HSBC HOLDINGS PLC
Form 20-F
March 07, 2012
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As filed with the Securities and Exchange Commission on March 7, 2012.

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 20-F

¨ **REGISTRATION STATEMENT PURSUANT TO SECTION 12(b) OR 12(g) OF THE SECURITIES EXCHANGE ACT OF 1934**

Or

þ **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the fiscal year ended December 31, 2011

Or

¨ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

Or

¨ **SHELL COMPANY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

Date of event requiring this shell company report __________

For the transition period from N/A to N/A

Commission file number: 1-14930

HSBC Holdings plc

(Exact name of Registrant as specified in its charter)

N/A	**United Kingdom**
(Translation of Registrant s name into English)	(Jurisdiction of incorporation or organisation)

8 Canada Square

London E14 5HQ

United Kingdom

(Address of principal executive offices)

Russell C Picot

8 Canada Square

London E14 5HQ

United Kingdom

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(Name, Telephone, Email and/or Facsimile number and Address of Company Contact Person)

Securities registered or to be registered pursuant to Section 12(b) of the Securities Exchange Act of 1934:

Title of each class	Name of each exchange on which registered
Ordinary Shares, nominal value US$0.50 each.	London Stock Exchange Hong Kong Stock Exchange Euronext Paris Bermuda Stock Exchange New York Stock Exchange*
American Depository Shares, each representing 5 Ordinary Shares of nominal value US$0.50 each.	New York Stock Exchange
6.20% Non-Cumulative Dollar Preference Shares, Series A	New York Stock Exchange*
American Depositary Shares, each representing one-fortieth of a Share of 6.20% Non-Cumulative Dollar Preference Shares, Series A	New York Stock Exchange
5.25% Subordinated Notes 2012	New York Stock Exchange
5.10% Senior Unsecured Notes Due 2021	New York Stock Exchange
4.875% Senior Unsecured Notes Due 2022	New York Stock Exchange
7.625% Subordinated Notes due 2032	New York Stock Exchange
7.35% Subordinated Notes due 2032	New York Stock Exchange

6.5% Subordinated Notes 2036	New York Stock Exchange
6.5% Subordinated Notes 2037	New York Stock Exchange
6.8% Subordinated Notes Due 2038	New York Stock Exchange
6.100% Senior Unsecured Notes due 2042	New York Stock Exchange
8.125% Perpetual Subordinated Capital Securities Exchangeable at the Issuer s Option into Non-Cumulative Dollar Preference Shares	New York Stock Exchange
8.00% Perpetual Subordinated Capital Securities Exchangeable at the Issuer s Option into Non-Cumulative Dollar Preference Shares, Series 2	New York Stock Exchange

Securities registered or to be registered pursuant to Section 12(g) of the Securities Exchange Act of 1934: None

Securities for which there is a reporting obligation pursuant to Section 15(d) of the Securities Exchange Act of 1934: None

Indicate the number of outstanding shares of each of the issuer s classes of capital or common stock as of the close of the period covered by the annual report:

Ordinary Shares, nominal value US$0.50 each 17,868,085,646

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

þ Yes ¨ No

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

¨ Yes þ No.

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

þ Yes ¨ No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

¨ Yes ¨ No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer þ Accelerated filer ¨ Non-accelerated filer ¨

Indicate by check mark which basis of accounting the registrant has used to prepare the financial statements included in this filing:

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

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

¨ Item 17 ¨ Item 18

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

¨ Yes þ No

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

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HSBC HOLDINGS PLC

Annual Report and Accounts 2011

Certain defined terms

Unless the context requires otherwise, HSBC Holdings means HSBC Holdings plc and HSBC , the Group , we , us and our refers to HSBC Holdings together with its subsidiaries. Within this document the Hong Kong Special Administrative Region of the People s Republic of China is referred to as Hong Kong . When used in the terms shareholders equity and total shareholders equity , shareholders means holders of HSBC Holdings ordinary shares and those preference shares classified as equity. The abbreviations US$m and US$bn represent millions and billions (thousands of millions) of US dollars, respectively.

Financial statements

The consolidated financial statements of HSBC and the separate financial statements of HSBC Holdings have been prepared in accordance with International Financial Reporting Standards (IFRSs) as issued by the International Accounting Standards Board (IASB) and as endorsed by the European Union (EU). EU-endorsed IFRSs may differ from IFRSs as issued by the IASB if, at any point in time, new or amended IFRSs have not been endorsed by the EU. At 31 December 2011, there were no unendorsed standards effective for the year ended 31 December 2011 affecting these consolidated and separate financial statements, and there was no difference between IFRSs endorsed by the EU and IFRSs issued by the IASB in terms of their application to HSBC. Accordingly, HSBC s financial statements for the year ended 31 December 2011 are prepared in accordance with IFRSs as issued by the IASB.

We use the US dollar as our presentation currency because the US dollar and currencies linked to it form the major currency bloc in which we transact and fund our business. Unless otherwise stated, the information presented in this document has been prepared in accordance with IFRSs.

When reference to underlying or underlying basis is made in tables or commentaries, comparative information has been expressed at constant currency (see page 16), eliminating the impact of fair value movements in respect of credit spread changes on HSBC s own debt and adjusting for the effects of acquisitions and disposals of subsidiaries and businesses. A reconciliation of reported and underlying profit before tax is presented on page 17.

Contents

1 *Detailed contents are provided on the referenced pages.*

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Who we are and what we do

HSBC is one of the world s largest banking and financial services organisations. With around 7,200 offices in both established and faster-growing markets, we aim to be where the growth is, connecting customers to opportunities, enabling businesses to thrive and economies to prosper, and ultimately helping people to fulfil their hopes and realise their ambitions.

We serve around 89 million customers through our four global businesses: Retail Banking and Wealth Management, Commercial Banking, Global Banking and Markets, and Global Private Banking. Our network covers 85 countries and territories in six geographical regions: Europe, Hong Kong, Rest of Asia-Pacific, Middle East and North Africa, North America and Latin America. Our aim is to be acknowledged as the world s leading international bank.

Listed on the London, Hong Kong, New York, Paris and Bermuda stock exchanges, shares in HSBC Holdings plc are held by over 220,000 shareholders in 132 countries and territories.

Highlights

Profit before tax up 15% to US$21.9bn on a reported basis.

Underlying pre-tax profit down 6% to US$17.7bn.

Launched strategy to reshape the Group, improve returns and position for growth.

Strong performance in faster-growing regions, with revenue up 12% in Hong Kong, Rest of Asia-Pacific, Latin America and the Middle East and North Africa.

Record year in Commercial Banking with profit before tax of US$7.9bn, up 31%.

Achieved sustainable cost savings of US$0.9bn with a strong pipeline of further savings.

Dividends declared in respect of 2011 US$7.3bn or US$0.41 per ordinary share, up 14% on 2010.

Core tier 1 capital ratio 10.1%, down from 10.5% in 2010, largely reflecting the introduction of Basel 2.5.

Cover image

A Chinese ship in Brazil s largest port, Santos, illustrates the growing trade links between the two countries. China is today Brazil s largest trading partner, with HSBC financing an increasing share of that trade.

