

REPORT OF THE DIRECTORS

The Directors have pleasure in presenting their report together with the audited financial statements for the year ended 31 December 2006.

Principal Activities

The Bank and its subsidiaries and associates are engaged in the provision of banking and related financial services.

Profits

The consolidated profit of the Bank and its subsidiaries and associates for the year is set out on page 89 together with particulars of dividends which have been paid or declared.

Major Customers

The Directors believe that the five largest customers of the Bank accounted for less than 30% of the total of interest income and other operating income of the Bank in the year.

Subsidiaries

Particulars of the Bank's principal subsidiaries at 31 December 2006 are set out on page 137.

Share Capital

No change in either the authorised or issued share capital took place during the year.

Donations

Charitable donations made by the Bank and its subsidiaries during the year amounted to HK\$16.8 million.

Directors

The Directors of the Bank who were in office at the end of the year were Mr Michael R P Smith, Mr Raymond C F Or, Mr Edgar D Ancona, Mr John C C Chan, Mr Patrick K W Chan, Dr Y T Cheng, Dr Marvin K T Cheung, Mr Jenkin Hui, Mr Peter T C Lee, Dr Eric K C Li, Dr Vincent H S Lo, Mr Joseph C Y Poon, Dr David W K Sin, Mr Richard Y S Tang and Mr Peter T S Wong.

Mr S J Glass resigned from the Board with effect from 24 March 2006.

Mr Edgar D Ancona was appointed a Director of the Bank with effect from 4 September 2006. He retires under the provisions of the Bank's Articles of Association and, being eligible, offers himself for re-election.

The Directors retiring by rotation in accordance with the Bank's Articles of Association are Mr John C C Chan, Dr Eric K C Li, Dr Vincent H S Lo and Dr David W K Sin, who, being eligible, offer themselves for re-election.

No Director proposed for re-election at the forthcoming Annual General Meeting has a service contract with the Bank which is not determinable by the Bank within one year without payment of compensation (other than statutory compensation).

No contract of significance, to which the Bank or any of its holding companies or any of its subsidiaries or fellow subsidiaries was a party and in which a Director of the Bank had a material interest, subsisted at the end of the year or at any time during the year.

Status Of Independent Non-Executive Directors

The Bank has received from each independent non-executive Director an annual confirmation of his independence pursuant to Rule 3.13 of the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited ("Stock Exchange") ("the Listing Rules") and the Bank still considers the independent non-executive Directors to be independent.

Directors' And Alternate Chief Executives' Interests

At the end of the financial year, the interests of the Directors and Alternate Chief Executives in the shares, underlying shares of equity derivatives and debentures of the Bank and its associated corporations (all within the meaning of Part XV of the Securities and Futures Ordinance ("SFO")) disclosed in accordance with the Listing Rules were detailed below.

	Personal Interests (held as beneficial owner)	Family Interests (Interests of spouse or child under 18)	Corporate Interests (Interests of controlled corporation)	Other Interests	Total Interests	Total Interests as % of the relevant issued share capital
Number of Ordinary Shares of HK\$5 each in the Bank						
Directors:						
Mr Raymond C F Or	50,000	–	–	–	50,000	0.00
Mr John C C Chan	–	–	–	1,000 ⁽¹⁾	1,000	0.00
Mr Patrick K W Chan	–	1,000	–	–	1,000	0.00
Mr Joseph C Y Poon	5,000	–	–	–	5,000	0.00
Number of Ordinary Shares of US\$0.50 each in HSBC Holdings plc						
Directors:						
Mr Michael R P Smith	143,800 ⁽²⁾	–	–	305,777 ⁽⁷⁾	449,577	0.00
Mr Raymond C F Or	152,119	36,874	–	248,052 ⁽⁷⁾	437,045	0.00
Mr Edgar D Ancona	217,567	–	–	203,807 ⁽⁷⁾	421,374	0.00
Mr John C C Chan	14,283	–	–	3,000 ⁽¹⁾	17,283	0.00
Mr Patrick K W Chan	2,390	5,018	–	49,571 ⁽⁷⁾	56,979	0.00
Mr Jenkin Hui	10,601	24,342	1,174,636 ⁽³⁾	–	1,209,579	0.01
Dr Eric K C Li	–	18,132	79,622 ⁽⁴⁾	–	97,754	0.00
Mr Joseph C Y Poon	27,468 ⁽⁵⁾	59,818	–	60,966 ⁽⁷⁾	148,252	0.00
Mr Peter T S Wong	86,783	20,896	–	87,491 ⁽⁷⁾	195,170	0.00
Alternate Chief Executives:						
Mr William W Leung	10,714	–	–	39,082 ⁽⁷⁾	49,796	0.00
Mrs Dorothy K Y P Sit	5,680 ⁽⁶⁾	728	–	53,008 ⁽⁷⁾	59,416	0.00

