible assets, excluding the PVIF, was as follows:

	Trade names US$m	**Mortgage servicing rights US$m**	**Internally generated software US$m**	**Purchased software US$m**	**Customer/ merchant relation-ships US$m**	**Other US$m**	**Total US$m**
Cost							
At 1 January 2006	**43**	**979**	**2,094**	**295**	**1,034**	**373**	**4,818**
Additions[1]	**–**	**99**	**589**	**70**	**96**	**3**	**857**
Acquisition of subsidiaries	**15**	**–**	**–**	**6**	**195**	**114**	**330**
Disposals	**–**	**–**	**(3)**	**(21)**	**–**	**(1)**	**(25)**
Amounts written-off	**–**	**–**	**–**	**–**	**(71)**	**–**	**(71)**
Exchange differences	**(1)**	**–**	**150**	**17**	**28**	**39**	**233**
Other changes	**–**	**–**	**41**	**278**	**373**	**(349)**	**343**
At 31 December 2006	**57**	**1,078**	**2,871**	**645**	**1,655**	**179**	**6,485**
Accumulated amortisation							
At 1 January 2006	**(15)**	**(560)**	**(1,301)**	**(170)**	**(173)**	**(24)**	**(2,243)**
Charge for the year[2]	**(7)**	**(59)**	**(345)**	**(107)**	**(137)**	**(36)**	**(691)**
Impairment	**–**	**–**	**(25)**	**(3)**	**(56)**	**–**	**(84)**
Disposals	**–**	**–**	**–**	**20**	**–**	**–**	**20**
Amounts written-off	**–**	**–**	**–**	**–**	**71**	**–**	**71**
Exchange differences	**1**	**–**	**(97)**	**(13)**	**(1)**	**(4)**	**(114)**
Other changes	**–**	**–**	**(4)**	**(153)**	**(24)**	**51**	**(130)**
At 31 December 2006	**(21)**	**(619)**	**(1,772)**	**(426)**	**(320)**	**(13)**	**(3,171)**
Net carrying amount at 31 December 2006	**36**	**459**	**1,099**	**219**	**1,335**	**166**	**3,314**

Notes on the Financial Statements (continued)

	Trade names US$m	Mortgage servicing rights US$m	Internally generated software US$m	Purchased software US$m	Customer/ merchant relation- ships US$m	Other US$m	Total US$m
Cost							
At 1 January 2005	41	791	1,823	210	764	393	4,022
Additions[1]	–	136	420	49	13	8	626
Acquisition of subsidiaries	–	–	–	–	271	–	271
Disposals	–	–	–	(63)	(15)	(1)	(79)
Exchange differences	2	2	(104)	(19)	(72)	(44)	(235)
Other changes	–	50	(45)	118	73	17	213
At 31 December 2005	43	979	2,094	295	1,034	373	4,818
Accumulated amortisation							
At 1 January 2005	(8)	(474)	(1,064)	(115)	(95)	(7)	(1,763)
Charge for the year[2]	(6)	(27)	(354)	(76)	(99)	(19)	(581)
Disposals	–	–	–	29	–	–	29
Exchange differences	(1)	1	123	(37)	5	2	93
Other changes	–	(60)	(6)	29	16	–	(21)
At 31 December 2005	(15)	(560)	(1,301)	(170)	(173)	(24)	(2,243)
Net carrying amount at 31 December 2005	28	419	793	125	861	349	2,575

1 *At 31 December 2006, HSBC had US$23 million (2005: US$56 million) of contractual commitments to acquire intangible assets.*
2 *The amortisation charge for the year is recognised within the income statement under 'Amortisation and impairment of intangible assets', with the exception of the amortisation of mortgage servicing rights that is charged to net fee income.*

22 Impairment of assets other than financial instruments

During 2006 there was no impairment of goodwill (2005: nil; 2004: nil). Impairment testing in respect of goodwill is performed annually by comparing the recoverable amount of cash generating units ('CGUs') determined at 1 July 2006 based on a value in use calculation. That calculation uses cash flow estimates based on management's cash flow projections, extrapolated in perpetuity using a nominal long-term growth rate based on current GDP and inflation for the countries within which the CGU operates. Cash flows are extrapolated in perpetuity due to the long-term perspective within the Group of the business units making up the CGUs. The discount rate used is based on the cost of capital HSBC allocates to investments in the countries within which the CGU operates.

The cost of capital assigned to an individual CGU and used to discount its future cash flows can have a significant effect on its valuation. The cost of capital percentage is generally derived from an appropriate capital asset pricing model, which itself depends on inputs reflecting a number of financial and economic variables including the risk-free rate in the country concerned and a premium to reflect the inherent risk of the business being evaluated. These variables are established on the basis of management judgement.

Management judgement is required in estimating the future cash flows of the CGUs. These values are sensitive to the cash flows projected for the periods for which detailed forecasts are available, and to assumptions regarding the long-term sustainable pattern of cash flows thereafter. While the acceptable range within which underlying assumptions can be applied is governed by the requirement for resulting forecasts to be compared with actual performance and verifiable economic data in future years, the cash flow forecasts necessarily and appropriately reflect management's view of future business prospects.

The following CGUs include in their carrying value goodwill that is a significant proportion of total goodwill reported by HSBC. These CGUs do not carry on their balance sheets any intangible assets with indefinite useful lives, other than goodwill.

Cash Generating Unit	**2006** Goodwill at 1 July 2006 US$m	**2006** Discount rate %	**2006** Nominal growth rate beyond initial cash flow projections %	2005 Goodwill at 1 July 2005 US$m	2005 Discount rate %	2005 Nominal growth rate beyond initial cash flow projections %
Personal Financial Services – Europe	**4,149**	**10.6**	**5.0**	3,515	10.2	4.3
Commercial Banking – Europe	**2,948**	**10.2**	**4.5**	2,913	9.9	3.9
Private Banking – Europe	**4,417**	**10.0**	**4.2**	3,701	10.0	3.2
Corporate, Investment Banking and Markets – Europe	**3,792**	**8.2**	**4.5**	3,694	10.1	4.0
Personal Financial Services – North America	**12,205**	**10.0**	**5.8**	10,451	10.0	6.1
Total goodwill in the CGUs listed above	**27,511**			24,274		

There was no evidence of impairment arising from this review. The only circumstances where a reasonably possible change in key assumptions might have caused an impairment loss to be recognised was in respect of Private Banking Europe where a fall of 0.9 per cent in the long-term growth rate beyond the initial cash flow projections, or an increase of 0.8 per cent in the discount rate would have caused an impairment loss to be recognised. Recognising this, the calculation of the value in use for Private Banking – Europe, based on discounted projected cash flows, has been additionally benchmarked against market transactions in private banking companies in Europe to ensure the carrying value is supportable.

At 1 July 2006, aggregate goodwill of US$2,833 million had been allocated to CGUs that were not considered individually significant. These CGUs do not carry on their balance sheets any intangible assets with indefinite useful lives, other than goodwill.

Notes on the Financial Statements (continued)

Note 23

23 Property, plant and equipment

HSBC

Property, plant and equipment

	Freehold land and buildings US$m	Long leasehold land and buildings US$m	Short leasehold land and buildings[1] US$m	Equipment, fixtures and fittings[2] US$m	Equipment on operating leases US$m	Total[3] US$m
Cost or fair value						
At 1 January 2006	**4,828**	**2,235**	**2,265**	**8,639**	**4,964**	**22,931**
Additions at cost[4]	**376**	**24**	**253**	**1,473**	**274**	**2,400**
Acquisition of subsidiaries	**189**	**–**	**17**	**55**	**1**	**262**
Fair value adjustments	**64**	**77**	**23**	**–**	**–**	**164**
Disposals	**(407)**	**(421)**	**(66)**	**(972)**	**(28)**	**(1,894)**
Transfers	**–**	**(38)**	**38**	**–**	**–**	**–**
Exchange differences	**287**	**102**	**65**	**633**	**474**	**1,561**
Other changes	**(6)**	**(43)**	**(21)**	**(126)**	**238**	**42**
At 31 December 2006	**5,331**	**1,936**	**2,574**	**9,702**	**5,923**	**25,466**
Accumulated depreciation						
At 1 January 2006	**(252)**	**(132)**	**(604)**	**(5,418)**	**(1,319)**	**(7,725)**
Depreciation charge for the year	**(85)**	**(46)**	**(131)**	**(1,075)**	**(177)**	**(1,514)**
Disposals	**30**	**2**	**59**	**915**	**89**	**1,095**
Transfers	**–**	**1**	**(1)**	**–**	**–**	**–**
Exchange differences	**(28)**	**(8)**	**(40)**	**(401)**	**(190)**	**(667)**
Other changes	**(7)**	**15**	**(6)**	**5**	**(238)**	**(231)**
At 31 December 2006	**(342)**	**(168)**	**(723)**	**(5,974)**	**(1,835)**	**(9,042)**
Net carrying amount at 31 December 2006	**4,989**	**1,768**	**1,851**	**3,728**	**4,088**	**16,424**
Cost or fair value						
At 1 January 2005	4,384	2,153	2,252	8,722	6,117	23,628
Additions at cost[4]	601	142	124	1,269	751	2,887
Acquisition of subsidiaries	10	–	5	14	–	29
Fair value adjustments	48	95	58	–	–	201
Disposals	(224)	(87)	(77)	(542)	(359)	(1,289)
Transfers	30	–	(30)	–	–	–
Exchange differences	(245)	(82)	(55)	(445)	(660)	(1,487)
Other changes	224	14	(12)	(379)	(885)	(1,038)
At 31 December 2005	4,828	2,235	2,265	8,639	4,964	22,931
Accumulated depreciation						
At 1 January 2005	(204)	(74)	(590)	(5,375)	(1,761)	(8,004)
Depreciation charge for the year	(76)	(55)	(101)	(1,082)	(318)	(1,632)
Disposals	6	–	51	431	243	731
Exchange differences	18	5	35	285	182	525
Other changes	4	(8)	1	323	335	655
At 31 December 2005	(252)	(132)	(604)	(5,418)	(1,319)	(7,725)
Net carrying amount at 31 December 2005	4,576	2,103	1,661	3,221	3,645	15,206

Leasehold land and buildings are considered to be held under finance lease contracts where the value of the land cannot reliably be separated from the value of the lease, and the respective contracts do not meet the criteria for classification as operating leases.

1 *Including assets held on finance leases with a net book value of US$11 million (2005: US$7 million).*
2 *Including assets held on finance leases with a net book value of US$450 million (2005: US$327 million).*
3 *Including assets with a net book value of US$425 million (2005: US$13 million) pledged as security for liabilities.*
4 *At 31 December 2006, HSBC had US$1,380 million (2005: US$1,256 million) of contractual commitments to acquire property, plant and equipment.*

Included within 'Short leasehold land and buildings' are the following amounts in respect of assets classed as improvements to buildings, which are carried at depreciated historical cost:

	2006		2005	
	Cost US$m	**Accumulated depreciation US$m**	Cost US$m	Accumulated depreciation US$m
At 1 January	**1,026**	**(315)**	993	(347)
Additions	**218**	**–**	124	–
Disposals	**(67)**	**47**	(58)	36
Depreciation charge for the year	**–**	**(35)**	–	(22)
Impairment loss recognised	**–**	**(3)**	–	–
Exchange differences	**63**	**(37)**	(52)	32
Other changes	**37**	**(8)**	19	(14)
At 31 December	**1,277**	**(351)**	1,026	(315)
Net carrying amount at 31 December	**926**		711	

Investment properties

The composition of the investment properties at fair value in the year was as follows:

	Freehold land and buildings US$m	Long leasehold land and buildings US$m	Short leasehold land and buildings US$m	Total US$m
Fair value				
At 1 January 2006	**1,438**	**477**	**255**	**2,170**
Additions at cost	**179**	**–**	**–**	**179**
Disposals	**(178)**	**(371)**	**(8)**	**(557)**
Fair value adjustments	**64**	**77**	**23**	**164**
Exchange differences	**42**	**12**	**–**	**54**
Other changes	**(12)**	**(21)**	**(28)**	**(61)**
At 31 December 2006	**1,533**	**174**	**242**	**1,949**
At 1 January 2005	704	250	209	1,163
Additions at cost	455	137	–	592
Disposals	(47)	(3)	(12)	(62)
Fair value adjustments	48	95	58	201
Exchange differences	(8)	(4)	–	(12)
Other changes	286	2	–	288
At 31 December 2005	1,438	477	255	2,170

Investment properties are valued on an open market value basis as at 31 December each year by independent professional valuers who have recent experience in the location and type of properties. Investment properties in Hong Kong, the Macau Special Administrative Region and mainland China, which represent 25 per cent by value of HSBC's investment properties subject to revaluation, were valued by DTZ Debenham Tie Leung Limited, which is a member of the Hong Kong Institute of Surveyors.

As a result of the revaluation, the net book value of investment properties increased by US$164 million (2005: surplus of US$201 million), which was credited to the income statement for the year ended 31 December 2006.

HSBC Holdings had no investment properties at 31 December 2006 or 2005.

Included within 'Other operating income' was rental income of US$153 million (2005: US$116 million) earned by HSBC on its investment properties. Direct operating expenses of US$61 million (2005: US$39 million) incurred in respect of the investment properties during the year were recognised in 'General and administrative expenses'. Direct operating expenses arising in respect of investment properties that did not generate rental income during 2006 amounted to nil (2005: US$3 million).

HSBC recognised US$144 million (2005: US$10 million) as contractual obligations to purchase, construct, develop, maintain or enhance investment properties.

Notes on the Financial Statements (continued)

Note 24

HSBC properties leased to customers

HSBC properties leased to customers included US$470 million at 31 December 2006 (2005: US$646 million) let under operating leases, net of accumulated depreciation of US$53 million (2005: US$42 million). None was held by HSBC Holdings.

24 Investments in subsidiaries

Principal subsidiary undertakings of HSBC Holdings

	At 31 December 2006		
	Country of incorporation or registration	HSBC's interest in equity capital %	Issued equity capital
Europe			
HFC Bank Limited	England	100	£109m
HSBC Investments (UK) Limited	England	100	£37m
HSBC Asset Finance (UK) Limited	England	100	£265m
HSBC Bank A.S.	Turkey	100	TRL277m
HSBC Bank Malta p.l.c.	Malta	70.03	Lm36m
HSBC Bank Middle East Limited	Jersey	100	US$431m
HSBC Bank plc	England	100	£797m
HSBC France	France	99.99	€378m
HSBC Guyerzeller Bank AG	Switzerland	100	SFr95m
HSBC Insurance Brokers Limited	England	100	£2.8m
HSBC Life (UK) Limited	England	100	£94m
HSBC Private Bank (Guernsey) Limited	Guernsey	100	US$22m
HSBC Private Bank (Suisse) S.A.	Switzerland	100	SFr683m
HSBC Private Bank (UK) Limited	England	100	£177m
HSBC Trinkaus & Burkhardt AG	Germany	78.60	€70m
Hong Kong			
Hang Seng Bank Limited	Hong Kong	62.14	HK$9,559m
HSBC Insurance (Asia) Limited	Hong Kong	100	HK$125m
HSBC Life (International) Limited	Bermuda	100	HK$327m
The Hongkong and Shanghai Banking Corporation Limited	Hong Kong	100	HK$22,494m
Rest of Asia-Pacific			
HSBC Bank Australia Limited	Australia	100	A$811m
HSBC Bank Egypt S.A.E.	Egypt	94.53	E£1,073m
HSBC Investments (Taiwan) Limited	Taiwan	100	TWD788m
HSBC Bank Malaysia Berhad	Malaysia	100	RM$114m
North America			
The Bank of Bermuda Limited	Bermuda	100	US$30m
HSBC Bank Canada	Canada	100	C$1,125m
HSBC Bank USA, N.A.	United States	100	US$2m
HSBC Finance Corporation	United States	100	US$3,038m
HSBC Securities (USA) Inc.	United States	100	–[1]
HSBC Technology & Services (USA) Inc.	United States	100	–[1]
Latin America			
HSBC Bank Argentina S.A.	Argentina	99.99	ARS1,103m
HSBC Bank Brasil S.A. – Banco Múltiplo	Brazil	100	BRL2,147m
HSBC La Buenos Aires Seguros S.A.	Argentina	99.53	ARS44m
HSBC Mexico S.A.	Mexico	99.99	MXP3,930m
HSBC Seguros (Brasil) S.A.	Brazil	97.94	BRL350m
Maxima S.A. AFJP	Argentina	59.99	ARS200m
Primer Banco del Istmo, S.A.	Panama	99.39	US$576m

1 *Issued equity capital is less than US$1 million.*
2 *Details of the debt, subordinated debt and preference shares issued by the principal subsidiaries to parties external to the Group are included in the Notes 28 'Debt securities in issue', 32 'Subordinated liabilities' and 37 'Minority interests' respectively.*

All the above subsidiaries are included in the HSBC consolidated financial statements.

Details of all HSBC companies will be annexed to the next Annual Return of HSBC Holdings filed with the UK Registrar of Companies.

All the above make their financial statements up to 31 December except for HSBC Bank Argentina S.A., HSBC La Buenos Aires Seguros S.A. and Maxima S.A. AFJP, whose financial statements are made up to 30 June annually.

The principal countries of operation are the same as the countries of incorporation except for HSBC Bank Middle East Limited which operates mainly in the Middle East, and HSBC Life (International) Limited which operates mainly in Hong Kong.

Subsidiaries which experience significant restrictions on their ability to transfer funds to HSBC in the form of cash dividends or to repay loans and advances

During 2006 and 2005, none of the Group's subsidiaries has experienced significant restrictions on paying dividends or repaying loans and advances.

Subsidiaries where HSBC owns less than 50 per cent of the voting rights

Subsidiary	HSBC's interest in equity capital %	Description of relationship that gives HSBC control
2006		
Beijing HSBC Insurance Brokers Limited	24.9	HSBC has the right to appoint the majority of the board, therefore has management control.
HSBC Insurance Brokers (India) Private Limited	25.9	HSBC has the right to appoint the majority of the board, therefore has management control.
HSBC Private Equity Fund 3	38.8	HSBC is the fund manager and controls the fund.
HSBC Global Technology Alpha Fund	23.9	The fund is a 'Wider Purpose Fund' and consolidation is required under IAS 27 'Consolidated and Separate Financial Statements'.
2005		
Beijing HSBC Insurance Brokers Limited	24.9	HSBC has the right to appoint the majority of the board, therefore has management control.
HSBC Insurance Brokers (India) Private Limited	25.9	HSBC has the right to appoint the majority of the board, therefore has management control.
HSBC Private Equity Fund 3	38.8	HSBC is the fund manager and controls the fund.
HSBC Continental European Alpha Fund	6.1	The fund is a 'Wider Purpose Fund' and consolidation is required under IAS 27.
HSBC Global Technology Alpha Fund	48.7	The fund is a 'Wider Purpose Fund' and consolidation is required under IAS 27.

Investments where HSBC owns 20 per cent or more of the voting rights but does not classify the investment as a subsidiary, joint venture or associate

Investment	HSBC's interest in equity capital %	Description of relationship that results in HSBC accounting for entity as an investment
2005		
Zhong-Run Company Limited	25.0	Entity is held by a venture capital organisation which is exempt from classifying investments as associates under IAS 28.

In 2006 there were no significant investments where HSBC owned 20 per cent or more of the voting rights but did not classify the investment as a subsidiary, joint venture or associate.

Acquisitions

HSBC made the following acquisitions of subsidiaries or business operations in 2006, which were accounted for using the purchase method:

On 23 November 2006 HSBC acquired 99.98 per cent of Grupo Banistmo, S.A. ('Banistmo') for a total consideration of US$1,968 million, comprising US$1,773 million in cash and US$195 million in contingent consideration. The contingent consideration is in respect of a binding offer to preference shareholders for the purchase of their

Notes on the Financial Statements (continued)

Note 24

preference shares within one year after acquisition. Banistmo is a leading banking group in Central America and has operations in Panama, Colombia, Costa Rica, El Salvador, Honduras and Nicaragua. The post-acquisition profit of Banistmo was US$1 million.

Goodwill of US$1,450 million arose from this acquisition. The goodwill on the Banistmo acquisition represents value obtainable from synergies with HSBC, expertise HSBC brings to the proposition and the access to the Central American market that the acquisition provides to the Group.

HSBC also made the following acquisitions of significant subsidiaries or business operations in 2006, which were accounted for using the purchase method:

(i) On 30 April 2006 HSBC acquired the entire share capital of BNL Inversiones Argentinas S.A., the holding company of the bank Banca Nazionale del Lavoro S.A., which had net liabilities of US$3 million, for a cash consideration of US$155 million. Goodwill of US$158 million arose on acquisition.

(ii) On 4 October 2006 HSBC acquired the entire share capital of Solstice Capital Group Inc. for a cash consideration of US$50 million. Goodwill of US$46 million arose on acquisition.

(iii) On 4 September 2006 HSBC acquired the Australian custody business from Westpac Banking Corporation for a total consideration of US$105 million, comprising US$91 million in cash and US$14 million contingent consideration. Goodwill of US$32 million arose on acquisition.

The fair values of the assets, liabilities and contingent liabilities of the companies acquired during the year, which relate principally to Banistmo, were as follows:

	Fair value US$m	Carrying value immediately prior to acquisition US$m
At date of acquisition		
Cash and balances at central banks	244	244
Items in the course of collection from other banks	91	91
Trading assets	29	29
Loans and advances to banks	1,473	1,473
Loans and advances to customers	7,031	7,031
Financial investments	1,224	1,227
Interests in associates and joint ventures	16	16
Intangible assets	330	169
Property, plant and equipment	262	260
Prepayments and accrued income	111	111
Other assets	582	575
Deposits by banks	(1,706)	(1,706)
Customer accounts	(7,652)	(7,652)
Items in the course of transmission to other banks	(119)	(119)
Debt securities in issue	(238)	(238)
Retirement benefit liabilities	(10)	(10)
Provisions	(154)	(72)
Other liabilities	(550)	(550)
Liabilities under insurance contracts issued	(72)	(72)
Accruals and deferred income	(73)	(73)
Subordinated liabilities	(93)	(93)
Less: minority interests	(134)	(134)
Net assets acquired	592	507
Goodwill attributable:		
Subsidiaries (Note 21)	1,686	
Total consideration including costs of acquisition	2,278	

Included within provisions above are US$46 million of contingent liabilities recognised on acquisition.

In addition to the above, there were other minor acquisitions and increases in investment in subsidiaries which increased goodwill by US$40 million.

In addition to cash and balances at central banks, items in the course of collection from other banks and items in the course of transmission to other banks, included in the assets and liabilities acquired above are cash and cash equivalents of US$736 million.

25 Other assets

	2006 US$m	2005 US$m
Bullion	**3,145**	2,358
Assets held for sale	**1,826**	959
Reinsurers' share of liabilities under insurance contracts (Note 30)	**1,769**	1,545
Current taxation recoverable	**380**	496
Deferred taxation (Note 31)	**3,241**	2,665
Endorsements and acceptances	**9,577**	7,973
Other accounts	**13,506**	10,600
	33,444	26,596

Assets held for sale

	2006 US$m	2005 US$m
Disposal groups and non-current assets held for sale		
Interests in associates	**25**	162
Property, plant and equipment	**1,149**	774
Receivables	**634**	23
Other	**18**	–
Total assets classified as held for sale	**1,826**	959

Property, plant and equipment

The property, plant and equipment classified as held for sale is the result of repossession of property that had been pledged as collateral by customers. These assets are disposed of within 12 months of acquisition. Neither a gain nor loss was recognised on reclassifying these assets as held for sale. The majority arose within the geographical segment North America.

Receivables

The receivables classified as held for sale in 2006 relate mainly to a residential mortgage book in New Zealand for which an agreement to negotiate the sale was entered into in January 2007. Neither a gain nor loss was recognised on reclassifying these assets as held for sale. These assets are presented within the geographical segment Rest of Asia-Pacific.

26 Trading liabilities

	2006 US$m	2005 US$m
Deposits by banks	**32,040**	20,829
Customer accounts	**89,166**	59,863
Other debt securities in issue	**34,115**	26,977
Other liabilities – net short positions	**71,287**	66,696
	226,608	174,365

Notes on the Financial Statements (continued)

Note 27, 28 and 29

27 Financial liabilities designated at fair value

HSBC

	2006 US$m	2005 US$m
Deposits by banks and customer accounts	**577**	253
Liabilities to customers under investment contracts	**13,278**	10,445
Debt securities in issue (Note 28)	**33,167**	28,338
Subordinated liabilities (Note 32)	**18,503**	18,447
Preference shares (Note 32)	**4,686**	4,346
	70,211	61,829

The carrying amount at 31 December 2006 of financial liabilities designated at fair value was US$1,257 million (2005: US$1,899 million) higher than the contractual amount at maturity. At 31 December 2006, the accumulated amount of the change in fair value attributable to changes in credit risk was US$1,535 million (2005: US$1,144 million).

HSBC Holdings

	2006 US$m	2005 US$m
Subordinated liabilities (Note 32):		
– owed to third parties	**9,839**	9,315
– owed to HSBC undertakings	**4,231**	4,055
	14,070	13,370

The carrying amount at 31 December 2006 of financial liabilities designated at fair value was US$551 million (2005: US$910 million) higher than the contractual amount at maturity. At 31 December 2006, the accumulated amount of the change in fair value attributable to changes in credit risk was US$335 million (2005: US$398 million).

28 Debt securities in issue

	2006 US$m	2005 US$m
Bonds and medium term notes	**203,404**	165,773
Other debt securities in issue	**94,203**	77,613
	297,607	243,386
Of which debt securities in issue reported as:		
– trading liabilities	**(34,115)**	(26,976)
– financial liabilities designated at fair value (Note 27)	**(33,167)**	(28,338)
	230,325	188,072

Certain debt securities in issue are managed on a fair value basis as part of HSBC's interest rate risk management policies. The hedged portion of these debt securities is presented within the balance sheet caption 'Financial liabilities designated at fair value', with the remaining portion included within 'Trading liabilities'.

The following table analyses the carrying amount of bonds and medium term notes in issue at 31 December with original maturities greater than one year:

	2006 US$m	2005 US$m
Fixed rate		
Debentures – 8.375%: due 2007	**100**	101
Secured financing:		
1.14% to 3.99%: due 2007	**195**	1,669
4.00% to 4.99%: due 2007 to 2010	**1,730**	5,090
5.00% to 5.99%: due 2007 to 2011	**6,096**	843
6.00% to 6.99%: due 2007 to 2011	**–**	41
7.00% to 7.99%: due 2007 to 2011	**98**	141
8.00% to 8.99%: due 2007 to 2011	**215**	–
Other fixed rate senior debt:		
2.15% to 3.99%: due 2007 to 2066	**17,326**	10,527
4.00% to 4.99%: due 2007 to 2046	**17,759**	32,295
5.00% to 5.99%: due 2007 to 2016	**34,191**	21,302
6.00% to 6.99%: due 2007 to 2036	**16,196**	25,356
7.00% to 7.99%: due 2007 to 2032	**6,692**	12,450
8.00% to 9.99%: due 2007 to 2015	**1,665**	2,743
10.00% or higher: due 2007 to 2010	**399**	890
	102,662	113,448
Variable interest rate		
Secured financings – 5.00% to 9.99%: due 2007 to 2009	**23,212**	15,601
FHLB advances – 5.00% to 5.99%: due 2007 to 2036	**5,000**	5,000
Other variable interest rate senior debt – 2.16% to 9.99%: due 2007 to 2036	**63,504**	24,374
	91,716	44,975
Structured notes		
Interest rate linked	**379**	2,748
Equity, equity index or credit linked	**8,647**	4,602
	9,026	7,350
Total bonds and medium term notes	**203,404**	165,773

29 Other liabilities

	HSBC		HSBC Holdings	
	2006 US$m	2005 US$m	**2006 US$m**	2005 US$m
Amounts due to investors in funds consolidated by HSBC	**966**	683	**–**	–
Current taxation	**1,805**	1,640	**–**	–
Obligations under finance leases	**707**	639	**–**	–
Dividend declared and payable by HSBC Holdings	**1,507**	1,193	**1,507**	1,193
Endorsements and acceptances	**9,577**	8,033	**–**	–
Other liabilities	**15,262**	14,327	**10**	10
	29,824	26,515	**1,517**	1,203
Obligations under finance leases falling due:				
– within 1 year	**41**	25	**–**	–
– between 1 and 5 years	**21**	54	**–**	–
– over 5 years	**645**	560	**–**	–
	707	639	**–**	–

Notes on the Financial Statements (continued)

Note 30

30 Liabilities under insurance contracts

	2006		
	Gross US$m	Reinsurers' share US$m	Net US$m
Non-life insurance liabilities			
Unearned premium provision	**1,262**	**(176)**	**1,086**
Notified claims	**949**	**(355)**	**594**
Claims incurred but not reported	**460**	**(58)**	**402**
Other	**268**	**(76)**	**192**
	2,939	**(665)**	**2,274**
Life insurance policyholders' liabilities			
Life (non-linked)	**11,026**	**(1,046)**	**9,980**
Investment contracts with discretionary participation features[1]	**20**	**–**	**20**
Life (linked)	**3,685**	**(58)**	**3,627**
	14,731	**(1,104)**	**13,627**
Total liabilities under insurance contracts	**17,670**	**(1,769)**	**15,901**

	2005		
	Gross US$m	Reinsurers' share US$m	Net US$m
Non-life insurance liabilities			
Unearned premium provision	1,346	(202)	1,144
Notified claims	872	(335)	537
Claims incurred but not reported	424	(130)	294
Other	229	(2)	227
	2,871	(669)	2,202
Life insurance policyholders' liabilities			
Life (non-linked)	8,369	(807)	7,562
Investment contracts with discretionary participation features[1]	9	–	9
Life (linked)	2,895	(69)	2,826
	11,273	(876)	10,397
Total liabilities under insurance contracts	14,144	(1,545)	12,599

1 *Though investment contracts with discretionary participation features are financial instruments, HSBC continued to treat them as insurance contracts as permitted by IFRS 4.*

The movement of liabilities under insurance contracts during the year ended 31 December 2006 was as follows:

Non-life insurance liabilities

	2006		
	Gross	**Reinsurers' share**	**Net**
	US$m	**US$m**	**US$m**
Unearned premium provision			
At 1 January	**1,346**	**(202)**	**1,144**
Gross written premiums	**1,824**	**(451)**	**1,373**
Gross earned premiums	**(1,946)**	**499**	**(1,447)**
Exchange differences and other movements	**38**	**(22)**	**16**
At 31 December	**1,262**	**(176)**	**1,086**
Notified and incurred but not reported claims			
At 1 January	**1,296**	**(465)**	**831**
Notified claims	**872**	**(335)**	**537**
Claims incurred but not reported	**424**	**(130)**	**294**
Claims paid in current year	**(889)**	**228**	**(661)**
Claims incurred in respect of current year	**680**	**(147)**	**533**
Claims incurred in respect of prior years	**219**	**(24)**	**195**
Exchange differences and other movements	**103**	**(5)**	**98**
At 31 December	**1,409**	**(413)**	**996**
Notified claims	**949**	**(355)**	**594**
Claims incurred but not reported	**460**	**(58)**	**402**
	1,409	**(413)**	**996**
Other	**268**	**(76)**	**192**
Total non-life insurance liabilities	**2,939**	**(665)**	**2,274**

	2005		
	Gross	Reinsurers' share	Net
	US$m	US$m	US$m
Unearned premium provision			
At 1 January	1,250	(217)	1,033
Gross written premiums	2,364	(479)	1,885
Gross earned premiums	(2,139)	419	(1,720)
Exchange differences and other movements	(129)	75	(54)
At 31 December	1,346	(202)	1,144
Notified and incurred but not reported claims			
At 1 January	1,360	(463)	897
Notified claims	871	(408)	463
Claims incurred but not reported	489	(55)	434
Claims paid in current year	(966)	146	(820)
Claims incurred in respect of current year	1,070	(150)	920
Claims incurred in respect of prior years	(32)	6	(26)
Exchange differences and other movements	(136)	(4)	(140)
At 31 December	1,296	(465)	831
Notified claims	872	(335)	537
Claims incurred but not reported	424	(130)	294
	1,296	(465)	831
Other	229	(2)	227
Total non-life insurance liabilities	2,871	(669)	2,202

Notes on the Financial Statements (continued)

Life insurance policyholders' liabilities

	2006		
	Gross US$m	**Reinsurers' share US$m**	**Net US$m**
Life (non-linked)			
At 1 January	**8,369**	**(807)**	**7,562**
Benefits paid	**(814)**	**154**	**(660)**
Claims incurred	**3,021**	**(208)**	**2,813**
Exchange differences and other movements	**450**	**(185)**	**265**
At 31 December	**11,026**	**(1,046)**	**9,980**
Investment contracts with discretionary participation features			
At 1 January	**9**	**–**	**9**
Claims incurred	**6**	**–**	**6**
Foreign exchange and other movements	**5**	**–**	**5**
At 31 December	**20**	**–**	**20**
Life (linked)			
At 1 January	**2,895**	**(69)**	**2,826**
Benefits paid	**(495)**	**9**	**(486)**
Claims incurred	**1,146**	**11**	**1,157**
Exchange differences and other movements	**139**	**(9)**	**130**
At 31 December	**3,685**	**(58)**	**3,627**
Total policyholders' liabilities	**14,731**	**(1,104)**	**13,627**

	2005		
	Gross US$m	Reinsurers' share US$m	Net US$m
Life (non-linked)			
At 1 January	6,860	(1,049)	5,811
Benefits paid	(621)	111	(510)
Claims incurred	2,304	80	2,384
Exchange differences and other movements	(174)	51	(123)
At 31 December	8,369	(807)	7,562
Investment contracts with discretionary participation features			
At 1 January	–	–	–
Claims incurred	9	–	9
At 31 December	9	–	9
Life (linked)			
At 1 January	2,523	(73)	2,450
Benefits paid	(357)	11	(346)
Claims incurred	802	(22)	780
Exchange differences and other movements	(73)	15	(58)
At 31 December	2,895	(69)	2,826
Total policyholders' liabilities	11,273	(876)	10,397

The claims incurred represent the aggregate of all events giving rise to additional policyholders' liabilities in the year. These include death claims, surrenders, lapses, the setting up of liability to policyholders at the initial inception of the policy, the declaration of bonuses and other amounts attributable to policyholders.

