

Report of the Directors: Overview

Financial highlights

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Earnings per share

US\$0.74 – down 20%

2011: US\$0.92
2010: US\$0.73

Dividends per ordinary share¹

US\$0.41

2011: US\$0.39
2010: US\$0.34

Net assets per share

US\$9.09 – up 7%

2011: US\$8.48
2010: US\$7.94

For the year

Profit before taxation

US\$20,649m – down 6%

2011: US\$21,872m
2010: US\$19,037m

Underlying profit before taxation

US\$16,385m – up 18%

2011: US\$13,861m

Total operating income

US\$82,545m – down 1%

2011: US\$83,461m
2010: US\$80,014m

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

US\$68,330m – down 5%

2011: US\$72,280m
2010: US\$68,247m

Profit attributable to the ordinary shareholders of the parent company

US\$13,454m – down 17%

2011: US\$16,224m
2010: US\$12,746m

At the year-end

Loans and advances to customers

US\$998bn – up 6%

2011: US\$940bn
2010: US\$958bn

Customer accounts

US\$1,340bn – up 7%

2011: US\$1,254bn
2010: US\$1,228bn

Ratio of customer advances to customer accounts

74.4%

2011: 75.0%
2010: 78.1%

Total equity

US\$183bn – up 10%

2011: US\$166bn
2010: US\$155bn

Average total shareholders' equity to average total assets

6.2%

2011: 5.6%
2010: 5.5%

Risk-weighted assets

US\$1,124bn – down 7%

2011: US\$1,210bn
2010: US\$1,103bn

Capital ratios

Core tier 1 ratio

12.3%

2011: 10.1%
2010: 10.5%

Tier 1 ratio

13.4%

2011: 11.5%
2010: 12.1%

Total capital ratio

16.1%

2011: 14.1%
2010: 15.2%

Performance ratios

Credit coverage ratios

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

Return ratios

Return on average ordinary shareholders' equity ²	Return on average invested capital ³	Post-tax return on average total assets	Pre-tax return on average risk-weighted assets
8.4%	8.0%	0.6%	1.8%
2011: 10.9% 2010: 9.5%	2011: 10.2% 2010: 8.7%	2011: 0.6% 2010: 0.6%	2011: 1.9% 2010: 1.7%

Efficiency and revenue mix ratios

Cost efficiency ratio ⁴	Net interest income to total operating income	Net fee income to total operating income	Net trading income to total operating income
62.8%	45.6%	19.9%	8.6%
2011: 57.5% 2010: 55.2%	2011: 48.7% 2010: 49.3%	2011: 20.6% 2010: 21.7%	2011: 7.8% 2010: 9.0%

Share information at the year-end

US\$0.50 ordinary shares in issue	Market capitalisation	Closing market price		
		London	Hong Kong	American Depositary Share ⁵
18,476m	US\$194bn	£6.47	HK\$81.3	US\$53.07
2011: 17,868m 2010: 17,686m	2011: US\$136bn 2010: US\$180bn	2011: £4.91 2010: £6.51	2011: HK\$59.00 2010: HK\$79.70	2011: US\$38.10 2010: US\$51.04
		Total shareholder return ⁶		
		Over 1 year	Over 3 years	Over 5 years
To 31 December 2012		139	104	113
Benchmarks:				
– FTSE 100 ⁷		110	121	111
– MSCI World ⁸		117	124	97
– MSCI Banks ⁹		128	106	68

For footnotes, see page 120.

Report of the Directors: Overview (continued)**Group Chairman's Statement****Group Chairman's Statement**

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

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

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

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

which we reached in December, in our Interim Report.

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

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

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

Performance in 2012

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

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

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

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

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

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

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

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

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

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

Progress on regulatory reform

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

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

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

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

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

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

Report of the Directors: Overview (continued)

Group Chairman's Statement

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

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

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

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

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

Enforcing global standards

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

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

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

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

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

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

Board changes

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

We welcome two new directors to the Board.

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

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

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

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

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

Social contribution

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

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

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

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

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

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

Looking ahead

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

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

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



D J Flint, *Group Chairman*
4 March 2013

Report of the Directors: Overview (continued)**Group Chief Executive's Business Review****Group Chief Executive's Business Review**

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

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

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

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

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

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

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

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

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

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

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

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

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

We are investing to build this distinctive international competitive position.