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Report of the Directors: Overview

Financial highlights

Earnings per share

US$0.92 *up 26%*

2010: US$0.73
2009: US$0.34

Dividends per ordinary share[1]

US$0.39

2010: US$0.34
2009: US$0.34

Net assets per share

US$8.48 *up 7%*

2010: US$7.94
2009: US$7.17

For the year

Profit before taxation

US$21,872m *up 15%*

2010: US$19,037m
2009: US$7,079m

Underlying profit before taxation

US$17,696m *down 6%*

2010: US$18,925m

Total operating income

US$83,461m *up 4%*

2010: US$80,014m
2009: US$78,631m

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

US$72,280m *up 6%*

2010: US$68,247m
2009: US$66,181m

Profit attributable to the ordinary shareholders of the parent company

US$16,224m *up 27%*

2010: US$12,746m
2009: US$5,565m

At the year-end

Loans and advances to customers

US$940bn *down 2%*

2010: US$958bn
2009: US$896bn

Customer accounts

US$1,254bn *up 2%*

2010: US$1,228bn
2009: US$1,159bn

Ratio of customer advances to customer accounts

75.0%

2010: 78.1%
2009: 77.3%

Total equity

Average total shareholders equity to average total assets

Risk-weighted assets

US$166bn *up 7%*	5.6%	US$1,210bn *up 10%*
2010: US$155bn	2010: 5.5%	2010: US$1,103bn
2009: US$136bn	2009: 4.7%	2009: US$1,133bn

Capital ratios

Core tier 1 ratio	**Tier 1 ratio**	**Total capital ratio**
10.1%	11.5%	14.1%
2010: 10.5%	2010: 12.1%	2010: 15.2%
2009: 9.4%	2009: 10.8%	2009: 13.7%

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Annual Report and Accounts 2011

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
13.8%	1.2%	42.3%
2010: 16.9% 2009: 31.7%	2010: 1.5% 2009: 2.8%	2010: 43.0% *(restated for change in disclosure policy see page 105)*

Return ratios

Return on average invested capital[2]	Return on average ordinary shareholders equity[3]	Post-tax return on average total assets	Pre-tax return on average risk-weighted assets
10.2%	10.9%	0.6%	1.9%
2010: 8.7% 2009: 4.1%	2010: 9.5% 2009: 5.1%	2010: 0.6% 2009: 0.3%	2010: 1.7% 2009: 0.6%

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
57.5%	48.7%	20.6%	7.8%
2010: 55.2% 2009: 52.0%	2010: 49.3% 2009: 51.8%	2010: 21.7% 2009: 22.5%	2010: 9.0% 2009: 12.5%

Share information at the year-end

			Closing market price	
US$0.50 ordinary	**Market**	London	Hong Kong	American

shares in issue	**capitalisation**			Depositary Share[5]
17,868m	US$136bn	£4.91	HK$59.00	US$38.10
2010: 17,686m	2010: US$180bn	2010: £6.51	2010: HK$79.70	2010: US$51.04
2009: 17,408m	2009: US$199bn	2009: £7.09	2009: HK$89.40	2009: US$57.09

	Total shareholder return[6]		
	Over 1 year	Over 3 years	Over 5 years
To 31 December 2011	79.1	96.8	78.2
Benchmarks:			
FTSE 100[7]	97.8	140.3	107.9
MSCI World[7]	95.7	129.4	114.9
MSCI Banks[7]	82.7	107.5	60.5

For footnotes, see page 95.

HSBC HOLDINGS PLC

Annual Report and Accounts 2011

Cautionary statement regarding forward-looking statements

The *Annual Report and Accounts 2011* contains certain forward-looking statements with respect to HSBC s financial condition, results of operations and business.

Statements that are not historical facts, including statements about HSBC s beliefs and expectations, are forward-looking statements. Words such as expects , anticipates , intends , plans , believes , seeks , estimates , potential and reasonably possible , variations of these words and expressions are intended to identify forward-looking statements. These statements are based on current plans, estimates and projections, and therefore undue reliance should not be placed on them. Forward-looking statements speak only as of the date they are made. HSBC makes no commitment to revise or update any forward-looking statements to reflect events or circumstances occurring or existing after the date of any forward-looking statements.

Written and/or oral forward-looking statements may also be made in the periodic reports to the US Securities and Exchange Commission, summary financial statements to shareholders, proxy statements, offering circulars and prospectuses, press releases and other written materials, and in oral statements made by HSBC s Directors, officers or employees to third parties, including financial analysts.

Forward-looking statements involve inherent risks and uncertainties. Readers are cautioned that a number of factors could cause actual results to differ, in some instances materially, from those anticipated or implied in any forward-looking statement. These include, but are not limited to:

- changes in general economic conditions in the markets in which we operate, such as continuing or deepening recessions and fluctuations in employment beyond those factored into consensus forecasts; changes in foreign exchange rates and interest rates; volatility in equity markets; lack of liquidity in wholesale funding markets; illiquidity and downward price pressure in national real estate markets; adverse changes in central banks policies with respect to the provision of liquidity support to financial markets; heightened market concerns over sovereign creditworthiness in over-indebted countries; adverse changes in the funding status of public or private defined benefit pensions; and consumer perception as to the continuing availability of credit and price competition in the market segments we serve;

- changes in government policy and regulation, including the monetary, interest rate and other policies of central banks and other regulatory authorities; initiatives to change the size, scope of activities and interconnectedness of financial institutions in connection with the implementation of stricter regulation of financial institutions in key markets worldwide; revised capital and liquidity benchmarks which could serve to deleverage bank balance sheets and lower returns available from the current business model and portfolio mix; imposition of levies or taxes designed to change business mix and risk appetite; the practices, pricing or responsibilities of financial institutions serving their consumer markets; expropriation, nationalisation, confiscation of assets and changes in legislation relating to foreign ownership; changes in bankruptcy legislation in the principal markets in which we operate and the consequences thereof; general changes in government policy that may significantly influence investor decisions; extraordinary government actions as a result of current market turmoil; other unfavourable political or diplomatic developments producing social instability or legal uncertainty which in turn may affect demand for our products and services; the costs, effects and outcomes of product regulatory reviews, actions or litigation, including any additional compliance requirements; and the effects of competition in the markets where we operate including increased competition from non-bank financial services companies, including securities firms; and factors specific to HSBC, including our success in adequately identifying the risks we face, such as the incidence of loan losses or delinquency, and managing those risks (through account management, hedging and other techniques). Effective risk management depends on, among other things, our ability through stress testing and other techniques to prepare for events that cannot be captured by the statistical models it uses; and our success in addressing operational, legal and regulatory, and litigation challenges.

Report of the Directors: Overview (continued)

Group Chairman s Statement

Throughout its history HSBC has sought to facilitate economic growth, as it is through such growth that businesses flourish and individuals fulfil the aspirations they have for themselves and those close to them. The cover of this year s Annual Report and Accounts illustrates a core element of HSBC s strategic direction that is connecting markets by providing the financing and risk management products that facilitate trade and investment flows. In so doing, we help our customers to achieve their growth ambitions and generate economic returns for savers and investors.

The picture also illustrates the shift in emphasis towards the faster-growing markets that underpins HSBC s investment priorities. The port is Santos in Brazil, which is the largest container port in South America; the ship is from China, delivering heavy machinery. The Brazil-China trade corridor has been one of the fastest growing over the last decade with a compound annual rate of growth of around 30%. China is now Brazil s largest trade partner representing 18% of its total trade flows, versus 4% in 2000.

HSBC entered Brazil in 1997 and since then has built its operations to generate pre-tax profits of US$1.2 billion in 2011, an increase of 19% over the prior year. We estimate that we finance over 6% of Brazil s total trade and some 9% of its trade with China. In 2011 we were recognised as Financial institution of the year by the Brazil-China Chamber of Commerce for having contributed most to the growth and development of the Brazil-China trade corridor.

The purpose of the above introduction is to highlight the fact that, notwithstanding the major

uncertainties and risks concentrating minds in the advanced economies of Europe and the US, there are still attractive growth opportunities to pursue where our international network and strong balance sheet provide distinctive advantages.

Performance in 2011

In 2011 in our heartland of Asia, throughout the Middle East and in Latin America we made good progress in developing customer business in line with the risk appetite endorsed by the Board. Largely driven by growth in lending in these faster-growing regions, our Commercial Banking business delivered a record performance. In Europe and the US we concentrated on supporting our core customer base, targeting trade services while constraining risk appetite within the financial sector. We also made significant further progress in working down our exit businesses in the US. The Group Chief Executive s Review expands upon the execution of our strategy during 2011.