31 Provisions

Total provisions at 31 December 2006 were US$2,859 million (2005: US$1,966 million), of which US$1,096 million (2005: US$530 million) relates to deferred tax and US$1,763 million (2005: US$1,436 million) relates to other provisions.

Deferred taxation

HSBC

	2006			2005		
	Total US$m	**Deferred tax asset US$m**	**Deferred tax liability US$m**	Total US$m	Deferred tax asset US$m	Deferred tax liability US$m
Temporary differences:						
– retirement benefits	**1,599**	**169**	**1,430**	1,621	1,537	84
– loan impairment allowances	**2,775**	**2,607**	**168**	2,220	1,899	321
– assets leased to customers	**(1,676)**	**(82)**	**(1,594)**	(1,342)	(1,250)	(92)
– revaluation of property	**(469)**	**(166)**	**(303)**	(339)	61	(400)
– accelerated capital allowances	**(80)**	**91**	**(171)**	(55)	(5)	(50)
– other short-term timing differences	**(71)**	**657**	**(728)**	(107)	247	(354)
Unused tax losses	**180**	**59**	**121**	223	176	47
Provision for tax on profit remitted from overseas	**(112)**	**(93)**	**(19)**	(86)	–	(86)
	2,146	**3,242**	**(1,096)**	2,135	2,665	(530)

The amount of temporary differences for which no deferred tax asset is recognised in the balance sheet is US$1,067 million (2005: US$835 million). Of this amount, US$876 million (2005: US$458 million) has no expiry date and US$191 million (2005: US$377 million) is scheduled to expire within 10 years.

HSBC Holdings

	Deferred tax asset/(liability)	
	2006 US$m	2005 US$m
Temporary differences:		
– short-term timing differences	**1**	(5)
– fair valued assets and liabilities	**10**	–
– share-based payments	**24**	–
Provision for tax on profit remitted from overseas	**–**	(65)
	35	(70)

The deferred tax asset at 31 December 2006 is included within 'Other assets' on the balance sheet.

Deferred tax is not recognised on temporary differences associated with investments in subsidiaries and branches because earnings are intended to be indefinitely reinvested in the case of subsidiaries and no further tax is expected to arise in the foreseeable future in the case of branches. The total of such relevant temporary differences amounted to US$22,424 million (2005: US$15,367 million).

There are no deductible temporary differences, unused tax losses and unused tax credits for which no deferred tax asset is recognised in the balance sheet.

Other provisions

	2006 US$m	2005 US$m
At 1 January	**1,436**	2,636
IFRSs transition adjustment at 1 January 2005[1]	**–**	(1,033)
Additional provisions/increase in provisions[2]	**652**	637
Acquisition of subsidiaries	**54**	–
Provisions utilised	**(379)**	(327)
Amounts reversed	**(154)**	(310)
Exchange differences and other movements	**154**	(167)
At 31 December	**1,763**	1,436

Notes on the Financial Statements (continued)

Note 32

1 *For an explanation of the IFRSs transition adjustment at 1 January 2005, see Note 46 on the Financial Statements in the Annual Report and Accounts 2005.*
2 *The increase in 'other provisions' includes unwinding of discounts of US$8 million (2005: US$11 million) in relation to vacant space provisions and US$19 million (2005: US$23 million) in relation to Brazilian provisions for civil and fiscal labour claims.*

Included within 'Other provisions' are:

(i) Provisions for onerous property contracts of US$106 million (2005: US$149 million), of which US$71 million (2005: US$74 million) relates to discounted future costs associated with leasehold properties that became vacant as a consequence of HSBC's move to Canary Wharf in 2002. The provisions cover rent voids while finding new tenants, shortfalls in expected rent receivable compared with rent payable, and the cost of refurbishing the buildings to attract tenants. Uncertainties arise from movements in market rents, delays in finding new tenants and the timing of rental reviews.

(ii) Labour, civil and fiscal litigation provisions in HSBC's Brazil operations of US$282 million (2005: US$235 million). These relate to labour and overtime litigation claims brought by employees after leaving the bank. The provisions are based on the expected number of departing employees, their individual salaries and historical trends. The timing of the settlement of these claims is uncertain.

(iii) Provisions of US$749 million (2005: US$652 million) have been made in respect of costs arising from contingent liabilities and contractual commitments (Note 41), including guarantees of US$64 million (2005: US$55 million) and commitments of US$93 million (2005: US$122 million).

32 Subordinated liabilities

HSBC

	Carrying amount	
	2006	2005
	US$m	US$m
Subordinated liabilities		
At amortised cost	**22,672**	16,537
– subordinated liabilities	**17,296**	11,546
– preferred securities	**5,376**	4,991
Designated at fair value (Note 27)	**23,189**	22,793
– subordinated liabilities	**18,503**	18,447
– preferred securities	**4,686**	4,346
	45,861	39,330
Subordinated liabilities		
HSBC Holdings	**14,271**	10,765
Other HSBC	**31,590**	28,565
	45,861	39,330

HSBC's subordinated borrowings

		2006 US$m	2005 US$m
Amounts owed to third parties by HSBC Holdings (see below)		**14,271**	10,765
Other HSBC subordinated borrowings			
€1,400m	5.3687% Non-cumulative Step-up Perpetual Preferred Securities[1]	**1,918**	1,653
£700m	5.844% Non-cumulative Step-up Perpetual Preferred Securities[2]	**1,374**	1,205
US$1,350m	9.547% Non-cumulative Step-up Perpetual Preferred Securities, Series 1[1]	**1,336**	1,350
US$1,200m	Primary capital subordinated undated floating rate notes	**1,205**	1,207
£600m	4.75% subordinated notes 2046	**1,160**	–
US$1,250m	4.61% Non-cumulative Step-up Perpetual Preferred Securities[1]	**1,158**	1,250
€800m	Callable subordinated floating rate notes 2016[3]	**1,052**	–
US$1,000m	5.875% subordinated notes 2034	**1,048**	1,017
£500m	5.375% subordinated notes 2033	**1,043**	940
€750m	5.13% Non-cumulative Step-up Perpetual Preferred Securities[1]	**1,011**	885
US$1,000m	4.625% subordinated notes 2014	**998**	997
US$1,000m	5.911% trust preferred securities 2035[5]	**991**	990
£500m	8.208% Non-cumulative Step-up Perpetual Preferred Securities[1]	**982**	861
£500m	4.75% callable subordinated notes 2020[4]	**942**	861
US$900m	10.176% Non-cumulative Step-up Perpetual Preferred Securities, Series 2[1]	**900**	900
€600m	4.25% Callable subordinated notes 2016[9]	**801**	731
€600m	8.03% Non-cumulative Step-up Perpetual Preferred Securities[1]	**790**	708
US$750m	Undated floating rate primary capital notes	**750**	752
£350m	5.375% Callable subordinated step-up notes 2030[6]	**701**	647
£350m	5% Callable subordinated notes 2023[8]	**687**	613
US$750m	5.625% subordinated notes 2035	**685**	737
£350m	Callable subordinated variable coupon notes 2017[7]	**675**	635
€500m	Callable subordinated floating rate notes 2020[10]	**658**	588
£300m	5.862% Non-cumulative Step-up Perpetual Preferred Securities[2]	**599**	558
£300m	6.5% subordinated notes 2023	**585**	509
US$500m	Undated floating rate primary capital notes	**501**	502
US$450m	Callable subordinated floating rate notes 2016[3]	**448**	–
£225m	6.25% subordinated notes 2041	**438**	384
US$300m	7.65% subordinated notes 2025[11]	**373**	358
US$300m	6.95% subordinated notes 2011	**326**	326
£150m	8.625% step-up undated subordinated notes[12]	**304**	277
US$300m	Undated floating rate primary capital notes Series 3	**300**	302
BRL608m	Subordinated debentures 2008	**285**	261
US$250m	5.875% subordinated notes 2008	**243**	240
BRL500m	Subordinated Certificates of Deposits 2016	**234**	–
US$250m	7.20% subordinated debentures 2097	**217**	216
US$200m	7.53% capital securities 2026	**209**	202
US$200m	7.75% subordinated notes 2009	**205**	207
US$200m	7.808% capital securities 2026	**200**	200
US$200m	6.625% subordinated notes 2009	**197**	198
US$200m	8.38% capital securities 2027	**191**	200
US$500m	7.625% subordinated notes 2006	**–**	507
US$300m	7% subordinated notes 2006	**–**	300
£150m	9.25% step-up undated subordinated notes	**–**	268
US$200m	7.50% trust preferred securities 2031	**–**	202
US$200m	8.25% trust preferred securities 2031	**–**	200
	Other subordinated liabilities each less than US$200m	**2,870**	2,621
		31,590	28,565
		45,861	39,330

Subordinated loan capital is repayable at par on maturity, but some is repayable prior to maturity at the option of the borrower, generally with the consent of the Financial Services Authority, and, where relevant, the local banking regulator, and in certain cases at a premium over par. Interest rates on the floating rate loan capital are related to interbank offered rates. On the remaining subordinated loan capital, interest is payable at fixed rates up to 10.176 per cent.

1 *See Step-up Perpetual Preferred Securities, note (a) Guaranteed by HSBC Holdings.*
2 *See Step-up Perpetual Preferred Securities, note (b) Guaranteed by HSBC Bank.*

Notes on the Financial Statements (continued)

3 *The interest margin on the €800m and US$450m callable subordinated floating rate notes 2016 increases by 0.5 per cent from March 2011 and July 2011, respectively.*
4 *The interest rate on the 4.75 per cent callable subordinated notes 2020 changes in September 2015 to three-month sterling LIBOR plus 0.82 per cent.*
5 *The distributions on the trust preferred securities change in November 2015 to three-month dollar LIBOR plus 1.926 per cent.*
6 *The interest rate on the 5.375 per cent callable subordinated step-up notes 2030 changes in November 2025 to three month sterling LIBOR plus 1.50 per cent.*
7 *The interest rate on the callable subordinated variable coupon notes 2017 is fixed at 5.75 per cent until June 2012. Thereafter, the rate per annum is the sum of the gross redemption yield of the then prevailing five-year UK gilt plus 1.70 per cent.*
8 *The interest rate on the 5 per cent callable subordinated notes 2023 changes in March 2018 to become the rate per annum which is the sum of the gross redemption yield of the prevailing five-year UK gilt plus 1.80 per cent.*
9 *The interest rate on the 4.25 per cent callable subordinated notes changes in March 2011 to three-month EURIBOR plus 1.05 per cent.*
10 *The interest margin on the callable subordinated floating notes 2020 increases by 0.5 per cent from September 2015.*
11 *The 7.65 per cent subordinated notes 2025 are repayable at the option of each of the holders in May 2007.*
12 *The interest rate on the 8.625 per cent step-up updated subordinated notes changes in December 2007 to become, for each successive five year period, the rate per annum which is the sum of the yield on the then five year benchmark UK gilt plus 1.87 per cent.*

Footnotes 3 to 12 (excluding footnote 1) all relate to notes that are repayable at the option of the borrower on the date of the change of the interest rate, and at subsequent interest rate reset dates and interest payment dates in some cases, subject to the prior consent of the Financial Services Authority and, where relevant, the local banking regulator.

Step-up Perpetual Preferred Securities

(a) Guaranteed by HSBC Holdings

The seven issues of Non-cumulative Step-up Perpetual Preferred Securities (footnote 1) were made by Jersey limited partnerships and are guaranteed, on a subordinated basis, by HSBC Holdings. The proceeds of the issues were on-lent to HSBC Holdings by the limited partnerships by issue of subordinated notes. The Preferred Securities qualify as innovative tier 1 capital for HSBC. The Preferred Securities, together with the guarantee, are intended to provide investors with rights to income and capital distributions and distributions upon liquidation of HSBC Holdings that are equivalent to the rights that they would have had if they had purchased non-cumulative perpetual preference shares of HSBC Holdings.

The Preferred Securities are perpetual, but redeemable in 2014, 2010, 2013, 2016, 2015, 2030 and 2012 respectively at the option of the general partner of the limited partnerships. If not redeemed, the distributions payable step-up and become floating rate or, for the sterling issue, for each successive five-year period the sum of the then five-year benchmark UK gilt plus a margin. There are limitations on the payment of distributions if prohibited under UK banking regulations or other requirements, if a payment would cause a breach of HSBC's capital adequacy requirements, or if HSBC Holdings has insufficient distributable reserves (as defined).

HSBC Holdings has covenanted that if it is prevented under certain circumstances from paying distributions on the Preferred Securities in full, it will not pay dividends or other distributions in respect of its ordinary shares, or effect repurchase or redemption of its ordinary shares, until after a distribution has been paid in full.

If (i) HSBC's total capital ratio falls below the regulatory minimum ratio required, or (ii) the Directors expect that, in view of the deteriorating financial condition of HSBC Holdings, (i) will occur in the near term, then the Preferred Securities will be substituted by Preference Shares of HSBC Holdings having economic terms which are in all material respects equivalent to those of the Preferred Securities and the guarantee taken together.

(b) Guaranteed by HSBC Bank

The two issues of Non-cumulative Step-up Perpetual Preferred Securities (footnote 2) were made by Jersey limited partnerships and are guaranteed, on a subordinated basis, by HSBC Bank. The proceeds of the issues were on-lent to HSBC Bank by the limited partnerships by issue of subordinated notes. The Preferred Securities qualify as innovative tier 1 capital for HSBC and for HSBC Bank on a solo and consolidated basis and, together with the guarantee, are intended to provide investors with rights to income and capital distributions and distributions upon liquidation of HSBC Bank that are equivalent to the rights they would have had if they had purchased non-cumulative perpetual preference shares of HSBC Bank.

The two issues of Preferred Securities are perpetual, but redeemable in 2031 and 2020, respectively, at the option of the general partner of the limited partnerships. If not redeemed the distributions payable step-up and become floating rate. The same limitations on the payment of distributions apply to HSBC Bank as to HSBC, as described above. HSBC Bank has provided a similar covenant to that provided by HSBC Holdings, also as described above.

If (i) any of the two issues of Preferred Securities are outstanding in November 2048 or April 2049, respectively, or (ii) the total capital ratio of HSBC Bank on a solo and consolidated basis falls below the regulatory minimum ratio required, or (iii) in view of the deteriorating financial condition of HSBC Bank, the Directors expect (ii) to occur in the near term, then the Preferred Securities will be substituted by Preference Shares of HSBC Bank having economic terms which are in all material respects equivalent to those of the Preferred Securities and the guarantee taken together.

HSBC Holdings

	2006 US$m	2005 US$m
Subordinated liabilities		
At amortised cost	**8,423**	5,236
Designated at fair value	**14,070**	13,370
	22,493	18,606

HSBC Holdings subordinated borrowings

		Amounts falling due after more than 1 year	
		2006 US$m	2005 US$m
Amounts owed to third parties			
€2,000m	Callable subordinated floating rate notes 2014[1]	**2,648**	2,374
US$2,000m	6.5% subordinated notes 2036	**2,056**	–
US$1,400m	5.25% subordinated notes 2012	**1,401**	1,421
€1,000m	5.375% subordinated notes 2012	**1,394**	1,322
£650m	5.75% subordinated notes 2027	**1,365**	1,267
US$1,000m	7.5% subordinated notes 2009	**1,088**	1,115
€700m	3.625% callable subordinated notes 2020[2]	**888**	831
US$750m	Callable subordinated floating rate note 2016[1]	**750**	–
US$750m	Callable subordinated floating rate notes 2015[1]	**749**	749
£250m	9.875% subordinated bonds 2018[3]	**637**	595
US$488m	7.625% subordinated notes 2032	**609**	482
€300m	5.5% subordinated notes 2009	**418**	390
US$222m	7.35% subordinated notes 2032	**268**	219
		14,271	10,765
Amounts owed to HSBC undertakings			
€1,400m	5.3687% fixed/floating subordinated notes 2043 – HSBC Capital Funding (Euro 2) LP	**1,995**	1,878
US$1,350m	9.547% subordinated step-up cumulative notes 2040 – HSBC Capital Funding (Dollar 1) LP	**1,332**	1,331
US$1,250m	4.61% fixed/floating subordinated notes 2043 – HSBC Capital Funding (Dollar 2) LP	**1,187**	1,185
€750m	5.13% fixed/floating subordinated notes 2044 – HSBC Capital Funding (Euro 3) LP.	**1,049**	992
£500m	8.208% subordinated step-up cumulative notes 2040 – HSBC Capital Funding (Sterling 1) LP	**974**	853
US$900m	10.176% subordinated step-up cumulative notes 2040 – HSBC Capital Funding (Dollar 1) LP	**900**	900
€600m	8.03% subordinated step-up cumulative notes 2040 – HSBC Capital Funding (Euro 1) LP	**785**	702
		8,222	7,841
		22,493	18,606

1 *The interest margins on the callable subordinated floating rate notes 2014, 2015 and 2016 increase by 0.5 per cent from September 2009, March 2010 and October 2011 respectively. The notes are repayable from their step up date at the option of the borrower, subject to the prior consent of the Financial Services Authority.*

2 *The interest rate on the 3.625 per cent callable subordinated notes 2020 changes in June 2015 to become three-month EURIBOR plus 0.93 per cent. The notes may be redeemed at par from June 2015 at the option of the borrower, subject to the prior consent of the Financial Services Authority.*

3 *The interest rate on the 9.875 per cent subordinated bonds 2018 changes in April 2013 to become the higher of (i) 9.875 per cent or (ii) the sum of the yield on the relevant benchmark treasury stock plus 2.5 per cent. The bonds may be redeemed in April 2013 at par and redemption has also been allowed from April 1998, subject to the prior consent of the Financial Services Authority, for an amount based on the redemption yields of the relevant benchmark treasury stocks.*

Notes on the Financial Statements (continued)

Notes 33 and 34

33 Fair values of financial instruments

HSBC

The following table provides an analysis of the fair value of financial instruments not carried at fair value on the balance sheet:

	2006		2005	
	Carrying amount US$m	**Fair value US$m**	Carrying amount US$m	Fair value US$m
Assets				
Loans and advances to banks	**185,205**	**185,151**	125,965	126,218
Loans and advances to customers	**868,133**	**864,320**	740,002	739,439
Financial investments: Treasury and other eligible bills	**45**	**45**	208	208
Financial investments: Debt securities	**9,326**	**9,628**	8,082	8,263
Liabilities				
Deposits by banks	**99,694**	**99,691**	69,727	69,540
Customer accounts	**896,834**	**896,429**	739,419	739,316
Debt securities in issue	**230,325**	**231,189**	188,072	188,401
Subordinated liabilities	**22,672**	**22,468**	16,537	16,380

The methods used to determine fair values for financial instruments for the purpose of measurement and disclosure are set out in Note 2(d). The majority of HSBC's financial instruments carried at fair value are valued using quoted market prices, or valuation techniques based on observable market data. Observable market prices are not, however, available for many of HSBC's financial assets and liabilities not carried at fair value. The fair values of the assets and liabilities in the table above are determined as follows:

(i) Loans and advances to banks and customers

The fair values of personal and commercial loans and advances are estimated by discounting anticipated cash flows (including interest at contractual rates).

Performing loans are grouped, as far as possible, into homogeneous pools segregated by maturity and coupon rates. In general, cash flows are discounted using current market rates for instruments with similar maturity, repricing and credit risk characteristics. For fixed rate loans, assumptions are made on the expected prepayment rates appropriate to the type of loan.

Conforming residential mortgages in the US are treated differently because there is an established market for the related asset-backed securities. In such cases, fair value is estimated by reference to quoted market prices for loans with similar characteristics and maturities.

For impaired commercial loans, fair value is estimated by discounting the future cash flows over the time period they are expected to be recovered.

(ii) Financial investments

Held-to-maturity treasury and other eligible bills and debt securities are initially recorded at fair value plus any directly attributable transaction costs, and are subsequently measured at amortised cost using the effective interest rate method, less any impairment losses.

The fair values of listed financial investments are determined using bid market prices. The fair values of unlisted financial investments are determined using valuation techniques that take into consideration future earnings streams and valuations of equivalent quoted securities.

(iii) Deposits by banks and customer accounts

Deposits by banks and customer accounts are grouped by residual maturity. Fair values are estimated using discounted cash flows, applying either market rates, where applicable, or current rates offered for deposits of similar remaining maturities.

(iv) Debt securities in issue and subordinated liabilities

Fair values are determined using quoted market prices at the balance sheet date where available, or by reference to quoted market prices for similar instruments.

The fair values presented in the table above are stated at a specific date and may be significantly different from the amounts which will actually be paid or received on the maturity or settlement dates of the instruments. In many cases, it would not be possible to realise immediately the estimated fair values. Accordingly, these fair values do not represent the value of these financial instruments to HSBC as a going concern.

The fair values of intangible assets, such as values placed on portfolios of core deposits, credit card and customer relationships, are not included above, because they are not financial instruments.

As other entities may use different valuation methodologies and assumptions in determining fair values, comparisons of fair values between entities may not be meaningful and users are advised to exercise caution when using this data.

The following table lists those financial instruments for which their carrying amount is a reasonable approximation of fair value because, for example, they are short term in nature or reprice to current market rates frequently:

Assets	**Liabilities**
Cash and balances at central banks	Hong Kong Government currency notes in circulation
Items in the course of collection from other banks	Items in the course of transmission to other banks
Hong Kong Government certificates of indebtedness	
Endorsements and acceptances	Endorsements and acceptances
Short-term receivables within 'Other assets'	Short-term payables within 'Other liabilities'
Accrued income	Accruals

HSBC Holdings

	2006		2005	
	Carrying amount US$m	**Fair value US$m**	Carrying amount US$m	Fair value US$m
Assets				
Loans and advances to HSBC undertakings	**14,456**	**14,537**	14,092	12,252
Liabilities				
Amounts owed to HSBC undertakings	**3,100**	**3,155**	4,075	3,728
Subordinated liabilities	**8,423**	**9,439**	5,236	6,493

34 Maturity analysis of assets and liabilities

The following is an analysis, by remaining contractual maturities at the balance sheet date, of asset and liability line items that represent amounts expected to be recovered or settled in under one year, and after one year.

Trading assets and liabilities are excluded because they are not held for collection or settlement over the period of contractual maturity.

Notes on the Financial Statements (continued)

Notes 34 and 35

HSBC

	At 31 December 2006		
	Due within one year US$m	Due after more than one year US$m	Total US$m
Assets			
Financial assets designated at fair value	**3,735**	**16,838**	**20,573**
Loans and advances to banks[1]	**179,240**	**5,965**	**185,205**
Loans and advances to customers	**360,191**	**507,942**	**868,133**
Financial investments	**87,848**	**116,958**	**204,806**
Other financial assets	**20,833**	**6,422**	**27,255**
	651,847	**654,125**	**1,305,972**
Liabilities			
Deposits by banks	**89,043**	**10,651**	**99,694**
Customer accounts	**871,881**	**24,953**	**896,834**
Financial liabilities designated at fair value	**1,410**	**68,801**	**70,211**
Debt securities in issue	**111,622**	**118,703**	**230,325**
Other financial liabilities	**25,938**	**2,197**	**28,135**
Subordinated liabilities	**326**	**22,346**	**22,672**
	1,100,220	**247,651**	**1,347,871**

	At 31 December 2005		
	Due within one year US$m	Due after more than one year US$m	Total US$m
Assets			
Financial assets designated at fair value	1,537	13,509	15,046
Loans and advances to banks[1]	121,387	4,578	125,965
Loans and advances to customers	301,181	438,821	740,002
Financial investments	79,239	103,103	182,342
Other financial assets	12,589	134	12,723
	515,933	560,145	1,076,078
Liabilities			
Deposits by banks	60,863	8,864	69,727
Customer accounts	712,317	27,102	739,419
Financial liabilities designated at fair value	6,854	54,975	61,829
Debt securities in issue	100,636	87,436	188,072
Other financial liabilities	10,565	799	11,364
Subordinated liabilities	313	16,224	16,537
	891,548	195,400	1,086,948

1 *Loans and advances to banks includes US$147,512 million (2005: US$100,527 million) which is repayable on demand or at short notice.*

HSBC Holdings

	At 31 December 2006		
	Due within one year US$m	**Due after more than one year US$m**	**Total US$m**
Assets			
Loans and advances to HSBC undertakings	**6,886**	**7,570**	**14,456**
Financial investments	**–**	**3,614**	**3,614**
Other assets	**91**	**–**	**91**
Prepayments and accrued income	**32**	**9**	**41**
	7,009	**11,193**	**18,202**
Liabilities			
Amounts owed to HSBC undertakings	**301**	**2,799**	**3,100**
Financial liabilities designated at fair value	**–**	**14,070**	**14,070**
Other liabilities	**1,507**	**10**	**1,517**
Accruals and deferred income	**111**	**–**	**111**
Subordinated liabilities	**–**	**8,423**	**8,423**
	1,919	**25,302**	**27,221**

	At 31 December 2005		
	Due within one year US$m	Due after more than one year US$m	Total US$m
Assets			
Loans and advances to HSBC undertakings	4,661	9,431	14,092
Financial investments	–	3,517	3,517
Other assets	171	–	171
Prepayments and accrued income	11	8	19
	4,843	12,956	17,799
Liabilities			
Amounts owed to HSBC undertakings	1,900	2,175	4,075
Financial liabilities designated at fair value	–	13,370	13,370
Other liabilities	1,196	7	1,203
Accruals and deferred income	95	–	95
Subordinated liabilities	–	5,236	5,236
	3,191	20,788	23,979

35 Foreign exchange exposures

Structural foreign exchange exposures

HSBC's structural foreign exchange exposures are represented by the net asset value of its foreign exchange equity and subordinated debt investments in subsidiary undertakings, branches, joint ventures and associates. Gains or losses on structural foreign exchange exposures are taken to reserves. HSBC's management of its structural foreign exchange exposures is discussed in the 'Report of the Directors: The Management of Risk' section on page 223.

In its separate financial statements, HSBC Holdings recognises its foreign exchange gains and losses on structural foreign exchange exposures in the income statement.

