Group Chief Executive's Business Review

Stuart Gulliver *Group Chief Executive*

"...we will continue to target growth in the most strategically attractive markets for HSBC and build our capabilities in connectivity, one of our distinctive strengths as a globally connected bank."

Underlying financial performance continued to improve in 2010 and shareholders continued to benefit from HSBC's universal banking model. All regions and customer groups were profitable, as Personal Financial Services and North America returned to profit. Commercial Banking made an increased contribution to underlying earnings and Global Banking and Markets also remained strongly profitable, albeit behind 2009's record performance, reflecting a well-balanced and diversified business.

Credit experience continued to improve, as a result of a stronger global economy and our actions to reduce balance sheet risk. As a globally connected bank with a growing presence across the world's faster-growing regions, HSBC also benefited from higher trade volumes and strong momentum in emerging economies, especially in Asia. Asia contributed the largest proportion to underlying pre-tax profits, while the contributions made by Latin America and the Middle East also increased. Together with our conservative management of the balance sheet, this improved performance allowed us to concentrate on serving our customers and to further strengthen our capital position.

Group performance headlines[1]

- Profit before tax improved year on year. On a reported basis, profits increased by nearly US$12 billion from US$7.1 billion to US$19 billion. On an underlying basis, profits increased by 36 per cent, or almost US$5 billion, from US$13.5 billion to US$18.4 billion.

1 All figures are on a reported basis and all references to profits are profits before tax unless otherwise stated.

Connecting people with the world's financial markets…

…by understanding our customers' lifestyles

HSBC Premier: tapping into our global network

This HSBC Premier customer divides her time between two cities in two countries on two continents. Living in Paris and paying frequent visits to her family in Chennai, India, she needs a bank account that complements her lifestyle. An account with the Premier Centre on the Champs Elysées (bottom left) – which opened in 2010 and is one of HSBC's largest Premier centres – fits the bill.

As a customer, she can tap into our global network and all the benefits that it provides. Not only does she now have easy access to her money wherever she is, but her Relationship Manager in Paris recently helped her open another Premier account, in Chennai (top) to facilitate her aim of purchasing a house near her relatives.

Premier is also helping her to maximise her savings. HSBC's World Selection Fund is an investment vehicle that uses our local experts worldwide to advise on investments in emerging markets, and a fund manager to manage the fund proactively to reduce risks and maximise returns.

Moving money online between her French and Indian accounts, and using her Premier MasterCard to pay in Indian rupees when dining out with family and friends (bottom right), our customer has found a banking relationship that matches her modern lifestyle.

- In a period of sustained low interest rates, revenues remained constrained, reflecting four principal factors: reducing loan balances in our US business; lower trading income in Global Banking and Markets resulting from lower client activity; adverse fair value movements on non-qualifying hedges; and a reduced contribution from Balance Sheet Management in line with earlier guidance.
- Strong asset growth in Commercial Banking, particularly in Asia, higher trade-related revenues generally, and expansion of our wealth management business, again most notably in Asia, partially offset these revenue pressures.
- Loan impairment charges reduced by almost half to US$14.0 billion. All regions and customer groups improved. The US experienced the greatest improvement, largely in the cards and consumer finance portfolios. Loan impairment charges also declined significantly in Latin America and the Middle East.
- In Global Banking and Markets, loan impairment charges fell significantly, notably in Europe as economic conditions improved. Credit risk provisions reduced by US$1 billion to US$0.4 billion in the available-for-sale asset-backed-securities portfolios due to a slowing in the rate of anticipated losses on underlying assets, in line with previous guidance. The associated available for sale reserve declined to US$6.4 billion from US$12.2 billion.
- The cost efficiency ratio rose to 55.2 per cent, which is above our target range and unacceptable to me. The causes were constrained revenues and, in part, investment in strategic growth initiatives across the business together with higher staff costs. It additionally reflected one-off payroll taxes of US$0.3 billion paid in 2010 in respect of the previous year and a pension accounting credit of US$0.5 billion in 2009 and US$0.1 billion in 2010. However, it is also clear that we need to re-engineer the business to remove inefficiencies.
- Return on average total shareholders' equity rose from 5.1 per cent to 9.5 per cent, reflecting increased profit generation during the year.
- HSBC continued to grow its capital base and strengthen its capital ratios further. The core tier 1 ratio increased from 9.4 per cent to 10.5 per cent, as a result of capital generation and lower risk-weighted assets.
- Total loans and advances to customers increased by 7 per cent to US$958 billion while deposits increased by 6 per cent to US$1.2 trillion.