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

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

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

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

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

Group performance headlines

- Reported profit before tax was US\$20.6bn, US\$1.2bn lower than in 2011, including US\$5.2bn of adverse movements in the fair value of our own debt attributable to credit spreads compared with favourable movements of US\$3.9bn in 2011. This variance of US\$9.1bn was partially offset by an increase of US\$7.5bn in respect of gains from the disposal of businesses, notably from the sale of the US Card and Retail Services business and the agreement to sell our stake in Ping An.
- Underlying profit before tax was US\$16.4bn, up US\$2.5bn, mainly due to higher revenues and lower loan impairment charges and other credit risk provisions. These factors were partially offset by an increase in operating expenses, primarily reflecting the settlement of the investigations into past inadequate compliance with anti-money laundering and sanction laws and increased provisions for UK customer redress programmes.
- Underlying revenues rose by 7%, led by Global Banking and Markets where the majority of our businesses grew, notably Credit and Rates in Europe, as spreads tightened and investor sentiment improved following stimuli by central banks globally. Commercial Banking also recorded revenue growth as customer loans and advances increased in all regions, with over half of this growth coming from our faster-growing regions of Hong Kong, Rest of Asia-Pacific and Latin America, driven by higher trade-related lending. Customer deposits also rose as we continued to attract deposits through Payments

Report of the Directors: Overview (continued)

Group Chief Executive's Business Review

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

- We achieved growth in reported loans and advances to customers of more than US\$57bn during the year, notably in residential mortgages and term and trade-related lending. Customer deposits increased by over US\$86bn, allowing us to maintain a strong ratio of customer advances to customer accounts of 74.4%.
- Underlying costs were US\$4.3bn higher than in 2011 including payments of US\$1.9bn made as part of the settlement of the investigations into past inadequate compliance with anti-money laundering and sanctions laws, additional provisions in respect of UK customer redress programmes of US\$1.4bn, and a credit in 2011 of US\$0.6bn relating to defined benefit pension obligations in the UK which did not recur. Operating expenses also increased due to inflationary pressures, for example, on wages and salaries, in certain of our Latin American and Asian markets. Other increases arose from investment in strategic initiatives including certain business expansion projects, enhanced processes and technology capabilities, and increased investment in regulatory and compliance infrastructure primarily in the US.
- The reported cost efficiency ratio deteriorated from 57.5% to 62.8% and from 63.4% to 66.0% on an underlying basis, as a result of higher notable cost items, as described above.
- Return on equity was 8.4%, down from 10.9% in 2011, primarily reflecting the adverse movement in fair value of own debt attributable to movements in credit spreads, a higher tax charge and higher average shareholders' equity. Similarly, the Group's pre-tax return on average risk-weighted assets ('RoRWA') for 2012 was 1.8% or 1.5% on an underlying basis. Adjusting for the negative returns on US consumer finance business and legacy credit in Global Banking and Markets, the remainder of the Group achieved a RoRWA of 1.9% in 2012 and 2.1% in 2011.
- The core tier 1 ratio increased during the year from 10.1% at the end of 2011 to 12.3%. This

increase was driven by capital generation and a reduction in risk-weighted assets following business disposals.

- The Basel III capital rules began their staged 6-10 year implementation in some parts of the world in January 2013. Nevertheless, the FSA has set our 2013 capital target calculation on a Basel III end point basis. This effectively accelerates our implementation of Basel III by several years relative to European regulations and other global banks. Consistent with this, we now operate to an internal capital target set on a Basel III end point basis of 9.5%-10.5%.
- Profit attributable to ordinary shareholders was US\$13.5bn, of which US\$8.3bn was declared in dividends in respect of the year. This compared with US\$2.9bn of variable pay awarded (net of tax) to our employees for 2012.
- Dividends per ordinary share declared in respect of 2012 were US\$0.45, an increase of 10% compared with 2011, with a fourth interim dividend for 2012 of US\$0.18 per ordinary share.

Global standards

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

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

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

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

Outlook

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

The US economy should continue its gradual recovery, with continuing quantitative easing measures supporting a recovery in the housing market, although the recovery is still not strong enough to support a sustained reduction in

unemployment. We expect higher growth in Latin America in 2013, due in part to a modest recovery in Brazil. The biggest risk to the world economy remains an uncharted shock from Europe and an exacerbation of the sovereign debt crisis. We remain cautious on the outlook for Europe due to weak demand, slow growth, and political and regulatory uncertainty.

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



S T Gulliver, *Group Chief Executive*
4 March 2013

Report of the Directors: Overview (continued)

Disclosure philosophy // HSBC's vision > Principal activities / HSBC Values

Our disclosure philosophy

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

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

Enhanced Disclosure Task Force

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

2012 risk disclosures and continuing into 2013 and beyond.