Notes on the Financial Statements (continued)

Notes 35, 36, 37 and 38

Net structural foreign exchange exposures

	2006 US$m	2005 US$m
Currency of structural exposure		
Euros	**21,202**	18,821
Sterling	**18,562**	15,615
Chinese renminbi	**5,678**	5,135
Mexican pesos	**4,536**	3,777
Hong Kong dollars	**4,461**	2,945
Canadian dollars	**3,284**	2,926
Brazilian reais	**2,684**	2,174
Swiss francs	**2,495**	1,957
UAE dirhams	**1,647**	1,111
Indian rupees	**1,575**	1,182
Turkish lira	**970**	919
Malaysian ringgit	**876**	705
Korean won	**769**	506
Australian dollars	**692**	609
Singapore dollars	**411**	334
Japanese yen	**338**	252
Egyptian pounds	**325**	234
Thai baht	**305**	234
Taiwanese dollars	**299**	298
Saudi riyals[1]	**286**	347
Maltese lira	**269**	250
Philippine pesos	**213**	176
Argentine pesos[2]	**211**	(85)
Chilean pesos	**189**	187
Costa Rican colon	**162**	–
New Zealand dollars	**158**	141
Indonesia rupiah	**155**	188
Qatari rial	**150**	98
Honduran lempira	**148**	–
Omani rial	**114**	78
South African rand	**106**	106
Others, each less than US$100 million	**839**	611
Total	**74,109**	61,831

1 *After deducting sales of Saudi riyals amounting to US$750 million (2005: US$480 million) in order to manage the foreign exchange risk of the investments.*
2 *The negative net investment in Argentine pesos in 2005 reflects the deficiency in domestic net assets following the pesification of certain balances formerly denominated in US dollars.*

36 Assets charged as security for liabilities and collateral accepted as security for assets

Financial assets pledged to secure liabilities are as follows:

	Assets pledged at 31 December	
	2006 US$m	2005 US$m
Treasury bills and other eligible securities	**6,480**	7,607
Loans and advances to banks	**934**	1,310
Loans and advances to customers	**63,956**	36,590
Debt securities	**106,652**	89,973
Equity shares	**11,634**	5,137
Other	**390**	537
	190,046	141,154

These transactions are conducted under terms that are usual and customary to standard lending, and stock borrowing and lending activities.

Collateral accepted as security for assets

The fair value of financial assets accepted as collateral that HSBC is permitted to sell or repledge in the absence of default is US$188,008 million (2005: US$138,303 million).

The fair value of financial assets accepted as collateral that have been sold or repledged was US$135,998 million (2005: US$97,113 million). HSBC is obliged to return equivalent securities.

These transactions are conducted under terms that are usual and customary to standard stock borrowing and lending activities.

37 Minority interests

	2006 US$m	2005 US$m
Minority interests attributable to holders of ordinary shares in subsidiaries	**4,026**	3,618
Preference shares issued by subsidiaries	**2,550**	2,176
Total minority interests	**6,576**	5,794

Preference shares issued by subsidiaries

		2006 US$m	2005 US$m
US$575m	6.36% non-cumulative preferred stock, Series B[1]	**559**	559
US$518m	Floating rate non-cumulative preferred stock, Series F[2]	**518**	518
US$374m	Floating rate non-cumulative preferred stock, Series G[3]	**374**	374
US$374m	6.50% non-cumulative preferred stock, Series H[3]	**374**	–
CAD175m	Non-cumulative redeemable class 1 preferred shares, Series C[4]	**150**	150
CAD175m	Non-cumulative class 1 preferred shares, Series D[4]	**150**	150
US$150m	Depositary shares each representing 25% interest in a share of adjustable rate cumulative preferred stock, Series D[5]	**150**	150
US$150m	Cumulative preferred stock[6]	**150**	150
US$125m	Dutch auction rate transferable securities preferred stock, Series A and B[7]	**125**	125
		2,550	2,176

1 *The series B preferred stock is redeemable, at the option of HSBC Finance Corporation, in whole or part, from 24 June 2010 at par.*
2 *The series F preferred stock is redeemable at par, at the option of HSBC USA Inc., in whole or part, on any dividend payment date on or after 7 April 2010.*
3 *The series G and Series H preferred stock are redeemable at par, at the option of HSBC USA Inc., in whole or part, at any time from 1 January 2011 and 1 July 2011, respectively.*
4 *The Series C and Series D preferred stock are redeemable at a declining premium above par, at the option of HSBC Bank Canada, in whole or part, from 30 June 2010 and 31 December 2010, respectively.*
5 *The preferred stock has been redeemable, at the option of HSBC USA Inc., in whole or part, from 1 July 1999 at par.*
6 *The preferred stock is redeemable, at the option of HSBC USA Inc., in whole or part, at any time on or after 1 October 2007 at par.*
7 *The preferred stock of each series is redeemable, at the option of HSBC USA Inc., in whole or part, on any dividend payment date at par.*

All redemptions are subject to the prior consent of the Financial Services Authority and, where relevant, the local banking regulator.

38 Called up share capital

Authorised

The authorised ordinary share capital of HSBC Holdings at 31 December 2006 and 2005 was US$7,500 million divided into 15,000 million ordinary shares of US$0.50 each.

At 31 December 2006 and 2005, the authorised preference share capital of HSBC Holdings was 10 million non-cumulative preference shares of £0.01 each, 10 million non-cumulative preference shares of US$0.01 each, and 10 million non-cumulative preference shares of €0.01 each.

At 31 December 2006 and 2005, the authorised non-voting deferred share capital of HSBC Holdings was £301,500 divided into 301,500 non-voting deferred shares of £1 each.

Notes on the Financial Statements (continued)

Note 38

Issued

	2006 US$m	2005 US$m
HSBC Holdings ordinary shares	**5,786**	5,667

	Number	US$m
HSBC Holdings ordinary shares		
At 1 January 2006	**11,333,603,942**	**5,667**
Shares issued in connection with the maturity of HSBC Finance 8.875 per cent Adjustable Conversion-Rate Equity Security Units	**3,424,742**	**2**
Shares issued under HSBC Finance share plans	**643,520**	**–**
Shares issued under HSBC employee share plans	**75,956,784**	**38**
Shares issued in lieu of dividends	**158,578,747**	**79**
At 31 December 2006	**11,572,207,735**	**5,786**
At 1 January 2005	11,172,075,550	5,587
Shares issued in connection with the early settlement of HSBC Finance 8.875 per cent Adjustable Conversion-Rate Equity Security Units	324,726	–
Shares issued under HSBC Finance share plans	878,224	–
Shares issued under HSBC employee share plans	56,363,536	28
Shares issued in lieu of dividends	103,961,906	52
At 31 December 2005	11,333,603,942	5,667

All ordinary shares confer identical rights in respect of capital, dividends, voting and otherwise.

	Number	US$m
HSBC Holdings preference shares		
At 1 January 2006 and 31 December 2006	**1,450,000**	**–**
At 1 January 2005	–	–
Issue of non-cumulative preference shares of US$0.01 each	1,450,000	–
At 31 December 2005	1,450,000	–

Dividends on HSBC Holdings non-cumulative dollar preference shares are paid quarterly at the sole and absolute discretion of the Board of Directors. The Board of Directors will not declare a dividend on the preference shares if payment of the dividend would cause HSBC Holdings not to meet the applicable capital adequacy requirements of the FSA or the profit of HSBC Holdings available for distribution as dividends are not sufficient to enable HSBC Holdings to pay in full both dividends on the preference shares and dividends on any other shares that are scheduled to be paid on the same date and that have an equal right to dividends. HSBC Holdings may not declare or pay dividends on any class of its shares ranking lower in the right to dividends than the preference shares nor redeem nor purchase in any manner any of its other shares ranking equal with or lower than the preference shares unless it has paid in full, or set aside an amount to provide for payment in full, the dividends on the preference shares for the then-current dividend period. The preference shares carry no rights to conversion into ordinary shares of HSBC Holdings. Holders of the preference shares will only be entitled to attend and vote at general meetings of shareholders of HSBC Holdings if the dividend payable on the preference shares has not been paid in full for four consecutive dividend payment dates. In such circumstances, holders of preference shares will be entitled to vote on all matters put to general meetings until such time as HSBC Holdings shall have paid a full dividend on the preference shares. HSBC Holdings may redeem the preference shares in whole at any time on or after 16 December 2010, with the consent of the FSA.

The 301,500 non-voting deferred shares were in issue throughout 2005 and 2006 and are held by a subsidiary undertaking of HSBC Holdings. Holders of the non-voting deferred shares are not entitled to receive dividends on these shares. In addition, on winding-up or other return of capital, holders are entitled to receive the amount paid up on their shares after distribution to ordinary shareholders of the amount of £10,000,000 in respect of each ordinary share held by them.

Details of the options outstanding to subscribe for HSBC Holdings ordinary shares under the HSBC Holdings Group Share Option Plan, HSBC Holdings Executive Share Option Scheme, the HSBC Share Plan and HSBC Holdings savings-related share option plans are given in Note 9. In aggregate, options outstanding under these plans is as follows:

	Number of HSBC Holdings ordinary shares	Period of exercise	Exercise price
31 December 2006	**267,270,662**	**2007 to 2015**	**£5.0160 – £9.642**
	6,661,998	**2007 to 2012**	**HK$103.4401**
	264,838	**2007 to 2012**	**€11.0062**
	2,932,100	**2007 to 2012**	**US$13.3290 – US$14.1621**
31 December 2005	341,281,540	2006 to 2015	£2.1727 – £9.642
31 December 2004	374,369,127	2005 to 2014	£2.1727 – £9.642

Following the acquisition of HSBC France in 2000, outstanding employee share options over HSBC France shares vested. On exercise of the options, the HSBC France shares are exchangeable for HSBC Holdings ordinary shares in the same ratio as for the acquisition of HSBC France (13 HSBC Holdings ordinary shares for each HSBC France share).

During 2006, 445,115 (2005: 435,784) HSBC France shares were issued following the exercise of employee share options and exchanged for 5,786,495 HSBC Holdings ordinary shares, such shares being delivered from The HSBC Holdings Employee Benefit Trust 2001 (No. 1) (2005: 5,665,192 HSBC Holdings ordinary shares). During 2006, no options over HSBC France shares lapsed (2005: nil). During 2006, there were no (2005: 1,500) HSBC France shares previously issued following the exercise of employee share options that were exchanged for HSBC Holdings ordinary shares (2005: 19,500 HSBC Holdings ordinary shares). There were 1,287,881 HSBC France employee share options exchangeable for HSBC Holdings ordinary shares outstanding at 31 December 2006 (2005: 1,732,996). At 31 December 2006, The HSBC Holdings Employee Benefit Trust 2001 (No. 1) held 15,316,328 (2005: 21,102,823) HSBC Holdings ordinary shares which may be exchanged for HSBC France shares arising from the exercise of options.

HSBC France options effectively outstanding over HSBC Holdings ordinary shares under this arrangement are as follows:

	Number of HSBC France shares exchangeable for HSBC Holdings ordinary shares	Period of exercise	Exercise price
31 December 2006	**1,287,881**	**2007 to 2010**	**€37.05 – €142.50**
31 December 2005	1,732,996	2006 to 2010	€35.52 – €142.50
31 December 2004	2,170,280	2005 to 2010	€32.78 – €142.50

There also exist outstanding options over the shares of HSBC Private Bank France, a subsidiary of HSBC France which are exchangeable for HSBC Holdings ordinary shares, the details of which are set out in the Directors' Report on pages 271 and 272 and summarised below.

On exercise of options over shares of HSBC Private Bank France, the HSBC Private Bank France shares are exchangeable for HSBC Holdings ordinary shares in the ratio of 1.83 HSBC Holdings shares for each HSBC Private Bank France share. During 2006, 194,804 (2005: 473,400) HSBC Private Bank France shares were issued following the exercise of employee share options and exchanged for 356,472 (2005: 841,291) HSBC Holdings ordinary shares, such shares being delivered from The CCF Employee Benefit Trust 2001 (Private Banking France). During 2006, no options over HSBC Private Bank France shares lapsed (2005: 59,875). During 2006, 6,000 (2005: 1,150) HSBC Private Bank France shares previously issued following the exercise of employee share options were exchanged for 10,980 (2005: 2,104) HSBC Holdings ordinary shares. At 31 December 2006, 8,819 (2005: 14,819) HSBC Private Bank France shares were in issue and will be exchanged for HSBC Holdings ordinary shares on the fifth anniversary of the date of the awards of the options. There were 402,856 HSBC Private Bank France employee share options exchangeable for HSBC Holdings ordinary shares outstanding at 31 December 2006 (2005: 597,660). At 31 December 2006, The CCF Employee Benefit Trust 2001 held 1,085,323 (2005: 1,452,775) HSBC Holdings ordinary shares which may be exchanged for HSBC Private Bank France shares arising from the exercise of options.

HSBC Private Bank France options (including shares issued but not exchanged) effectively outstanding over HSBC Holdings ordinary shares under this arrangement are as follows:

Notes on the Financial Statements (continued)

Note 38

	Number of HSBC Private Bank France shares exchangeable for HSBC Holdings ordinary shares	Period of exercise	Exercise price
31 December 2006	**411,675**	**2007 to 2012**	**€10.84 – €22.22**
31 December 2005	612,479	2006 to 2012	€10.84 – €22.22
31 December 2004	1,132,060	2005 to 2012	€10.84 – €22.22

On the acquisition of Banque Hervet in 2001, Banque Hervet shares were held in a Plan d'Epargne Entreprise on behalf of Banque Hervet employees to vest and be released to employees over a 5 year period. It was agreed to exchange these Banque Hervet shares, on vesting, for HSBC Holdings ordinary shares in the ratio of 3.46 HSBC Holdings ordinary shares for each Banque Hervet share. During 2006, 163,369 (2005: 7,670) Banque Hervet shares were released in connection with the vesting of interests in the Plan d'Epargne Entreprise and exchanged for 565,151 (2005: 26,539) HSBC Holdings ordinary shares, such shares being delivered from The CCF Employee Benefit Trust 2001 (Banque Hervet). At 31 December 2006, The CCF Employee Benefit Trust 2001 (Banque Hervet) held no (2005: 586,213) HSBC Holdings ordinary shares.

Banque Hervet shares to be exchanged for HSBC Holdings ordinary shares under this arrangement were as follows:

	Number of Banque Hervet shares exchangeable for HSBC Holdings ordinary shares	Period of vesting
31 December 2006	**–**	**–**
31 December 2005	169,416	2006
31 December 2004	177,086	2005 – 2006

Following the acquisition of HSBC Finance Corporation in 2003, all outstanding options and equity-based awards over HSBC Finance Corporation common shares were converted into rights to receive HSBC Holdings ordinary shares in the same ratio as the share exchange offer for HSBC Finance Corporation (2.675 HSBC Holdings ordinary shares for each HSBC Finance Corporation common share) and the exercise prices per share adjusted accordingly. During 2006, options over 10,484,937 (2005: 3,563,020) HSBC Holdings ordinary shares were exercised and 9,781,228 (2005: 2,638,816) HSBC Holdings ordinary shares delivered from The HSBC (Household) Employee Benefit Trust 2003 to satisfy the exercise of these options. During 2006, options over 300,555 (2005: 152,936) HSBC Holdings ordinary shares lapsed. At 31 December 2006, The HSBC (Household) Employee Benefit Trust 2003 and the HSBC (Household) Employee Benefit Trust 2003 (No.2) held a total of 8,670,335 (2005: 9,173,100) HSBC Holdings ordinary shares and 198,665 (2005: 2,198,829) ADSs, each of which represents five HSBC Holdings ordinary shares, which may be used to satisfy the exercise of these options and equity-based awards under the HSBC Finance Corporation share plans.

Options and equity-based awards outstanding over HSBC Holdings ordinary shares under the HSBC Finance Corporation share plans are as follows:

	Number of HSBC Holdings ordinary shares	Period of exercise	Exercise price
31 December 2006	**27,322,438**	**2007 to 2012**	**nil – US$21.37**
31 December 2005	38,107,930	2006 to 2012	nil – US$21.37
31 December 2004	41,823,886	2005 to 2021	nil – US$25.40

Prior to its acquisition by HSBC Holdings, HSBC Finance Corporation issued 8.875 per cent Adjustable Conversion-Rate Equity Security Units ('Units') which included a contract under which the holder agreed to purchase, for US$25 each, HSBC Finance Corporation common shares on 15 February 2006, with an option for early settlement. The Units which remained outstanding following the acquisition of HSBC Finance Corporation were converted into contracts to purchase HSBC Holdings ordinary shares. Units exercised at maturity, 15 February 2006, entitled the holder to receive a number of shares based on the market value of HSBC Holdings ordinary shares at the time, which was 2.6041 HSBC Holdings ordinary shares for each Unit. During 2006, 3,424,742 (2005: 324,726) HSBC Holdings ordinary shares were issued in connection with the maturity of 1,315,140 (2005: 124,698) Units.

The maximum number of Units outstanding over HSBC Holdings ordinary shares were as follows:

	Number of Units exchangeable for HSBC Holdings ordinary shares	Period of exercise	Exercise price
31 December 2006	–	–	–
31 December 2005	1,315,140	2006	US$8.00 – US$9.60
31 December 2004	1,439,838	2005 to 2006	US$8.00 – US$9.60

Following the acquisition of Bank of Bermuda in 2004, all outstanding employee share options over Bank of Bermuda shares were converted into rights to receive HSBC Holdings ordinary shares based on the consideration of US$40 for each Bank of Bermuda share and the average closing price of HSBC Holdings ordinary shares, derived from the London Stock Exchange Daily Official List, for the five business days preceding the closing date of the acquisition. During 2006, options over 529,233 HSBC Holdings ordinary shares were exercised (2005: 459,091) and delivered from the HSBC (Bank of Bermuda) Employee Benefit Trust 2004 to satisfy the exercise of these options. During 2006, options over 126,854 (2005: 744,421) HSBC Holdings ordinary shares lapsed. At 31 December 2006, the HSBC (Bank of Bermuda) Employee Benefit Trust 2004 held 2,266,949 (2005: 2,796,182) HSBC Holdings ordinary shares which may be used to satisfy the exercise of options.

Options outstanding over HSBC Holdings ordinary shares under the Bank of Bermuda share plans are as follows:

	Number of HSBC Holdings ordinary shares	Period of exercise	Exercise price
31 December 2006	**2,710,368**	**2007 to 2013**	**US$7.04 – US$18.35**
31 December 2005	3,366,455	2006 to 2013	US$7.04 – US$18.35
31 December 2004	4,569,967	2005 to 2013	US$3.86 – US$18.35

The maximum obligation at 31 December 2006 to deliver HSBC Holdings ordinary shares under all of the above option arrangements, together with Performance Share and Restricted Share awards under the HSBC Holdings Restricted Share Plan 2000 and The HSBC Share Plan, was 404,348,508 (2005: 486,436,966). The total number of shares at 31 December 2006 held by employee benefit trusts that may be used to satisfy such obligations to deliver HSBC Holdings ordinary shares was 133,346,569 (2005: 130,812,676).

Notes on the Financial Statements (continued)

Note 39

39 Equity

	2006										
				Other reserves							
	Called up share capital US$m	Share premium[1] US$m	Retained earnings[2] US$m	Available-for-sale fair value reserve US$m	Cash flow hedging reserve[4] US$m	Foreign exchange reserve US$m	Share-based payment reserve US$m	Merger reserve[3] US$m	Total share-holders' equity US$m	Minority interests[4] US$m	Total equity US$m
At 1 January	5,667	6,896	56,223	1,104	233	(284)	1,535	21,058	92,432	5,794	98,226
Shares issued under employee share plans	40	975	–	–	–	–	–	–	1,015	–	1,015
Shares issued in lieu of dividends and amounts arising thereon[1]	79	(82)	2,528	–	–	–	–	–	2,525	–	2,525
Profit for the year	–	–	15,789	–	–	–	–	–	15,789	1,082	16,871
Dividends to shareholders	–	–	(8,769)	–	–	–	–	–	(8,769)	(785)	(9,554)
Own shares adjustment	–	–	(529)	–	–	–	–	–	(529)	–	(529)
Share of changes recognised directly in equity in the equity of associates or joint ventures	–	–	20	–	–	–	–	–	20	–	20
Actuarial gains/(losses) on defined benefit plans	–	–	(92)	–	–	–	–	–	(92)	14	(78)
Exchange differences	–	–	4,446	89	(8)	26	38	–	4,591	84	4,675
Fair value gains taken to equity	–	–	–	1,514	1,560	–	–	–	3,074	62	3,136
Amounts transferred to the income statement[4]	–	–	–	(601)	(2,219)	–	–	–	(2,820)	(22)	(2,842)
Exercise of HSBC share awards	–	–	684	–	–	–	(623)	–	61	–	61
Charge to the income statement in respect of equity settled share-based payments	–	–	–	–	–	–	854	–	854	–	854
Other movements	–	–	(102)	(9)	2	–	345	–	236	(103)	133
Tax on items taken directly to or transferred from equity	–	–	(355)	(3)	323	–	–	–	(35)	(9)	(44)
Transfers	–	–	(4,446)	(89)	8	4,565	(38)	–	–	–	–
Net increase in minority interest arising on acquisitions, disposals and capital issuance	–	–	–	–	–	–	–	–	–	459	459
At 31 December	5,786	7,789	65,397	2,005	(101)	4,307	2,111	21,058	108,352	6,576	114,928

1 *Share premium includes the deduction of US$3 million issue costs incurred during the year.*
2 *Retained earnings include 135,603,870 (US$2,107 million) of own shares held within HSBC's insurance business, its retirement funds for the benefit of policyholders or beneficiaries within employee trusts for the settlement of shares expected to be delivered under employee share schemes or bonus plans, and the market-making activities in Global Markets.*
3 *Statutory share premium relief under Section 131 of the Companies Act 1985 was taken in respect of the acquisition of HSBC Bank plc in 1992, HSBC France in 2000 and HSBC Finance Corporation in 2003 and the shares issued were recorded at their nominal value only. In HSBC's consolidated accounts the fair value difference of US$8,290 million in respect of CCF and US$12,768 million in respect of HSBC Finance Corporation is a merger reserve.*
4 *Amounts transferred to the income statement in respect of cash flow hedges include US$479 million taken to 'Net interest income' and US$1,719 million taken to 'Net trading income'.*

Cumulative goodwill amounting to US$5,138 million has been charged against reserves in respect of acquisitions of subsidiaries prior to 1 January 1998, including US$3,469 million charged against the merger reserve arising on the acquisition of HSBC Bank plc. The balance of US$1,669 million has been charged against retained earnings.

	2005										
				Other reserves							
	Called up share capital US$m	Share premium[2] US$m	Retained earnings[3] US$m	Available-for-sale fair value reserve US$m	Cash flow hedging reserve US$m	Foreign exchange reserve US$m	Share-based payment reserve US$m	Merger reserve[4] US$m	Total share-holders' equity US$m	Minority interests US$m	Total equity US$m
At 1 January	5,587	4,881	49,432	–	–	3,215	1,349	21,058	85,522	13,675	99,197
IFRSs transition adjustment at 1 January 2005[1]	–	–	(1,762)	1,919	410	686	–	–	1,253	(10,077)	(8,824)
Shares issued under employee share plans	28	662	–	–	–	–	–	–	690	–	690
Shares issued in lieu of dividends and amounts arising thereon	52	(52)	1,811	–	–	–	–	–	1,811	–	1,811
New share capital subscribed, net of costs[2]	–	1,405	–	–	–	–	–	–	1,405	–	1,405
Profit for the year	–	–	15,081	–	–	–	–	–	15,081	792	15,873
Dividends to shareholders	–	–	(7,750)	–	–	–	–	–	(7,750)	(689)	(8,439)
Own shares adjustment	–	–	(558)	–	–	–	127	–	(431)	–	(431)
Share of changes recognised directly in equity in the equity of associates or joint ventures	–	–	161	–	–	–	–	–	161	–	161
Actuarial gains/(losses) on defined benefit plans	–	–	(820)	–	–	–	–	–	(820)	8	(812)
Exchange differences	–	–	(3,449)	(141)	(41)	(568)	14	–	(4,185)	(72)	(4,257)
Fair value losses taken to equity	–	–	–	(351)	(63)	–	–	–	(414)	(78)	(492)
Amounts transferred to the income statement[5]	–	–	–	(226)	(106)	–	–	–	(332)	(14)	(346)
Exercise of HSBC share awards	–	–	303	–	–	–	(481)	–	(178)	–	(178)
Charge to the income statement in respect of equity settled share-based payments	–	–	–	–	–	–	540	–	540	–	540
Other movements	–	–	58	(400)	–	–	–	–	(342)	–	(342)
Tax on items taken directly to or transferred from equity	–	–	267	162	(8)	–	–	–	421	16	437
Transfers	–	–	3,449	141	41	(3,617)	(14)	–	–	–	–
Net increase in minority interest arising on acquisitions, disposals and capital issuance	– –	–	–	–	–	–	–	–	–	2,233	2,233
At 31 December	5,667	6,896	56,223	1,104	233	(284)	1,535	21,058	92,432	5,794	98,226

1 *For an explanation of the IFRSs transition adjustment at 1 January 2005, see Note 46 on the Financial Statements in the Annual Report and Accounts 2005.*

2 *Share premium includes the deduction of US$40 million of issue costs incurred during the year.*

3 *Retained earnings include 108,309,061 (US$1,939 million) of own shares held within HSBC's insurance business, its retirement funds for the benefit of policyholders or beneficiaries within employee trusts for the settlement of shares expected to be delivered under employee share schemes or bonus plans, and the market-making activities in Global Markets.*

4 *Statutory share premium relief under Section 131 of the Companies Act 1985 was taken in respect of the acquisition of HSBC Bank plc in 1992, HSBC France in 2000 and HSBC Finance Corporation in 2003 and the shares issued were recorded at their nominal value only. In HSBC's consolidated accounts the fair value difference of US$8,290 million in respect of HSBC France and US$12,768 million in respect of HSBC Finance Corporation is a merger reserve.*

5 *Amounts transferred to the income statement in respect of cash flow hedges include US$101 million taken to 'Net interest income' and US$5 million taken to 'Net trading income'.*

Cumulative goodwill amounting to US$5,138 million has been charged against reserves in respect of acquisitions of subsidiaries prior to 1 January 1998, including US$3,469 million charged against the merger reserve arising on the acquisition of HSBC Bank plc. The balance of US$1,669 million has been charged against retained earnings.

Notes on the Financial Statements (continued)

Notes 39 and 40

	2004								
				Other reserves					
	Called up share capital US$m	Share premium US$m	Retained earnings[1] US$m	Foreign exchange reserve[2] US$m	Share-based payment reserve US$m	Merger reserve[3] US$m	Total share-holders' equity US$m	Minority interests US$m	Total equity US$m
At 1 January	5,481	4,406	41,673	–	1,130	21,058	73,748	11,105	84,853
Shares issued/redeemed in connection with the HSBC Finance 8.875 per cent Adjustable Conversion-Rate Equity Security Units	1	–	–	–	(1)	–	–	–	–
Shares issued under employee share plans	25	555	–	–	–	–	580	–	580
Shares issued in lieu of dividends and amounts arising thereon	80	(80)	2,607	–	–	–	2,607	–	2,607
Profit for the year	–	–	12,918	–	–	–	12,918	1,340	14,258
Dividends to shareholders	–	–	(6,914)	–	–	–	(6,914)	(1,194)	(8,108)
Own shares adjustment	–	–	(842)	–	235	–	(607)	–	(607)
Actuarial gains/(losses) on defined benefit plans	–	–	(709)	–	–	–	(709)	(22)	(731)
Exchange differences	–	–	–	3,215	–	–	3,215	505	3,720
Charge to the income statement in respect of equity settled share-based payments	–	–	–	–	450	–	450	–	450
Exercise of HSBC share awards	–	–	380	–	(465)	–	(85)	–	(85)
Tax on items taken directly to or transferred from equity	–	–	319	–	–	–	319	–	319
Net increase in minority interest on acquisitions, disposals and capital issuance	– –	–	–	–	–	–	–	1,941	1,941
At 31 December	5,587	4,881	49,432	3,215	1,349	21,058	85,522	13,675	99,197

1 *Retained earnings include 36,255,999 (US$1,424 million) of own shares held within HSBC's insurance business, its retirement funds for the benefit of policyholders or beneficiaries within employee trusts for the settlement of shares expected to be delivered under employee share schemes or bonus plans, and the market-making activities in Global Markets.*
2 *Net exchange differences arising on the retranslation of amounts recognised in 'Retained earnings'.*
3 *Statutory share premium relief under Section 131 of the Companies Act 1985 was taken in respect of the acquisition of HSBC Bank plc in 1992, HSBC France in 2000 and HSBC Finance Corporation in 2003 and the shares issued were recorded at their nominal value only. In HSBC's consolidated accounts the fair value difference of US$8,290 million in respect of HSBC France and US$12,768 million in respect of HSBC Finance Corporation is a merger reserve.*

Cumulative goodwill amounting to US$5,138 million has been charged against reserves in respect of acquisitions of subsidiaries prior to 1 January 1998, including US$3,469 million charged against the merger reserve arising on the acquisition of HSBC Bank plc. The balance of US$1,669 million has been charged against retained earnings.

40 Notes on the cash flow statement

Non-cash items included in profit before tax

	HSBC			HSBC Holdings	
	2006	2005	2004	2006	2005
	US$m	US$m	US$m	US$m	US$m
Depreciation, amortisation and impairment	2,528	2,213	2,225	–	11
Revaluations on investment property	(164)	(201)	(99)	–	–
Share-based payment expense	854	540	450	58	13
Loan impairment losses gross of recoveries	11,331	8,295	7,104	–	–
Provisions for liabilities and charges	498	327	1,181	–	–
Impairment of financial investments	21	–	(105)	–	(11)
Charge for defined benefit pension schemes	664	676	825	–	
Accretion of discounts and amortisation of premiums	(776)	(446)	(175)	–	–
	14,956	11,404	11,406	58	13

Change in operating assets

	HSBC			HSBC Holdings	
	2006	2005	2004	2006	2005
	US$m	US$m	US$m	US$m	US$m
Change in loans to HSBC undertakings	–	–	–	(1,060)	2,544
Change in prepayments and accrued income	(2,478)	7,121	(5,329)	(22)	(14)
Change in net trading securities and net derivatives	(13,620)	4,940	2,695	(740)	1,052
Change in loans and advances to banks	(11,505)	307	10,825	–	–
Change in loans and advances to customers	(132,987)	(80,150)	(139,072)	–	–
Change in financial assets designated at fair value	(4,883)	(15,048)	–	–	–
Change in other assets	(7,796)	(8,923)	(2,262)	(5)	(19)
	(173,269)	(91,753)	(133,143)	(1,827)	3,563

Change in operating liabilities

	HSBC			HSBC Holdings	
	2006	2005	2004	2006	2005
	US$m	US$m	US$m	US$m	US$m
Change in accruals and deferred income	3,549	(3,810)	2,578	16	(77)
Change in deposits by banks	28,378	(14,328)	12,187	–	–
Change in customer accounts	149,849	46,394	104,877	–	–
Change in debt securities in issue	42,253	(19,047)	52,256	–	–
Change in financial liabilities designated at fair value	8,382	61,837	–	700	12,448
Change in other liabilities	4,967	1,166	3,605	340	(16,771)
	237,378	72,212	175,503	1,056	(4,400)

Cash and cash equivalents

	HSBC			HSBC Holdings	
	2006	2005	2004	2006	2005
	US$m	US$m	US$m	US$m	US$m
Cash at bank with HSBC undertakings	–	–	–	729	756
Cash and balances at central banks	12,732	13,712	9,944	–	–
Items in the course of collection from other banks	14,144	11,300	6,338	–	–
Loans and advances to banks of one month or less	162,998	100,527	117,658	–	–
Treasury bills, other bills and certificates of deposit less than three months	38,237	22,790	32,317	–	–
Less: items in the course of transmission to other banks	(12,625)	(7,022)	(5,301)	–	–
Total cash and cash equivalents	215,486	141,307	160,956	729	756

Notes on the Financial Statements (continued)

Total interest paid by HSBC during the year was US$47,794 million (2005: US$33,974 million, 2004: US$19,038 million). Total interest received by HSBC during the year was US$85,143 million (2005: US$65,799 million, 2004: US$49,021 million). Total dividends received by HSBC during the year were US$1,525 million (2005: US$808 million, 2004: US$640 million).