The strong progress made on strategy execution was all the more marked when contrasted with the fragile confidence that pervaded the advanced economies of the world. Continuing uncertainties arising from the eurozone debt crisis contributed to credit demand remaining muted in Europe, while US recovery lagged expectations held earlier in the year. As investors crowded into the safest asset classes, market activity levels dropped markedly and prices of securities outside the favoured asset classes weakened. These factors markedly reduced trading revenues in the second half of the year.

Against the backdrop of the economic and financial market conditions described above, the Board considered the Group s performance in 2011 to be satisfactory in aggregate and strong in the faster growing markets. Earnings per share rose by 26% to US$0.92 and the Board approved a fourth interim dividend of US$0.14 per ordinary share taking total dividends in respect of 2011 to US$0.41 per share, an increase of US$0.05 per share or 14%. The Board confirmed its intention to continue to pay quarterly dividends during 2012 at the rate of US$0.09 per ordinary share in respect of each of the first three quarters, in line with 2011.

Notably, the capital strengthening required by regulatory reform is being successfully delivered while maintaining the strongest dividend paying record of any bank outside mainland China.

Total dividends declared during 2011 amounted to US$7.3 billion and in the last four years, that is since the financial crisis started, they have amounted

Report of the Directors: Overview (continued)

to US$27.2 billion, making HSBC the second largest dividend payer in the FTSE100 during this period.

Addressing a matter of public interest, the cost to shareholders of performance-related rewards made within our Global Banking and Markets business in 2011 and during the past four years amounted to some US$1 billion and US$4.7 billion, respectively. Pre-tax profit from Global Banking and Markets was, in aggregate, US$30 billion in the same four years, and represented the largest contribution, at 52%, of Group pre-tax profits during that period.

At the end of 2011, total shareholders equity stood at US$159 billion, up 24% from its pre-crisis level of US$128 billion at the end of 2007. Over the same period, our balance sheet grew by only 9%. The core tier 1 ratio at the end of 2011 stood at 10.1%, in line with our target range.

As foreshadowed in last year s Statement, the UK government proceeded with its plan to raise £2.5 billion through a levy on the global balance sheets of UK domiciled banks. The cost to HSBC was US$570 million of which US$340 million related to non-UK banking activity. The levy, which is not tax deductible, is the equivalent of US$0.03 per ordinary share and, as indicated last year, would otherwise be available for distribution to shareholders.

Progress on regulatory reform

A number of important milestones were passed during 2011 on the regulatory reform agenda. In the UK the Independent Commission on Banking (ICB) delivered its report in September and the Government published its response in December. In the US, greater clarity on the Dodd-Frank legislation was delivered through a multitude of notices of proposed new regulation and four US financial regulatory agencies issued proposed uniform regulations that would implement the Volcker Rule, which aims to constrain major financial institutions from engaging in proprietary trading and most hedge fund and proprietary investment activities. The Basel Committee, in conjunction with the Financial Stability Board, set out its proposals to identify and increase capital requirements for Global Systemically Important Banks and most major jurisdictions published their proposals around recovery and resolution planning for major institutions. Europe continued to embed the Basel III proposals within a new draft Capital Requirements Directive (CRD IV), the European Banking Authority formally came into existence as the hub of financial regulatory bodies in Europe and, in the UK,

HM Treasury published its proposals for a new approach to financial regulation and the replacement of the FSA with a new supervisory structure, directed by the Bank of England.

Many topics remain subject to further debate including cross-border resolution protocols, the governance and operation of central counterparties, the prospective role of clearing systems and exchanges, the calibration of the proposed new liquidity framework, the definition and operation of proposed proprietary trading restrictions, the possible harmonisation and peer review of the calculation of the risk weights that drive capital requirements, a re-assessment of the risk free treatment of sovereign debt and some 22 follow-on workstreams are ongoing in the wake of the UK Government s response to the ICB Report.

It is clear from the above that the industry will continue to bear a heavy burden of both time commitment and cost as it works with policymakers to finalise the regulatory reforms, including addressing the many inconsistencies within and extra-territorial dimensions of national rule-making. We are committed to all necessary constructive dialogue and support to speed the finalisation of these remaining issues. Our input will stress that it is critical that the reforms deliver a sustainable business model that can attract external economic capital. This is essential for the financial system to be able to contribute as fully as it should to the economic growth agenda which is being mandated by political leaders globally.

Board changes

We bid farewell at the upcoming AGM to two directors who have given huge service to HSBC over many years and who will not stand for re-election.

Sir Brian Williamson has served on the Board of HSBC Holdings since 2002 and brought great insight and wisdom to the Board from a distinguished career in financial services, most notably in the areas of money and bond markets, clearing, exchanges and electronic trading platforms where he was a pioneer in establishing The London International Financial Futures and Options Exchange.

Gwyn Morgan has served on the Board of HSBC Holdings since 2006 and before that on the Board of HSBC Canada for some nine years. His vast experience of leading large international companies in the engineering and energy sectors brought a balanced industrialist s perspective to Board discussions and debate.

Report of the Directors: Overview (continued)

We shall miss them both and thank them sincerely for their contributions over many years.

We are delighted to welcome two new faces to the Board. Joachim Faber and John Lipsky will join the Board on 1 March.

Joachim Faber stepped down from the Management Board of Allianz at the end of 2011 where he served latterly as CEO of Allianz Global Investors one of the top five investment managers globally. He brings a wealth of experience from the perspective of the investor as well as in depth knowledge of banking, insurance, finance and capital markets from previous roles in a long and distinguished career.

John Lipsky is one of the world s best known and respected economists who most recently served as First Deputy Managing Director at the IMF from which he retired in November 2011. Over the last five years John has been one of the key links between macroeconomic policymakers and the financial community and brings to the Board an exceptional depth of knowledge and understanding of the macroeconomic and geopolitical issues that will shape the future of the global economy.

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

Brand and reputation

At HSBC we continue to think long-term as we build business platforms and relationships that will create options for value creation in generations to come.

Tactically there are necessary difficult decisions to take in today s subdued economic environment but these are always weighed against what is right for the long-term health of the business. Similarly when things go wrong, as they will from time to time, we judge ourselves, inter alia, against how we respond and how quickly we learn from the experience. Nothing is more important than our reputation.

It was a moment of great pride within the organisation when we were judged to be the most valuable banking brand in the world in the recent *Brand Finance® Banking 500 2012* report. This is the fourth time HSBC has headed the list in the last five years. This recognition is a testament to the work of all my colleagues in building value for customers that translates to shareholder value.

At the same time, however, we reflect that in 2011 we continued to deal with legacy regulatory, legal and reputational issues which remind us that our good work can be destroyed by lapses of judgement or control. The settlement of claims around the historical selling of Payment Protection Insurance in the UK, the fine and compensation arising from the now closed NHFA Limited business and ongoing regulatory and legal investigations in the US across a number of areas are all matters from which we need to learn to ensure they do not recur. The programme of values training which the Group Chief Executive is leading for all employees is but one measure to this end. We are truly sorry to all those who were adversely affected by our failings and to our shareholders for the reputational damage incurred.

Looking ahead

It is just over a year now since Stuart Gulliver and I took on our respective roles. During that time, the leadership team around Stuart has grown in stature and cohesion and is, I believe, among the best in our industry. That team is supported strongly by talented colleagues whose engagement and commitment to the strategic priorities laid out before them is evident and enthusiastic. On behalf of the Board I want to take this opportunity to thank them for their support and dedication. The uncertain economic and geopolitical backdrop will continue to raise challenges throughout 2012 and beyond. I am, however, confident that HSBC has the people, the financial strength and the right strategic focus and values to do well for those who place their trust in us, thereby meeting their expectations of us and contributing to the fulfilment of their aspirations and ambitions. That is what we exist to do.