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

Our approach

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

Guide to the implementation of EDTF recommendations in this Report

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

Type of risk	Disclosure	Page
General	• Risks to which the business is exposed, risk appetite and stress testing.	124 to 128
	• Top and emerging risks.	130 to 136
Risk Governance and risk management strategies/business models	• Group Risk Committee.	323 to 328
	• Diagram of risk exposures by global business.	20
Capital adequacy and risk-weighted assets	• Reconciliation of the accounting balance sheet to the regulatory balance sheet.	287
	• Regulatory capital flow statement.	285
	• Analysis of credit risk by Basel asset class.	<i>Pillar 3 Disclosures 2012</i> 23 to 28 and 32 to 38
	• Risk-weighted assets flow statements for each risk-weighted asset type.	282 and 284
Liquidity	• Liquid asset buffer.	206 to 207
Funding	• Encumbrance.	211 to 214
	• Maturity analysis by balance sheet line.	485 to 492
	• Sources of funding and funding strategy.	209 to 211
Market risk	• Relationship between the market risk measures for trading and non-trading portfolios and balance sheet classification.	218 to 219
Credit risk	• Policies for impaired loans and reconciliation of movement in impaired loans.	162 and 254 to 259
	• Loan forbearance policies.	257
	• Credit risk mitigation and collateral.	163 to 168
Other risks	• Quantified measures on the management of operational risk.	227 to 230

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

HSBC's vision

Purpose	Reason why we exist	We aim to be where the economic growth is, connecting customers to opportunities, enabling businesses to thrive and economies to prosper, and ultimately helping people to fulfil their hopes and realise their ambitions.
Values	How we behave and conduct business	Act with courageous integrity by being: <ul style="list-style-type: none"> dependable and doing the right thing; open to different ideas and cultures; and connected to customers, regulators and each other.
Strategy	Where and how we compete	<ul style="list-style-type: none"> International network connecting faster-growing and developed markets Develop Wealth Management services and invest in retail banking only in markets where we can achieve profitable scale
Outcome	Being the world's leading international bank	Our pro forma post-tax profit allocation in 2012 ¹¹ : <ul style="list-style-type: none"> 60% of earnings retained 29% to shareholders as dividends 11% variable pay 

For footnote, see page 120.

Principal activities

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

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

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

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

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

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

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

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

HSBC Values

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

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

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

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

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

Report of the Directors: Overview (continued)

HSBC Values / Business and operating models

Ensuring our conduct matches our values

In line with our ambition to be recognised as the world's leading international bank, we aspire to lead the industry in our standards of conduct. As international markets become more interconnected and complex and, as threats to the global financial system grow, we are strengthening further the policies and practices which govern how we do business and with whom.

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

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

Under the supervision of HSBC's Global Standards Steering Meetings of the Group Management Board ('GMB'), we are already strengthening policies and processes in a number of important areas, described on the right.

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

We have adopted the UK Code of Practice for the Taxation of Banks and seeks to apply the spirit as well as the letter of the law in all the territories in which it operates. We deal with tax authorities in an open and honest manner. We are strengthening our policies and controls with the objective of ensuring our services are not used by clients seeking to evade their tax obligations.

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

Global standards execution framework – priority areas

Financial crime filter

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

Tax transparency

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

Sanctions

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

Information sharing

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

Customer due diligence

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

Affiliates' due diligence

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

Bearer shares

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

Business and operating models

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

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

Business model

We take deposits from our customers and use these funds to make loans, either directly or through the capital markets. Our direct lending includes residential and commercial mortgages and overdrafts, and term loan facilities. We finance importers and exporters engaged in international trade and provide

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

Our operating income is primarily derived from:

- net interest income – interest income we earn on customer loans and advances and on our surplus funds, less interest expense we pay on interest-bearing customer accounts and debt securities in issue;
- net fee income – fee income we earn from the provision of financial services and products to customers; and

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

At our Investor Day in May 2012, we outlined our geographical priorities where we expect future growth opportunities to be concentrated. We have defined the UK and Hong Kong as our home markets, and a further 20 countries as priority growth markets. These 22 markets accounted for over 90% of our profit before tax in 2012, and will be the primary focus of capital deployment. Network markets are markets with strong international relevance which serve to complement our international network, operating mainly through CMB and GB&M. Our combination of home, priority growth and network markets covers around 85-90% of all international trade and financial flows.