41 Contingent liabilities, contractual commitments and financial guarantee contracts

	HSBC		HSBC Holdings	
	2006	2005	**2006**	2005
	US$m	US$m	**US$m**	US$m
Contingent liabilities and financial guarantee contracts				
Guarantees and irrevocable letters of credit pledged as collateral security[1]:				
– 1 year and under	**42,427**	28,152	**–**	–
– over 1 year	**34,983**	29,323	**17,605**	36,877
Other contingent liabilities	**330**	152	**–**	–
	77,740	57,627	**17,605**	36,877
Commitments				
Documentary credits and short-term trade-related transactions	**9,659**	8,090	**–**	–
Forward asset purchases and forward forward deposits placed	**2,077**	2,179	**–**	–
Undrawn note issuing and revolving underwriting facilities	**213**	468	**–**	–
Undrawn formal standby facilities, credit lines and other commitments to lend:				
– 1 year and under	**584,167**	527,506	**2,920**	2,517
– over 1 year	**118,514**	103,398	**1,047**	1,146
	714,630	641,641	**3,967**	3,663

1 *Including financial guarantee contracts.*

The above table discloses the nominal principal amounts of third party off-balance sheet transactions, the amounts relating to other contingent liabilities and the nominal principal amounts relating to financial guarantee contracts. Contingent liabilities and commitments are mainly credit-related instruments which include non-financial guarantees and commitments to extend credit. Contractual amounts represent the amounts at risk should contracts be fully drawn upon and clients default. Since a significant portion of guarantees and commitments are expected to expire without being drawn upon, the total of the contractual amounts is not representative of future liquidity requirements.

At 31 December 2006, HSBC had US$1,259 million (2005: US$1,218 million) of capital commitments contracted but not provided for and US$289 million (2005: US$333 million) of capital commitments authorised but not contracted for.

Guarantees (including financial guarantee contracts)

HSBC provides guarantees and similar undertakings on behalf of both third party customers and other entities within the HSBC Group. These guarantees are generally provided in the normal course of HSBC's banking business. The principal types of guarantees provided, and the maximum potential amount of future payments which HSBC could be required to make at 31 December 2006, were as follows:

	At 31 December 2006		At 31 December 2005	
	Guarantees in favour of third parties	**Guarantees by HSBC Holdings in favour of other HSBC Group entities**	Guarantees in favour of third parties	Guarantees by HSBC Holdings in favour of other HSBC Group entities
	US$m	**US$m**	US$m	US$m
Guarantee type				
Financial guarantee contracts[1]	**22,746**	**17,605**	19,080	36,877
Standby letters of credit which are financial guarantee contracts[2]	**4,535**	**–**	3,649	–
Other direct credit substitutes[3]	**5,514**	**–**	5,302	–
Performance bonds[4]	**8,070**	**–**	6,355	–
Bid bonds[4]	**592**	**–**	595	–
Standby letters of credit related to particular transactions[4]	**7,301**	**–**	6,640	–
Other transaction-related guarantees[4]	**28,627**	**–**	15,709	–
Other items	**25**	**–**	145	–
	77,410	**17,605**	57,475	36,877

1 *Financial guarantees are contracts that require the issuer to make specified payments to reimburse the holder for a loss incurred because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument. The amounts in the above table are nominal principal amounts.*
2 *Standby letters of credit which are financial guarantee contracts are irrevocable obligations on the part of HSBC to pay third parties when customers fail to make payments when due.*
3 *Other direct credit substitutes include re-insurance letters of credit and trade-related letters of credit issued without provision for the issuing entity to retain title to the underlying shipment.*
4 *Performance bonds, bid bonds, standby letters of credit and other transaction-related guarantees are undertakings by which the obligation on HSBC to make payment depends on the outcome of a future event.*

The amounts disclosed in the above table reflect HSBC’s maximum exposure under a large number of individual guarantee undertakings. The risks and exposures arising from guarantees are captured and managed in accordance with HSBC’s overall credit risk management policies and procedures. Approximately half of the above guarantees have a term of less than one year. Guarantees with terms of more than one year are subject to HSBC’s annual credit review process.

Joint ventures

HSBC and its operations are contingently liable with respect to lawsuits and other matters that arise in the normal course of business. Management is of the opinion that while it is impossible to ascertain the ultimate legal and financial liability with respect to these contingencies, their eventual outcome is not expected to materially affect the Group’s financial position and operations.

In relation to joint ventures, HSBC had no contingent liabilities, incurred jointly or otherwise.

HSBC had no capital commitments incurred jointly or otherwise in relation to its interests in joint ventures.

Post-employment benefit obligations

HSBC had no contingent liabilities relating to post-employment benefits.

Notes on the Financial Statements (continued)

Notes 42, 43 and 44

42 Lease commitments

Finance lease commitments

HSBC leases land and buildings (including branches) and equipment from third parties under finance lease arrangements to support its operations.

	2006 US$m	2005 US$m
Total future minimum payments:		
– no later than one year	**60**	50
– later than one year and no later than five years	**145**	152
– later than five years	**707**	630
	912	832
Less: future interest charges	**(205)**	(193)
Present value of finance lease commitments	**707**	639

At 31 December 2006, future minimum sublease payments of US$163 million (2005: US$26 million) are expected to be received under non-cancellable subleases at the balance sheet date.

Operating lease commitments

At 31 December 2006, HSBC was obligated under a number of non-cancellable operating leases for properties, plant and equipment on which the future minimum lease payments extend over a number of years.

	2006		2005	
	Land and buildings US$m	**Equipment US$m**	Land and buildings US$m	Equipment US$m
Future minimum lease payments under non-cancellable operating leases:				
– no later than one year	**789**	**10**	712	32
– later than one year and no later than five years	**2,290**	**21**	1,730	24
– later than five years	**1,198**	**–**	1,452	–
	4,277	**31**	3,894	56

In 2006, US$781 million (2005: US$704 million; 2004: US$588 million) was charged to 'General and administrative expenses' in respect of lease and sublease agreements, of which US$762 million (2005: US$683 million; 2004: US$567 million) related to minimum lease payments, US$19 million (2005: US$21 million; 2004: US$21 million) to contingent rents, and nil (2005: nil; 2004: nil) to sublease payments.

The contingent rent represents escalation payments made to landlords for operating, tax and other escalation expenses.

Finance lease receivables

HSBC leases a variety of assets to third parties under finance leases, including transport assets (such as aircraft), property and general plant and machinery. At the end of lease terms, assets may be sold to third parties or leased for further terms. Lessees may participate in any sales proceeds achieved. Lease rentals arising during the lease terms will either be fixed in quantum or be varied to reflect changes in, for example, tax or interest rates. Rentals are calculated to recover the cost of assets less their residual value, and earn finance income.

	2006			2005		
	Total future minimum payments	**Unearned finance income**	**Present value**	Total future minimum payments	Unearned interest income	Present value
	US$m	**US$m**	**US$m**	US$m	US$m	US$m
Lease receivables:						
– no later than one year	**2,305**	**(460)**	**1,845**	2,170	(266)	1,904
– later than one year and no later than five years	**7,207**	**(1,400)**	**5,807**	5,908	(1,329)	4,579
– later than five years	**9,206**	**(2,944)**	**6,262**	8,369	(3,109)	5,260
	18,718	**(4,804)**	**13,914**	16,447	(4,704)	11,743

At 31 December 2006, unguaranteed residual values of US$212 million (2005: US$68 million) had been accrued, and the accumulated allowance for uncollectible minimum lease payments receivable amounted to US$28 million (2005: US$15 million).

During the year, a total of US$59 million (2005: nil) was received as contingent rents and recognised within 'Other operating income'.

Operating lease receivables

HSBC leases a variety of different assets to third parties under operating lease arrangements, including transport assets (such as rolling stock), property and general plant and machinery.

	2006		2005	
	Land and buildings	**Equipment**	Land and buildings	Equipment
	US$m	**US$m**	US$m	US$m
Future minimum lease payments under non-cancellable operating leases:				
– no later than one year	**47**	**808**	71	397
– later than one year and no later than five years	**17**	**1,561**	160	1,136
– later than five years	**12**	**573**	153	456
	76	**2,942**	384	1,989

43 Litigation

HSBC is party to legal actions in a number of jurisdictions including the UK, Hong Kong and the US, arising out of its normal business operations. HSBC considers that none of the actions is regarded as material, and none is expected to result in a significant adverse effect on the financial position of HSBC, either individually or in the aggregate. Management believes that adequate provisions have been made in respect of such litigation. HSBC has not disclosed any contingent liability associated with these legal actions because it is not practicable to do so.

44 Related party transactions

The Group's related parties include associates, joint ventures, post-employment benefit plans for the benefit of HSBC employees, key management personnel, close family members of key management personnel and entities which are controlled, jointly controlled or significantly influenced, or for which significant voting power is held, by key management personnel or their close family members.

Transactions with Directors and other key management personnel

Key management personnel are defined as those persons having authority and responsibility for planning, directing and controlling the activities of HSBC Holdings, being the members of the Board of Directors of HSBC Holdings and Group Managing Directors.

Notes on the Financial Statements (continued)

Note 44

Compensation of Directors and other key management personnel

	HSBC	
	2006	2005
	US$m	US$m
Short-term employee benefits	**76**	71
Post-employment benefits	**3**	2
Share-based payment	**61**	21
	140	94

Transactions, arrangements and agreements involving Directors and others

Particulars of transactions, arrangements and agreements entered into by subsidiaries of HSBC Holdings with Directors and connected persons and companies controlled by them and with officers of HSBC Holdings, disclosed pursuant to section 232 of the Companies Act 1985, were as follows:

	2006		2005	
	Number of persons	**Balance at 31 December US$000**	Number of persons	Balance at 31 December US$000
Directors and connected persons and companies controlled by them[1]	**85**		76	
Loans		**407,176**		279,297
Credit cards		**317**		250
Guarantees		**21,751**		10,622
Officers[2,3]	**12**		37	
Loans		**16,706**		42,857
Credit cards		**687**		352
Guarantees		**23**		164

Further information on related party transactions, disclosed pursuant to the requirements of IAS 24, is shown below. The disclosure of the year-end balance and the highest amount outstanding during the year is considered the most meaningful information to represent the amount of the transactions and the amount of outstanding balances during the year.

1 *All of the Directors are key management personnel of HSBC Holdings. The aggregate of the highest amounts outstanding during 2006 of loans, credit card transactions and guarantees with HSBC for the Directors and close members of their family and companies that they control, jointly control or significantly influence, or for which significant voting power is held were US$550,175,512, US$696,444 and US$24,929,062 respectively (2005: US$495,990,427, US$617,259 and US$16,775,779 respectively).*

2 *Included within Officers are non-Director members of the key management personnel of HSBC Holdings. During 2006, 17 non-Director key management personnel and close members of their family and companies that they control, jointly control or significantly influence, or for which significant voting power is held entered into loan, credit card transactions and guarantees with HSBC (2005: 13 persons). The aggregate of the highest amounts outstanding during 2006 of loans, credit card transactions and guarantees with HSBC for the non-Director key management personnel and close members of their family and companies that they control, jointly control or significantly influence, or for which significant voting power is held were US$32,429,961, US$941,114 and US$22,747 respectively (2005: US$30,116,609, US$287,888 and US$20,385 respectively). The aggregate of the balances of loans and credit card transactions and guarantees with HSBC outstanding at 31 December 2006 for the non-Director key management personnel and close members of their family and companies that they control, jointly control or significantly influence, or for which significant voting power is held were US$16,418,110, US$658,890 and US$22,747 respectively (2005: US$20,166,452, US$66,467 and US$20,385 respectively).*

3 *For 2006, Officers comprise ten Group Managing Directors, the Group Chief Accounting Officer and the Group Company Secretary. For 2005, Officers comprised six Group Managing Directors, 30 Group General Managers and the Group Company Secretary.*

Particulars of Directors' transactions are recorded in a register held at the Registered Office of HSBC Holdings which is available for inspection by members for 15 days prior to the HSBC Holdings Annual General Meeting and at the Annual General Meeting itself.

Some of the transactions were connected transactions, as defined by the Rules Governing The Listing of Securities on The Stock Exchange of Hong Kong Limited but were exempt from any disclosure requirements under the provisions of those Rules.

The above transactions were made in the ordinary course of business and on substantially the same terms, including interest rates and security, as for comparable transactions with persons of a similar standing or, where applicable, with other employees. The transactions did not involve more than the normal risk of repayment or present other unfavourable features.

Shareholdings and options of Directors and other key management personnel

	At 31 December 2006 '000	2005 '000
Number of options over HSBC Holdings ordinary shares made under employee share plans held by Directors and other key management personnel	**4,563**	14,217
Number of HSBC Holdings ordinary shares held beneficially and non-beneficially by Directors and other key management personnel	**20,912**	24,304
	25,475	38,521

Transactions with other related parties of HSBC

Associates and joint ventures

The Group provides certain banking and financial services to associates and joint ventures. Details of the interests in associates and joint ventures are given in Note 20. Transactions and balances during the year with associates and joint ventures were as follows:

	2006		2005	
	Highest balance during the year[1] **US$m**	**Balance at 31 December**[1] **US$m**	Highest balance during the year[1] US$m	Balance at 31 December[1] US$m
Amounts due from joint ventures:				
– unsubordinated	746	80	539	539
Amounts due from associates:				
– subordinated	52	15	63	29
– unsubordinated	586	376	1,133	333
	1,384	471	1,735	901
Amounts due to joint ventures	1,490	58	1,382	1,382
Amounts due to associates	892	506	161	133
	2,382	564	1,543	1,515

1 *The disclosure of the year-end balance and the highest balance during the year is considered the most meaningful information to represent transactions during the year.*

The above outstanding balances arose from the ordinary course of business and on substantially the same terms, including interest rates and security, as for comparable transactions with third party counterparties.

Pension funds

At 31 December 2006, US$15.1 billion (2005: US$19.4 billion) of HSBC pension fund assets were under management by HSBC companies. Fees of US$49 million (2005: US$50 million) were earned by HSBC companies for these management services. HSBC's pension funds had placed deposits of US$348 million (2005: US$252 million) with its banking subsidiaries. The above outstanding balances arose from the ordinary course of business and on substantially the same terms, including interest rates and security, as for comparable transactions with third party counterparties.

HSBC Bank (UK) Pension Scheme entered into swap transactions with HSBC to manage the inflation and interest rate sensitivity of the liabilities. At 31 December 2006, the gross notional value of the swaps was US$14.5 billion, the swaps had a negative fair value of US$273 million to the scheme and HSBC had delivered collateral of US$265 million to the scheme in respect of these swaps. All swaps were executed at prevailing market rates and within standard market bid-offer spreads.

In order to satisfy diversification requirements, the Trustee has requested special collateral provisions for the swap transactions between HSBC and the scheme. The collateral agreement stipulates that the scheme never posts collateral to HSBC. Collateral is posted to the scheme by HSBC at an amount that the Trustee is highly confident would be sufficient to replace the swaps in the event of default by HSBC Bank plc.

With the exception of the special collateral arrangements detailed above, all other aspects of the swap transactions between HSBC and the scheme are on substantially the same terms as comparable transactions with third party counterparties.

HSBC International Staff Retirements Benefits Scheme entered into swap transactions with HSBC to manage the inflation and interest rate sensitivity of the liabilities and selected assets. At 31 December 2006, the gross notional value of the swaps was US$1.2 billion (2005: US$1.0 billion), and the swaps had a net positive fair value of US$14 million to the scheme (2005: US$53 million).

HSBC Holdings

Details of HSBC Holdings' principal subsidiaries are shown in Note 24.

Transactions and balances during the year with subsidiaries were as follows:

	2006		2005	
Subsidiaries	**Highest balance during the year[1] US$m**	**Balance at 31 December[1] US$m**	Highest balance during the year[1] US$m	Balance at 31 December[1] US$m
Assets				
Cash at bank	**784**	**729**	756	756
Derivatives	**1,599**	**1,599**	1,795	968
Loans and advances	**14,935**	**14,456**	17,282	14,092
Financial investments	**3,426**	**3,316**	6,240	3,256
Investments in subsidiaries	**62,356**	**62,356**	58,038	58,038
Total related party assets	**83,100**	**82,456**	84,111	77,110
Liabilities				
Amounts owed to HSBC undertakings	**4,279**	**3,100**	7,352	4,075
Derivatives	**385**	**177**	286	286
Subordinated liabilities:				
– cost	**3,991**	**3,991**	3,997	3,786
– fair value	**4,231**	**4,231**	4,498	4,055
Total related party liabilities	**12,886**	**11,499**	16,133	12,202
Guarantees	**36,877**	**17,605**	41,455	36,877

1 *The disclosure of the year-end balance and the highest balance during the year is considered the most meaningful information to represent transactions during the year.*

The above outstanding balances arose in the ordinary course of business and are on substantially the same terms, including interest rates and security, as for comparable transactions with third party counterparties, with no exceptions in respect of loans and advances to subsidiaries (exceptions in 2005: US$3,296 million), and exceptions of US$640 million (2005: US$3,235 million) in respect of loans from HSBC undertakings to HSBC Holdings made at an agreed zero per cent interest.

Some employees of HSBC Holdings are members of the HSBC Bank (UK) Pension Scheme, which is sponsored by a separate Group company. HSBC Holdings incurs a charge for these employees equal to the contributions paid into the scheme on their behalf. Disclosure in relation to the scheme is made in Note 7 to the accounts.

45 Events after the balance sheet date

As a consequence of inviting proposals for a sale and leaseback of 8 Canada Square, London, under an operating lease arrangement, the property has been reclassified as a non-current asset held for sale after 31 December 2006. This is in accordance with IFRS 5 'Non-current Assets Held for Sale and Discontinued Operations'. The reclassification was made at carrying value, with no financial impact on the income statement. At 31 December 2006, the carrying amount of the property, included in 'Property, plant and equipment', was US$742 million and the carrying amount of the long leasehold land, included in 'Prepayments and accrued income', was US$210 million. The building and leasehold interest are included in the assets of the Europe geographical segment and the 'Other' customer group segment.

On 1 March 2007, Ping An Insurance (Group) Company of China Limited ('Ping An Insurance'), an associate of HSBC, issued 1,150 million new shares for a total consideration of RMB38,870 million (approximately US$4,920 million). HSBC did not subscribe for any additional shares and, as a result, its interest in the equity of Ping An Insurance decreased from 19.9 per cent to 16.8 per cent. While the Group's interest has reduced, the assets of Ping An Insurance have substantially increased as a result of this issue. Consequently, it is expected that this transaction would result in an increase in HSBC's share of underlying net assets of Ping An Insurance.

A fourth interim dividend for 2006 of US$0.36 per share (US$4,171 million) (2005: US$0.31 per share, US$3,513 million) was declared by the Directors after 31 December 2006.

These accounts were approved by the Board of Directors on 5 March 2007 and authorised for issue.

46 UK and Hong Kong accounting requirements

The financial statements have been prepared in accordance with IFRSs. There would be no significant differences had they been prepared in accordance with Hong Kong Financial Reporting Standards.

47 Differences between IFRSs and US GAAP

The consolidated financial statements of HSBC are prepared in accordance with IFRSs which differ significantly in certain respects from US GAAP. The following is a summary of the significant differences applicable to HSBC.

Shareholders' interest in the long-term insurance fund

IFRSs

- IFRS 4 permits entities to continue to account for insurance contracts under previous GAAP until a comprehensive standard relating to the measurement of insurance liabilities is developed.
- Under UK GAAP and, hence, current IFRSs, the value placed on insurance contracts that are classified as long-term insurance business and are in force at the balance sheet date is recognised as an asset. The present value of in-force long-term insurance business is determined by discounting future cash flows expected to emerge from business currently in force using appropriate assumptions in assessing factors such as future mortality, lapse rates and levels of expenses and a risk discount rate that reflects the risk premium attributable to the respective long-term insurance business.
- Movements in the present value of in-force long-term insurance business are included in 'Other operating income' on a gross of tax basis.

US GAAP

- The net present value of future earnings is not recognised. Acquisition costs and fees are deferred and amortised in accordance with Statement of Financial Accounting Standard ('SFAS') 97 'Accounting and Reporting by Insurance Enterprises for Certain Long-duration Contracts and for Realised Gains and Losses from the Sale of Investments'.

Impact

- Under US GAAP, shareholders' equity is lower than under IFRSs because the present value of in-force long-term insurance business is not recognised.
- This effect is partly offset by the treatment of acquisition costs, which are deferred and amortised under US GAAP but are written off immediately as an expense of long-term insurance business under IFRSs.

Pension costs

IFRSs

- IAS 19 'Employee Benefits' ('IAS 19') requires pension liabilities to be assessed on the basis of current actuarial valuations performed on each plan, and pension assets to be measured at fair value. The net pension surplus or deficit, representing the difference between plan assets and liabilities, is recognised on the balance sheet.

- In accordance with IAS 19 (revised 2006), HSBC has elected to record all actuarial gains and losses on the pension surplus or deficit in the year in which they occur within the 'Consolidated statement of recognised income and expense'.

US GAAP

- SFAS 87, 'Employers' Accounting for Pensions', prescribes a similar method of actuarial valuation for pension liabilities and requires the measurement of plan assets at fair value.
- SFAS 158 'Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans – an amendment of FASB Statements No. 87, 88, 106 and 132(R)' (SFAS 158), was adopted by HSBC as at 31 December 2006 and aligns the US GAAP balance sheet treatment with IFRSs by requiring the funded status of HSBC's benefit plan (the difference between plan assets at fair value and the plan benefit obligations) to be recognised on the balance sheet.
- In 2005, when the value of benefits accrued based on employee service up to the balance sheet date (the accumulated benefit obligation) exceeded the value of plan assets, HSBC recognised an additional minimum pension liability to the extent that the excess was greater than any accrual already established for unfunded pension costs.
- SFAS 87 does not permit recognition of all actuarial gains and losses in a statement other than the primary income statement. As permitted by US GAAP, HSBC uses the 'corridor method', whereby actuarial gains and losses outside a certain range are recognised in the income statement in equal amounts over the remaining service lives of current employees. That range is 10 per cent of the greater of plan assets and plan liabilities. The remaining additional minimum pension liability and the transition to SFAS 158 are recognised directly in Other comprehensive income ('OCI').

Impact

- Net income under US GAAP is lower than under IFRSs as a result of the amortisation of the amount by which actuarial losses exceed gains beyond the 10 per cent 'corridor'.

Stock-based compensation

IFRSs

- IFRS 2, 'Share-based Payment', requires that when annual bonuses are paid in restricted shares and the employee must remain with the employer for a fixed period in order to receive the shares, the fair value of the award is expensed over that period.

US GAAP

- For awards made before 1 July 2005, SFAS 123, 'Accounting for Stock-based Compensation', ('SFAS 123') requires that compensation cost be recognised over the period(s) in which the related employee services are rendered. HSBC has interpreted this service period as the period to which the bonus relates.
- For 2005 bonuses awarded in early 2006, HSBC will follow SFAS 123 (revised 2004) 'Share-based Payment' ('SFAS 123R'). SFAS 123R is consistent with IFRS 2 in requiring that restricted bonuses are expensed over the period the employee must remain with HSBC. However, SFAS 123R only applies to awards made after the date of adoption, which for HSBC is 1 July 2005.

Impact

- Some of the bonuses awarded in respect of 2002, 2003 and 2004 were recognised over the relevant vesting period and were, therefore, expensed in 'Net income' under IFRSs during 2005. Under US GAAP, these awards were expensed in the years for which they were granted. 2005 bonuses will be expensed over the vesting period under both IFRSs and US GAAP. Net income was, therefore, higher under US GAAP in 2005.
- IFRSs and US GAAP are now largely aligned and this transition difference will be eliminated over the next few years.

Goodwill, purchase accounting and intangible assets

IFRSs

- Prior to 1998, goodwill under UK GAAP was written off against equity. HSBC did not elect to reinstate this goodwill on its balance sheet upon transition to IFRSs. From 1 January 1998 to 31 December 2003, goodwill was capitalised and amortised over its useful life. The carrying amount of goodwill existing at 31 December 2003 under UK GAAP was carried forward under the transition rules of IFRS 1 from 1 January 2004, subject to certain adjustments.
- IFRS 3 'Business Combinations' requires that goodwill should not be amortised but should be tested for impairment at least annually at the cash generating unit level by applying a test based on recoverable amounts.
- Quoted securities issued as part of the purchase consideration are valued for the purpose of determining the cost of the acquisition at their market price on the date the transaction is completed.

US GAAP

- Up to 30 June 2001, goodwill acquired was capitalised and amortised over its useful life, which could not exceed 25 years. The amortisation of previously acquired goodwill ceased with effect from 31 December 2001.
- Quoted securities issued as part of the purchase consideration are fair valued for the purpose of determining the cost of acquisition at their average market price over a reasonable period before and after the date on which the terms of the acquisition are agreed and announced.

Impact

- Total goodwill and shareholders' equity are both higher under US GAAP than under IFRSs because, under US GAAP, (i) pre-1998 goodwill is included on the balance sheet and (ii) the amortisation of goodwill ceased on 31 December 2001 compared with 31 December 2003 under IFRSs.
- However, goodwill on the acquisition of HSBC Finance in March 2003 is lower under US GAAP than under IFRSs. This is principally the result of differences in the accounting for securitisations and intangibles. Under IFRSs, previously recognised gains on the sale of assets to securitisation vehicles are eliminated and the securitised assets are recognised on balance sheet. However, because HSBC elected not to restate business combinations prior to 1 January 2004 on transition to IFRSs, a significant amount of intangible assets arising on acquisition were not recognised for IFRSs purposes. Under US GAAP, recognition of these assets was required.
- Offsetting this was the recognition of a deferred tax liability under US GAAP in respect of these intangibles and gains on sale of securitised assets.
- The effect of these items was further offset by the higher value under US GAAP of HSBC shares issued as part of the purchase consideration. The HSBC share price fell between the time of the announcement of the acquisition in November 2002 and its completion in March 2003, so the average price under US GAAP exceeded the price on the date of acquisition under IFRSs.

Derivatives and hedge accounting

IFRSs

- Derivatives are recognised initially, and are subsequently remeasured, at fair value. Fair values of exchange-traded derivatives are obtained from quoted market prices. Fair values of over-the-counter derivatives are obtained using valuation techniques, including discounted cash flow models and option pricing models.
- In the normal course of business, the fair value of a derivative on initial recognition is considered to be the transaction price (that is the fair value of the consideration given or received). However, in certain circumstances the fair value of an instrument will be evidenced by comparison with other observable current market transactions in the same instrument (without modification or repackaging) or will be based on a valuation technique whose variables include only data from observable markets, including interest rate yield curves, option volatilities and currency rates. When such evidence exists, HSBC recognises a trading gain or loss on inception of the derivative. When unobservable market data have a significant impact on the valuation of derivatives, the entire initial difference in fair value indicated by the valuation model from the transaction price is not recognised immediately in the income statement but is recognised over the life of the transaction on an appropriate basis, or when the inputs become observable, or the transaction matures or is closed out.

Notes on the Financial Statements (continued)

- Derivatives may be embedded in other financial instruments; for example, a convertible bond has an embedded conversion option. An embedded derivative is treated as a separate derivative when its economic characteristics and risks are not clearly and closely related to those of the host contract, its terms are the same as those of a stand-alone derivative, and the combined contract is not held for trading or designated at fair value. These embedded derivatives are measured at fair value with changes in fair value recognised in the income statement.
- Derivatives are classified as assets when their fair value is positive, or as liabilities when their fair value is negative. Derivative assets and liabilities arising from different transactions are only netted if the transactions are with the same counterparty, a legal right of offset exists, and the cash flows are intended to be settled on a net basis.
- The method of recognising the resulting fair value gains or losses depends on whether the derivative is held for trading, or is designated as a hedging instrument and, if so, the nature of the risk being hedged. All gains and losses from changes in the fair value of derivatives held for trading are recognised in the income statement. When derivatives are designated as hedges, HSBC classifies them as either: (i) hedges of the change in fair value of recognised assets or liabilities or firm commitments ('fair value hedge'); (ii) hedges of the variability in highly probable future cash flows attributable to a recognised asset or liability, or a forecast transaction ('cash flow hedge'); or (iii) hedges of net investments in a foreign operation ('net investment hedge'). Hedge accounting is applied to derivatives designated as hedging instruments in a fair value, cash flow or net investment hedge provided certain criteria are met.

  Hedge accounting

  - It is HSBC's policy to document, at the inception of a hedge, the relationship between the hedging instruments and the hedged items, as well as the risk management objective and strategy for undertaking the hedge. The policy also requires documentation of the assessment, both at hedge inception and on an ongoing basis, of whether the hedging instruments, primarily derivatives, that are used in the hedging transaction are highly effective in offsetting changes in fair values or cash flows of hedged items attributable to the hedged risks. Interest on designated qualifying hedges is included in 'Net interest income'.

  Fair value hedge

  - Changes in the fair values of derivatives that are designated and qualify as fair value hedging instruments are recorded in the income statement, together with changes in the fair values of the hedged assets or liabilities or groups thereof that are attributable to the hedged risks.
  - If the hedging relationship no longer meets the criteria for hedge accounting, the cumulative adjustment to the carrying amount of a hedged item is amortised to the income statement based on a recalculated effective interest rate over the residual period to maturity, unless the hedged item has been derecognised, in which case it is released to the income statement immediately.

  Cash flow hedge

  - The effective portion of changes in the fair values of derivatives that are designated and qualify as cash flow hedges are recognised in equity within the cash flow hedging reserve. Any gain or loss relating to an ineffective portion is recognised immediately in the income statement.
  - Amounts accumulated in equity are recycled to the income statement in the periods in which the hedged item will affect profit or loss. However, when the forecast transaction that is hedged results in the recognition of a non-financial asset or a non-financial liability, the gains and losses previously deferred in equity are transferred from equity and included in the initial measurement of the cost of the asset or liability.
  - When a hedging instrument expires or is sold, or when a hedge no longer meets the criteria for hedge accounting, any cumulative gain or loss existing in equity at that time remains in equity until the forecast transaction is eventually recognised in the income statement. When a forecast transaction is no longer expected to occur, the cumulative gain or loss that was reported in equity is immediately transferred to the income statement.