Notes:

- (1) 1,000 shares in the Bank and 3,000 shares in HSBC Holdings plc were held by a trust of which Mr and Mrs John C C Chan were beneficiaries.
- (2) These shares were jointly held by Mr and Mrs Michael R P Smith.
- (3) Mr Jenkin Hui was entitled to fully control the voting power at general meetings of Parc Palais Incorporated, a private company, which beneficially held all of those shares referred to above as his corporate interests.
- (4) Dr Eric K C Li was entitled to control no less than one-third of the voting power at general meetings of a private company which beneficially held all of those shares referred to above as his corporate interests.
- (5) 22,599 shares were jointly held by Mr and Mrs Joseph C Y Poon.
- (6) These shares were jointly held by Mrs Dorothy K Y P Sit and her husband.

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(7) These represent interests in (i) options granted to Directors and Alternate Chief Executives under the HSBC Share Option Plans/HSBC Finance 1996 Long-Term Executive Incentive Compensation Plan to acquire ordinary shares of US\$0.50 each in HSBC Holdings plc and (ii) conditional awards of shares under the HSBC Holdings plc Restricted Share Plan/HSBC Share Plans made in favour of Directors and Alternate Chief Executives and held by various trusts for ordinary shares of US\$0.50 each in HSBC Holdings plc, as set against their respective names below:

	Options (please refer to the options table below for details)	Conditional awards of shares under the HSBC Holdings plc Restricted Share Plan/ HSBC Share Plans (please refer to the awards table below for further information)	Total
Directors:			
Mr Michael R P Smith	–	305,777	305,777
Mr Raymond C F Or	2,504	245,548	248,052
Mr Edgar D Ancona	135,438	68,369	203,807
Mr Patrick K W Chan	26,000	23,571	49,571
Mr Joseph C Y Poon	28,454	32,512	60,966
Mr Peter T S Wong	–	87,491	87,491
Alternate Chief Executives:			
Mr William W Leung	13,322	25,760	39,082
Mrs Dorothy K Y P Sit	5,435	47,573	53,008

Options

At the end of the financial year, the Directors and Alternate Chief Executives mentioned below held unlisted physically settled options to acquire the number of ordinary shares of US\$0.50 each in HSBC Holdings plc set against their respective names. These options were granted for nil consideration by HSBC Holdings plc.

	Options held at 31 December 2006	Options exercised during the Director's/ Alternate Chief Executive's term of office in 2006 (ordinary shares of US\$0.50 each)	Exercise price per share	Date granted	Exercisable from	Exercisable until
Directors:						
Mr Michael R P Smith	–	22,500 ⁽¹⁾	£3.3334	1 Apr 1996	1 Apr 1999	1 Apr 2006
	–	24,000 ⁽¹⁾	£5.0160	24 Mar 1997	24 Mar 2000	24 Mar 2007
	–	24,000 ⁽¹⁾	£6.2767	16 Mar 1998	16 Mar 2001	16 Mar 2008
Mr Raymond C F Or	1,515	–	£6.4720	10 May 2004	1 Aug 2009	31 Jan 2010
	989	–	£6.6792	24 May 2005	1 Aug 2010	31 Jan 2011
	2,504					
Mr Edgar D Ancona	33,438 ⁽⁵⁾	–	US\$10.66	20 Nov 2002	20 Nov 2003	20 Nov 2012
	51,000	–	£9.1350	3 Nov 2003	3 Nov 2006	3 Nov 2013
	51,000	–	£8.2830	30 Apr 2004	30 Apr 2007	30 Apr 2014
	135,438					