D J Flint, *Group Chairman*

27 February 2012

Report of the Directors: Overview (continued)

Group Chief Executive s

Business Review

2011 was a year of change for HSBC as we articulated a clear strategy to become the world s leading international bank. We made significant progress in executing this strategy to reshape the Group and improve returns. First, we conducted a Group-wide portfolio review to improve our capital deployment and have now announced the disposal or closure of 16 non-strategic businesses during the year, and a further three in 2012. Second, we took action to improve our cost efficiency, achieving sustainable cost saving of US$0.9bn. Third, and most importantly, we continued to position the business for growth, increasing revenues in each of the world s faster-growing regions, particularly in mainland China, India, Malaysia, Brazil and Argentina. Commercial Banking achieved record revenue and profits, helped by loan growth as well as growth in cross-selling from Global Banking and Markets. In Wealth Management we made modest progress towards our target of US$4bn of incremental revenue over the medium term.

Executing our strategy is the primary lever to improve the Group s performance. A substantial amount has been achieved during 2011 but this will be a long journey with significant headwinds, so we are increasing the intensity of execution in 2012.

Group performance headlines

HSBC s financial performance was resilient.

Reported profit before tax was US$21.9bn, up US$2.8bn on 2010, including US$3.9bn of favourable fair value movements on our own debt attributable to credit spreads, compared with a negative movement of US$63m in 2010.
Underlying profit before tax was US$17.7bn, down US$1.2bn on 2010 due to higher costs which were partly offset by a significant improvement in loan impairment charges and other credit risk provisions.

We recorded a strong performance in each of the faster-growing regions. Underlying revenues grew in Rest of Asia-Pacific by 12%, in Hong Kong by 6% and in Latin America by 13%. The strong performance in these regions also led to record revenues in Commercial Banking.

We achieved strong revenue growth in key markets including mainland China, India, Malaysia, Brazil and Argentina, driving increases in profit before tax.

On an underlying basis, total revenues were broadly in line with 2010, despite the turmoil in the eurozone and its adverse effect on Credit and Rates revenue, combined with lower income in Balance Sheet Management and the continued reduction of our consumer finance portfolios in the US.

As the process of internationalising the renminbi continued, we strengthened our leadership position with a bond clearing licence in mainland China and as the market leader in the offshore Dim Sum bond market. In addition, Commercial Banking and Global Banking and Markets successfully completed our first global US dollar-renminbi cross-currency swap and we extended our renminbi capability to over 50 markets in all regions.

Despite the eurozone sovereign debt concerns which dominated European market sentiment and depressed revenues in Global Banking and Markets, revenues grew strongly in over half of our business lines in Global Banking and Markets, including Equities and Foreign Exchange, and in Global Banking. This in part reflected the collaboration with Commercial Banking which has delivered more than US$500m in incremental revenues.

In Wealth Management we made modest progress towards our medium-term target of US$4bn incremental revenue, with revenue growth of some US$300m. Notably, we generated strong sales of insurance products in Hong Kong, Latin America and Rest of Asia-Pacific, while revenue from distribution of investment products to our clients and Global Asset Management was broadly unchanged, reflecting difficult market conditions, particularly in the second half of the year.

Report of the Directors: Overview (continued)

Costs rose by 10%, reflecting wage inflation in key markets and higher average full-time equivalent employee numbers for the year (although numbers have fallen since the first quarter), as well as an increase in significant items. These included restructuring costs (including the impairment of certain intangible assets) of US$1.1bn, UK customer redress programmes of US$898m and a bank levy introduced by the UK Government of US$570m, partly offset by a UK pension credit of US$587m. The rise in costs was partially offset by US$0.9bn in sustainable cost savings achieved so far in executing our strategy.

As a result of these factors, the cost efficiency ratio worsened from 55.2% to 57.5% on a reported basis, and from 55.6% to 61.0% on an underlying basis.

Our results continue to be adversely affected by the losses in the US consumer finance business, which, on an underlying basis, were US$2.4bn and US$2.2bn in 2011 and 2010, respectively. We have agreed the sale of the profitable US Card and Retail Services portfolio with the remainder of the loss-making US consumer finance business being run down.

Return on average ordinary shareholders equity was 10.9%, up from 9.5% in 2010, reflecting the favourable movement on the fair value of our own debt.

The Group s pre-tax return on risk-weighted assets (RoRWA) for 2011 was 1.9%, or 1.5% on an underlying basis. Adjusting for negative returns on US consumer finance business and legacy credit in Global Banking and Markets, the remainder of the Group achieved a RoRWA of 2.2% in 2011 and 2.3% in 2010.

Dividends declared in respect of 2011 totalled US$7.3bn, or US$0.41 per ordinary share, an increase of 14%, with a fourth interim dividend for 2011 of US$0.14 per ordinary share.

The core tier 1 ratio was 10.1% at 31 December 2011, down from 10.5% at 31 December 2010, reflecting an increase in risk-weighted assets (RWA s) due to the introduction of Basel 2.5 in Global Banking and Markets and growth in lending balances including those classified as held for sale. The growth in RWAs was notably in Commercial Banking, which included an increase in the RWAs of our mainland China associates.

Profit attributable to ordinary shareholders increased by 27% to US$16.2bn, of which US$7.3bn was declared in dividends in respect of the year. This compared with US$3.4bn of variable pay awarded (net of tax) to our employees for 2011.

Progress on strategy

There are two major trends which are key to HSBC s future: the continuing growth of international trade and capital flows; and wealth creation, particularly in faster-growing markets. In May, we defined a new strategy for the Group to capitalise on these trends and connect customers to opportunities by building on our distinctive presence in the network of markets which generate the major trade and capital flows, capturing wealth creation in target markets and focusing on retail banking only where we can achieve profitable scale.

In a difficult operating environment this strategy is key to improving our performance and we remain focused on delivering our targets of a return on average shareholders equity of 12-15% and a cost efficiency ratio of 48-52% by the end of 2013. We are executing the strategy by deploying capital more effectively, implementing measures to improve our cost efficiency and positioning the business for growth. We have made significant progress in all of these three areas.

First, to ensure effective deployment of capital, we undertook a Group-wide review of our business, testing each part of the portfolio against our five filters framework. This looks at the strategic relevance of each country, and each business in each country, assessing their connectivity, economic development, profitability, cost efficiency and liquidity. As a result, we announced 16 disposals or closures in 2011 and a further three in 2012, including two large transactions in the US, the withdrawal from Georgia and the exit of Retail Banking and Wealth Management operations in Russia, Chile, Thailand and Poland. When completed, these disposals and closures should represent a reduction of around US$50bn of risk-weighted assets and the transfer to the acquirers of approximately 12,000 full-time equivalent employees. We are continuing this process in 2012 and have identified a number of further transactions.

Second, to improve cost efficiency we achieved US$0.9bn of sustainable savings. Our programmes to implement consistent business models and restructure global businesses and global functions progressed well. We are creating a leaner Group, removing layers of management to give staff greater

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Report of the Directors: Overview (continued)

responsibility, improve decision making and reduce bureaucracy. We have identified a strong pipeline of further sustainable cost savings which we believe will deliver at the upper end of our target of US$2.5-3.5bn of sustainable savings by 2013.

Third, we continued to position the business for growth, as outlined in the performance headlines.

We are increasing the intensity of strategy execution in 2012 and will provide a further update at our forthcoming Investor Strategy Day.