Net investment hedge

- Hedges of net investments in foreign operations are accounted for in a similar way to cash flow hedges. A gain or loss on the effective portion of the hedging instrument is recognised in equity; a gain or loss on the ineffective portion is recognised immediately in the income statement. Gains and losses accumulated in equity are included in the income statement on the disposal of the foreign operation.

Hedge effectiveness testing

- To qualify for hedge accounting, IAS 39 requires that at inception of the hedge and throughout its life, each hedge must be expected to be highly effective (prospective effectiveness), and demonstrate actual effectiveness (retrospective effectiveness) on an ongoing basis.
- The documentation of each hedging relationship sets out how the effectiveness of the hedge is assessed. The method HSBC entities adopt for assessing hedge effectiveness will depend on their risk management strategies.
- For prospective effectiveness, the hedging instrument must be expected to be highly effective in offsetting changes in fair value or cash flows attributable to the hedged risk during the period for which the hedge is designated. For actual effectiveness to be achieved, the changes in fair value or cash flows must offset each other in the range of 80 per cent to 125 per cent for the hedge to be deemed effective.

Derivatives that do not qualify for hedge accounting

- All gains and losses from changes in the fair value of derivatives that do not qualify for hedge accounting are recognised immediately in the income statement. These gains and losses are reported in 'Net trading income', except where derivatives are managed in conjunction with financial instruments designated at fair value, in which case gains and losses are reported in 'Net income from financial instruments designated at fair value', other than interest settlements on derivatives managed in conjunction with issued debt securities designed at fair value which are reported in 'Interest expense'. All other gains and losses on these derivatives are reported in 'Net income from financial instruments designated at fair value'.

From 1 January 2004 to 31 December 2004

- *Derivative financial instruments comprised futures, forward, swap and option transactions undertaken by HSBC in the foreign exchange, interest rate, equity, credit derivative, and commodity markets that were held off balance sheet. Netting was applied where a legal right of set-off existed.*
- *Accounting for these instruments was dependent upon whether the transactions were undertaken for trading or non-trading purposes.*

Trading transactions

- *Trading transactions included transactions undertaken for market-making, to service customers' needs and for proprietary purposes, as well as any related hedges.*
- *Transactions undertaken for trading purposes were marked to market and the net present value of any gain or loss arising was recognised in the income statement as 'Net trading income', after appropriate deferrals for unearned credit margins and future servicing costs. Derivative trading transactions were valued by reference to an independent liquid price where this was available. For those transactions with no readily available quoted prices, predominantly over the counter transactions, market values were determined by reference to independently sourced rates, using valuation models. If market observable data was not available, the initial increase in fair value indicated by the valuation model, but based on unobservable inputs, was not recognised immediately in the income statement. This amount was held back and recognised over the life of the transaction where appropriate, or released to the income statement when the inputs became observable, or when the transaction matured or was closed out. Adjustments were made for illiquid positions when appropriate.*
- *Assets, including gains, resulting from derivative exchange rate, interest rate, equities, credit derivative and commodity contracts which were marked to market were included in 'Derivatives' on the asset side of the balance sheet. Liabilities, including losses, resulting from such contracts, were included in 'Derivatives' on the liability side of the balance sheet.*

Notes on the Financial Statements (continued)

Non-trading transactions

- *Non-trading transactions, which were those undertaken for hedging purposes as part of HSBC's risk management strategy against cash flows, assets, liabilities or positions, were measured on an accrual basis. Non-trading transactions included qualifying hedges and positions that synthetically altered the characteristics of specified financial instruments.*
- *Non-trading transactions were accounted for on an equivalent basis to the underlying assets, liabilities or net positions. Any gains or losses arising were recognised on the same basis as those arising from the related assets, liabilities or positions.*
- *To qualify as a hedge, a derivative was required effectively to reduce the price, foreign exchange or interest rate risk of the asset, liability or anticipated transaction to which it was linked and be capable of designation as a hedge at inception of the derivative contract. Accordingly, changes in the market value of the derivative were required to be highly correlated to changes in the market value of the underlying hedged item at inception of the hedge and over the life of the hedge contract. If these criteria were met, the derivative was accounted for on the same basis as the underlying hedged item. Derivatives used for hedging purposes included swaps, forwards and futures. Interest rate swaps were also used to alter synthetically the interest rate characteristics of financial instruments. In order to qualify for synthetic alteration, a derivative instrument had to be linked to specific individual, or pools of similar, assets or liabilities by the notional principal and interest rate risks of the associated instruments, and had to achieve a result that was consistent with defined risk management objectives. If these criteria were met, accruals based accounting was applied, i.e. income or expense was recognised and accrued to the next settlement date in accordance with the contractual terms of the agreement.*
- *Any gain or loss arising on the termination of a qualifying derivative was deferred and amortised to earnings over the original life of the terminated contract. Where the underlying asset, liability or position was sold or terminated, the qualifying derivative was immediately marked to market and any gain or loss arising was taken to the income statement.*

US GAAP

- The accounting under SFAS 133 'Accounting for derivative instruments and hedging activities' is generally consistent with that under IAS 39, which HSBC has followed in its IFRSs reporting from 1 January 2005, as described above. However, specific assumptions regarding hedge effectiveness under US GAAP are not permitted by IAS 39.
- The requirements of SFAS 133 have been effective from 1 January 2001.
- During 2006, HSBC's US operating subsidiaries discontinued the use of the 'shortcut method'. The US GAAP 'shortcut method' permits an assumption of zero ineffectiveness in hedges of interest rate risk with an interest rate swap provided specific criteria have been met. IAS 39 does not permit such an assumption, requiring a measurement of actual ineffectiveness at each designated effectiveness testing date.
- However, IFRSs allow greater flexibility in the designation of the hedged item. Under US GAAP, all contractual cash flows must form part of the designated relationship, whereas IAS 39 permits the designation of identifiable benchmark interest cash flows only.
- Certain issued structured notes are classified as trading liabilities under IFRSs, but not under US GAAP. Under IFRSs, these notes will be held at fair value, with changes in fair value reflected in the income statement. Under US GAAP, if the embedded derivative would otherwise require bifurcation, an irrevocable election may be made to initially and subsequently measure the entire issued note at fair value, with changes in fair value recognised through income. This election is made under US GAAP when the underlying issued notes are classified as trading liabilities under IFRS. If the embedded derivative is clearly and closely related to the host contract, the issued note will be held at amortised cost in its entirety, with changes in the amortised cost reflected in the income statement.
- Under US GAAP, derivatives receivable and payable with the same counterparty may be reported net on the balance sheet when there is an executed ISDA Master Netting Arrangement covering enforceable jurisdictions. These contracts do not meet the requirements for offset under IAS 32 and hence are presented gross on the balance sheet under IFRSs.

Impact

- Prior to 2006, HSBC's North American subsidiaries followed the 'shortcut method' of hedge effectiveness testing for certain transactions in their US GAAP reporting. Alternative hedge effectiveness testing methodologies were sought under IFRSs for these hedging relationships.
- Apart from certain subsidiaries in North America, HSBC has chosen not to adopt hedge accounting for US GAAP purposes as this would require a designated hedged item inconsistent with the approach adopted under IFRSs. Qualifying IAS 39 hedging derivatives have been measured at fair value with the gain or loss recognised in net income for US GAAP purposes.

Designation of financial assets and liabilities at fair value through profit and loss

IFRSs

- Under IAS 39, a financial instrument, other than one held for trading, is classified in this category if it meets the criteria set out below, and is so designated by management. An entity may designate financial instruments at fair value where the designation:
  - eliminates or significantly reduces a measurement or recognition inconsistency that would otherwise arise from measuring financial assets or financial liabilities or recognising the gains and losses on them on different bases; or
  - applies to a group of financial assets, financial liabilities or a combination of both that is managed and its performance evaluated on a fair value basis, in accordance with a documented risk management or investment strategy, and where information about that group of financial instruments is provided internally on that basis to management; or
  - relates to financial instruments containing one or more embedded derivatives that significantly modify the cash flows resulting from those financial instruments.
- Financial assets and financial liabilities so designated are recognised initially at fair value, with transaction costs taken directly to the income statement, and are subsequently remeasured at fair value. The designation, once made, is irrevocable in respect of the financial instruments to which it relates. Financial assets and financial liabilities are recognised when HSBC enters into the contractual provisions of the arrangements with counterparties, which is generally on trade date.
- Gains and losses from changes in the fair value of such assets and liabilities are recognised in the income statement as they arise, together with related interest income and expense and dividends, within 'Net income from financial instruments designated at fair value', except for interest on own debt issued by HSBC, and related derivatives, which is reported in 'Interest expense'.

US GAAP

- Generally, for financial assets to be measured at fair value with gains and losses recognised immediately in the income statement, they must meet the definition of trading securities in SFAS 115 'Accounting for Certain Investments in Debt and Equity Securities' ('SFAS 115'). Financial liabilities are usually reported at amortised cost under US GAAP.
- Since 1 January 2006, HSBC has accounted for hybrid financial instruments under the provisions of SFAS 155 'Hybrid Financial Instruments'. Hybrid financial instruments used that contain an embedded derivative that would otherwise require bifurcation are, where so designated through an irrevocable election, initially and subsequently measured at fair value, with changes in fair value recognised through income.

Impact

- HSBC has principally used the fair value designation option in the following cases:
  - for certain fixed rate long-term debt issues whose interest rate characteristic has been changed to floating through interest rate swaps as part of a documented interest rate management strategy. In 2006, approximately US$56 billion (2005: US$51 billion) of the Group's debt issues have been accounted for using this option. The movement in fair value of these debt issues includes the effect of changes in own credit spread and any ineffectiveness in the economic relationship between the related swaps and own debt. Such ineffectiveness arises from the different credit characteristics of the swap and own debt coupled with

the sensitivity of the floating leg of the swap to changes in short-term interest rates. In addition, the economic relationship between the swap and own debt can be affected by relative movements in market factors, such as bond and swap rates, and the relative bond and swap rates at inception. The size and direction of the accounting consequences of changes in own credit spread and ineffectiveness can be volatile from period to period, but do not alter the cash flows envisaged as part of the documented interest rate management strategy.

- certain financial assets held by insurance operations and managed at fair value to meet liabilities under insurance contracts (in 2006, approximately US$6 billion; 2005: US$4 billion of assets);
- financial liabilities under investment contracts and the related financial assets, when the change in value of the assets is correlated with the change in value of the liabilities to policyholders (in 2006, approximately US$12 billion; 2005: US$8 billion of liabilities and related assets).

- Under US GAAP, debt issues are generally reported at amortised cost. There are circumstances, by virtue of different technical requirements and the transition arrangements to IFRSs, where derivatives providing an economic hedge for an asset or liability, and so designated under IFRSs, are not so treated under US GAAP, thereby creating a reconciliation difference and asymmetrical accounting between the asset and liability and the offsetting derivative. Such derivatives result in an adjustment that is included in the reconciliations below, within ‘Derivatives and hedge accounting’.
- Prior to 1 January 2006, debt issues which had embedded derivatives were also reported at amortised cost with any embedded derivatives bifurcated where required by SFAS 133.
- From 1 January 2006, as described above, the Group’s hybrid debt issues that contain an embedded derivative that would otherwise require bifurcation are accounted for in a consistent manner under both IFRSs and US GAAP, where such instruments are designated to be measured at fair value. On the US GAAP balance sheet, such instruments are reclassified as ‘Financial liabilities designated at fair value’.
- Under US GAAP, assets held to meet insurance/investment contracts are reported as available-for-sale, with gains and losses taken directly to ‘Other comprehensive income’. When the corresponding liability is reported at fair value, with movements reported immediately in net income, this also results in asymmetrical accounting being reflected in US GAAP net income.
- All these adjustments are included as ‘Derivatives and hedge accounting’ in the reconciliations below.

Available-for-sale securities

IFRSs

- Treasury bills, debt securities and equity shares intended to be held on a continuing basis are classified as available-for-sale securities unless designated at fair value (see above) or classified as held-to-maturity.
- Available-for-sale securities are initially measured at fair value plus direct and incremental transaction costs. They are subsequently remeasured at fair value. Changes in fair value are recognised in equity until the securities are either sold or impaired. On the sale of available-for-sale securities, cumulative gains or losses previously recognised in equity are recognised through the income statement and classified as ‘Gains less losses from financial investments’. Interest income is recognised on such securities using the effective interest rate method, calculated over the asset’s expected life. When dated available-for-sale securities are purchased at a premium or a discount, the premiums and discounts are included in the calculation of the effective interest rate.
- If an available-for-sale security is determined to be impaired, the cumulative loss (measured as the difference between the acquisition cost, net of any principal repayments and amortisation, and the current fair value, less any impairment loss on that financial asset previously recognised in the income statement) is removed from equity and recognised in the income statement. If, in a subsequent period, the fair value of a debt instrument classified as available-for-sale increases and the increase can be objectively related to an event occurring after the impairment loss was recognised in the income statement, the impairment loss is reversed through the income statement. Impairment losses recognised in the income statement on equity instruments are not reversed through the income statement.

- Foreign exchange differences on available-for-sale monetary items, such as debt securities, denominated in foreign currency are recognised in net income to the extent that they relate to the translation of the amortised cost of the security.

1 January 2004 to 31 December 2004

- *Debt securities and equity shares intended to be held on a continuing basis were classified as financial investments and included in the balance sheet at cost less provision for any permanent diminution in value. Other participating interests were accounted for on the same basis. Premiums or discounts on dated investment securities purchased at other than face value were amortised through the income statement over the period from date of purchase to date of maturity and included in 'Interest income'. Any gain or loss on realisation of these securities was recognised in the income statement as it arose and included in 'Gains less losses from financial investments'.*
- *Foreign exchange differences on foreign currency-denominated monetary items, including securities, were recognised in the income statement.*

US GAAP

- Available-for-sale securities are measured at fair value with unrealised holding gains and losses excluded from earnings and reported net of applicable taxes and minority interests as a separate component of shareholders' funds.
- A decline in fair value below the cost of an available-for-sale or held-to-maturity security is treated as a realised loss and included in earnings if it is considered 'other than temporary'. The reduced fair value is then treated as the cost basis for the security. A decline in fair value is generally considered other than temporary when management does not intend or expect to hold the investment for sufficient time to enable the fair value to rise back to the original cost of the investment.
- Foreign exchange differences on available-for-sale securities denominated in foreign currency are excluded from earnings and recorded as part of a separate component of shareholders' funds.

Impact

- In 2005, certain assets have been reported at fair value for IFRSs purposes (see above). Under US GAAP, equity shares that do not have a readily determinable fair value as defined in SFAS 115 are recorded at cost rather than at fair value under IFRSs.
- Foreign exchange differences on available-for-sale securities denominated in foreign currency are recognised in 'Net income' under IFRSs. Under US GAAP, they are not reflected in net income but are deferred and recognised on maturity or sale of the security.

Unquoted equity securities

HSBC holds certain equity securities whose market price is not quoted on a recognised exchange, but for which the fair value can be reliably measured either through an active market, comparison to similar equity securities which are quoted, or by using discounted cash flow calculations.

IFRSs

- Under IAS 39, equity securities which are not quoted on a recognised exchange, but for which fair value can be reliably measured, are required to be measured at fair value. Accordingly, such securities are measured at fair value and classified as either available-for-sale securities, with changes in fair value recognised in equity, or as trading securities with changes in fair value recognised in the income statement.

US GAAP

- Under SFAS 115, equity securities that are not quoted on a recognised exchange are not considered to have a readily determinable fair value and are required to be measured at cost (less any provisions for impairment). Unquoted equity securities are reported within 'Other assets'.

Impact

- Changes in fair value of equity securities for which IFRSs require recognition of the change in fair value and US GAAP requires the securities to be held at amortised cost, impact net income and shareholders' equity when the security is classified as trading under IFRSs and impact shareholders' equity when the security is classified as available-for-sale under IFRSs.

Loan origination

IFRSs

From 1 January 2005

- Certain loan fee income and incremental directly attributable loan origination costs are amortised to the income statement over the life of the loan as part of the effective interest calculation under IAS 39.

1 January 2004 to 31 December 2004

- *Prior to 1 January 2005, fee and commission income was accounted for in the period when receivable, except when charged to cover the costs of a continuing service to, or risk borne for, the customer, or was interest in nature. In these cases, income was recognised on an appropriate basis over the relevant period. Loan costs associated with origination were generally expensed as incurred.*

US GAAP

- Certain loan fee income and direct but not necessarily incremental loan origination costs, including an apportionment of compensation and related benefit costs, are deferred and amortised to the income statement account over the life of the loan as an adjustment to interest income (SFAS 91, 'Accounting for Non-refundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases'.)

Impact

- More costs are deferred and amortised under US GAAP, such as an apportionment of base salaries, than under IFRSs. Base salaries are written off in the period they are incurred under IFRSs. This difference in treatment results in increased net income and shareholders' equity under US GAAP because, in the years presented, the extra cost deferral under US GAAP exceeds the amortisation of previously deferred costs.

Securitisations

IFRSs

- The continued recognition of securitised assets is governed by a three-step process, which may be applied to the whole asset, or, in certain circumstances, a part of an asset:
  - If the rights to the cash flows arising from securitised assets have been transferred to a third party, and substantially all the risks and rewards of the assets have been transferred, the assets concerned are derecognised.
  - If, subject to certain detailed criteria, the rights to the cash flows are retained by HSBC but there is a contractual obligation to pay them to another party, substantially all the risks and rewards of the assets have been transferred, and the securitised assets concerned are derecognised.
  - If some significant risks and rewards of ownership have been transferred, but some have also been retained, it must be determined whether or not control has been retained. If control has been retained, HSBC continues to recognise the assets to the extent of its continuing involvement; if not, the assets are derecognised.

US GAAP

- SFAS 140, 'Accounting for Transfers and Servicing of Finance Assets and Extinguishments of Liabilities', requires that receivables that are sold to a special purpose entity ('SPE') and securitised can only be derecognised and a gain or loss on sale recognised if the originator has surrendered control over the securitised assets.
- Control is surrendered over transferred assets if and only if all of the following conditions are met:

  - The transferred assets are put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership.
  - Each holder of interests in the transferee (i.e. holder of issued notes) has the right to pledge or exchange their beneficial interests, and no condition constrains this right and provides more than a trivial benefit to the transferor.
  - The transferor does not maintain effective control over the assets through either an agreement that obligates the transferor to repurchase or to redeem them before their maturity, or through the ability to unilaterally cause the holder to return specific assets other than through a clean-up call.
- If these conditions are not met the securitised assets continue to be consolidated.
- When HSBC retains an interest in securitised assets, such as a servicing right or the right to residual cash flows from the special purpose entity, HSBC recognises this interest at fair value on sale of the assets to the SPE.

Impact

- Gains on sale of assets to securitisation vehicles are recognised under US GAAP in cases when no such gain is recognised under IFRSs. This results in higher US GAAP net income in periods in which there is significant securitisation activity.
- Since early 2004, HSBC has reduced securitisation activity that results in 'gain on sale' accounting under US GAAP. As a result, net income is lower under US GAAP because the amortisation of HSBC's retained interest in previous securitisations exceeds the gains on new transactions where a gain is recognised. The new transactions largely replenish short-term loan assets held by existing vehicles.
- Note (l) on page 430 gives further details of transactions during the year where assets are derecognised under US GAAP.

Loan impairment

IFRSs

- When statistical models, using historic loss rates adjusted for economic conditions, provide evidence of impairment in portfolios of loans, their values are written down to their net recoverable amount. The net recoverable amount is the present value of the estimated future recoveries discounted at the portfolio's original effective interest rate. The calculations include a reasonable estimate of recoveries on loans individually identified for write-off pursuant to HSBC's credit guidelines.

US GAAP

- When the delinquency status of loans in a portfolio is such that there is no realistic prospect of recovery, the loans are written off in full, or to recoverable value where collateral exists. Delinquency depends on the number of days payments is overdue. The delinquency status is applied consistently across similar loan products in accordance with HSBC's credit guidelines. When local regulators mandate the delinquency status at which write-off must occur for different retail loan products and these regulations reasonably reflect estimated recoveries on individual loans, this basis of measuring loan impairment is reflected in US GAAP accounting. Cash recoveries relating to pools of such written-off loans, if any, are reported as loan recoveries upon collection.

Impact

- Under both IFRSs and US GAAP, HSBC's policy and regulatory instructions mandate that individual loans evidencing adverse credit characteristics which indicate no reasonable likelihood of recovery, are written off. When, on a portfolio basis, cash flows can reasonably be estimated in aggregate from these written-off loans, an asset equal to the present value of the future cash flows is recognised under IFRSs.
- No asset for future recoveries arising from written-off assets was recognised in the balance sheet under IFRSs prior to 1 January 2005.

Interest recognition

IFRSs

- The calculation of effective interest rates under IAS 39 requires an estimate of all fees and points paid or received between parties to the contract that are an integral part of the effective interest rate be included.

US GAAP

- FAS 91 also generally requires all fees and costs associated with originating a loan to be recognised as interest but, when the interest rate increases during the term of the loan, it prohibits the recognition of interest income to the extent that the net investment in the loan would increase to an amount greater than the amount at which the borrower could settle the obligation.

Impact

- When HSBC provides introductory incentives in the form of either a low or nil interest rate for the early period of a loan, interest income on such products is recognised under IFRSs on the basis of the overall effective interest rate over the expected life of the product. No interest income is recognised during the incentive period under US GAAP.

Mortgage servicing rights

IFRSs

- Intangible assets that have a finite useful life, such as mortgage servicing rights, are stated at cost less amortisation and accumulated impairment losses and are amortised over their estimated useful lives. Estimated useful life is the lower of legal duration and expected economic life.

US GAAP

- SFAS 156 'Accounting for Servicing of Financial Assets' was issued by the FASB in March 2006. SFAS 156 amends SFAS 140 'Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities' with respect to the accounting for separately recognised servicing assets and liabilities. SFAS 156 requires that all separately recognised servicing assets and liabilities be initially measured at fair value with subsequent measurement at either fair value, with changes in fair value reported in the income statement when they occur, or using the amortisation method. At the date of adoption, SFAS 156 permits a one-time reclassification of available-for-sale securities to trading securities where those securities are identified as offsetting exposure to changes in the fair value of servicing assets and liabilities that have been elected to be subsequently measured at fair value. HSBC elected to adopt SFAS 156 from 1 January 2006.
- From 1 January 2006 HSBC elected to subsequently measure at fair value certain classes of mortgage servicing rights held by its US subsidiaries.

Impact

- Prior to 1 January 2006 the amortisation method was used to account for mortgage servicing rights under US GAAP and, therefore, no difference with IFRSs arose.
- Upon adoption of SFAS 156 the cumulative effect adjustment to US GAAP retained earnings, representing the difference between the fair value and cost less amortisation of mortgage servicing rights, was immaterial.
- At 1 January 2006 an election was made to reclassify certain securities used by one of HSBC's US subsidiaries to offset changes in the fair value of mortgage servicing rights from available-for-sale financial investments to trading assets. At 31 December 2005 those securities had a cost of US$115m and a fair value of US$111m. This resulted in a transfer out of US GAAP other comprehensive income of the accumulated loss of US$4m at 1 January 2006, with an offsetting amount recorded as a cumulative effect adjustment to retained earnings.
- In 2006 the net difference between the fair value adjustment of the mortgage servicing asset and the offsetting changes in the fair value of mortgage servicing rights classified as trading assets is recorded as an adjustment to US GAAP net income.

Unearned commission income

IFRSs

- In accordance with IAS 18, revenue on commissions received from third party insurance providers is recognised when HSBC does not expect to render further service under the contract, taking into account expectations of future policy termination.

US GAAP

- Under Staff Accounting Bulletin No. 104 (SAB 104), revenue should be recognised when, along with other criteria, the seller's price to the buyer is fixed or determinable. Commissions which are earned when the customer has the right to cancel and receive a proportionate refund are not considered to be fixed and determinable under US GAAP until the cancellation privilege expires. Cancellation privileges generally expire rateably over the contract.
- Under the American Institute of Certified Public Accountants ('AICPA') Audit and Accounting Guide for Deposit and Lending Institutions; Insurance Commissions received from an independent insurer should be deferred and systematically amortised to income over the life of the related insurance contract.

Impact

- The difference between recognising revenue based on the likelihood that future services will be rendered and rateably over the life of the policy creates a timing difference in the recognition of revenue under IFRSs and US GAAP. Net income under US GAAP will generally be lower, but would be higher if new commission revenue decreased below the level of commissions earned from prior years policies.
- The liability for customers fees which have not been earned under US GAAP, net of amounts deferred under IFRSs, decrease shareholders' net assets under US GAAP.

Interests in own shares held

IFRSs

- In accordance with IAS 32, long positions in HSBC Holdings' shares are deducted from shareholders' funds. No gains or losses are recognised on own shares held.
- IAS 32 also applies to derivatives over HSBC's own shares, when they meet the definition of an equity instrument, and HSBC shares held to meet liabilities under insurance and investment contracts.

US GAAP

- AICPA Accounting Research Bulletin 51, 'Consolidated Financial Statements' ('ARB 51'), requires a reduction in shareholders' equity for own shares held. The rules in ARB 51 do not extend to derivatives over own shares.
- AICPA Accounting Research Bulletin 43 'Restatement and Revision of Accounting Research Bulletins' also requires a reduction in shareholders' equity for own shares held. HSBC shares held as long-term insurance assets attributable to policyholders are classified as an asset when the criteria for classification as 'separate accounts' are met.

Impact

- Certain HSBC insurance operations hold shares in HSBC as part of policyholder funds that qualify for classification as 'separate accounts'. These shares represent an addition to shareholders' equity for US GAAP purposes and are reported within 'Other assets' with gains and losses during the period reported in 'Other income', where they are matched with corresponding movements in the amounts attributable to policyholders. No such gains and losses are recognised under IFRSs and the cost of the shares is deducted from shareholders' equity.

Revaluation of property

IFRSs

- As allowed by the transition rules of IFRS 1, HSBC elected to adopt the value of all its properties held for its own use as at 1 January 2004 as their 'deemed cost' at that date. Assets are carried at cost less any accumulated depreciation and impairment losses. Freehold land is not depreciated.
- Investment properties are carried at current market values with gains or losses thereon recognised in the income statement for the period. Investment properties are not depreciated.

US GAAP

- US GAAP does not permit revaluations of property, including investment property, although it requires recognition of asset impairment. Any realised surplus or deficit is, therefore, reflected in net income upon disposal of the property. Depreciation is charged on all properties based on cost.

Impact

- Under IFRSs, the value of property held for own use reflects revaluation surpluses recorded prior to 1 January 2004. Consequently, the values of tangible fixed assets and shareholders' equity are lower under US GAAP than under IFRSs.
- There is a correspondingly lower depreciation charge and higher net income under US GAAP, partially offset by higher gains (or smaller losses) on the disposal of fixed assets.
- For investment properties, net income under US GAAP does not reflect the gain or loss recorded under IFRSs for the period.

Restructuring provisions

IFRSs

- In accordance with IAS 37, 'Provisions, Contingent Liabilities and Contingent Assets', provisions are made for any direct costs arising from a business that management is committed to restructure, sell or terminate; has a detailed formal plan and has raised a valid expectation of carrying out that plan.

US GAAP

- SFAS 146, 'Accounting for Costs Associated with Exit or Disposal Activities', requires that the fair value of a liability for a cost associated with an exit or disposal activity be recognised when the liability is incurred. Accordingly, provisions are recognised upon the implementation of the restructuring plan.

Impact

- The recognition of costs associated with plans to restructure and streamline operations is earlier under IFRSs than under US GAAP, for example, where there is a time lag between developing and communicating a formal plan, and putting it into practice. This resulted in marginally higher net income and shareholders' equity under US GAAP in 2005.

Consolidation of special purpose entities or variable interest entities

IFRSs

- Under the IASB's Standing Interpretations Committee ('SIC') Interpretation 12 ('SIC-12'), a special purpose entity ('SPE') should be consolidated when the substance of the relationship between an enterprise and the SPE indicates that the SPE is controlled by that entity.

US GAAP

- FASB Interpretation No. 46 (revised December 2003), 'Consolidation of Variable Interest Entities' ('FIN 46R'), requires consolidation of variable interest entities ('VIE's) in which HSBC is the primary beneficiary and disclosures in respect of all other VIEs in which it has a significant variable interest.
- A VIE is an entity in which equity investors hold an investment that does not possess the characteristics of a controlling financial interest or does not have sufficient equity at risk for the entity to finance its activities.

HSBC is the primary beneficiary of a VIE if its variable interests absorb a majority of the entity's expected losses. Variable interests are contractual, ownership or other pecuniary interests in an entity that change with changes in the fair value of an entity's net assets exclusive of variable interests. If no party absorbs a majority of the entity's expected losses, HSBC consolidates the VIE if it receives a majority of the expected residual returns of the entity.

Impact

- When HSBC is deemed the primary beneficiary under US GAAP, but does not consolidate the vehicle under IFRSs, the assets and liabilities of that vehicle are consolidated on the US GAAP balance sheet. This results in a grossing up of the balance sheet but does not have a material impact on net income for the period or on shareholders' equity.
- When HSBC is deemed not to be the primary beneficiary under US GAAP of a vehicle that is consolidated under IFRSs, the assets and liabilities of that vehicle are de-consolidated in the US GAAP balance sheet. This results in a reclassification in the 2004 balance sheet but does not have a material impact on shareholders' equity or on net income for 2004 or 2005.

Long-term insurance assets and liabilities

IFRSs

- Long-term insurance fund assets, excluding own shares held, are classified in accordance with IAS 39, for example, available-for-sale securities, or financial instruments designated at fair value. The accounting for these financial assets is consistent with other holdings of similar assets.
- Liabilities attributable to policyholders under insurance contracts are recognised in accordance with IFRS 4 and appropriate actuarial principles as 'Liabilities under insurance contracts issued'. Liabilities attributable to policyholders under linked investment contracts are recognised as financial liabilities designated at fair value and classified under 'Financial liabilities designated at fair value'.

US GAAP

- Under the Statement of Position issued by the AICPA 03-1 ('SOP 03-1'), 'Accounting and Reporting by Insurance Enterprises for Certain Non-traditional and Long-duration Contracts and for Separate Accounts', which became fully effective in 2004, when long-term insurance assets qualify for separate accounting they are measured at fair value and are reported in the financial statements as a summary total, with an equivalent summary total for related liabilities. Otherwise, assets that do not qualify for separate accounting and that represent policyholders' funds are accounted for and recognised as general account assets, that is consistent with other holdings of similar assets. Any related liability is accounted for as a general account liability.