Impact of the evolving regulatory environment on the business

Much of the detail around the potential impact of change for banks remains uncertain. However, analysis of what we know confirms that our ability to generate capital and manage our risk-weighted assets positions HSBC strongly – and competitively – within the industry as the pace of change intensifies.

HSBC fully supports the rationale of the Basel III proposals which require banks to hold more capital. This is absolutely core to ensuring that governments and taxpayers are better protected in future than they have been in the past.

Certain aspects of the Basel III rules remain uncertain as to interpretation and application by national regulators. Notably, this includes any capital requirements which may be imposed on the Group over the implementation period in respect of the countercyclical capital buffer and any additional regulatory requirements for SIFIs. However, we believe that ultimately the level for the common equity tier 1 ratio of the Group may lie in the range 9.5 to 10.5 per cent. This exceeds the minimum requirement for common equity tier 1 capital plus the capital conservation buffer.

We have estimated the pro forma common equity tier 1 ratio of the Group based on our interpretation of the new Basel III rules as they will apply from 1 January 2019, based on the position of the Group at year-end 2010. The rules will be phased in from 2013 with a gradual impact and we have estimated that their full application, on a pro forma basis, would result in a common equity tier 1 ratio which is lower than the

Connecting businesses with new markets…

…by facilitating global trade

A virtuous circle: creating export opportunities

The journey that these tyres make exemplifies the connections that criss-cross the global economy. Starting life in the Hengfeng Rubber and Plastic factory in Shandong Province, China (top), the tyres are shipped directly to Treadsetters' appointed dealers worldwide or to its distribution facility in Telford, UK (bottom left), before finally being delivered to the customer. A typical end-use for Treadsetters' tyres is found at this gold mine in Kalgoorlie, Western Australia (bottom right) – on earthmovers used to haul rock out of the mine tunnels.

Treadsetters became an HSBC customer in 2005. We have fostered a strong relationship with the company, providing long-term loan, receivables and import finance facilities to help it expand. As a result, Treadsetters has achieved an eightfold increase in turnover in five years and launched a range of budget tyres, representing a milestone in accessing new export markets.

The company took part in HSBC's Business Thinking programme, created in 2010 to broaden the horizons of some of the UK's most innovative small and medium-sized enterprises. Through a trip to China, Mexico or Turkey, these SMEs have gained fresh insights into business in key emerging markets.

Treadsetters, which won a regional Business Thinking award, is now one of Europe's principal tyre and wheel wholesalers, exporting to over 30 markets worldwide.

Basel II core tier 1 ratio by some 250-300 basis points. The changes relate to increased capital deductions, new regulatory adjustments and increases in risk-weighted assets. However, as the changes will progressively take effect over six years leading up to 2019 and as HSBC has a strong track record of capital generation and actively manages its risk-weighted assets, we are confident in our ability to mitigate the effect of the new rules before they come into force.

Last year, HSBC committed to reviewing its target shareholder return on equity once the effects of new regulation became clearer. Now that we have better visibility on the impact of increased capital requirements, we believe that higher costs of the evolving regulatory framework will, all other things being equal, depress returns for shareholders of banks. We will therefore target a return on average shareholders' equity of 12 to 15 per cent in the future.

As Group Chief Executive, it is right that, in managing the business and developing Group strategy, my principal office should be in Hong Kong – a global financial hub of growing importance at the centre of HSBC's strategically most important region. However, the company is headquartered in London and we hope to remain there. London's pre-eminence as an international financial services centre is widely recognised and well-deserved and reflects successful government policy over decades to build that position. It is therefore important to us that the UK's competitive position is protected and sustained. Appropriate supervision is an important part of the larger equation. Policymakers should continue to legislate and regulate, but they must not destroy London's competitive position in the process.

As the Group Chairman has outlined, new legislation is expected to be enacted in the UK, effective from the start of 2011, one curious consequence of which is an explicit incremental cost of being headquartered in the UK for any global bank. Had this been applied for 2010, this annual charge would have amounted to approximately US$0.6 billion in HSBC's case. Moreover, the overseas balance sheet would account for the majority of the annual charge, with the UK balance sheet accounting for approximately one-third of the total.