Our purpose and values

HSBC is one of the world s largest banking and financial services organisations. We serve around 89 million customers and our network covers 85 countries and territories. With around 7,200 offices in both established and faster-growing markets, we aim to be where the growth is, connecting customers to opportunities, enabling businesses to thrive and economies to prosper, and ultimately helping people to realise their ambitions.

We are putting a new emphasis on values at HSBC, so that our employees are empowered to do the right thing and to act with courageous integrity. We recognise that we have not always got this right in the past. The inappropriate advice given to customers of NHFA Limited was completely unacceptable. We are profoundly sorry about what happened and are committed to standing fully behind our customers. This case has reinforced our determination to address legacy issues in HSBC.

Over the past year we have made our values more explicit to ensure we meet the expectations of society, customers, regulators and investors. Those values are that we are dependable, open to different ideas and cultures and connected to customers, communities, regulators and each other. We are ensuring that everyone who works for HSBC lives by these values and have made them a key part of every individual s annual performance review. By

setting the highest standards of behaviour our aim is that all of our employees and customers can be proud of our business.

Outlook

In 2012, notwithstanding the macroeconomic, regulatory and political uncertainties which we believe will persist, we expect continued strong growth in the dynamic markets of Asia, Latin America and the Middle East, although at a more moderate pace than in 2011, and that mainland China will achieve a soft landing. We believe that trade and capital flows between emerging areas of the world will also continue to grow, and could increase tenfold in the next 40 years.

As these results demonstrate, HSBC is well-positioned in the faster-growing markets and across international trade flows to benefit from these engines of global growth.

In 2011 we generated a return on average ordinary shareholders equity of 10.9% compared with 9.5% in 2010. The strength of our position gives us confidence that by the end of 2012 we will have developed a clear trajectory towards meeting our target of 12-15% by the end of 2013.

Finally, I am pleased to report we had good results in January.

S T Gulliver, *Group Chief Executive*

27 February 2012

Report of the Directors: Overview (continued)

Principal activities

HSBC is one of the largest banking and financial services organisations in the world, with a market capitalisation of US$136bn at 31 December 2011. 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 7,200 offices in 85 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.

Following a Group-wide review of our businesses, 16 disposals or closures were announced in 2011, and a further three in 2012. The most significant of these were the sales of 195 retail branches, primarily in upstate New York, our US Card and Retail Services portfolio and our businesses in Costa Rica, El Salvador and Honduras. For further information on these disposals, see page 379.

There were no significant acquisitions during the year.

Business and operating models

Business model

We accept deposits and channel these deposits into lending activities, either directly or through the capital markets. We also offer a range of products and financial services including broking, underwriting and credit facilities, trade finance, credit cards, sales of insurance and investment products and funds under management. These banking and financial services are provided to a wide range of clients including governments, large and mid-market corporates, small and medium-sized enterprises (SMEs), high net worth individuals, and mass affluent and retail customers.

Our operating income is primarily derived from:

- net interest income interest income on customer loans and advances, less interest expense on interest bearing customer accounts and debt securities in issue;

- net fee income fee income earned from the provision of financial services and products to customers of our global businesses; and net trading income income from trading activities primarily conducted in Global Markets, including Foreign Exchange, Credit, Rates and Equities trading.

Operating model

HSBC has a matrix management structure which includes global businesses, geographical regions and global functions.

Holding company

HSBC Holdings plc, the holding company of the Group, has listings 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 where necessary.

Under authority delegated by the Board of HSBC Holdings, the Group Management Board (GMB) is responsible for management and day-to-day running of the Group. The Board, together with GMB, ensures 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, is not 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, sometimes referred to as subsidiarisation, which underpins our strong balance sheet and helps generate a resilient stream of earnings.

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.

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HSBC HOLDINGS PLC

Report of the Directors: Overview (continued)

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 the 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 reporting requirements and maintains a capital buffer consistent with the Group s appetite for risk in its country or region. Each bank manages its own funding and liquidity within parameters set centrally, and is required to consider its risk appetite, consistent with the Group s risk appetite for the relevant country or region.

Global functions

Our global functions are Communications, Company Secretaries, Corporate Sustainability, Finance, Human Resources, Internal Audit, Legal, Marketing, Risk (including Compliance) and Strategy and Planning. They 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 strategy is aligned to two long-term trends:

Financial flows the world economy is becoming ever-more connected. Growth in world trade and cross-border capital flows continues to outstrip growth of gross domestic product. Financial flows between countries and regions are highly concentrated. Over the next decade we expect 35 markets to represent 90% of world trade growth and a similar degree of concentration in cross-border capital flows.

Economic development by 2050, we expect economies currently deemed emerging to have increased five-fold in size, benefiting from demographics and urbanisation, and 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 our network of markets relevant for international financial flows, our access and exposure to high growth markets and businesses, and our strong balance sheet generating 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 ideally positioned to capture the growing international financial flows. Our franchise puts us in a privileged position to serve corporate clients as they grow from small enterprises into large and international corporates, and personal clients as they become more affluent. Access to local retail funding and our international product capabilities allows us to offer distinctive solutions to these clients in a profitable manner.

Wealth management and retail with local scale we will leverage our position in faster-growing markets to capture social mobility and wealth creation through our Wealth Management and Private Banking businesses. We will only invest in retail businesses in markets where we can achieve profitable scale.

Implementing this strategy relies on actions across three areas:

Capital deployment (five filters) we are improving the way we deploy capital as part of our efforts to achieve our targeted return on equity of between 12% and 15% over the business cycle. We have introduced a strategic and financial framework assessing each of our businesses on a set of five strategic evaluation criteria, namely international connectivity, economic development, profitability, cost efficiency and liquidity. The results of this review determine whether we invest in, turn around, continue with or exit businesses.

Cost efficiency (four programmes) we have launched four programmes which we believe will achieve sustainable savings of between US$2.5bn and US$3.5bn by the end of 2013, resulting in a leaner and more values-driven organisation. These are: (i) implement consistent business models, (ii) re-engineer operational processes, (iii) streamline IT, and (iv) re-engineer global functions. Sustainable cost savings are intended to facilitate self-funded growth in key markets and investment in new products, processes and technology, and provide a buffer against regulatory and inflationary headwinds.

Growth we continue to position ourselves for growth. We are increasing our relevance in fast-growing markets and in wealth management,

Report of the Directors: Overview (continued)

and are improving the collaboration between our international network of businesses, particularly between CMB and GB&M.
If we are successful in executing this strategy, we will 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.

Risk

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

We have identified a comprehensive suite of risk factors which informs our 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 our results of 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.

Changes in foreign currency exchange rates may affect our results.

Macroprudential, regulatory and legal risks to our business model

Our businesses are subject to wide-ranging legislation and regulation and to regulatory and governmental oversight. Unfavourable legislative or regulatory developments, or changes in the policy of regulators or governments, could have a significant adverse effect on our operations, financial condition and prospects.

The Independent Commission on Banking has published its final report on competition and possible structural reforms in the UK banking industry. The implementation of the recommendations included in the final report could have a material adverse effect on us.

We are subject to a number of legal and regulatory actions and investigations, the outcomes of which are inherently difficult to predict, but unfavourable outcomes could have a material adverse effect on our operating results and brand.

We 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

Our risk management measures may not be successful.

Operational risks are inherent in our business.

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 our cost or availability of funding and adversely affect our liquidity position and interest margins.

Risks concerning borrower credit quality are inherent in our businesses.

Our insurance businesses are 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 its obligations with respect to its debt securities, and to provide profits for payment of future dividends to shareholders.

We may be required to make substantial contributions to our pension plans.