Impact

- Long-term insurance assets that are recorded in accounts meeting the definition of 'separate accounts' in SOP 03-1 are measured at fair value through net income and disclosed in a single line, 'Other assets', in the US GAAP balance sheet.

Notes on the Financial Statements (continued)

Note 47

Reconciliation of net income and shareholders' equity under IFRSs and US GAAP

The following tables summarise the significant adjustments to consolidated net income and shareholders' equity which would result from the application of US GAAP:

	Year ended 31 December		
	2006	2005	2004
	US$m	US$m	US$m
Net income			
Profit attributable to shareholders of the parent company of HSBC (IFRSs)	**15,789**	15,081	12,918
Shareholders' interest in long-term insurance fund	**(532)**	88	(102)
Pension costs	**(209)**	(175)	(125)
Stock-based compensation	**119**	225	(83)
Intangible assets	**(264)**	(325)	(323)
Purchase accounting adjustments	**(303)**	(520)	(1,239)
Derivatives and hedge accounting	**514**	(2,144)	244
Foreign exchange differences on available-for-sale securities	**1,203**	2,235	1,069
Loan origination	**156**	249	143
Securitisations	**(57)**	(237)	(33)
Loan impairment	**(36)**	20	–
Interest recognition	**2**	(131)	–
Mortgage servicing rights	**14**	–	–
Unquoted equity securities	**(45)**	–	–
Unearned commission income	**(291)**	–	–
Other	**92**	(44)	74
Taxation, including taxation on reconciling items	**81**	578	(77)
Minority interest in reconciling items	**125**	(197)	40
Net income (US GAAP)	**16,358**	14,703	12,506

	Year ended 31 December		
	2006	2005	2004
	US$	US$	US$
Per share amounts (US GAAP)			
Basic earnings per ordinary share	**1.45**	1.33	1.15
Diluted earnings per ordinary share	**1.44**	1.32	1.13

	At 31 December	
	2006	2005
	US$m	US$m
Shareholders' equity		
Total shareholders' equity (IFRSs)	**108,352**	92,432
Shareholders' interest in long-term insurance fund	**(1,678)**	(1,077)
Pension costs	**–**	1,585
Unquoted equity shares	**(1,311)**	(597)
Goodwill	**1,246**	1,048
Revaluation of property	**(1,490)**	(1,530)
Purchase accounting adjustments	**18**	155
Intangible assets	**1,845**	2,127
Derivatives and hedge accounting	**1,129**	(58)
Loan origination	**916**	717
Securitisations	**101**	158
Loan impairment	**(372)**	(327)
Interest recognition	**(257)**	(259)
Unearned commission income	**(291)**	–
Mortgage servicing rights	**16**	–
Other	**79**	112
Taxation including taxation on reconciling items	**(51)**	(1,213)
Minority interest in reconciling items	**288**	251
Total shareholders' equity (US GAAP)	**108,540**	93,524

	2006 US$m	2005 US$m	2004 US$m
Movement in shareholders' equity (US GAAP)			
Balance brought forward (as previously published)	**93,524**	90,082	80,251
Adoption of SFAS 155 at 1 January 2006	**467**		
Balance brought forward (restated)	**93,991**		
Net income	**16,358**	14,703	12,506
Dividends	**(8,769)**	(7,750)	(6,932)
Share options	**735**	450	234
Shares issued in lieu of dividends	**2,525**	1,811	2,607
New share capital subscribed net of costs	**–**	1,405	581
Other, including movements in own shares held	**567**	94	(148)
Net change in net unrealised losses on available-for-sale securities, net of tax effect	**(450)**	(2,716)	(837)
Net change in net unrealised gains on derivatives classified as cash flow hedges, net of tax effect	**(255)**	1	(349)
Minimum pension liability adjustment, net of tax effect	**340**	(236)	(195)
SFAS 158 transition adjustment, net of tax	**(1,406)**	–	–
Exchange differences and other movements	**4,904**	(4,320)	2,364
Total other comprehensive income	**3,133**	(7,271)	983
At 31 December	**108,540**	93,524	90,082

Notes on the Financial Statements (continued)

Note 47

Consolidated US GAAP balance sheet

The following table provides an estimated summarised consolidated balance sheet for HSBC which incorporates the adjustments arising from the application of US GAAP.

	At 31 December	
	2006	2005
	US$m	US$m
Assets		
Cash and balances at central banks	**12,725**	13,712
Items in the course of collection from other banks	**14,626**	11,300
Hong Kong Government certificates of indebtedness	**13,165**	12,554
Trading assets	**325,149**	235,964
Derivatives	**43,083**	29,295
Loans and advances to banks	**185,081**	125,751
Loans and advances to customers	**798,534**	689,414
Financial investments	**212,233**	188,637
Interest in associates and joint ventures	**7,915**	7,163
Goodwill and intangible assets	**39,003**	35,081
Property, plant and equipment	**13,580**	14,891
Other assets (including prepayments and accrued income)	**47,533**	43,182
Total assets	**1,712,627**	1,406,944
Liabilities		
Hong Kong currency notes in circulation	**13,165**	12,554
Deposits by banks	**99,089**	69,895
Customer accounts	**846,647**	704,647
Items in the course of transmission to other banks	**12,625**	7,022
Trading liabilities	**164,744**	148,451
Derivatives	**40,837**	29,410
Debt securities in issue	**279,859**	225,681
Financial liabilities designated at fair value	**28,368**	–
Retirement benefit liabilities	**5,555**	3,217
Other liabilities (including accruals and deferred income)	**27,993**	39,385
Liabilities under insurance contracts issued	**17,672**	14,157
Provisions	**16,601**	4,285
Subordinated liabilities	**45,031**	45,612
Total liabilities	**1,598,186**	1,304,316
Equity		
Total shareholders' equity	**108,540**	93,524
Minority interests	**5,901**	9,104
Total equity	**114,441**	102,628
Total equity and liabilities	**1,712,627**	1,406,944

Net assets arising due to reverse repo transactions of US$45,019 million (2005: US$24,754 million), US$18,755 million (2005: US$14,610 million) and US$74,344 million (2005: US$51,125 million) are included in 'Loans and advances to banks', 'Loans and advances to customers' and 'Trading assets' respectively.

Net liabilities arising due to repo transactions of US$18,094 million (2005: US$10,005 million), US$13,600 million (2005: US$13,523 million) and US$65,445 million (2005: US$52,218 million) are included in 'Deposits by banks', 'Customer accounts' and 'Trading liabilities' respectively. Average repo liabilities during the year were US$102,715 million (2005: US$74,143 million). The maximum quarter-end repo liability outstanding during the year was US$109,689 million (2005: US$78,590 million).

At 31 December 2006, collateral received under reverse repo transactions which HSBC had the right to sell or repledge amounted to US$161,638 million gross (2005: US$103,977 million). Approximately US$119 billion (2005: approximately US$79 billion) of the collateral obtained from reverse repo transactions had been sold or repledged by HSBC in connection with repo transactions and securities sold not yet purchased.

HSBC also enters into stock lending and borrowing transactions by which either cash or other securities may be received in exchange for stock. At 31 December 2006, stock borrowing transactions where the securities borrowed were subject to sale or repledge amounted to US$26,370 million (2005: US$25,783 million).

Approximately US$17 billion (2005: US$18 billion) of the consideration received has been sold or repledged in connection with stock borrowing transactions.

(a) Pension and post-retirement costs

On 31 December 2006, HSBC adopted the recognition and disclosure provisions of SFAS 158 'Employers' Accounting for Defined Benefit Pension and Other Post-retirement Plans – an amendment of FASB Statements No. 87, 88, 106 and 132(R)' (SFAS 158), SFAS 158 requires HSBC to recognise the funded status of its pension plans in a manner similar to IAS 19.

The provisions of SFAS 87 'Employers' accounting for pensions' and SFAS 158 have been applied to HSBC's main defined benefit pension plans, which make up approximately 96 per cent of all HSBC's schemes by plan assets. For non-US schemes, HSBC has applied SFAS 87 with effect from 30 June 1992 as it was not feasible to apply as at 1 January 1989, the date specified in the standard.

The transition adjustments for adoption of SFAS 158 for pensions and post-retirement costs were as follows:

	Before application of Statement 158 US$m	Adjustments US$m	After application of Statement 158 US$m
Other assets (including prepayments and accrued income)	47,589	56	47,533
Total assets	1,712,683	56	1,712,627
Retirement benefit liabilities	7,555	2,000	5,555
Provisions	15,951	(650)	16,601
Total liabilities	1,596,836	(1,350)	1,598,186
Total shareholders' equity	109,946	1,406	108,540

Components of net periodic benefit cost related to HSBC's defined benefit pension plans and post-retirement benefits other than pensions under US GAAP were as follows:

	2006 US$m	2005 US$m	2004 US$m
Components of net periodic benefit cost			
Service cost	779	684	590
Interest cost	1,485	1,377	1,305
Expected return on plan assets	(1,601)	(1,365)	(1,317)
Amortisation of transition obligation	–	8	12
Amortisation of prior service cost	7	(6)	5
Amortisation of recognised net actuarial loss	202	165	142
Curtailment	(8)	(4)	225
Net periodic pension cost under US GAAP	864	859	962
Net periodic pension cost under IFRSs	664	684	837

In 2007, components of net periodic benefit cost will include US$7 million for the amortisation of prior service cost and US$164 million for amortisation of recognised net actuarial loss.

Under the provisions of SFAS 87, when a pension plan's accumulated benefit obligation (the value of the benefits accrued based on employee service up to the balance sheet date) exceeds the fair value of its assets, an additional minimum pension liability equal to this excess is recognised by the employer to the extent that the excess is greater than any accrual which has already been established for unfunded pension costs. Simultaneously, an intangible asset is established equal to the lower of the liability recognised for the unfunded benefit obligation and the amount of any unrecognised prior service cost.

At 31 December 2006, HSBC recognised an additional minimum pension liability of US$3,130 million prior to adoption of FAS158 (2005: US$3,206 million) in respect of its unfunded accumulated benefit obligation.

Notes on the Financial Statements (continued)

Note 47

Disclosures in 2005

	2005 US$m
Funded status as per IFRSs balance sheet (Note 7)	(3,941)
Unrecognised net actuarial loss	4,756
Unrecognised prior service cost	35
Accrued pension cost	850
Additional minimum liability	(3,206)
Net amount recognised under US GAAP	(2,356)
Amounts recognised under US GAAP in the balance sheet consist of:	
– prepaid benefit cost	1,434
– accrued benefit liability	(584)
– additional minimum liability	(3,206)
	(2,356)
US GAAP adjustment	
Amount recognised under US GAAP	(2,356)
Amounts recognised for these schemes under IFRSs	(3,941)
	1,585

In 2005, plans with an aggregated accumulated benefit obligation of US$21,098 million and assets with an aggregated fair value of US$18,444 million had an accumulated benefit obligation in excess of plan assets. Plans with an aggregated projected benefit obligation of US$22,595 million and assets with an aggregated fair value of US$18,795 million had a projected benefit obligation in excess of plan assets.

The projected benefit obligations at 31 December 2005 for HSBC's main pension plans have been calculated using the same financial assumptions as detailed in Note 7.

The accumulated benefit obligation in respect of the above schemes was:

	2005 US$m
HSBC Bank (UK) Pension Scheme	19,709
Other schemes	5,241

The projected benefit obligations at 31 December 2006 and 2005 for HSBC's main post-retirement healthcare plans have been calculated using the same financial assumptions as detailed in Note 7.

(b) Goodwill

Goodwill arises on the acquisition of subsidiaries, investments in associates and interests in joint ventures when the cost of acquisition exceeds the fair value of HSBC's share of the identifiable assets, liabilities and contingent liabilities acquired.

Under IFRSs (and before them, UK GAAP), goodwill arising on acquisitions made on or after 1 January 1998 is included in the balance sheet in 'Goodwill and intangible assets' in respect of subsidiary undertakings, and in 'Interests in associates and joint ventures' in respect of associates and joint ventures. Capitalised goodwill was amortised over its estimated useful life on a straight-line basis until the adoption of IFRSs on 1 January 2004, since then it is not amortised but is subject to annual impairment testing. Goodwill arising on acquisitions prior to 1 January 1998 was charged against reserves in the year of acquisition. This goodwill was not reinstated on the balance sheet upon adoption of IFRSs.

Under US GAAP, goodwill on acquisitions made before 1 July 2001, including those made before 1 January 1998, would have been capitalised and amortised over its useful economic life. Goodwill on acquisitions made after 1 July 2001 is capitalised but not amortised, and is subject to annual impairment testing. Goodwill on acquisitions made before 1 July 2001 ceased to be amortised on 1 January 2002 and is subject to annual impairment testing.

At 31 December 2006, the cost of goodwill arising on the acquisition of subsidiaries on a US GAAP basis was US$37,670 million (2005: US$34,147 million; 2004: US$36,084 million) and the accumulated amortisation of goodwill was US$3,952 million (2005: US$3,873 million; 2004: US$4,385 million).

(c) Intangible assets

The following intangible assets were recognised under US GAAP:

	2006 US$m	2005 US$m
Balance brought forward at 1 January	**4,702**	4,608
Additions	**857**	580
On acquisition of subsidiaries	**330**	271
Amortisation charge	**(840)**	(905)
Changes in fair value of mortgage servicing rights	**(44)**	–
Provision for impairment	**(84)**	34
Exchange differences and other movements	**364**	114
Balance carried forward at 31 December	**5,285**	4,702

Since 1 January 2004, the accounting treatment for intangible assets has generally been consistent between IFRSs and US GAAP. The additional intangible assets recognised under US GAAP represent those acquired in business combinations during the period between SFAS 141 'Business combinations' becoming effective on 30 June 2001 and IFRSs being adopted on 1 January 2004. They primarily comprise credit card and other loan relationships, merchant relationships and other intangibles assumed on the acquisition of HSBC Finance.

The provision for impairment in 2006 relates primarily to a write down of a merchant relationship. Provision for impairment in 2005 relates to the release of a provision for the write-down of mortgage servicing rights, as prepayment rates slowed. Changes in the value of mortgage servicing rights in 2006 follow the adoption of SFAS 156 on 1 January 2006.

HSBC conducts an annual impairment test of intangible assets which are not subject to annual amortisation since HSBC determines these assets have indefinite lives. As a result of this testing in 2006, no impairment charge was recorded (2005: US$13 million was recorded relating to a trade name in the UK).

	Weighted average amortisation period Months	At 31 December 2006 Cost US$m	Accumulated Amortisation US$m	Carrying Value US$m
Intangible assets subject to annual amortisation				
Purchased credit card relationships and related programmes	98	**2,503**	**(636)**	**1,867**
Retail services merchant relationship	60	**270**	**(203)**	**67**
Other loan related relationships	109	**333**	**(135)**	**198**
Technology, customer lists and other contracts	61	**3,162**	**(2,056)**	**1,106**
Core deposit relationships	210	**233**	**(144)**	**89**
Other	60	**649**	**(80)**	**569**
		7,150	**(3,254)**	**3,896**
Intangible assets not subject to annual amortisation				
Trade name		**928**	**(13)**	**915**
		8,078	**(3,267)**	
Intangible assets measured at fair value				
Mortgage servicing rights				**474**
				5,285

The intangible asset amortisation expense under US GAAP for the next five years is estimated to be:

	2007 US$m	2008 US$m	2009 US$m	2010 US$m	2011 US$m
Amortisation charge	765	662	548	515	411

(d) Derivatives and hedge accounting

Under IFRSs, all derivatives are recorded at fair value, consistent with US GAAP. Under IFRSs, HSBC has elected either hedge accounting or fair value option for certain economic hedging relationships. With the exception of US operating subsidiaries, HSBC has not elected hedge accounting in its US GAAP financial statements.

HSBC's US operating subsidiaries designate certain derivative financial instruments as qualifying hedging instruments under SFAS 133.

HSBC utilised the shortcut method when the critical terms of the hedge instrument were identical to those of the hedged item at the hedge inception date. HSBC's US subsidiaries made use of the assumption of no ineffectiveness in its fair value hedge accounting for short-cut hedges. As a result, no retrospective or prospective assessment of effectiveness was required and no hedge ineffectiveness was recognised. All other hedge relationships were accounted for under the 'long-haul' method whereby effectiveness is assessed and ineffectiveness on effective hedges is recorded in the income statement.

During 2006, new designations of hedges were made using the long-haul method of accounting under SFAS 133 and certain relationships have been re-designated using this method. As a result, there were no longer any cash flow hedges or fair value hedges using the shortcut method of accounting at 31 December 2006.

The following table summarises HSBC's hedges of financial instruments that have been designated and qualify as effective hedges under SFAS 133 at the end of the period.

	Nominal values				Number of derivatives			
	Fair value hedges 2006 US$bn	**Cash flow hedges 2006 US$bn**	Fair value hedges 2005 US$bn	Cash flow hedges 2005 US$bn	**Fair value hedges 2006**	**Cash flow hedges 2006**	Fair value hedges 2005	Cash flow hedges 2005
Financial investments:								
Available for sale debt securities								
Shortcut	–	–	–	–	–	–	1	–
Long-haul	**1.8**	–	0.2	–	**52**	–	10	–
Customer deposits								
Shortcut	–	–	–	–	–	–	–	–
Long-haul	–	**10.9**	–	6.8	**2**	**24**	1	17
Debt securities in issue and subordinated liabilities								
Shortcut	–	–	3.0	–	–	–	16	–
Long-haul	**33.0**	**52.1**	18.2	46.8	**112**	**160**	45	165
Total	**34.8**	**63.0**	21.4	53.6	**166**	**184**	73	182

Fair value hedges

HSBC's US operating subsidiaries designate certain derivative financial instruments as qualifying fair value hedges of certain fixed rate assets and liabilities under SFAS 133. In order to qualify initially, hedge effectiveness is assessed and demonstrated on a prospective basis utilising statistical regression analysis.

Since 1 January 2005, almost all derivatives designated as fair value hedges under US GAAP in HSBC's US operating subsidiaries have been reported under the fair value option for IFRSs purposes, with movements in fair value reported as 'Net income from financial instruments designated as at fair value'. HSBC's US operating subsidiaries have also elected to record financial instruments at fair value for which fair value hedge accounting is not utilised for US GAAP.

Reporting of these arrangements as fair value hedges under US GAAP resulted in increased net income for 2006 of US$194 million, which included US$348 million arising from elimination of losses due to movements in own credit spread recorded in IFRS net income. Off-setting the increase to net income under US GAAP arising for the elimination of losses due to own credit spread is a decrease to US GAAP net income of US$134 million due to amortization of hedge valuation adjustments for de-designated hedge relationships under US GAAP that are accounted as FVO under IFRSs.

Reporting of these arrangements as fair value hedges under US GAAP resulted in decreased net income for 2005 of US$179 million, including US$7 million arising from elimination of gains due to movements in own credit spread recorded in IFRSs net income and reduced ineffectiveness of US$172 million on shortcut fair value hedges for US GAAP purposes. In addition, there were US$9 million of gains on such derivatives that did not qualify for hedge accounting under US GAAP and amortisation of hedge valuation adjustments for de-designated hedge relationships.

On electing to report under the fair value option under IAS 39, unamortised purchase accounting adjustments on HSBC Finance Corporation's own debt were eliminated through retained earnings upon transition to IAS 39 on 1 January 2005. As a result, a US$27 million benefit (2005: US$298 million benefit) to US GAAP net income was not recognised under IFRSs.

Cash flow hedges

HSBC's US operating subsidiaries designate under SFAS 133 certain derivative financial instruments, including interest rate swaps and cross-currency contracts, as qualifying cash flow hedges of the forecast repricing of certain deposit liabilities and issues of debt. A number of variable rate commercial loans were also subject to cash flow hedges up until 2004.

In order to qualify initially, hedge effectiveness is assessed and demonstrated on a prospective basis utilising both statistical regression analysis and the cumulative dollar offset method. The latter is used in order to satisfy the retrospective assessment of effectiveness for SFAS 133, and subsequent ineffectiveness is recognised in the income statement on a monthly basis. The time value component of the derivative contracts is excluded from the assessment of hedge effectiveness.

Since 1 January 2005, such hedging arrangements have been recognised as cash flow hedges for IFRSs purposes. US GAAP net income for 2006 was lower than that under IFRSs by US$20 million (2005: US$6 million), relating to differences in amortisation of other comprehensive income for de-designated hedge relationships under US GAAP and IFRS and unrecorded ineffectiveness on shortcut cash flow hedges during 2005 for US GAAP purposes.

Trading derivatives

From 1 January 2005, certain hedging relationships outside North America were elected and qualified as fair value hedges, were designated under the fair value option, or were elected and qualified as cash flow hedges under IAS 39, but were not elected as hedges under SFAS 133. The mark to market for these derivatives has been reported directly in net income for US GAAP purposes.

For fair value hedges recognised under IFRSs, no corresponding, offsetting fair value movement of the hedged item with respect to the hedged risk has been recorded for US GAAP purposes. For hedging relationships designated as at fair value for IFRSs purposes, no fair value movement in respect of own debt is recorded under US GAAP.

The effect of this was to increase US GAAP net income by US$214 million (2005: US$1,266 million reduction), net of elimination of a loss under IFRS of US$41 million (2005: US$76 million loss) of own credit spread, outside North America.

Fair value option

HSBC has also applied the fair value option under IFRSs to groups of financial assets and liabilities which are managed and evaluated on a fair value basis, and to financial instruments containing embedded derivatives (see Note 3). In addition, movements in the fair value of certain liabilities which meet the definition of 'held for trading' under IAS 39 are taken through net income. US GAAP does not include a fair value election and does not generally permit liabilities to be reported at fair value.

From 1 January 2006, with HSBC's adoption of SFAS 155, the Group's hybrid debt issues that contain an embedded derivative that would otherwise require bifurcation, are accounted for in a consistent manner under both IFRSs and US GAAP, where such instruments are designated to be measured at fair value. The elimination of all other fair value option accounting increased US GAAP net income for 2006 by US$193 million (2005: US$733 million reduction prior to the adoption of SFAS 155).

Notes on the Financial Statements (continued)

(e) Foreign exchange gains on available-for-sale securities

HSBC holds, in a number of different currencies, securities which are classified as available-for-sale. For example, in the private bank in Switzerland, which has the US dollar as its reporting currency, HSBC holds euro-denominated bonds funded in euros and Swiss franc securities funded in Swiss francs. No foreign exchange exposure arises from this because, although the value of the assets in US dollar terms changes according to the exchange rate, there is an identical offsetting change in the US dollar value of the related funding. Under IFRSs both the assets and the liabilities are translated at closing exchange rates and the differences between historical book value and current value are reflected in foreign exchange trading income. This reflects the economic substance of holding currency assets financed by currency liabilities.

However, under US GAAP accounting rules, the change in value of the investments classified as available-for-sale is taken directly to reserves while the offsetting change in US dollar terms of the borrowing is taken to earnings. This leads to an accounting result which does not reflect either the underlying risk position or the economics of the transactions. It is also a situation that will reverse on maturity of the asset or earlier sale.

A similar difference arises when foreign currency exposures on foreign currency assets are covered using forward contracts but HSBC does not manage these hedges to conform with the detailed US hedge designation requirements.

The result is that for 2006, US GAAP net income was increased by US$1,203 million (2005: increased by US$2,235 million; 2004: increased by US$1,069 million) compared with IFRSs profits. There was no difference in shareholders' equity between IFRSs and US GAAP as a result of this item.

Approximately 50 per cent of the adjustment for the year ended 2006 reflected the level of adjustments in prior periods on the maturity or disposal of securities. The remainder of the adjustment reflected a weakening of the US dollar, where a loss on US dollar denominated available-for-sale securities in subsidiaries with sterling as their reporting currency was offset by gains on sterling and euro denominated available-for-sale securities in subsidiaries with the US dollar and the Hong Kong dollar as their reporting currencies. This loss has been recorded in IFRSs net income but is recorded directly in 'Other comprehensive income' under US GAAP. Any gain on foreign currency liabilities funding the securities is recorded in net income under both IFRSs and US GAAP.

(f) Financial investments

Under US GAAP, HSBC's financial investments with a readily determinable market value are classified as available-for-sale securities, except for certain securities held by Republic New York Corporation at acquisition, which were classified as held-to-maturity. All other securities are categorised as trading securities.

The amortised cost of available-for-sale investment securities which are subject to the provisions of SFAS 115 was US$216,096 million (2005: US$188,868 million) under US GAAP. During the year, excluding the effects of foreign exchange, US$910 million (2005: losses of US$899 million; 2004: gains of US$376 million) of net unrealised gains on available-for-sale securities were included in 'Other comprehensive income'. US$644 million (2005: gains of US$626 million; 2004: gains of US$476 million) of net gains were reclassified out of 'Other comprehensive income' and recognised as part of income for the year.

Available-for-sale

Unrealised losses on investment securities:

Under US GAAP, investment securities that had unrealised losses are summarised according to the length of time the losses have existed:

	Period investment has been in an unrealised loss position:					
	less than one year		greater than or equal to one year		Total	
	Fair value	Unrealised losses	Fair value	Unrealised losses	Fair value	Unrealised losses
	US$m	US$m	US$m	US$m	US$m	US$m
At 31 December 2006						
US Treasury	**794**	**(12)**	**618**	**(9)**	**1,412**	**(21)**
US Government agencies	**2,825**	**(41)**	**1,339**	**(35)**	**4,164**	**(76)**
US Government sponsored entities	**3,343**	**(114)**	**6,009**	**(171)**	**9,352**	**(285)**
UK Government	**2,070**	**(23)**	**–**	**–**	**2,070**	**(23)**
Hong Kong Government	**–**	**–**	**631**	**(6)**	**631**	**(6)**
Other governments	**5,188**	**(56)**	**5,472**	**(49)**	**10,660**	**(105)**
Asset-backed securities	**3,989**	**(5)**	**1,252**	**(6)**	**5,241**	**(11)**
Corporate debt and other securities	**26,330**	**(43)**	**17,943**	**(226)**	**44,273**	**(269)**
Debt securities	**44,539**	**(294)**	**33,264**	**(502)**	**77,803**	**(796)**
Equity securities	**41**	**(8)**	**–**	**–**	**41**	**(8)**
Total	**44,580**	**(302)**	**33,264**	**(502)**	**77,844**	**(804)**

Under US GAAP, 4,811 debt security investments and 37 investments in equity shares had unrealised losses at 31 December 2006.

	Period investment has been in an unrealised loss position:					
	less than one year		greater than or equal to one year		Total	
	Fair value	Unrealised losses	Fair value	Unrealised losses	Fair value	Unrealised losses
	US$m	US$m	US$m	US$m	US$m	US$m
At 31 December 2005						
US Treasury	1,136	(22)	78	(1)	1,214	(23)
US Government agencies	1,385	(28)	570	(24)	1,955	(52)
US Government sponsored entities	8,955	(192)	2,811	(100)	11,766	(292)
UK Government	56	–	225	(1)	281	(1)
Hong Kong Government	1,259	(23)	126	–	1,385	(23)
Other governments	3,457	(33)	6,187	(54)	9,644	(87)
Asset-backed securities	1,522	(7)	367	(5)	1,889	(12)
Corporate debt and other securities	32,423	(284)	8,726	(131)	41,149	(415)
Debt securities	50,193	(589)	19,090	(316)	69,283	(905)
Equity securities	52	(6)	–	–	52	(6)
Total	50,245	(595)	19,090	(316)	69,335	(911)

Under US GAAP, 3,615 debt security investments and 15 investments in equity shares had unrealised losses at 31 December 2005.

It is HSBC's policy, under both IFRSs and US GAAP, to recognise in the income statement an impairment if the fair value of a financial investment significantly declines below its cost or if the decline is prolonged over a period exceeding six months. The only exception to this policy is in respect of debt securities whose decline in market value is due solely to an increase in underlying interest rates, and which HSBC has the ability and intent to hold until recovery. None of the securities disclosed in the table above were considered 'other-than-temporarily' impaired at 31 December 2006 or 2005.

(g) Taxation

The components of the net deferred tax liability calculated under SFAS 109 'Accounting for income taxes', were as follows:

	2006	2005
	US$m	US$m
Deferred tax liabilities		
Leasing transactions	**1,681**	2,533
Capital allowances	**310**	138
Provision for additional UK tax on overseas dividends	**112**	18
Reconciling items	**1,334**	2,163
Other	**4,227**	2,004
Total deferred tax liabilities	**7,664**	6,856
Deferred tax assets		
Loan impairment allowances	**3,011**	1,974
Tax losses	**847**	587
Reconciling items	**1,349**	1,050
Other	**5,664**	4,981
Total deferred tax assets before valuation allowance	**10,871**	8,592
Less: valuation allowance	**(1,187)**	(794)
Deferred tax assets less valuation allowance	**9,684**	7,798
Net deferred tax asset under SFAS 109	**2,020**	942
Included within 'other assets' under US GAAP	**2,592**	2,717
Included within 'deferred tax liabilities' under US GAAP	**(572)**	(1,775)

The valuation allowance against deferred tax assets principally relates to trading and capital losses carried forward, which have not been recognised due to uncertainty over their utilisation. A valuation allowance is established to reduce deferred tax assets if, based on available evidence, it is considered more likely than not that any of the deferred tax assets will not be realised.

At 31 December 2006, HSBC had recognised deferred tax assets in respect of tax losses (net of valuation allowances) totalling US$180 million (2005: US$223 million), of which US$4 million (2005: US$4 million) expire within two to five years and US$176 million (2005: US$219 million) expire in 5 years or more.

(h) Loans and advances

Loans assessed under SFAS 114 'Accounting by creditors for impairment of a loan'

SFAS 114 was amended by SFAS 118 'Accounting by creditors for impairment of a loan – income recognition and disclosures'. SFAS 114 addresses accounting by creditors for impairment of a loan by specifying how allowances for credit losses for certain loans should be determined. A loan is impaired when it is probable that the creditor will be unable to collect all amounts in accordance with the contractual terms of the loan agreement. Impairment is measured based on the present value of expected future cash flows discounted at the loan's effective rate or, as an expedient, at the fair value of the loan's collateral. Leases, smaller-balance homogeneous loans and debt securities are excluded from the scope of SFAS 114.

At 31 December 2005, HSBC estimated that the difference between the carrying value of its loan portfolio on the basis of SFAS 114 and its value in HSBC's IFRSs financial statements was such that no adjustment to net income or total shareholders' equity was required.