The final category, small markets, includes those where our operations are of sufficient scale to operate profitably, or markets where we maintain representative offices. This structure is illustrated below.

HSBC's market structure

	Hong Kong and Rest of Asia-Pacific	Europe	Middle East and North Africa	North America	Latin America
Home markets	<ul style="list-style-type: none"> • Hong Kong 	<ul style="list-style-type: none"> • UK 			
Priority growth markets	<ul style="list-style-type: none"> • Australia • Mainland China • India • Indonesia • Malaysia • Singapore • Taiwan • Vietnam 	<ul style="list-style-type: none"> • France • Germany • Switzerland • Turkey 	<ul style="list-style-type: none"> • Egypt • Saudi Arabia • UAE 	<ul style="list-style-type: none"> • Canada • USA 	<ul style="list-style-type: none"> • Argentina • Brazil • Mexico
Network markets	<ul style="list-style-type: none"> • Operations primarily focused on international clients and businesses of CMB and GB&M • Together with home and priority markets these cover 85-90% of international trade and capital flows 				
Small markets	<ul style="list-style-type: none"> • Markets where HSBC has profitable scale and focused operations • Representative Offices 				

Operating model

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

Holding company

HSBC Holdings plc, the holding company of the Group, is listed in London, Hong Kong, New York, Paris and Bermuda. HSBC Holdings is the primary provider of equity capital to its subsidiaries and provides non-equity capital to them when necessary.

Under authority delegated by the Board of HSBC Holdings, the GMB is responsible for management and day-to-day running of the Group,

Report of the Directors: Overview (continued)

Business and operating models / Strategic direction

within the risk appetite set by the Board. The Board, through the GMB, works to ensure that there are sufficient cash resources to pay dividends to shareholders, interest to bondholders, expenses and taxes.

HSBC Holdings does not provide core funding to any subsidiary, nor is a lender of last resort and does not carry out any banking business in its own right. HSBC has a legal entity-based Group structure, with subsidiaries operating under their own boards of directors as separately capitalised, ring-fenced entities, implementing Group strategy and delivering Group products and services, in most cases in the country or territory in which they are domiciled.

Main business activities by global business

Global businesses	RBWM	CMB	GB&M	GPB
Liability driven	<ul style="list-style-type: none"> Deposits Account services 	<ul style="list-style-type: none"> Deposits Payments and cash management 	<ul style="list-style-type: none"> Deposits Payments and cash management Balance sheet management 	<ul style="list-style-type: none"> Deposits Account services
Asset driven	<ul style="list-style-type: none"> Credit and lending 	<ul style="list-style-type: none"> Credit and lending Trade and receivables finance 	<ul style="list-style-type: none"> Credit and lending Asset and trade finance 	<ul style="list-style-type: none"> Credit and lending
Fee driven and other	<ul style="list-style-type: none"> Asset management Wealth solutions and financial planning Broking¹² Life insurance manufacturing 	<ul style="list-style-type: none"> Commercial insurance and investments 	<ul style="list-style-type: none"> Corporate finance¹³ Markets¹⁴ Securities services 	<ul style="list-style-type: none"> Asset management¹⁵ Financial advisory¹⁶ Broking¹² Corporate finance (via GB&M)¹³ Alternative investments¹⁷

For footnotes, see page 120.

Geographical regions

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

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

Global businesses

Our four global businesses are responsible for developing, implementing and managing their business propositions consistently across the Group, focusing on profitability and efficiency. They set their strategies within the confines of the Group strategy in liaison with the geographical regions, are responsible for issuing planning guidance regarding their businesses, are accountable for their profit and loss performance, and manage their headcount.

The main business activities of our global businesses are summarised below. Further details are provided on page 60.

Global functions

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

Strategic direction

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

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

- *International trade and capital flows* – the world economy is becoming ever more connected. Growth in world trade and cross-border capital flows continues to outstrip growth in average gross domestic product. Financial flows between countries and regions are highly concentrated, and over the next decade we expect 35 markets to generate 90% of world trade growth with a similar degree of concentration in cross-border capital flows.
- *Economic development and wealth creation* – we expect economies currently deemed 'emerging' to have increased five-fold in size by 2050, benefiting from demographics and urbanisation, by which time they will be larger than the developed world. By then, we expect 19 of the 30 largest economies will be markets that are currently described as emerging.