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Report of the Directors: Overview (continued)

Macroeconomic and geopolitical risk

Current economic and market conditions may adversely affect our results

Our earnings are affected by global and local economic and market conditions. Following the global financial crisis in 2007, a difficult economic climate remains with continued pressures on household and corporate finances. The peripheral eurozone economies, such as Greece, Ireland, Italy, Portugal and Spain, came under increasing pressure in 2011, the dominant concern being over the high levels of their sovereign debt. The large budget deficit and growing government indebtedness of the US and the recent downgrade of its sovereign debt by a major ratings agency are generating concerns regarding the financial position and economic prospects of the US, the global economy and the financial services sector. In addition, mainland China experienced a slowdown in economic growth in 2011 and faces uncertainty over future growth.

With unemployment remaining high and consumer confidence weak in developed markets, and amid signs of inflationary pressures in emerging markets, economic conditions are fragile and volatile and markets are weak. These adverse economic conditions continue to create a challenging operating environment for financial services companies such as HSBC. In particular, we may face the following challenges to our operations and operating model in connection with these factors:

- the demand for borrowing from creditworthy customers may diminish if economic activity slows or remains subdued;
- the heightened risk of overheating economies in emerging markets in recent years is giving rise to concerns that asset and credit bubbles may be created, leading to volatility and losses;
- European banks may come under stress as a result of the sovereign debt crisis in the eurozone;
- trade and capital flows may contract as a result of protectionist measures being introduced in certain markets or on the emergence of geopolitical risks;
- a prolonged period of modest interest rates will constrain, for example, through margin compression and low returns on assets, the interest income we earn from investing our excess deposits;
- our ability to borrow from other financial institutions or to engage in funding transactions may be adversely affected by market disruption, for example, in the event of contagion from stress in the eurozone sovereign and financial sectors; and
- market developments may depress consumer and business confidence. If growth in the UK or the US remains subdued, for example, asset prices and payment patterns may be adversely affected, leading to increases in delinquencies, default rates, write-offs and loan impairment charges beyond our expectations.

We have exposure to the ongoing economic crisis in the eurozone

The sovereign debt crisis that erupted in 2010 extended through 2011. Concern regarding the financial position of several economies which spread from those of peripheral eurozone countries such as Greece, Ireland, Italy, Portugal and Spain to include certain core eurozone countries, became increasingly widespread and severe. These negative trends caused considerable turbulence on the global financial markets.

The risk of contagion throughout and beyond the eurozone remains noteworthy. A significant number of financial institutions throughout Europe, including in core eurozone countries, have substantial exposure to sovereign debt issued by states which have come under considerable financial pressure, such as Greece. Should any of those nations default on their debt or experience a significant widening of credit spreads, major financial institutions and banking systems throughout Europe could be destabilised, intensifying the economic crisis. Although our direct exposure to peripheral eurozone economies is limited, we have substantial exposure to financial institutions and central banks in core European countries which may be affected by the ongoing crisis. For a further description of our exposures to selected eurozone countries, eurozone banks and other financial institutions and corporates see Areas of special interest on page 112.

While the authorities throughout Europe continue to work on agreeing a political solution which will encompass economic plans designed to address the fiscal instability of the eurozone, the ongoing economic crisis has increased the risk of its break-up. This would have a dramatic impact on the whole financial sector, creating new challenges in sovereign and corporate lending and resulting in significant disruption to financial activities at both the wholesale and retail levels.

Report of the Directors: Overview (continued)

We are subject to political and economic risks in the countries in which we operate

We operate through an international network of subsidiaries and affiliates in 85 countries and territories around the world. Our results are, therefore, subject to the risk of loss from unfavourable political developments, currency fluctuations, social instability and changes in government policies on such matters as expropriation, authorisations, international ownership, interest-rate caps, limits on dividend flows and tax in the jurisdictions in which we operate. For example, in the Middle East, the Arab Spring has led to political instability across the region. In Asia, tensions persist in certain areas following leadership/regime changes which pose the threat of instability and potential conflict. A break-up of the eurozone or continued social unrest triggered by the ongoing economic crisis and related austerity programmes may result in political and social disruption throughout Europe. The occurrence of any of these events or circumstances could have a material adverse effect on our business, financial condition and/or results of operations.

Changes in foreign currency exchange rates may affect our results

We prepare our accounts in US dollars, but because a substantial portion of our assets, liabilities, assets under management, revenues and expenses are denominated in other currencies, changes in foreign exchange rates have an effect on our reported income, cash flows and shareholders equity and may have a material adverse effect on our business, financial condition and/or results of operations.

Macroprudential, regulatory and legal risks to our business model

Our businesses are subject to wide-ranging legislation and regulation and to regulatory and governmental oversight. Unfavourable legislative or regulatory developments, or changes in the policy of regulators or governments, could have a significant adverse effect on our operations, financial condition and prospects

Our businesses are subject to ongoing regulation and associated regulatory risks, including the effects of changes in the laws, regulations, policies, voluntary codes of practice and interpretations in the UK, the US, Hong Kong, the European Union (EU) and the other markets where we operate. This is particularly the case in the current market environment, where

we are witnessing increased levels of government and regulatory intervention in the banking sector, which we expect to continue for the foreseeable future. Since 2008, regulators and governments have focused on the reform of the financial services industry, including enhanced capital, liquidity and leverage requirements, changes in compensation practices, tax levies and measures to address systemic risk. The US government, the UK government, the Financial Services Authority (FSA) and other regulators in the UK, Hong Kong, the EU or elsewhere may intervene further in relation to areas of industry risk already identified, or in new areas, which could adversely affect us. Future changes are difficult to predict but could materially and unfavourably affect our business.

Areas where changes could have an adverse impact include, but are not limited to:

- general changes in government, central bank or regulatory policy, or changes in regulatory regimes that may influence investor decisions in particular markets in which we operate, which may change the structure of those markets and the products offered or may increase the costs of doing business in those markets;

- external bodies applying or interpreting standards or laws differently to us;

- changes in competitive and pricing environments;

- further requirements relating to financial reporting, corporate governance, conduct of business and employee compensation; and

- expropriation, nationalisation, confiscation of assets and changes in legislation relating to foreign ownership.

Beginning in April 2011, the FSA commenced an internal reorganisation as a first step in a process towards the formal transition of regulatory and supervisory powers from it to the new Financial Conduct Authority (FCA) for the conduct of business supervision and to the Prudential Regulatory Authority (PRA) for capital and liquidity supervision in 2012. Until this time, the responsibility for regulating and supervising the activities of HSBC will remain with the FSA. In addition, new European supervisory authorities, the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority and the European Securities and Markets Authority are likely to exert greater influence on regulatory issues across the EU. These could change the way in which we are regulated and supervised.

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Report of the Directors: Overview (continued)

The Basel Committee has approved significant changes to the regulation of banking institutions capital and liquidity, involving a substantial strengthening of the minimum requirements. Implementation at the national level remains ongoing.

HSBC has been classified by the Financial Stability Board (FSB) as a Global Systemically Important Financial Institution (G-SIFI) under proposals that would place an additional capital buffer on the Group and may place us under additional regulatory scrutiny. As proposed, the capital surcharge will apply at a Group level and have implications for capital management for all our locally incorporated banks and branch operations which hold capital. The Basel committee issued in November 2011 its rules for Global Systemically Important Banks (G-SIBs). These provide a framework for more intensive supervision of G-SIBs and assessment methodology to determine additional requirements for loss absorbing capacity. See Capital on pages 211 to 217.

The implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) and related final regulations could result in additional costs or limit or restrict the way we conduct our business. Uncertainty remains about many of the details, impact and timing of these reforms and the effect they will ultimately have on HSBC. While we do not have segregated proprietary trading desks, the Volcker Rule could affect our businesses in North America and elsewhere in the world. In addition, the Federal Reserve Board stated in December 2011 that it expects to issue shortly a proposal to apply enhanced supervisory standards to large foreign banking organisations such as HSBC.