	Options held at 31 December 2006	Options exercised during the Director's/Alternate Chief Executive's term of office in 2006 (ordinary shares of US\$0.50 each)	Exercise price per share	Date granted	Exercisable from	Exercisable until
Mr Patrick K W Chan	–	1,059 ⁽²⁾	£5.3496	8 May 2003	1 Aug 2006	31 Jan 2007
	6,500	–	£7.4600	3 Apr 2000	3 Apr 2003	2 Apr 2010
	6,000	–	£8.7120	23 Apr 2001	23 Apr 2004	22 Apr 2011
	6,500	–	£8.4050	7 May 2002	7 May 2005	6 May 2012
	7,000	–	£6.9100	2 May 2003	2 May 2006	1 May 2013
	26,000					
Mr Joseph C Y Poon	–	3,750 ⁽⁴⁾	£5.0160	24 Mar 1997	24 Mar 2000	24 Mar 2007
	9,000	–	£6.3754	29 Mar 1999	29 Mar 2002	29 Mar 2009
	4,750	–	£7.4600	3 Apr 2000	3 Apr 2003	3 Apr 2010
	2,750	–	£8.7120	23 Apr 2001	23 Apr 2004	23 Apr 2011
	4,400	–	£8.4050	7 May 2002	7 May 2005	7 May 2012
	5,050	–	£6.9100	2 May 2003	2 May 2006	2 May 2013
	1,515	–	£6.4720	10 May 2004	1 Aug 2009	31 Jan 2010
	989	–	£6.6792	24 May 2005	1 Aug 2010	31 Jan 2011
	28,454					
Alternate Chief Executives:						
Mr William W Leung	–	7,000 ⁽³⁾	£7.4600	3 Apr 2000	3 Apr 2003	2 Apr 2010
	–	7,000 ⁽³⁾	£8.4050	7 May 2002	7 May 2005	6 May 2012
	–	1,059 ⁽²⁾	£5.3496	8 May 2003	1 Aug 2006	31 Jan 2007
	6,000	–	£6.9100	2 May 2003	2 May 2006	1 May 2013
	6,500	–	£8.2830	30 Apr 2004	30 Apr 2007	29 Apr 2014
	582	–	£6.4720	10 May 2004	1 Aug 2007	31 Jan 2008
	240	–	HK\$103.4401	26 Apr 2006	1 Aug 2007	31 Oct 2007
	13,322					
Mrs Dorothy K Y P Sit	3,000	–	£8.7120	23 Apr 2001	23 Apr 2004	22 Apr 2011
	2,435	–	£6.6792	24 May 2005	1 Aug 2010	31 Jan 2011
	5,435					

Notes:

- (1) At the date of exercise, 7 March 2006, the market value per share was £9.8950.
- (2) At the date of exercise, 1 August 2006, the market value per share was £9.60.
- (3) At the date of exercise, 10 October 2006, the market value per share was £10.10.
- (4) At the date of exercise, 9 November 2006, the market value per share was £10.20.
- (5) These represent Mr Edgar D Ancona's interests in options under HSBC Finance 1996 Long-Term Executive Incentive Compensation Plan. These options arise from options he held over shares of Household International, Inc. (now HSBC Finance Corporation) before its acquisition, which were converted into options over HSBC Holdings plc ordinary shares in the same ratio as the offer for HSBC Finance Corporation and the exercise prices per share adjusted accordingly. These options were granted at nil consideration.