The value of impaired loans at 31 December 2006 was US$13,800 million (2005: US$11,535 million). Of this total, loans which were included within the scope of SFAS 114 and for which a provision had been established amounted to US$5,944 million (2005: US$5,082 million). The impairment reserve in respect of these loans estimated in accordance with the provisions of SFAS 114 was US$2,572 million (2005: US$2,675 million). During the year ended 31 December 2006, impaired loans, including those excluded from the scope of SFAS 114, averaged US$11,791 million (2005: US$11,289 million) and interest income recognised on these loans was US$276 million (2005: US$120 million).

Loans outside the scope of SFAS 114

For smaller-balance homogeneous loans for which future cash flows from written-off balances can reasonably be estimated on a portfolio basis, an asset equal to the present value of the cash flows is recognised under IFRSs as it was previously under UK GAAP. This asset is not recognised for US GAAP purposes. This divergence resulted in lower net income in 2006 of US$45 million (2005: US$20 million higher) under US GAAP compared with IFRSs, and a reduction in the carrying value of loans and advances to customers and shareholders' equity at 31 December 2006 of US$372 million (2005: US$327 million).

(i) Earnings per share

Basic earnings per share under US GAAP, SFAS 128 'Earnings per Share', is calculated by dividing net income attributable to ordinary shareholders of the parent company of US$16,268 million (2005: US$14,703 million; 2004: US$12,506 million) by the weighted average number of ordinary shares in issue in 2006 of 11,214 million (2005: 11,042 million; 2004: US$10,916 million).

Diluted earnings per share under US GAAP is calculated by dividing net income, which requires no adjustment for the effects of dilutive ordinary potential shares, by the weighted average number of shares outstanding plus the weighted average number of ordinary shares that would be issued on conversion of all the dilutive potential ordinary shares in 2006 of 11,324 million (2005: 11,175 million; 2004: 11,063 million).

(j) Variable interest entities ('VIEs')

Nature, purpose and activities of VIEs with which HSBC is involved

HSBC uses VIE structures in the normal course of business in a variety of activities (outlined below), but primarily to facilitate client needs. HSBC's involvement in VIEs is, therefore, commercially driven. VIEs are only used after careful consideration is given to the most appropriate structure to achieve HSBC's objectives from control, risk allocation, taxation and regulatory perspectives. The main VIEs are discussed below.

(i) Asset-backed conduits ('ABCs') and securitisation vehicles

ABCs and securitisation vehicles are structures in which interests in consumer and commercial receivables are sold to investors. ABCs generally consist of entities which purchase assets from clients to meet their financing needs, while securitisation vehicles generally acquire assets originated by HSBC itself and thereby provide HSBC with a cost-effective source of financing. Under both structures, commercial paper, notes, or equity interests are issued to investors to fund the purchase of receivables, and cash received from the receivables is used to service the finance provided by the investors. In certain instances, HSBC receives fees for providing liquidity facility commitments and for acting as administrator of the vehicle.

HSBC's exposure to loss generally arises from commitments to provide back-up liquidity facilities for the vehicles; interest-rate swaps in which HSBC is the counterparty; retained or acquired interests in the receivables sold; or acquired interests in the vehicles themselves. In certain vehicles, the risk of loss to HSBC is reduced by credit enhancements provided by the originator of the receivables or other parties.

In addition to these securitisation vehicles, HSBC (primarily through its North American subsidiaries) securitises assets through entities that are not considered VIEs, including government-sponsored financing vehicles and vehicles considered qualifying special-purpose entities under US GAAP. These entities are not consolidated under US GAAP although certain of them are consolidated under IFRSs.

(ii) Infrastructure projects and funds

HSBC acts as an arranger for both public and private infrastructure projects and funds. The use of VIE structures in such projects is common as a method of attracting a wider class of investor by dividing into tranches the risk associated with such projects. HSBC's exposure to loss generally arises from the provision of subordinated or mezzanine debt finance to projects, either directly or through a consolidated investment fund investing in infrastructure projects.

HSBC is deemed to be the primary beneficiary of an infrastructure project or fund when its investment in a project's equity, subordinated debt or mezzanine debt, or its interest in a fund, is at a level at which it absorbs the majority of the expected losses or residual returns of the project or fund.

Application of FIN 46R

FIN 46R requires the consolidation of VIEs in which HSBC is the primary beneficiary, and disclosures in respect of other VIEs in which HSBC has a significant variable interest.

Under IFRSs, HSBC consolidates entities in which it has a controlling interest. For SPEs, determination of the entity that holds the controlling interest involves a balanced assessment of certain factors, including an analysis of risks and rewards incidental to their activities. HSBC's interests in entities deemed to be VIEs may result in differences in accounting and disclosure treatment under US GAAP.

The following table analyses HSBC's total consolidated VIE assets in a US GAAP balance sheet:

	At 31 December	
	2006	2005
	US$m	US$m
Classification		
Loans and advances to customers	**23,937**	23,843
Financial investments	**27,715**	4,403
Tangible fixed assets	**1,617**	2,017
Other assets	**876**	256
	54,145	30,519

Of the 2006 total, US$48,699 million (2005: US$23,843 million) represented asset-backed commercial paper conduits and securitisation vehicles, and US$2,683 million (2005: US$2,017 million) represented infrastructure projects and funds. The remaining balance consisted of guaranteed pension funds, investment funds, and other entities. Certain of these entities with assets of approximately US$54,145 million at 31 December 2006 (2005: US$19,475 million) were consolidated by HSBC in its IFRSs financial statements. There was no significant impact on net income under US GAAP for the year ended 31 December 2006 as a result of consolidating these VIEs.

HSBC also had significant involvement in, but was not the primary beneficiary of, VIEs with total assets of approximately US$101.3 billion (2005: US$86.2 billion), including asset-backed commercial paper conduits and securitisation vehicles with assets of approximately US$32.5 billion (2005: US$14.7 billion), infrastructure projects and funds of approximately US$6.0 billion (2005: US$6.2 billion), and interests in investment funds, low income housing tax credit partnerships, guaranteed pension funds, government debt restructuring programmes and other entities. HSBC's maximum exposure to loss in relation to these entities was estimated at US$19.5 billion (2005: US$9.7 billion) which arose from guarantees, retained interests and recourse liabilities. HSBC was also involved in other investment funds and similar entities that are considered VIEs for which its involvement was limited to that of administrator, investment adviser, or other service provider.

In addition, HSBC had an interest in certain capital funding vehicles that are consolidated under IFRSs. However, under US GAAP, these vehicles were not recognised on HSBC's balance sheet because it was not the primary beneficiary.

(k) Consolidated cash flow statement

HSBC prepares its cash flow statement in accordance with IAS 7 'Cash Flow Statements', which is consistent with the objectives and principles of SFAS 95 'Statement of Cash Flows' as amended by SFAS 104 'Statement of Cash Flows – Net Reporting of Certain Cash Receipts and Cash Payments and Classification of Cash Flows from Hedging Transactions'.

(l) Securitisations

HSBC Finance

Following the acquisition of HSBC Finance in 2003, HSBC increased its securitisation activity and the following discussion relates only to HSBC Finance's securitisation activities including securitised credit card receivables transferred to HSBC Bank USA. In other HSBC entities such activities do not represent a significant part of HSBC's business and retained interests in securitisations are not significant.

In the third quarter of 2004, HSBC began to structure all new collateralised funding transactions as secured financings. In a secured financing, the underlying receivables and debt remain on HSBC's balance sheet. HSBC does not recognise a gain in a secured financing transaction. At 31 December 2006, secured financings of US$23.9 billion included in long-term debt were secured by US$30.5 billion of customer loans.

Prior to the third quarter of 2004, HSBC sold MasterCard and Visa private label, personal non-credit card and vehicle finance loans in various securitisation transactions. HSBC continues to service and receive servicing fees on the outstanding balance of these securitised loans and retains rights to future cash flows arising from the loans after the investors receive their contractual return. HSBC has also, in certain cases, retained other subordinated interests in these securitisations. These transactions result in the recording of interest-only strip receivables, which represent the value of the future residual cash flows from securitised loans. The investors and the securitisation trusts have only limited recourse to HSBC assets for failure of debtors to pay. That recourse is limited to HSBC's rights to future cash flows and any subordinated interest retained. Servicing assets and liabilities are not recognised in conjunction with securitisations since HSBC receives adequate compensation relative to current market rates to service the loans sold.

Securitisation-related revenue includes income associated with the current and prior period securitisation of loans with limited recourse structured as sales under US GAAP. Such income includes gains on sales, net of the estimate of probable credit losses under the recourse provisions, servicing income and excess spread relating to those loans.

The following table provides a summary of securitisation revenue:

	2006 US$m	2005 US$m	2004 US$m
Net initial gains	**–**	–	25
Net replenishment gains from revolving securitisations	**30**	154	414
Servicing revenue and excess spread	**169**	212	569
Other	**–**	6	–
Total securitisation revenue	**199**	372	1,008

Certain revolving securitisation trusts, such as credit cards, are established at fixed levels and require frequent sales of new loan balances into the trusts to replace loans as they run off. These replenishments totalled US$6 billion in 2006 (2005: US$17.5 billion). Cash flows received from securitisation trusts were as follows:

	Real estate secured US$m	**Vehicle finance US$m**	**MasterCard /Visa US$m**	**Private label US$m**	**Personal non-credit card US$m**	**Total US$m**
2006						
Proceeds from initial securitisations	**–**	**–**	**–**	**–**	**–**	**–**
Servicing fees received	**–**	**16**	**22**	**45**	**10**	**93**
Other cash flows received on retained interests[1]	**–**	**97**	**108**	**11**	**18**	**234**
2005						
Proceeds from initial securitisations	–	–	–	–	–	–
Servicing fees received	–	45	97	50	46	238
Other cash flows received on retained interests[1]	–	40	243	109	52	444
2004						
Proceeds from initial securitisations	–	–	550	190	–	740
Servicing fees received	1	86	185	93	161	526
Other cash flows received on retained interests[1]	4	(9)	705	252	80	1,032

1 *Other cash flows included all cash flows from interest-only strip receivables, excluding servicing fees.*

At 31 December 2006, the sensitivity of the current fair value of the interest-only strip receivables to an immediate 10 per cent and 20 per cent unfavourable change in assumptions are presented in the table below. These sensitivities are based on assumptions used to value interest-only strip receivables at 31 December 2006.

	Vehicle finance	Credit Card	Personal non-credit card
Carrying value (fair value) of interest-only strip receivables (US$ millions)	**(4)**	**9**	**1**
Weighted average life (in years)	**0.7**	**0.3**	**0.3**
Payment speed assumption (annual rate)	**74.3%**	**98.9%**	**99.2%**
Impact on fair value of 10% adverse change (US$ millions)	**–**	**(1)**	**–**
Impact on fair value of 20% adverse change (US$ millions)	**(1)**	**(2)**	**–**
Expected credit losses (annual rate)	**10.0%**	**3.7%**	**9.8%**
Impact on fair value of 10% adverse change (US$ millions)	**(2)**	**–**	**–**
Impact on fair value of 20% adverse change (US$ millions)	**(3)**	**(1)**	**(1)**
Discount rate for residual cash flows (annual rate)	**10.0%**	**9.0%**	**11.0%**
Impact on fair value of 10% adverse change (US$ millions)	**–**	**–**	**–**
Impact on fair value of 20% adverse change (US$ millions)	**(1)**	**–**	**–**
Variable returns to investors (annual rate)	**–**	**4.7%**	**6.0%**
Impact on fair value of 10% adverse change (US$ millions)	**–**	**(1)**	**–**
Impact on fair value of 20% adverse change (US$ millions)	**–**	**(1)**	**(1)**

These sensitivities are hypothetical and should not be considered to be predictive of future performance. As the figures indicate, the change in fair value based on a 10 per cent variation in assumptions cannot necessarily be extrapolated because the relationship of the change in assumption to the change in fair value may not be linear. Also, in this table, the effect of a variation in a particular assumption on the fair value of the residual cash flow is calculated independently from any change in another assumption. In reality, changes in one factor may contribute to changes in another (for example, increases in market interest rates may result in lower prepayments) which might magnify or counteract the sensitivities. Furthermore, the estimated fair values as disclosed should not be considered indicative of future earnings on these assets.

Static pool credit losses are calculated by summing actual and projected future credit losses and dividing them by the original balance of each pool of asset. Due to the short-term revolving nature of MasterCard, Visa, and private label loan balances, the weighted average percentage of static pool credit losses is not considered to be materially different from the weighted average charge-off assumptions used in determining the fair value of interest-only strip receivables in the table above. At 31 December 2006, static pool credit losses for vehicle finance loans securitised in 2003 were estimated to be 10 per cent.

Activities of other North American subsidiaries

Through its North American operating subsidiaries, HSBC began acquiring residential mortgage loans from unrelated third parties in the middle of 2005 with the intention of securitising those loans. In 2006, certain loans originated by HSBC were also included in this securitisation program. HSBC does not service loans acquired from third parties in connection with these securitisations.

In addition to securitising loans, HSBC also securitises the net interest margin (NIM) associated with certain interests it retains from loan securitisations. A NIM securitisation is a structured finance transaction backed by the cash flows on certain classes of retained interests in loan securitisations, primarily residual interests. The notes issued in a NIM securitisation are collateralised by the excess spread left after absorbing any realised losses and satisfying the required over collateralisation levels in the underlying securitisation deal.

HSBC recorded pre-tax gains of US$113 million (2005: US$3 million) from securitisation transactions. Proceeds received from new securitisations were US$18 billion (2005: US$576 million), and cash flows from retained interests were US$35 million and (2005: US$7 million).

In connection with the securitisations, HSBC's retained interests include investment grade certificates of US$316 million and other residual interests of US$176 million at 31 December 2006. Residual interests of US$14 million were retained at 31 December 2005. Retained interests are recorded in trading assets and are measured at fair value. Investment grade certificates are valued using quoted market prices. Key assumptions used during 2006 and 2005 in measuring the fair value of residual interests at the date of securitisation are presented in the table below.

	2006	2005
Expected weighted average life (in years)	**2.1 – 2.7**	3
Payment speed assumption (annual rate)	**28.5 – 36.0%**	45.0%
Expected credit losses (annual rate)	**2.4 - 4.7%**	6.0%
Discount rate on residual cash flows (annual rate)	**15.0 – 25.0%**	20.0%

Key economic assumptions used in measuring the fair value of residual interests in mortgage loans securitisations and the sensitivity of the current fair values of residual interests to changes in those assumptions are presented in the table below:

	2006	2005
Expected weighted average life (in years)	**1.7 – 2.5**	3
Payment speed assumption (annual rate)	**31.5 – 44.2%**	45.0 %
Impact on fair value of 10% adverse change (US$ millions)	**(8)**	(1)
Impact on fair value of 20% adverse change (US$ millions)	**(17)**	(2)
Expected credit losses (annual rate)	**1.2 – 6.9%**	6.0%
Impact on fair value of 10% adverse change (US$ millions)	**(25)**	–
Impact on fair value of 20% adverse change (US$ millions)	**(41)**	–
Discount rate on residual cash flows (annual rate)	**15.0 – 25.0%**	20.0%
Impact on fair value of 10% adverse change (US$ millions)	**(8)**	–
Impact on fair value of 20% adverse change (US$ millions)	**(15)**	(1)

These sensitivities are hypothetical and should not be considered to be predictive of future performance. As the figures indicate, the change in fair value based on a 10 per cent variation in assumptions cannot necessarily be extrapolated because the relationship of the change in assumption to the change in fair value may not be linear. Also, in this table, the effect of a variation in a particular assumption on the fair value of the retained interests is calculated independently from any change in another assumption. In reality, changes in one factor may contribute to changes in another (for example, increases in market interest rates may result in lower prepayments) which might magnify or counteract the sensitivities.

Future US GAAP accounting developments

The Financial Accounting Standards Board ('FASB') has issued the following accounting standards, which will become fully effective in future financial statements.

In June 2006, the FASB issued Interpretation No. 48, 'Accounting for Uncertainty in Income Taxes – an Interpretation of FASB Statement No. 109' (FIN 48). FIN 48 establishes threshold and measurement attributes for financial statement measurement and recognition of tax positions taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. FIN 48 is effective for fiscal years beginning after 15 December 2006. Adoption of FIN 48 is not expected to have a material effect on the US GAAP information in HSBC's financial statements.

In September 2006, the FASB issued SFAS 157 'Fair Value Measurements'. SFAS 157 defines fair value, establishes a framework for measuring fair value in US GAAP and requires expanded disclosures about fair value measurements. SFAS 157 applies under many other extant US GAAP accounting pronouncements which prescribe that fair value is the relevant measurement, although the Statement does not extend the use of fair value for measurement purposes. SFAS 157 is effective for fiscal years beginning after 15 November 2007. HSBC is currently evaluating the impact that adoption of SFAS 157 will have on its US GAAP financial statements.

In February 2007, the FASB issued SFAS 159 'The Fair Value Option for Financial Assets and Financial Liabilities'. SFAS 159 creates a fair value option under which an entity may irrevocably elect fair value as the initial and subsequent measurement attribute for certain financial assets and liabilities on a contract-by-contract basis, with changes in fair value recognised in earnings as these changes occur. SFAS 159 is effective as of the beginning of the first fiscal year beginning after 15 November 2007. HSBC is currently studying the effect that adoption of SFAS 159 will have on its US GAAP financial statements.

Shareholder Information

Information about the enforceability of judgements made in the US

HSBC Holdings is a public limited company incorporated in England and Wales. Most of HSBC Holdings' Directors and executive officers live outside the US. As a result, it may not be possible to serve process on such persons or HSBC Holdings in the US or to enforce judgements obtained in US courts against them or HSBC Holdings based on civil liability provisions of the securities laws of the US. There is doubt as to whether English courts would enforce:

- certain civil liabilities under US securities laws in original actions; or
- judgements of US courts based upon these civil liability provisions.

In addition, awards of punitive damages in actions brought in the US or elsewhere may be unenforceable in the UK. The enforceability of any judgement in the UK will depend on the particular facts of the case as well as the laws and treaties in effect at the time.

Exchange controls and other limitations affecting equity security holders

There are currently no UK laws, decrees or regulations which would prevent the import or export of capital or remittance of distributable profits by way of dividends and other payments to holders of HSBC Holdings' equity securities who are not residents of the UK. There are also no restrictions under the laws of the UK or the terms of the Memorandum and Articles of Association of HSBC Holdings concerning the right of non-resident or foreign owners to hold HSBC Holdings' equity securities or, when entitled to vote, to do so.

Fourth interim dividend for 2006

The Directors have declared a fourth interim dividend of US$0.36 per ordinary share (in lieu of a final dividend). Information on the scrip dividend scheme and currencies in which shareholders may elect to have the cash dividend paid will be sent to shareholders on or about 3 April 2007. The timetable for the dividend is:

	2007
Shares quoted ex-dividend in London, Hong Kong and Bermuda; ADSs quoted ex-dividend in New York	21 March
Record date and closure of Hong Kong Overseas Branch Register of shareholders for one day	23 March
Shares quoted ex-dividend in Paris	26 March
Mailing of *Annual Report and Accounts 2006* and/or *Annual Review 2006*, Notice of Annual General Meeting and dividend documentation	3 April
Final date for receipt by registrars of forms of election and revocations of standing instructions for scrip dividends	26 April
Exchange rate determined for payment of dividends in sterling and Hong Kong dollars	30 April
Payment date: dividend warrants, new share certificates or transaction advices and notional tax vouchers mailed and shares credited to stock accounts in CREST	10 May

Shareholder Information (continued)

Dividends / Nature of trading market

Interim dividends for 2007

The Board has adopted a policy of paying quarterly interim dividends on the ordinary shares. Under this policy it is intended to have a pattern of three equal interim dividends with a variable fourth interim dividend. It is envisaged that the first interim dividend in respect of 2007 will be US$0.17 per ordinary share. The proposed timetables for the dividends in respect of 2007 are:

	Interim dividends for 2007			
	First	**Second**	**Third**	**Fourth**
Announcement	30 April 2007	30 July 2007	5 November 2007	3 March 2008
ADSs quoted ex-dividend in New York	16 May 2007	15 August 2007	20 November 2007	19 March 2008
Shares quoted ex-dividend in London, Hong Kong and Bermuda	16 May 2007	15 August 2007	21 November 2007	19 March 2008
Record date and closure of Hong Kong Overseas Branch Register of shareholders for one day	18 May 2007	17 August 2007	23 November 2007	25 March 2008
Shares quoted ex-dividend in Paris	21 May 2007	20 August 2007	26 November 2007	26 March 2008
Payment date	5 July 2007	4 October 2007	16 January 2008	7 May 2008

Dividends on the ordinary shares of HSBC Holdings

HSBC Holdings has paid dividends on its ordinary shares every year without interruption since it became the HSBC Group holding company by a scheme of arrangement in 1991. The dividends declared, per ordinary share, for each of the last five years were:

		First interim	Second interim	Third interim	Fourth interim[1]	Total[2]
2006	**US$**	**0.150**	**0.150**	**0.150**	**0.360**	**0.810**
	£	**0.082**	**0.079**	**0.078**	**0.183**	**0.422**
	HK$	**1.164**	**1.167**	**1.168**	**2.799**	**6.298**
2005	US$	0.140	0.140	0.140	0.310	0.730
	£	0.077	0.079	0.079	0.169	0.404
	HK$	1.088	1.086	1.085	2.403	5.662
2004	US$	0.130	0.130	0.130	0.270	0.660
	£	0.071	0.072	0.069	0.141	0.353
	HK$	1.013	1.014	1.013	2.104	5.144
2003	US$	0.240	0.120	0.240	–	0.600
	£	0.146	0.065	0.135	–	0.345
	HK$	1.860	0.931	1.871	–	4.654
2002	US$	0.205	0.325	–	–	0.530
	£	0.130	0.204	–	–	0.334
	HK$	1.599	2.535	–	–	4.134

1 *The fourth interim dividend for 2006 of US$0.360 per share has been translated into pounds sterling and Hong Kong dollars at the closing rate on 31 December 2006. The dividend will be paid on 10 May 2007.*
2 *The above dividends declared are accounted for as disclosed in Note 11 on the Financial Statements.*

Dividends are declared in US dollars and, at the election of the shareholder, paid in cash in one of, or in a combination of, US dollars, sterling and Hong Kong dollars, or satisfied in whole or in part by the issue of new shares in lieu of a cash dividend.

Nature of trading market

HSBC Holdings ordinary shares are listed or admitted to trading on the London Stock Exchange, the Hong Kong Stock Exchange ('HKSE'), Euronext Paris, the New York Stock Exchange ('NYSE') and the Bermuda Stock Exchange. HSBC Holdings maintains its principal share register in England and overseas branch share registers in Hong Kong and Bermuda (collectively, the 'share register').

As at 31 December 2006, there were a total of 205,958 holders of record of HSBC Holdings ordinary shares.

As at 31 December 2006, a total of 13,292,804 of the HSBC Holdings ordinary shares were registered in the HSBC Holdings share register in the name of 11,525 holders of record with addresses in the US. These shares represented 0.1149 per cent of the total HSBC Holdings ordinary shares in issue.

As at 31 December 2006, there were 11,079 holders of record of ADSs holding approximately 107 million ADSs, representing approximately 535 million HSBC Holdings ordinary shares. 10,856 of these holders had addresses in the US, holding approximately 106.9 million ADSs, representing 534.8 million HSBC Holdings ordinary shares. As at 31 December 2006, approximately 4.5 per cent of the HSBC Holdings ordinary shares were represented by ADSs held by holders of record with addresses in the US.

The following table shows, for the years, calendar quarters and months indicated, the highest and lowest prices for the HSBC Holdings ordinary shares and ADSs. These are based on mid-market prices at close of business on the London Stock Exchange, HKSE, Euronext Paris, NYSE and the Bermuda Stock Exchange.

Past share price performance should not be regarded as a guide to future performance.

High and low mid-market closing prices

	London US$0.50 shares		Hong Kong US$0.50 shares		New York ADSs[1]		Paris US$0.50 shares		Bermuda[2] US$0.50 shares	
	High pence	Low pence	High HK$	Low HK$	High US$	Low US$	High euro	Low euro	High US$	Low US$
2006	**1028**	**914**	**151.2**	**124.5**	**98.4**	**80.5**	**15.4**	**13.3**	**19.6**	**16.4**
2005	950	825	133.5	120.1	85.8	77.5	13.9	12.0	17.1	15.7
2004	954	784	136.5	109.5	87.8	70.0	13.6	11.8	17.3	14.5
2003	914	631	122.5	80.3	78.8	51.1	13.4	9.3	–	–
2002	866	643	97.5	78.8	64.4	50.3	13.9	10.2	–	–

	London US$0.50 shares		Hong Kong US$0.50 shares		New York ADSs[1]		Paris US$0.50 shares		Bermuda US$0.50 shares	
	High pence	Low pence	High HK$	Low HK$	High US$	Low US$	High euro	Low euro	High US$	Low US$
2006										
4th Quarter	**1028**	**916**	**151.2**	**140.3**	**98.4**	**90.2**	**15.4**	**13.6**	**19.6**	**18.1**
3rd Quarter	**975**	**942**	**142.2**	**134.8**	**91.8**	**86.6**	**14.5**	**13.7**	**18.4**	**17.3**
2nd Quarter	**985**	**914**	**142.2**	**130.6**	**92.1**	**84.2**	**14.4**	**13.3**	**18.1**	**16.7**
1st Quarter	**995**	**924**	**134.0**	**124.5**	**86.6**	**80.5**	**14.6**	**13.4**	**17.4**	**16.4**
2005										
4th Quarter	950	873	126.5	120.1	81.6	77.5	13.9	12.8	16.5	15.7
3rd Quarter	936	885	129.2	123.0	83.2	79.0	13.6	13.0	16.6	16.0
2nd Quarter	895	825	127.0	122.5	81.4	78.6	13.5	12.0	16.2	15.8
1st Quarter	907	832	133.5	122.5	85.8	78.3	13.3	12.2	17.1	15.9

	London US$0.50 shares		Hong Kong US$0.50 shares		New York ADSs[1]		Paris US$0.50 shares		Bermuda US$0.50 shares	
	High pence	Low pence	High HK$	Low HK$	High US$	Low US$	High euro	Low euro	High US$	Low US$
2007										
January	**953**	**914**	**145.4**	**139.0**	**93.1**	**90.0**	**14.4**	**13.9**	**18.8**	**18.0**
2006										
December	**937**	**916**	**144.6**	**140.3**	**93.4**	**90.2**	**14.1**	**13.6**	**18.7**	**18.1**
November	**1028**	**938**	**151.2**	**142.8**	**98.4**	**92.9**	**15.4**	**14.0**	**19.6**	**18.7**
October	**1017**	**968**	**147.2**	**141.8**	**95.8**	**91.6**	**15.2**	**14.3**	**19.1**	**18.2**
September	**975**	**949**	**142.1**	**138.1**	**91.8**	**89.2**	**14.5**	**14.0**	**18.4**	**17.9**
August	**970**	**942**	**142.2**	**137.9**	**91.4**	**89.2**	**14.3**	**13.9**	**18.4**	**17.9**
July	**974**	**942**	**140.2**	**134.8**	**91.0**	**86.6**	**14.3**	**13.7**	**18.3**	**17.3**

Notes

1 *In New York each ADS represents 5 underlying ordinary shares.*
2 *HSBC shares were not listed on the Bermuda Stock Exchange prior to 18 February 2004.*

Shareholder Information (continued)

Profile / Enquiries

Stock symbols

HSBC Holdings ordinary shares trade under the following stock symbols:

London Stock Exchange	HSBA
Hong Kong Stock Exchange	5
New York Stock Exchange (ADS)	HBC
Euronext Paris	HSB
Bermuda Stock Exchange	HSBC

Shareholder profile

At 31 December 2006 the register of members recorded the following details:

Ordinary shares held	Number of shareholders	Total shares held
1-100	**30,596**	**978,960**
101-400	**33,550**	**8,491,949**
401-500	**9,364**	**4,246,168**
501-1,000	**32,037**	**24,073,397**
1,001-5,000	**67,024**	**155,123,482**
5,001-10,000	**15,430**	**109,211,328**
10,001-20,000	**8,599**	**119,423,901**
20,001-50,000	**5,139**	**157,408,088**
50,001-200,000	**2,559**	**237,501,911**
200,001-500,000	**670**	**208,679,627**
500,001 and above	**990**	**10,547,068,924**
Total	**205,958**	**11,572,207,735**

Memorandum and Articles of Association

The discussion under the caption 'Memorandum and Articles of Association' contained in HSBC Holdings' Annual Reports on Form 20-F for the years ended 31 December 2000 and 2001 is incorporated by reference herein.

Interim results

The interim results for the six months to 30 June 2007 will be announced on 30 July 2007.

Annual General Meeting

The 2007 Annual General Meeting will be held at the Barbican Hall, Barbican Centre, London EC2 on 25 May 2007 at 11 am.

All resolutions considered at the 2006 Annual General Meeting were passed on a poll as follows:

Resolution	Total votes For[1]	Total votes Against	Total votes Abstain
1 To receive the Report and Accounts for 2005	4,480,852,415	21,235,648	107,249,007
2 To approve the Directors' Remuneration Report for 2005	4,428,404,417	154,287,152	70,543,557
3 To re-elect the following as Directors:			
(a) The Baroness Dunn	4,612,655,769	36,639,677	2,104,416
(b) M F Geoghegan	4,636,745,575	12,088,015	2,185,789
(c) S K Green	4,536,123,455	96,828,783	18,179,417
(d) Sir Mark Moody-Stuart	4,626,583,848	22,231,763	2,202,512
(e) S M Robertson	4,635,200,010	11,818,080	2,264,832
(f) H Sohmen	4,625,766,106	22,794,084	2,617,684
(g) Sir Brian Williamson	4,637,388,477	11,612,586	2,204,044
4 To reappoint the Auditor	4,581,736,221	25,270,259	46,246,917
5 To authorise the Directors to allot shares	4,588,458,934	60,705,949	6,033,860
6 To disapply pre-emption rights (Special Resolution)	4,593,975,127	54,420,754	6,831,574
7 To authorise the Company to purchase its own Ordinary Shares	4,620,218,288	15,470,061	9,882,035
8 To increase fees payable to each non-executive Directors to £65,000 p.a.	4,601,744,353	29,609,584	13,995,048

1 *Includes discretionary votes.*

Shareholder enquiries and communications

Enquiries

Any enquiries relating to your shareholding, for example transfers of shares, change of name or address, lost share certificates or dividend cheques, should be sent to the Registrars:

Principal Register	*Hong Kong Overseas Branch Register:*	*Bermuda Overseas Branch Register:*
Computershare Investor Services PLC PO Box 1064, The Pavilions Bridgwater Road Bristol BS99 3FA UK	Computershare Hong Kong Investor Services Limited Hopewell Centre, 46th Floor 183 Queen's Road East Wan Chai Hong Kong	Corporate Shareholder Services The Bank of Bermuda Limited 6 Front Street Hamilton HM 11 Bermuda
Telephone: 44 (0) 870 7020137 Email: web.queries@computershare.co.uk	Telephone: 852 2862 8628 Email: hkinfo@computershare.com.hk	Telephone: 1 441 299 6737

Any enquiries relating to ADSs should be sent to the depositary:

The Bank of New York
101 Barclay Street
Floor 22W
New York, NY 10286
USA
Telephone (US): 1 888 269 2377
Telephone (International): 001 610 382 7836
Email: shareowner-svcs@bankofny.com

Any enquiries relating to shares held through Euroclear France, the settlement and central depositary system for Euronext Paris, should be sent to the paying agent:

HSBC France
103, avenue des Champs Elysées
75419 Paris Cedex 08
France
Telephone: 33 1 40 70 22 56

Further copies of this *Annual Report and Accounts 2006* may be obtained by writing to the following departments:

For those in Europe, the Middle East and Africa:	*For those in Asia-Pacific:*	*For those in the Americas:*
Group Corporate Affairs HSBC Holdings plc 8 Canada Square London E14 5HQ UK	Group Public Affairs The Hongkong and Shanghai Banking Corporation Limited 1 Queen's Road Central Hong Kong	Employee Communications HSBC-North America 2700 Sanders Road Prospect Heights Illinois 60070 USA

Electronic communications

Shareholders may at any time choose to receive corporate communications in printed form or electronically. To register online to receive electronic communications, or revoke or amend an instruction to receive electronic communications, go to www.hsbc.com/ecomms. If you received this document electronically and would like to receive a printed copy or would like to receive future shareholder communications in printed form, please write to the appropriate Registrars at the address given above. Printed copies will be provided without charge.