There are also a number of ongoing regulatory initiatives at the EU and at national level in various stages of development which could result in additional costs or limit or restrict the way we conduct business. These include the EU s proposed Crisis Management Directive and its ongoing review of the existing Markets in Financial Instruments Directive. At a national level they include the FSA s Retail Distribution and Mortgage Market Reviews. Uncertainty remains about the details, impact and timing of some of these reforms and the effect they will ultimately have on HSBC.

Notwithstanding our efforts to comply with applicable regulations, we may fail, particularly in areas where applicable regulations may be unclear or where regulators revise existing guidance or courts overturn previous rulings. Authorities in many jurisdictions have the power to bring administrative

or judicial proceedings against us which could result in, among other things, suspension or revocation of our licenses, cease and desist orders, fines, civil penalties, criminal penalties or other disciplinary action which could materially adversely affect our results of operations and seriously harm our reputation.

Changes in laws, rules or regulations, or in their interpretation or enforcement, or the implementation of new laws, rules or regulations, may adversely affect our business, financial condition and/or results of operations. Further, uncertainty and lack of international regulatory coordination as enhanced supervisory standards are developed and implemented may adversely affect our ability to engage in effective business, capital and risk management planning.

The Independent Commission on Banking has published its final report on competition and possible structural reforms in the UK banking industry. The implementation of the recommendations included in the final report could have a material adverse effect on us

The UK Independent Commission on Banking (ICB) published its Final Report on 12 September 2011. The Commission s reform proposals, if adopted as legislation in substantially the form prescribed, would have wide-ranging implications for the structure and costs of large UK-headquartered banks and the UK banking industry.

In respect of large banks, including HSBC, the ICB proposes that there should be primary loss-absorbing capacity equal to at least 17% of risk-weighted assets (RWA s) calculated under Basel III. This capacity should be satisfied by complying with the Basel III capital requirements and issuing additional equity and/or long-term, unsecured bonds that are loss-absorbing at the point of non-viability. The UK supervisor would retain the power to increase this minimum loss-absorbing capacity to 20% of RWAs if it had concerns about the ability of the bank to restructure or liquidate at the point of failure.

In addition, in respect of UK universal banks, including HSBC s major UK banking subsidiary, HSBC Bank plc, the ICB has proposed a separation of the UK retail and wholesale banking operations through the creation of a ring-fenced retail bank. The ICB recommends that a large ring-fenced bank should be required to maintain an equity ring-fence buffer of at least 3% of RWAs above the Basel III base requirement of 7% of RWAs.

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Report of the Directors: Overview (continued)

The Chancellor of the Exchequer expressed broad approval of the ICB s Final Report and indicated that the UK Government endorses in principle the proposals to establish a ring-fenced bank and greater primary loss absorbing capacity. The Government is not, however, bound to adopt the Commission s recommendations and are proposing to undertake extensive consultation in two stages during 2012.

If the proposals described above are adopted, major changes to our corporate structure and business activities conducted in the UK through HSBC Bank plc might be required. The changes may include separating the ring-fenced bank from the existing UK incorporated universal bank. The proposals, if adopted, would take an extended period of time to implement and would significantly increase our costs, both to implement and to run the ongoing operations as restructured.

We are subject to a number of legal and regulatory actions and investigations, the outcomes of which are inherently difficult to predict, but unfavourable outcomes could have a material adverse effect on our operating results and brand

We face significant legal risks in our business and the volume and amount of damages claimed in litigation, regulatory proceedings and other adversarial proceedings against financial institutions are increasing.

We are subject to a number of material legal proceedings, regulatory actions and investigations as described in Note 44 on the Financial Statements on pages 405 to 409. It is inherently difficult to predict the outcome of many of the legal, regulatory and other adversarial proceedings involving our businesses, particularly those cases in which the matters are brought on behalf of various classes of claimants, seek damages of unspecified or indeterminate amounts or involve novel legal claims. An unfavourable result in one or more of these proceedings could have a material adverse effect on our results of operations.

We are subject to tax-related risks in the countries in which we operate which could have a material adverse effect on our operating results

HSBC is subject to the substance and interpretation of tax laws in all countries in which we operate and is subject to routine review and audit by tax authorities in relation thereto. We provide for

potential tax liabilities that may arise on the basis of the amounts expected to be paid to the tax authorities. The amounts ultimately paid may differ materially from the amounts provided depending on the ultimate resolution of such matters. Changes to tax law, tax rates and penalties for failure to comply could have a material adverse effect on our business, financial condition and/or results of operations.

For example, HM Treasury introduced a new bank levy in the Finance Act 2011. The bank levy is imposed on (among other entities) UK banking groups and subsidiaries, and therefore applies to HSBC. A charge of US$570m has been recognised in 2011 in respect of this levy, based on the consolidated balance sheet at the year end. A reduced rate is applied to longer-term liabilities. Other countries, including France, Germany and South Korea, have also introduced bank levies. These do not have the same global basis as the UK bank levy and do not have a material effect on the Group at present. It is possible that we will become subject to higher levies in the future, to similar taxes in other jurisdictions and/or to financial activity or transaction taxes which are currently under consideration.

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

Our risk management measures may not be successful

The management of risk is an integral part of all our activities. Risk constitutes our exposure to uncertainty and the consequent variability of return. Specifically, risk equates to the adverse effect on profitability or financial condition arising from different sources of uncertainty including retail and wholesale credit risk, market risk, operational risk, non-traded market risk, insurance risk, concentration risk, liquidity and funding risk, reputational risk, strategic risk, pension obligation risk and regulatory risk. We seek to monitor and manage our risk exposure through a variety of separate but complementary control and reporting systems such as financial, credit, market, operational, compliance and legal. While we employ a broad and diversified set of risk monitoring and risk mitigation techniques, such techniques, and the judgements that accompany their application, cannot anticipate every unfavourable event or the specifics and timing of every outcome. Failure to manage risks appropriately could have a significant effect on our business, financial condition and/or results of operations.

Report of the Directors: Overview (continued)

Operational risks are inherent in our business

We are exposed to many types of operational risk, including fraudulent and other criminal activities (both internal and external), breakdowns in processes or procedures and systems failure or non-availability. For example, failure to protect our operations from internet crime or cyber attacks could result in the loss of customer data or other sensitive information which could impact our reputation and our ability to attract and keep customers. The threat of external fraud may increase during adverse economic conditions especially in retail and commercial banking. We are also subject to the risk of disruption of our business arising from events that are wholly or partially beyond our control (for example, natural disasters, acts of terrorism, epidemics and transport or utility failures) which may give rise to losses in service to customers and/or economic loss to us. All of these risks are also applicable when we rely on outside suppliers or vendors to provide services to us and our customers.

Our operations are highly dependent on our information technology systems

The reliability and security of our information and technology infrastructure and our customer databases are crucial to maintaining the service availability of banking applications and processes and to protecting the HSBC brand. The proper functioning of our payment systems, financial control, risk management, credit analysis and reporting, accounting, customer service and other information technology systems, as well as the communication networks between our branches and main data processing centres, are critical to our operations. Critical system failure, any prolonged loss of service availability or any material breach of data security, particularly involving confidential customer data, could cause serious damage to our ability to service our clients, could breach regulations under which we operate and could cause long-term damage to our business and brand. For example, in 2010 HSBC Private Bank (Suisse) SA was the victim of a significant data theft resulting in reputational harm, intervention by regulators and remediation costs.

Our operations have inherent reputational risk

Reputational risk, meaning the risk to earnings and capital from negative public opinion, is inherent in our business. Negative public opinion can result from the actual or perceived manner in which we conduct our business activities, from our financial

performance, or from actual or perceived practices in the banking and financial industry. Modern technologies, in particular online social networks and other broadcast tools which facilitate communication with large audiences in short time frames and with minimal costs, may significantly enhance and accelerate the impact of damaging information and allegations. Negative public opinion may adversely affect our ability to keep and attract customers and, in particular, corporate and retail depositors.