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

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

- *Network of businesses connecting the world* – HSBC is well positioned to capture the growing international financial flows. Our global reach and range of services put us in a strong position to serve corporate clients as they grow from small enterprises into large and international corporates. Our access to local retail funding and our suite of international products allows us to offer distinctive solutions for these clients profitably. We will focus on 'South-South' trade, connecting faster-growing economies with each other.
- *Wealth management and retail with local scale* – social mobility and wealth creation in the faster-growing markets in which we are positioned will generate demand for financial services which we will meet through our Wealth Management and GPB businesses. We will only invest in retail businesses in markets where we can achieve critical mass.

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

Simplifying HSBC

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

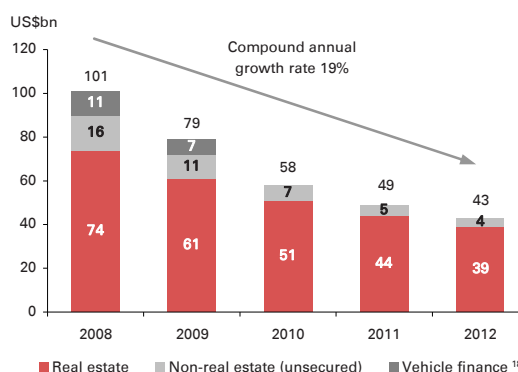
In 2012, we added a sixth filter to the existing five strategic evaluation criteria used to assess our business (international connectivity, economic development, profitability, cost efficiency and liquidity). The sixth filter requires compliance with our global standards on financial crime and involves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

Run-off portfolios

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

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

Run-off of portfolio receivables in the US



For footnote, see page 120.

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

Report of the Directors: Overview (continued)

Strategic direction / Risk

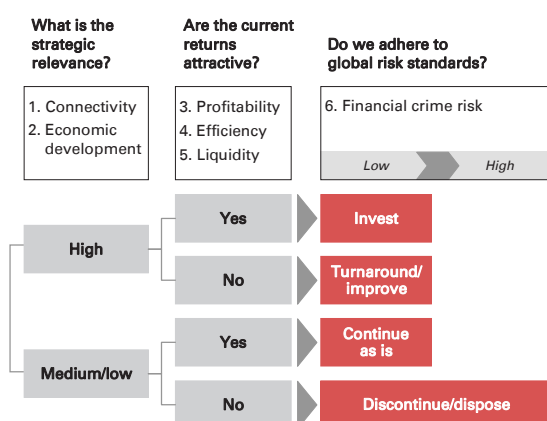
accretive basis. We have also identified the non-real estate portfolio for sale to reduce operational risk.

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

Addressing fragmentation

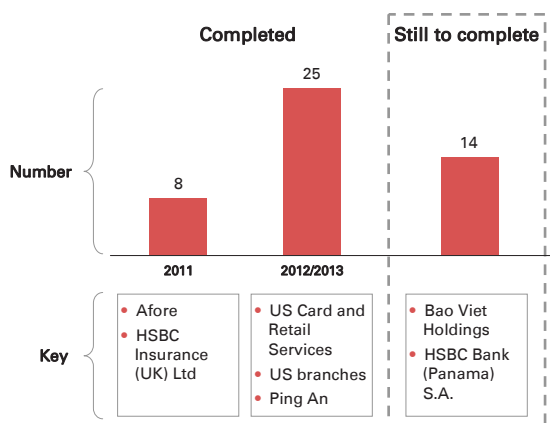
Fragmentation of the business is being addressed using the six filters to guide strategic actions.

Using the six filters in decision-making



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

Announced transactions¹⁹



For footnote, see page 120.

Improving organisational efficiency

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

- implementing consistent business models;
- re-engineering global functions;
- re-engineering operational processes; and
- streamlining IT.

Our approach to organisation, talent and values

Organisation	8 by 8 structure	<ul style="list-style-type: none"> Maximum of 8 layers between Group CEO and frontline Increased spans of control (8 reports per manager)
	4 global businesses	<ul style="list-style-type: none"> With target business and operating models As non-strategic businesses are exited, we can organise resources at the centre
	11 global functions	<ul style="list-style-type: none"> To manage resources globally Easier to enforce global controls
Talent		<ul style="list-style-type: none"> More visibility for our global talent pool Creating opportunities for talented individuals
Values (Guiding principle – courageous integrity)		<ul style="list-style-type: none"> Led from the top and cascaded through the organisation – ensuring global adherence to high standards Fully integrated into performance management

Restructuring HSBC

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

Global Banking and Markets

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

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

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

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

Our US businesses

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

branches and the repositioning of our activities towards international businesses.