REPORT OF THE DIRECTORS (continued)

Conditional Awards Of Shares

At the end of the financial year, the interests of the Directors and Alternate Chief Executives in the conditional awards of shares made in favour of them under the HSBC Holdings plc Restricted Share Plan/HSBC Share Plans and held by various trusts for ordinary shares of US\$0.50 each in HSBC Holdings plc were as follows:

	Awards held at 1 January 2006	Awards made during the Director's/ Alternate Chief Executive's term of office in 2006	Shares awarded released during the Director's/ Alternate Chief Executive's term of office in 2006	Awards held at 31 December 2006 ⁽¹⁾
Directors:				
Mr Michael R P Smith	278,038	75,684	60,879	305,777
Mr Raymond C F Or	210,576	53,483	28,789	245,548
Mr Edgar D Ancona	67,804 ⁽²⁾	–	–	68,369
Mr Patrick K W Chan	9,980	12,927	–	23,571
Mr Joseph C Y Poon	18,539	12,927	–	32,512
Mr Peter T S Wong	113,805	53,483	83,794	87,491
Alternate Chief Executives:				
Mr William W Leung	20,002	12,927	7,995	25,760
Mrs Dorothy K Y P Sit	35,472	10,342	–	47,573

Notes:

(1) This includes additional shares arising from scrip dividends.

(2) This represents the awards held by Mr Edgar D Ancona on 4 September 2006 when he was appointed a Director of the Bank.

All the interests stated above represent long positions. As at 31 December 2006, no short positions were recorded in the Register of Directors' and Alternate Chief Executives' Interests and Short Positions required to be kept under section 352 of the SFO.

Save as disclosed in the preceding paragraphs, at no time during the year was the Bank or any of its holding companies or its subsidiaries or fellow subsidiaries a party to any arrangement to enable the Directors of the Bank to acquire benefits by means of the acquisition of shares in or debentures of the Bank or any other body corporate.

No right to subscribe for equity or debt securities of the Bank has been granted by the Bank to, nor have any such rights been exercised by, any person during the year ended 31 December 2006.

Directors' Interests In Competing Businesses

Pursuant to Rule 8.10 of the Listing Rules, at the end of the year, the following Directors had declared interests in the following entities which compete or are likely to compete, either directly or indirectly, with the businesses of the Bank:

Mr Michael R P Smith is the President and Chief Executive Officer of The Hongkong and Shanghai Banking Corporation Limited. Mr Smith is also the Chairman of HSBC Bank Malaysia Berhad, and a Director of HSBC Bank Australia Ltd, HSBC Australia Holdings Pty Ltd and HSBC Finance Corporation.

Mr Raymond C F Or is a Director of The Hongkong and Shanghai Banking Corporation Limited.

Mr Edgar D Ancona is the Chief Financial Officer of The Hongkong and Shanghai Banking Corporation Limited. He is also a Director of certain subsidiaries of HSBC Holdings BV, including HSBC Asia Holdings BV, the immediate holding company of The Hongkong and Shanghai Banking Corporation Limited.

Mr Patrick K W Chan is a Director and Executive Committee Member of Industrial Bank Co., Ltd ("Industrial Bank"), in which the Bank holds a 12.78% stake. Industrial Bank conducts general banking business in mainland China.

Mr Peter T S Wong is Group General Manager and Executive Director, Hong Kong and Mainland China of The Hongkong and Shanghai Banking Corporation Limited. Mr Wong is a Director of HSBC Insurance (Asia-Pacific) Holdings Limited, a subsidiary of The Hongkong and Shanghai Banking Corporation Limited. Mr Wong is a Director of Ping An Bank Limited and Bank of Communications Co., Ltd., which conduct general banking business. He is also a Director of Ping An Insurance (Group) Company of China, Ltd., which conducts life insurance, property and casualty insurance and other financial services.

HSBC Holdings plc, through its subsidiaries and associated undertakings, including The Hongkong and Shanghai Banking Corporation Limited, the immediate holding company of the Bank, is engaged in providing a comprehensive range of banking, insurance and related financial services.

The entities in which the Directors have declared interests are managed by separate Boards of Directors and

management, which are accountable to their respective shareholders.

Further, Industrial Bank has a connected party transactions committee which is responsible for considering all matters concerning connected party transactions to be entered into by Industrial Bank as required by the laws of mainland China. All members of Industrial Bank's connected party transactions committee are independent non-executive Directors.