Outlook

We have been closely watching events unfold in parts of the Middle East and North Africa. Our primary concern is for the security of our 12,000 staff across the region and we continue to work to ensure their safety. We have also activated robust continuity plans so that we can also stay open for business and support the needs of our customers. As a strongly capitalised global bank, HSBC's financial performance has not been materially affected by events to date. HSBC has been present in the Middle East for more than 50 years and we remain absolutely committed to its future. We also believe that the region's economies have a number of structural strengths which leave us positive on the longer-term outlook.

In the short term, risks to global growth remain, not least from an elevated oil price. We therefore expect cyclical volatility to continue – including in emerging markets – and progress is unlikely to be linear. In the longer term, we believe that growth rates in many Western markets will continue to significantly underperform those of the emerging world. Emerging markets are no longer simply leading the recovery from a Western crisis; the growth gap has become a sustained secular trend.

The global economy's structural position also still requires fundamental readjustment. Many Western economies must still deal with a large overhang of household and government debt and weak growth and high unemployment will make this a slow and painful process. As faster-growing nations seek to limit the effect of Western monetary policy on their own economies, we cannot discount the risk of increased tension over exchange rate and trade issues.

HSBC's balance sheet remains strongly positioned to benefit from future interest rate rises. We are realistic that, in many developed countries at least, historically low rates may continue to constrain income growth in the near-term. Nevertheless, maintaining a conservative liquidity position is core to our proposition and to our funding

Connecting investors with exclusive assets…

…by realising new investment opportunities

strength. In our risk appetite statement approved by the Board, we have set a maximum advances-to-deposits ratio for the Group of 90 per cent. This underlines our continuing commitment to a high level of liquidity and reflects our philosophy that HSBC should not be reliant on wholesale markets for funding. Even with a ratio currently slightly below 80 per cent, we have capacity for further lending growth.

In the short term, we expect the benefits of asset growth achieved in 2010 to continue to flow into revenues. In the medium term, we will continue to target growth in the most strategically attractive markets for HSBC and build our capabilities in connectivity, one of our distinctive strengths as a globally connected bank.

At the same time, with demand in many developed markets constrained and interest spreads remaining compressed, we fully recognise the importance of ever more robust cost management discipline and the need to continue re-engineering the business to improve efficiency.

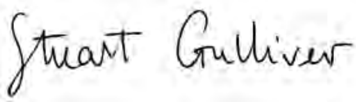
Furthermore, capital is becoming a scarcer resource and, as a new regulatory environment evolves, I am committed to making capital allocation a more disciplined and rigorous process at HSBC in order to drive the correct investment decisions for the future.

We will talk more to investors about each of these initiatives later in the spring. However, as a result of this focus, we are committed to delivering a cost efficiency ratio and a return on average shareholders' equity within our published target range.

We also recognise the importance of reliable dividend income for our shareholders and I believe it should be possible to benchmark a payout ratio of between 40 to 60 per cent of attributable profits under normal market conditions.

In closing, I would like to acknowledge the huge contribution that my predecessor, Mike Geoghegan, made to HSBC in his five years as Group Chief Executive – not least during 2010 – and I wish him well for the future.

Finally, I am pleased to report that we have had a good start to the year, with continued momentum in lending, mainly in emerging markets and in respect of global trade.



Stuart Gulliver
Group Chief Executive

28 February 2011

Alternative investment Club Deal Programme: making new connections

1540 Broadway, Times Square, New York: this 44-storey, 907,000-square-foot 'trophy' office building in one of the world's global cities is an attractive investment opportunity (top and bottom right).

In 2010, HSBC Alternative Investments in London, working with a fund adviser in the US, secured a 49 per cent stake in the prime commercial property in an exclusive 'off market' deal for a select group of HSBC Private Bank clients, each of whom invested a minimum of US$5 million. Using our global reach, we put together a syndicate of Private Bank clients from both developed and emerging markets – including high net worth investors from our major Asian Private Banking centres (bottom left) – who shared the aim of building a diversified real estate investment portfolio. Such a high value investment would not normally have been available to individual investors.

Our Club Deal Programme currently focuses on investments in the US and Europe, but plans to expand to Asia.