- CMB is now focused on five hubs contributing over 50% of US corporate imports and exports, including the West Coast Southeast and Midwest.
- Global Banking serves top-tier multinationals and Global Markets (New York) provides a hub for international clients across America and globally, providing US dollar funding.
- RBWM and GPB target internationally mobile clients in large metropolitan centres on the West and East coasts.

Global Private Banking

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

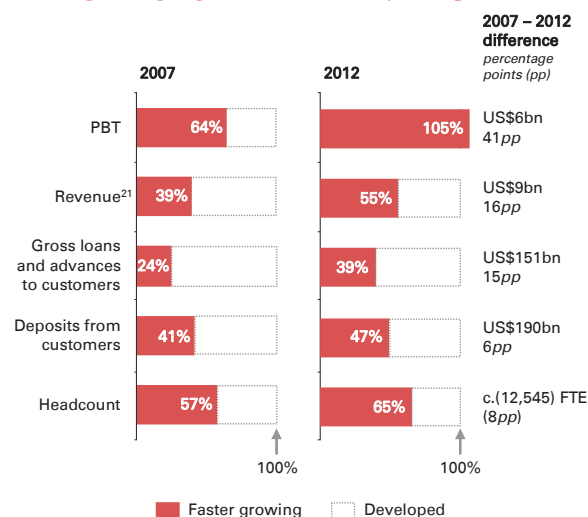
- *operational risk and compliance* – GPB will adhere to the highest standards in the industry, and will continue to strengthen its compliance and risk framework, focusing on global standards and tax transparency;
- *integrated operating model* – GPB has implemented a new global operating model that will provide better integration and coordination between geographical regions, and it will complete the roll-out of improved data security and compliance governance, systems and processes;
- *integration with the Group* – GPB will intensify collaboration with CMB to access wealth created by entrepreneurs who already bank with HSBC on the business side. GPB will also contribute to a seamless Group wealth proposition for personal customers; and
- *capturing growth* – GPB will focus investment on the most attractive developed and faster-growing wealth markets where it can build access to well established client franchises and strong local and international product capabilities.

Growing HSBC

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

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

Faster-growing regions²⁰ as a share of Group data



For footnotes, see page 120.

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

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

Risk

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

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

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

Report of the Directors: Overview (continued)

Risk

Exposure to risks arising from the business activities of global businesses

	HSBC				Other (including Holding Company)
Global business	RBWM	CMB	GB&M	GPB	
Business activities	<ul style="list-style-type: none"> Deposits Accounts services Credit and lending Asset management Wealth solutions and financial planning Broking Life insurance manufacturing 	<ul style="list-style-type: none"> Deposits Payments and cash management Credit and lending International trade and receivables finance Commercial insurance and investments 	<ul style="list-style-type: none"> Deposits Payments and cash management Balance sheet management Credit and lending Asset and trade finance Corporate finance Markets Securities services 	<ul style="list-style-type: none"> Deposits Account services Credit and lending Asset management Financial advisory Broking Corporate finance (via GB&M) Alternative investments 	<ul style="list-style-type: none"> HSBC holding company and central operations
Balance sheet ²²	US\$bn • Assets 535 • Customer accounts 562	US\$bn • Assets 363 • Customer accounts 338	US\$bn • Assets 1,859 • Customer accounts 332	US\$bn • Assets 118 • Customer accounts 106	US\$bn • Assets 187 • Customer accounts 2
RWAs	US\$bn • Credit risk 232 • Operational risk 45	US\$bn • Credit risk 366 • Operational risk 31	US\$bn • Credit risk 259 • Counterparty credit risk 48 • Operational risk 41 • Market risk 55	US\$bn • Credit risk 18 • Operational risk 4	US\$bn • Credit risk 25 • Operational risk –
Risk profile	Liquidity and funding risk, Pension risk, Fiduciary risk, Reputational risk, Compliance risk, Sustainability risk and Insurance risk, which is predominantly in RBWM and CMB.				

For footnote, see page 120.

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

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

Risk factors

Our businesses are exposed to a variety of risk factors that could potentially affect the results of our operations or financial condition. These are:

Macroeconomic and geopolitical risk

- Current economic and market conditions may adversely affect our results.
- We have exposure to the ongoing economic crisis in the eurozone.
- We are subject to political and economic risks in the countries in which we operate, including the risk of government intervention.
- Changes in foreign currency exchange rates may affect our results.

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

- Failure to comply with certain regulatory requirements would have an adverse material effect on our results and operations.
- We are subject to a number of legal and regulatory actions and investigations, the outcomes of which are inherently difficult to

predict, but unfavourable outcomes could have a material adverse effect on our operating results and brand.