The Board of the Bank includes eight independent non-executive Directors whose views carry significant weight in the Board's decisions. The Audit Committee of the Bank, which consists of three independent non-executive Directors, meets regularly to assist the Board of Directors in reviewing the financial performance, internal control and compliance systems of the Bank and its subsidiaries. The Bank is, therefore, capable of carrying on its businesses independently of, and at arm's length from, the businesses in which Directors have declared interests.

Directors' Emoluments

The emoluments of the Directors of the Bank (including executive Directors and independent non-executive Directors) on a named basis are set out on page 116 of the Bank's financial statements for the year ended 31 December 2006.

Substantial Interests In Share Capital

The register maintained by the Bank pursuant to the SFO recorded that, as at 31 December 2006, the following corporations had interests (as defined in that Ordinance) in the Bank set opposite their respective names:

Name of Corporation	Number of Ordinary Shares of HK\$5 each in the Bank (Percentage of total)
The Hongkong and Shanghai Banking Corporation Limited	1,188,057,371 (62.14%)
HSBC Asia Holdings BV	1,188,057,371 (62.14%)
HSBC Asia Holdings (UK)	1,188,057,371 (62.14%)
HSBC Holdings BV	1,188,057,371 (62.14%)
HSBC Finance (Netherlands)	1,188,057,371 (62.14%)
HSBC Holdings plc	1,188,057,371 (62.14%)

The Hongkong and Shanghai Banking Corporation Limited is a subsidiary of HSBC Asia Holdings BV, which is a wholly-owned subsidiary of HSBC Asia Holdings (UK), which in turn is a wholly-owned subsidiary of HSBC Holdings BV. HSBC Holdings BV is a wholly-owned subsidiary of HSBC Finance (Netherlands), which in turn is wholly-owned by HSBC Holdings plc. Accordingly, The Hongkong and Shanghai Banking Corporation Limited's interests are recorded as the interests of HSBC Asia Holdings BV, HSBC Asia Holdings (UK), HSBC Holdings BV, HSBC Finance (Netherlands) and HSBC Holdings plc.

The Directors regard HSBC Holdings plc to be the beneficial owner of 1,188,057,371 ordinary shares in the Bank (62.14%).

All the interests stated above represent long positions. As at 31 December 2006, no short positions were recorded in the Register of Interests in Shares and Short Positions required to be kept under section 336 of the SFO.

Capital

In 2006, the Bank issued floating-rate subordinated notes amounting to US\$450 million that mature in July 2016 with a one-time call option exercisable by the Bank in July 2011. The notes, listed on the Stock Exchange, were issued to strengthen the Bank's capital base and support business growth in both Hong Kong and mainland China as part of the Bank's strategy for continuing to increase shareholder value.

Purchase, Sale Or Redemption Of The Bank's Listed Securities

Save for the issuance of subordinated notes of US\$450 million, during the year, there was no purchase, sale or redemption by the Bank, or any of its subsidiaries, of the Bank's listed securities.

Public Float

As at the date of this report, the Bank has maintained the prescribed public float under the Listing Rules, based on the information that is publicly available to the Bank and within the knowledge of the Directors of the Bank.

Supervisory Policy Manuals On Financial Disclosure By And Corporate Governance Of Locally Incorporated Authorised Institutions

The statutory accounts of the Bank for the year ended 31 December 2006 fully comply with the module on "Financial Disclosure by Locally Incorporated Authorised Institutions" under the Supervisory Policy Manual issued by the Hong Kong Monetary Authority ("HKMA") in November 2002. The Bank also follows the module on "Corporate Governance of Locally Incorporated Authorised Institutions" under the Supervisory Policy Manual issued by the HKMA in September 2001. Details of the Bank's corporate governance practices are set out in the "Corporate Governance and Other Information" section under its 2006 Annual Report.

Auditors

KPMG retire and, being eligible, offer themselves for re-appointment. A resolution for the re-appointment of KPMG as auditors of the Bank is to be proposed at the forthcoming Annual General Meeting.

On behalf of the Board

Michael Smith

Chairman
Hong Kong, 5 March 2007