Chinese translation

A Chinese translation is available on request after 3 April 2007 from the Registrars:

Computershare Hong Kong Investor Services Limited
Hopewell Centre, 46th Floor
183 Queen's Road East
Wan Chai
Hong Kong

Shareholder Information (continued)

Investor relations / Where information is available / Taxation

Computershare Investor Services PLC
PO Box 1064, The Pavilions
Bridgwater Road
Bristol BS99 3FA
UK

Please also contact the Registrars if you wish to receive Chinese translations of future documents or if you have received a Chinese translation of this document and do not wish to receive such translations in future.

本年報備有中譯本，各界人士可向股份登記處索取（地址見上文）。

閣下如欲索取本文件的中譯本，或已收到譯本但不希望繼續收取有關譯本，均請聯絡股份登記處。

Investor relations

Enquiries relating to HSBC's strategy or operations may be directed to:

Senior Manager Investor Relations
HSBC Holdings plc
8 Canada Square
London E14 5HQ
UK
Telephone: +44 (0)20 7991 8041
Facsimile: +44 (0)20 7991 4663
E-mail: investorrelations@hsbc.com

Director – Corporate Finance and Investor Relations
HSBC Finance Corporation
2700 Sanders Road
Prospect Heights, IL 60070
USA
+1 847 564 6478
+1 847 205 7538
investor.relations@us.hsbc.com

Senior Manager External Relations
The Hongkong and Shanghai Banking Corporation Limited
1 Queen's Road Central
Hong Kong
+852 2822 4929
+852 2845 0113
investorrelations@hsbc.com.hk

Where more information about HSBC is available

This *Annual Report and Accounts 2006*, and other information on HSBC, may be viewed on HSBC's web site: www.hsbc.com.

US Investors may read and copy the reports, statements or information that HSBC Holdings files with the Securities Exchange Commission at its public reference room in Washington, DC, which is located at 100 F Street, Room 1580, Washington, DC 20549. These documents will also be available at the Commission's regional offices located at the Woolworth Building, 233 Broadway, New York, NY 10279 and at Citicorp Center, 500 West Madison Street, Suite 1400, Chicago, IL 60661. Investors should call the Commission at 1-800-SEC-0330 for further information on the operation of the public reference rooms. Investors can request copies of these documents upon payment of a duplicating fee, by writing to the Commission at 100 F Street, Mail Stop 5100, Washington, DC 50549. Investors may also obtain the reports and other information HSBC Holdings files at the offices of the New York Stock Exchange, Inc., 20 Broad Street, New York, NY 10005.

Taxation of shares and dividends

Taxation – UK residents

The following is a summary, under current law, of the principal UK tax considerations that are likely to be material to the ownership and disposition of shares. The summary does not purport to be a comprehensive description of all the tax considerations that may be relevant to a holder of shares. In particular, the summary deals principally with shareholders who are resident in the UK for UK tax purposes and only with holders who hold the shares as investments and who are the beneficial owners of the shares, and does not address the tax treatment of certain classes of holders such as dealers in securities. Holders and prospective purchasers should consult their own advisers regarding the tax consequences of an investment in shares in light of their particular circumstances, including the effect of any national, state or local laws.

Taxation of dividends

Currently no tax is withheld from dividends paid by HSBC Holdings. However, dividends are paid with an associated tax credit which is available for set-off by certain shareholders against any liability they may have to UK income tax. Currently, the associated tax credit is equivalent to 10 per cent of the combined cash dividend and tax credit, i.e. one-ninth of the cash dividend.

For individual shareholders who are resident in the UK for taxation purposes and liable to UK income tax at the basic rate, no further UK income tax liability arises on the receipt of a dividend from HSBC Holdings. Individual shareholders who are liable to UK income tax at the higher rate on UK dividend income (currently 32.5 per cent) are taxed on the combined amount of the dividend and the tax credit. The tax credit is available for set-off against the higher rate liability, leaving net higher rate tax to pay equal to 25 per cent of the cash dividend. Individual UK resident shareholders are not entitled to any tax credit repayment.

Although non-UK resident shareholders are generally not entitled to any repayment of the tax credit in respect of any UK dividend received, some such shareholders may be so entitled under the provisions of a double taxation agreement between their country of residence and the UK. However, in most cases no amount of the tax credit is, in practice, repayable.

Information on the taxation consequences of the HSBC Holdings scrip dividends offered in lieu of the 2004 fourth interim dividend and the first, second and third interim dividends for 2006 was set out in the Secretary's letters to shareholders of 4 April, 1 June, 30 August and 5 December 2006. In each case, the difference between the cash dividend foregone and the market value of the scrip dividend did not equal or exceed 15% of the market value and accordingly, the price of HSBC Holdings US$0.50 ordinary shares (the 'shares') for UK tax purposes for the dividends was the cash dividend foregone.

Taxation of capital gains

The computation of the capital gains tax liability arising on disposals of shares in HSBC Holdings by shareholders subject to UK capital gains tax can be complex, partly depending on whether, for example, the shares were purchased since April 1991, acquired in 1991 in exchange for shares in The Hongkong and Shanghai Banking Corporation Limited, or acquired subsequent to 1991 in exchange for shares in other companies.

For capital gains tax purposes, the acquisition cost for ordinary shares is adjusted to take account of subsequent rights and capitalisation issues. Further adjustments apply where an individual shareholder has chosen to receive shares instead of cash dividends, subject to scrip issues made since 6 April 1998 being treated for tax as separate holdings. Any capital gain arising on a disposal may also be adjusted to take account of indexation allowance and, in the case of individuals, taper relief. Except for gains made by a company chargeable to UK corporation tax, any such indexation allowance is calculated up to 5 April 1998 only.

If in doubt, shareholders are recommended to consult their professional advisers.

Inheritance tax

Shares or ADSs held by an individual whose domicile is determined to be the US for the purposes of the United States-United Kingdom Double Taxation Convention relating to estate and gift taxes (the 'Estate Tax Treaty') and who is not for such purposes a national of the UK will not, provided any US Federal estate or gift tax chargeable has been paid, be subject to UK inheritance tax on the individual's death or on a lifetime transfer of shares or ADSs except in certain cases where the shares or ADSs (i) are comprised in a settlement (unless, at the time of the settlement, the settlor was domiciled in the US and was not a national of the UK), (ii) is part of the business property of a UK permanent establishment of an enterprise, or (iii) pertains to a UK fixed base of an individual used for the performance of independent personal services. In such cases, the Estate Tax Treaty generally provides a credit against US Federal tax liability for the amount of any tax paid in the UK in a case where the shares or ADSs are subject to both UK inheritance tax and to US Federal estate or gift tax.

Stamp duty and stamp duty reserve tax

Transfers of shares by a written instrument of transfer generally will be subject to UK stamp duty at the rate of 0.5 per cent of the consideration paid for the transfer, and such stamp duty is generally payable by the transferee.

An agreement to transfer shares, or any interest therein, normally will give rise to a charge to stamp duty reserve tax at the rate of 0.5 per cent of the consideration. However, provided an instrument of transfer of the shares is executed pursuant to the agreement and duly stamped before the date on which the stamp duty reserve tax becomes payable, under the current practice of UK HM Revenue and Customs it will not be necessary to pay the stamp duty reserve tax, nor to apply for such tax to be cancelled. Stamp duty reserve tax is generally payable by the transferee.

Paperless transfers of shares within CREST, the UK's paperless share transfer system, are liable to stamp duty reserve tax at the rate of 0.5 per cent of the consideration. In CREST transactions, the tax is calculated and payment made automatically. Deposits of shares into CREST generally will not be subject to stamp duty reserve tax, unless the transfer into CREST is itself for consideration.

Taxation – US residents

The following is a summary, under current law, of the principal UK tax and US federal income tax considerations that are likely to be material to the ownership and disposition of shares or ADSs by a holder that is a resident of the US for the purposes of the income tax convention between the US and the UK (the 'Treaty'), and is fully eligible for benefits under the Treaty (an 'eligible US holder'). The summary does not purport to be a comprehensive description of all of the tax considerations that may be relevant to a holder of shares or ADSs. In particular, the summary deals only with eligible US holders that hold shares or ADSs as capital assets, and does not address the tax treatment of holders that are subject to special tax rules, such as banks, tax-exempt entities, insurance companies, dealers in securities or currencies, persons that hold shares or ADSs as part of an integrated investment (including a 'straddle') comprised of a share or ADS and one or more other positions, and persons that own, directly or indirectly, 10 per cent or more of the voting stock of HSBC Holdings. This discussion is based on laws, treaties, judicial decisions and regulatory interpretations in effect on the date hereof, all of which are subject to change. Under the current income tax treaty between the UK and the US, eligible US holders are no longer entitled to claim a special foreign tax credit in respect of dividends.

Holders and prospective purchasers should consult their own advisers regarding the tax consequences of an investment in shares or ADSs in light of their particular circumstances, including the effect of any national, state or local laws.

In general, the beneficial owner of a share or ADS will be entitled to benefits under the Treaty (and, therefore, will be an eligible US holder) if it is (i) an individual resident of the US, a US corporation meeting ownership criteria specified in the Treaty or other entity meeting criteria specified in the Treaty; and (ii) not also resident in the UK for UK tax purposes. Special rules, including a limitation of benefits provision, may apply. The Treaty benefits discussed below generally are not available to US holders that hold shares or ADSs in connection with the conduct of a business through a permanent establishment, or the performance of personal services through a fixed base, in the UK.

Taxation of dividends

An eligible US holder must include cash dividends paid on the shares or ADSs in ordinary income on the date that such holder or the ADS depositary receives them, translating dividends paid in UK pounds sterling into US dollars using the exchange rate in effect on the date of receipt. Subject to certain exceptions for positions that are held for less than 61 days or are hedged, and subject to a foreign corporation being considered a 'qualified foreign corporation' (which includes not being classified for US federal income tax purposes as a passive foreign investment company), certain dividends ('qualified dividends') received by an individual eligible US holder before 2009 generally will be subject to US taxation at a maximum rate of 15 per cent. Based on the company's audited financial statements and relevant market and shareholder data, HSBC Holdings believes that it was not treated as a passive foreign investment company for US federal income tax purposes with respect to its 2005 or 2006 taxable year. In addition, based on the company's audited financial statements and current expectations regarding the value and nature of its assets, and the sources and nature of its income, HSBC Holdings does not anticipate being classified as a passive foreign investment company for its 2007 taxable year. Accordingly, dividends paid on the shares or ADSs generally should be treated as qualified dividends.

Taxation of capital gains

Gains realised by an eligible US holder on the sale or other disposition of shares or ADSs normally will not be subject to UK taxation unless at the time of the sale or other disposition the holder carries on a trade, profession or vocation in the UK through a branch or agency or permanent establishment and the shares or ADSs are or have been used, held or acquired for the purposes of such trade, profession, vocation, branch or agency or permanent establishment. Such gains will be included in income for US tax purposes, and will be long-term capital gains if the shares or ADSs were held for more than one year. A long-term capital gain realised by an individual holder generally is subject to US tax at a maximum rate of 15 per cent.

Stamp duty and stamp duty reserve tax – ADSs

If shares are transferred into a clearance service or depository receipt ('ADR') arrangement (which will include a transfer of shares to the Depository) UK stamp duty and/or stamp duty reserve tax will be payable. The stamp duty or stamp duty reserve tax is generally payable on the consideration for the transfer and is payable at the aggregate rate of 1.5 per cent.

The amount of stamp duty reserve tax payable on such a transfer will be reduced by any stamp duty paid in connection with the same transfer.

No stamp duty will be payable on the transfer of, or agreement to transfer, an ADS, provided that the ADR and any separate instrument of transfer or written agreement to transfer remain at all times outside the UK, and provided further that any such transfer or written agreement to transfer is not executed in the UK. No stamp duty reserve tax will be payable on a transfer of, or agreement to transfer, an ADS effected by the transfer of an ADR.

On a transfer of shares from the Depository to a registered holder of an ADS upon cancellation of the ADS, a fixed stamp duty of £5 per instrument of transfer will be payable by the registered holder of the ADR cancelled.

US backup withholding tax and information reporting

Distributions made on shares and proceeds from the sale of shares or ADSs that are paid within the US, or through certain financial intermediaries to US holders, are subject to information reporting and may be subject to a US 'backup' withholding tax unless, in general, the US holder complies with certain certification procedures or is a corporation or other person exempt from such withholding. Holders that are not US persons generally are not subject to information reporting or backup withholding tax, but may be required to comply with applicable certification procedures to establish that they are not US persons in order to avoid the application of such information reporting requirements or backup withholding tax to payments received within the US or through certain financial intermediaries.

History and development of HSBC

1865 The founding member of the HSBC Group, The Hongkong and Shanghai Banking Corporation, is established in both Hong Kong and Shanghai.

1959 The Mercantile Bank of India Limited and The British Bank of the Middle East, now HSBC Bank Middle East Limited, are purchased.

1965 A 51 per cent interest (subsequently increased to 62.14 per cent) is acquired in Hang Seng Bank Limited. Hang Seng Bank is the fourth-largest listed bank in Hong Kong by market capitalisation.

1980 A 51 per cent interest in Marine Midland Banks, Inc., now HSBC USA, Inc, is acquired (with the remaining interest acquired in 1987).

1981 The Hongkong and Shanghai Bank Banking Corporation incorporates its then existing Canadian operations. HSBC Bank Canada has since made numerous acquisitions, expanding rapidly to become the largest foreign-owned bank in Canada and the seventh-largest overall at 31 December 2006.

1987 A 14.9 per cent interest in Midland Bank plc, now HSBC Bank plc, one of the UK's principal clearing banks, is purchased.

1991 HSBC Holdings plc is established as the parent company of the HSBC Group.

1992 HSBC purchases the remaining interest in Midland Bank plc.

1993 As a consequence of the Midland acquisition, HSBC's head office is transferred from Hong Kong to London in January.

1997 HSBC assumes selected assets, liabilities and subsidiaries of Banco Bamerindus do Brasil S.A., now HSBC Bank Brazil, following the intervention of the Central Bank of Brazil, and in Argentina completes the acquisition of Grupo Roberts, now part of HSBC Bank Argentina S.A.

1999 HSBC acquires Republic New York Corporation, subsequently merged with HSBC USA, Inc., and Safra Republic Holdings S.A.

2000 HSBC completes its acquisition of 99.99 per cent of the issued share capital of Crédit Commercial de France S.A., now HSBC France.

2002 HSBC acquires 99.59 per cent of Grupo Financiero Bital, S.A. de C.V., the holding company of what is now HSBC Mexico.

2003 HSBC acquires Household International, Inc., now HSBC Finance Corporation. HSBC Finance brings to the Group national coverage in the US for consumer lending, credit cards and credit insurance through multiple distribution channels.

2003 HSBC acquires Banco Lloyds TSB S.A.- Banco Múltiplo in Brazil and the country's leading consumer finance company, Losango Promotora de Vendas Limitada ('Losango').

2004 HSBC Bank USA, Inc. merges with HSBC Bank & Trust (Delaware) N.A. to form HSBC Bank USA, N.A.

2004 The acquisition of The Bank of Bermuda Limited is completed.

Shareholder Information (continued)

History and development / Organisational structure

2004 HSBC acquires Marks and Spencer Retail Financial Services Holdings Limited, which trades as Marks and Spencer Money (‘M&S Money’) in the UK.

2004 HSBC acquires 19.9 per cent of Bank of Communications, mainland China’s fifth-largest bank by total assets, and Hang Seng Bank acquires 15.98 per cent of Industrial Bank.

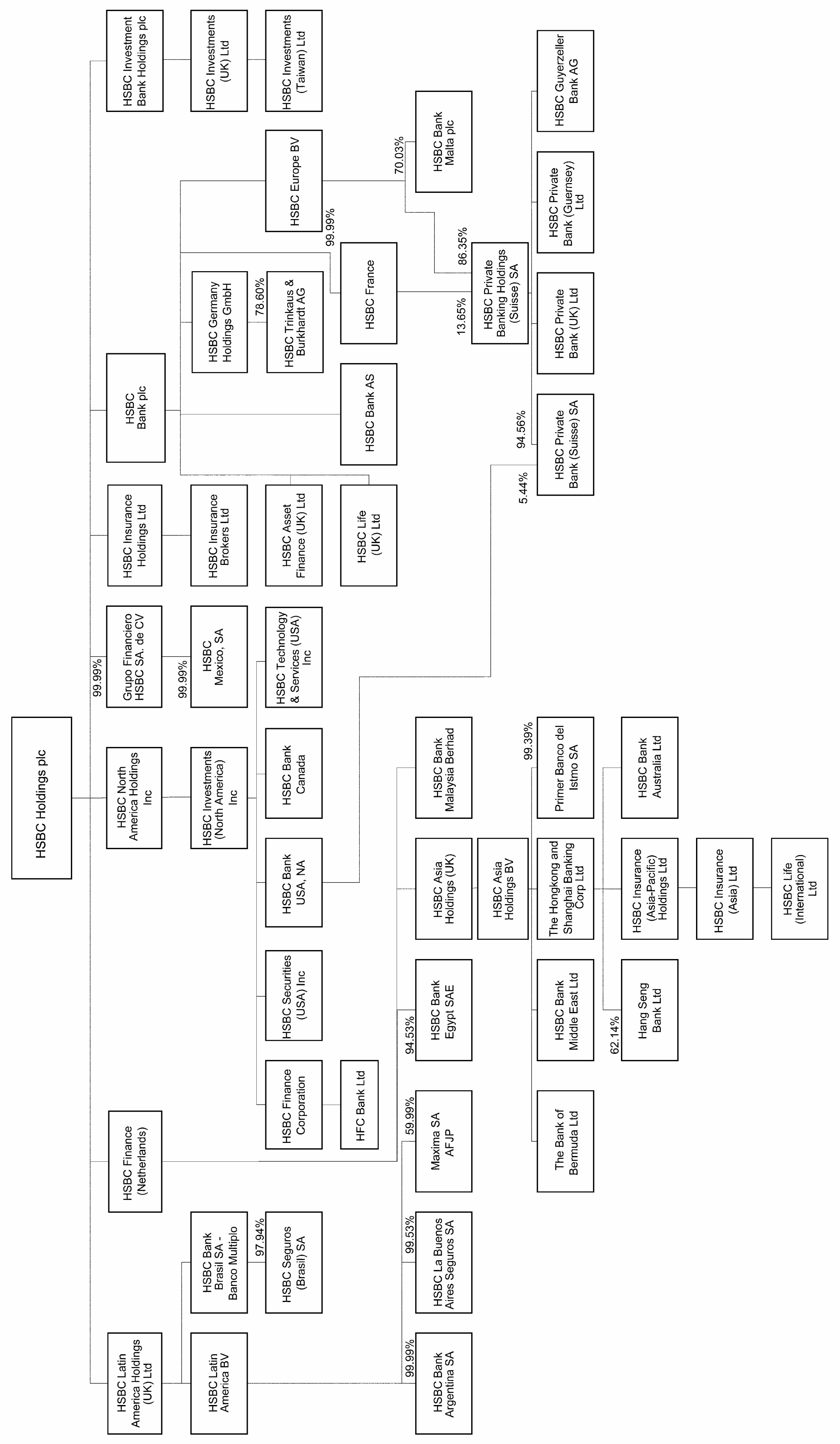
2005 HSBC increases its holding in Ping An Insurance to 19.9 per cent, having made its initial investment in 2002. Ping An Insurance is the second-largest life insurer and the third-largest property and casualty insurer in mainland China.

2005 HSBC Finance completes the acquisition of Metris Companies Inc. (‘Metris’), making HSBC the fifth-largest issuer of MasterCard and Visa cards in the USA.

2006 In July, HSBC enters into an agreement with Grupo Banistmo S.A. (‘Banistmo’), the leading banking group in Central America, to make a tender offer to acquire 99.98 per cent of the outstanding shares of Banistmo for US$1.77 billion in cash. The transaction is completed in November. Banistmo’s principal area of operation is Panama, but the group also has a significant presence in five countries new to HSBC, namely Costa Rica, Honduras, Colombia, Nicaragua and El Salvador.

Organisational Structure

Simplified Structure Chart of HSBC Holdings plc at 31 December 2006



1 This chart is a simplified ownership diagram only, not all intermediate holding companies are shown.
2 Places of incorporation are shown in Note 24 on the Financial Statements.

Glossary

Accounting terms used	US equivalent or brief description
Accounts	Financial Statements
Articles of Association	Bylaws
Associates	Long-term equity investments accounted for using the equity method
Attributable profit	Net income
Balance sheet	Statement of financial position
Bills	Notes
Called up share capital	Ordinary shares, issued and fully paid
Capital allowances	Tax depreciation allowances
Creditors	Payables
Debtors	Receivables
Deferred tax	Deferred income tax
Depreciation	Amortisation
Finance lease	Capital lease
Freehold	Ownership with absolute rights in perpetuity
Interests in associates and joint ventures	Long-term equity investments accounted for using the equity method
Loans and advances	Lendings
Loan capital	Long-term debt
Nominal value	Par value
One-off	Non-recurring
Ordinary shares	Common stock
Overdraft	A line of credit, contractually repayable on demand unless a fixed-term has been agreed, established through a customer's current account
Preference shares	Preferred stock
Premises	Real estate
Provisions	Allowances
Share capital	Ordinary shares or common stock issued and fully paid
Shareholders' equity	Stockholders' equity
Share premium account	Additional paid-in capital
Shares in issue	Shares outstanding
Write-offs	Charge-offs

Abbreviations used	Brief description
ABC	Asset-backed conduits
ABS	Asset-backed securities
ADR	American depositary receipt
ADS	American depositary share
AICPA	The American Institute of Certified Public Accountants
AIEA	Average interest-earning assets
ALCO	Asset and liability management committee
ARB	Accounting Research Bulletin (US)
ARM	Adjustable rate mortgage
ATM	Automated teller machines
Bank of Bermuda	The Bank of Bermuda Limited, which was acquired in February 2004
Bank of Communications	Bank of Communications Limited, mainland China's fifth largest bank in which HSBC acquired a 19.9 per cent interest in August 2004
Basel Committee	The Basel Committee on Banking Supervision
Basel II	The Final Accord of the Basel Committee on proposals for a new capital adequacy framework
Brazilian operations	HSBC Bank Brasil S.A.-Banco Múltiplo and subsidiaries, plus HSBC Serviços e Participações Limitada
CCF	CCF S.A., the former name of HSBC France
CGU	Cash generating unit
Combined Code	Combined Code on Corporate Governance issued by the Financial Reporting Council
CRM	Customer relationship management
CSA	Credit support annex
Decision One	Decision One Mortgage Company, HSBC Finance's subsidiary which originates loans referred by mortgage brokers
DPF	Discretionary participation feature of insurance and investment contracts
EITF	Emerging Issues Task Force (US)
EPS award	Earnings per share measure applied to half of the award of Performance Shares under The HSBC Share Plan
EU	European Union
FASB	Financial Accounting Standards Board (US)
FDIC	Federal Deposit Insurance Corporation (US)
FFIEC	Federal Financial Institution Examination Council
FHC	Financial holding company, as defined under the Gramm-Leach-Bliley Act amendments to the BHCA
FIN	FASB Interpretation (US)
FSA	Financial Services Authority (UK)
FSMA	Financial Services and Markets Act 2000 (UK)
FTSE	Financial Times – Stock Exchange index
GAAP	Generally Accepted Accounting Principles
GDP	Gross domestic product
GHOS	Hong Kong Government Home Ownership Scheme
Global Markets	HSBC's treasury and capital markets services in Corporate, Investment Banking and Markets
Group	HSBC Holdings together with its subsidiary undertakings
Hang Seng Bank	Hang Seng Bank Limited, the fourth largest bank in Hong Kong by market capitalisation
HFC	HFC Bank Limited, the UK-based consumer finance business acquired through the acquisition by HSBC of HSBC Finance Corporation
HKMA	The Hong Kong Monetary Authority
HKSE	The Stock Exchange of Hong Kong Limited
Hong Kong	The Hong Kong Special Administrative Region of the People's Republic of China

Glossary (continued)

Abbreviations used	Brief description
HNAH	HSBC North America Holdings Inc, the bank holding company formed on 1 January 2004 to hold all of HSBC's North America operations
HSBC	HSBC Holdings together with its subsidiary undertakings
HSBC Bank	HSBC Bank plc, formerly Midland Bank plc
HSBC Bank Argentina	HSBC Bank Argentina S.A.
HSBC Bank Brazil	HSBC Bank Brasil S.A.-Banco Múltiplo, HSBC's retail banking operation in Brazil, formerly Banco Bamerindus do Brasil S.A.
HSBC Bank Delaware	HSBC Trust Company (Delaware), N.A., a US nationally chartered bank restricted to trust activities
HSBC Bank Malaysia	HSBC Bank Malaysia Berhad
HSBC Bank Middle East	HSBC Bank Middle East Limited, formerly The British Bank of the Middle East
HSBC Bank Nevada	HSBC Bank Nevada, NA, (formerly Household Bank (SB), N.A.) a nationally chartered 'credit card bank' in the US which is a subsidiary of HSBC Finance Corporation
HSBC Bank USA	HSBC's retail bank in the US. From 1 July 2004, HSBC Bank USA, N.A. (formerly HSBC Bank USA, Inc.)
HSBC Finance	HSBC Finance Corporation, the US consumer finance company acquired in March 2003 (formerly Household International, Inc.)
HSBC France	HSBC's French banking subsidiary, whose name was changed from CCF S.A. (previously Crédit Commercial de France S.A.) in 2005
HSBC Holdings	HSBC Holdings plc, the parent company of HSBC
HSBC Mexico	HSBC México S.A., the commercial banking subsidiary of Grupo Financiero HSBC, S.A. de C.V. and the fifth-largest bank in Mexico by deposits and assets
HSBC Private Bank (Suisse)	HSBC Private Bank (Suisse) S.A., HSBC's private bank in Switzerland (formerly HSBC Republic Bank (Suisse) S.A.)
IAS	International Accounting Standard
IFRSs	International Financial Reporting Standards
IFRIC	International Financial Reporting Interpretations Committee
IGU	Income generating unit
Industrial Bank	Industrial Bank Co. Limited, a national joint-stock bank in mainland China of which Hang Seng acquired a 15.98 per cent interest in 2004
IPO	Initial public offering
Key Management Personnel	Directors and Group Managing Directors of HSBC Holdings
KPMG	KPMG Audit plc and its affiliates
Losango	Losango Promotora de Vendas Limitada, the Brazilian consumer finance company acquired in December 2003
Mainland China	People's Republic of China excluding Hong Kong
Metris	Metris Companies Inc., US credit card issuer acquired in December 2005
M&S Money	Marks and Spencer Retail Financial Services Holdings Limited, acquired by HSBC in November 2004
MMEs	Middle market enterprises
MSCI	Morgan Stanley Capital International index
MSRs	Mortgage servicing rights
NA	Nationally Chartered, a designation for certain categories of banks in the US
NIM	Net interest margin
NYSE	New York Stock Exchange
OCC	Office of the Comptroller of the Currency (US)
OCI	Other comprehensive income
OFT	Office of Fair Trading (UK)
Option ARMS	Adjustable rate mortgage with alternative payment options

Abbreviations used	Brief description
Patriot Act	The US Patriot Act of October 2001
Performance Shares	Awards of HSBC Holdings ordinary shares under employee share plans that are subject to corporate performance conditions
Pesification	The mandatory and asymmetrical conversion of onshore US dollar-denominated assets and liabilities in Argentina
Ping An Insurance	Ping An Insurance (Group) Company of China, Limited, the second-largest life insurer in the PRC, in which HSBC holds 16.8 per cent
PVBP	Present value of a basis point
PVIF	Present value of in-force long-term insurance business
Repos	Sale and repurchase transactions
Restricted shares	Awards of HSBC Holdings ordinary shares to which the employee will become entitled, normally after three years, subject to remaining an employee
Reverse repos	Securities purchased under commitments to sell
RMB	Renminbi, the currency of mainland China
SEC	Securities and Exchange Commission (US)
SIC	Standing Interpretations Committee (US)
Senior Management	Group Managing Directors, the Group Chief Accounting Officer and the Group Company Secretary
SFAS	Statement of Financial Accounting Standards (US)
SME	Small and medium-sized enterprise
SOP	Statement of Position issued by the AICPA (US)
SPE	Special purpose entity
The Hongkong and Shanghai Banking Corporation	The Hongkong and Shanghai Banking Corporation Limited, the founding member of the HSBC Group
TSR	Total shareholder return
TSR award	TSR measure applied to half of the award of Performance Shares under The HSBC Share Plan
UK	United Kingdom
UK GAAP	UK Generally Accepted Accounting Principles
US	United States of America
US GAAP	US Generally Accepted Accounting Principles
VAR	Value at risk
VIE	Variable interest entity
WHIRL	Worldwide Household International Revolving Lending system
WTAS	Wealth and Tax Advisory Services, Inc.
WWF	World Wide Fund for Nature

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