- Unfavourable legislative or regulatory developments, or changes in the policy of regulators or governments, could generate model risk and could have a significant adverse effect on our operations, financial condition and prospects.
- The UK Government has proposed draft legislation for banking reforms based on the recommendations of the Independent Commission on Banking. Additional proposals are being considered in France, Germany and the EU and any resulting structural changes could have a material adverse effect on us.
- We are subject to tax-related risks in the countries in which we operate which could have a material adverse effect on our operating results.

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

- Our risk management measures may not be successful.
- Operational risks are inherent in our business.
- Our operations are subject to the threat of fraudulent activity.
- Our operations are subject to disruption from the external environment.
- Our operations utilise third party suppliers.
- Our operations are highly dependent on our information technology systems.
- Our operations have inherent reputational risk.
- We may suffer losses due to employee misconduct.
- We rely on recruiting, retaining and developing appropriate senior management and skilled personnel.

- Our financial statements are based in part on assumptions and estimates which, if inaccurate, could cause material misstatement of the results and financial position of the Group.
- Third parties may use us as a conduit for illegal activities without our knowledge, which could have a material adverse effect on us.
- We may not achieve all the expected benefits of our strategic initiatives.

Risks related to our business

- We have significant exposure to counterparty risk within the financial sector and to other risk concentrations.
- Market fluctuations may reduce our income or the value of our portfolios.
- Liquidity, or ready access to funds, is essential to our businesses.
- Any reduction in the credit rating assigned to HSBC Holdings, any subsidiaries of HSBC Holdings or any of their respective debt securities could increase the cost or decrease the availability of our funding and adversely affect our liquidity position and interest margins.
- Risks concerning borrower credit quality are inherent in our businesses.
- Our Insurance business is subject to risks relating to insurance claim rates and changes in insurance customer behaviour.
- HSBC Holdings is a holding company and, as a result, is dependent on dividends from its subsidiaries to meet its obligations, including obligations with respect to its debt securities, and to provide profits for payment of future dividends to shareholders.
- We may be required to make substantial contributions to our pension plans.

Report of the Directors: Overview (continued)

Risk / KPIs

Top and emerging risks

We classify certain risks as ‘top’ or ‘emerging’. We define a ‘top risk’ as being a current, emerged risk which has arisen across any of our risk categories, regions or global businesses and has the potential to have a material impact on our financial results or our reputation and the sustainability of our long-term business model, and which may form and crystallise within a one-year horizon. We consider an ‘emerging risk’ to be one which has large uncertain outcomes which may form and crystallise beyond a one-year horizon and, if it were to crystallise, could have a material effect on our long-term strategy.

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

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

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

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

Macroeconomic and geopolitical risk

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

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

- Regulatory developments affecting our business model and Group profitability.
- Regulatory investigations, fines, sanctions and requirements relating to conduct of business and financial crime negatively affecting our results and brand.
- Dispute risk.

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

- Regulatory commitments and consent orders including under the Deferred Prosecution Agreements.
- Challenges to achieving our strategy in a downturn.
- Internet crime and fraud.
- Level of change creating operational complexity and heightened operational risk.
- Information security risk.
- Model risk.

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

Risk appetite

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

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

Key performance indicators

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

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

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

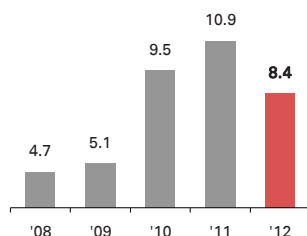
Employee engagement has been monitored through annual Global People Surveys. In 2012, quarterly Pulse Surveys were introduced, and the Global People Surveys scheduled biennially. The next Global People Survey will be in 2013. As the Pulse Surveys were not designed to report employee engagement information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

Strategy

Restructuring HSBC – improving the way we deploy capital

Key Performance Indicators

Return on average ordinary shareholders' equity²

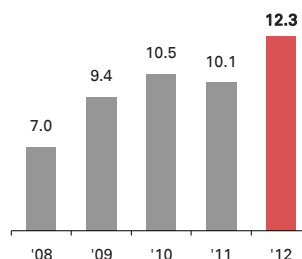


Measure: (percentage) profit attributable to ordinary shareholders divided by average ordinary shareholders' equity.

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

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

Core tier 1 capital ratio¹⁰

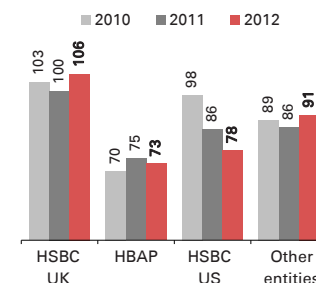


Measure: (percentage) ratio of core tier 1 capital comprising shareholders' equity and related non-controlling interests less regulatory deductions and adjustments to total risk-weighted assets.

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

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

Advances to core funding ratio²³



Measure: loans and advances to customers as a percentage of the total of core customer deposits and term funding with a remaining term to maturity in excess of one year.

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

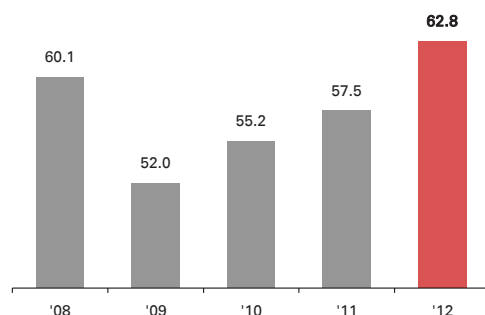
Outcome: the operating entities reported remained inside their advances to core funding limits of between 70% and 115% during 2012, except for one operating entity reported within the total of HSBC's other principal entities which operated with a limit of 125% during the year. This limit has been reduced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

Strategy

Simplifying HSBC – a lean and values-driven organisation

Key Performance Indicators

Cost efficiency (2012: underlying cost efficiency 66.0%)

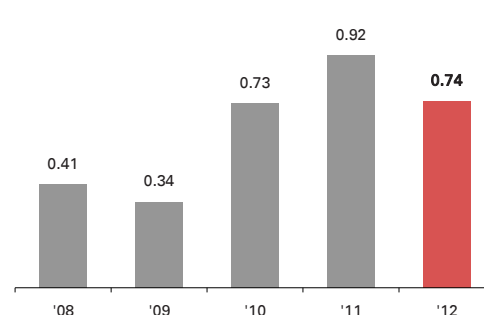


Measure: (percentage) total operating expenses divided by net operating income before loan impairment and other credit risk provisions.

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

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

Basic earnings per ordinary share



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

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

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

Report of the Directors: Overview (continued)

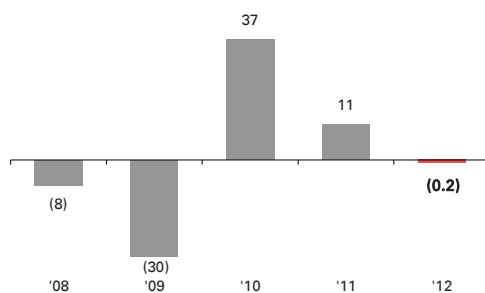
KPIs // Financial summary > Use of non-GAAP financial measures

Growing HSBC – continuing to position ourselves for growth

Strategy

Risk-adjusted revenue growth

(2012: underlying growth 13%)

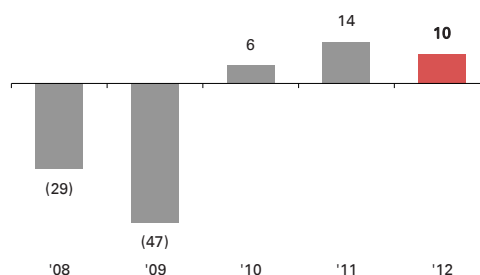


Measure: (percentage) increase in reported net operating income after loan impairment and other credit risk charges since last year.

Target: to deliver consistent growth in risk adjusted revenues.

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

Dividends per ordinary share growth



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

Target: to deliver sustained dividend per share growth.

Outcome: dividends per share increased by 10%.

Key Performance Indicators

Customer recommendation

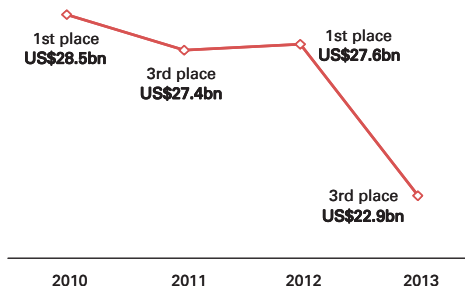
Measure: we measure our customer satisfaction through an independent market research survey of retail banking customers in selected countries, using a specific customer recommendation index ('CRI') to score performance. We benchmark our performance against key competitors in each market and set targets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

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

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

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

Brand value



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

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

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

Key Performance Indicators

For footnotes, see page 120.