We may suffer losses due to employee misconduct

Our businesses are exposed to risk from potential non-compliance with policies, employee misconduct or negligence and fraud, which could result in regulatory sanctions and serious reputational or financial harm. In recent years, a number of multinational financial institutions have suffered material losses due to the actions of rogue traders or other employees. It is not always possible to deter employee misconduct and the precautions we take to prevent and detect this activity may not always be effective.

We rely on recruiting, retaining and developing appropriate senior management and skilled personnel

Our continued success depends in part on the continued service of key members of our management team. The ability to continue to attract, train, motivate and retain highly qualified professionals is a key element of our strategy. The successful implementation of our growth strategy depends on the availability of skilled management, both at our head office and at each of our business units. If one of our business units or other functions fails to staff its operations appropriately or loses one or more of its key senior executives, and fails to replace them in a satisfactory and timely manner, our business, financial condition and/or results of operations, including control and operational risks, may be adversely affected. Likewise, if we fail to attract and appropriately train, motivate and retain qualified professionals, our business may be adversely affected.

Our financial statements are based in part on assumptions and estimates which, if inaccurate, could cause material misstatement of the results and financial position of the Group

The preparation of financial statements requires management to make judgements, estimates and

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Report of the Directors: Overview (continued)

assumptions that affect the reported amounts of assets, liabilities, income and expenses. Due to the inherent uncertainty in making estimates, actual results reported in future periods may be based upon amounts which differ from those estimates. Estimates, judgements and assumptions are continually evaluated and are based on historical experience and other factors, including expectations of future events that are believed to be reasonable under the circumstances. Revisions to accounting estimates are recognised in the period in which the estimate is revised and in any future periods affected. The accounting policies deemed critical to our results and financial position, based upon materiality and significant judgements and estimates, include impairment of loans and advances, goodwill impairment, valuation of financial instruments, impairment of available-for-sale financial assets, deferred tax assets and provision for liabilities, which are discussed in detail in Critical accounting policies on page 38.

The valuation of financial instruments measured at fair value can be subjective, in particular where models are used which include unobservable inputs. Given the uncertainty and subjectivity associated with valuing such instruments it is possible that the results of operations and financial position of the Group could be materially misstated if the estimates and assumptions used prove to be inaccurate. For further details, see Critical accounting policies on page 38.

If the judgement, estimates and assumptions we use in preparing our consolidated financial statements are subsequently found to be incorrect, there could be a material effect on our results of operations and a corresponding effect on our funding requirements and capital ratios.

Third parties may use us as a conduit for illegal activities without our knowledge, which could have a material adverse effect on us

We are required to comply with applicable anti-money laundering laws and regulations and have adopted various policies and procedures, including internal control and know-your-customer procedures, aimed at preventing use of HSBC for money laundering. A major focus of US governmental policy relating to financial institutions in recent years has been combating money laundering and enforcing compliance with US economic sanctions. For example, subsidiaries of HSBC Holdings have entered into a consent cease and desist order with the OCC and a similar consent order with the Federal Reserve Board which requires

the implementation of improvements to compliance procedures regarding obligations under the US Bank Secrecy Act (the BSA) and anti-money laundering (AML) rules. These consent orders do not preclude additional enforcement actions by bank regulatory, governmental or law enforcement agencies. Investigations by various authorities pertaining to, among other things, alleged violations of AML laws, the BSA and regulations issued by the Office of Foreign Asset Control are ongoing. See Note 44 on the Financial Statements on page 405.

In relevant situations and where permitted by regulation, we may rely upon certain counterparties to maintain and properly apply their own appropriate anti-money laundering procedures. While permitted by regulation, such reliance may not be completely effective in preventing third parties from using us (and our relevant counterparties) as a conduit for money laundering including illegal cash operations without our (and our relevant counterparties) knowledge. If we are associated with, or even accused of being associated with, or become a party to, money laundering, our reputation could suffer and we could become subject to fines, sanctions and/or legal enforcement (including being added to any blacklists that would prohibit certain parties from engaging in transactions with us), any one of which could have a material adverse effect on our business, financial condition and/or results of operations.

We may not achieve all the expected benefits of our strategic initiatives

In 2011 we developed and presented a new strategy for the Group. See further discussion in Strategic direction on page 11. Our strategy is built around two trends, continued growth of international trade and capital flows, and wealth creation, particularly in faster growing markets. Based on our analysis of those trends, we have developed criteria to help us better deploy capital. We have also launched an initiative to reduce costs, part of which includes the disposal of non-core businesses. The development and implementation of our strategy requires difficult, subjective and complex judgements, including forecasts of economic conditions in various parts of the world. We may fail to correctly identify the trends we seek to exploit and the relevant factors in making decisions as to capital deployment and cost reduction. Our ability to execute our strategy may also be limited by our operational capacity and the increasing complexity of the regulatory environment in which we operate. For example, the complexities of separating disposed assets from continuing operations, including transitional

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Report of the Directors: Overview (continued)

arrangements, could increase operational and reputational risks and threaten successful execution of an announced disposal. In addition, factors beyond our control, including but not limited to the market and economic conditions and other challenges discussed in detail above, could limit our ability to achieve all of the expected benefits of these initiatives.

Risks related to our business

We have significant exposure to counterparty risk within the financial sector and to other risk concentrations

We have exposure to virtually all major industries and counterparties, and we routinely execute transactions with counterparties in financial services, including brokers and dealers, commercial banks, investment banks, mutual and hedge funds, and other institutional clients. Many of these transactions expose us to credit risk in the event of default by our counterparty or client. Our ability to engage in routine transactions to fund our operations and manage our risks could be adversely affected by the actions and commercial soundness of other financial services institutions. Financial institutions are necessarily interdependent because of trading, clearing, counterparty or other relationships. As a consequence, a default by, or decline in market confidence in, individual institutions, or anxiety about the financial services industry generally, can lead to further individual and/or systemic difficulties, defaults and losses. Where counterparty risk has been mitigated by taking collateral, our credit risk may remain high if the collateral we hold cannot be realised or has to be liquidated at prices which are insufficient to recover the full amount of our loan or derivative exposure.

Market fluctuations may reduce our income or the value of our portfolios

Our businesses are inherently subject to risks in financial markets and in the wider economy, including changes in, and increased volatility of, interest rates, inflation rates, credit spreads, foreign exchange rates, commodity, equity, bond and property prices and the risk that our customers act in a manner inconsistent with our business, pricing and hedging assumptions.

Market movements will continue to have a significant impact on us in a number of key areas. For example, our pension scheme assets include equity and debt securities, the cash flows of which change as equity prices and interest rates vary. Banking and trading activities are subject to interest

rate risk, foreign exchange risk, inflation risk and credit spread risk. Changes in interest rate levels, interbank spreads over official rates, yield curves and spreads affect the interest rate spread realised between lending and borrowing costs. The potential for future volatility and margin changes remains. Competitive pressures on fixed rates or product terms in existing loans and deposits sometimes restrict our ability to change interest rates applying to customers in response to changes in official and wholesale market rates.

Our insurance businesses are exposed to the risk that market fluctuations will cause mismatches to occur between product liabilities and the investment assets which back them. Market risks can affect our insurance products in a number of ways depending upon the product and associated contract. For example, mismatches between assets and liability yields and maturities give rise to interest rate risk. Some of these risks are borne directly by the customer and some are borne by the insurance businesses. Some insurance contracts involve guarantees and options that increase in value in adverse investment markets. There is a risk that the insurance businesses will bear some of the cost of such guarantees and options. The insurance businesses also have capital directly invested in the markets that are exposed to market risk. The performance of the investment markets will thus have a direct impact upon the value embedded in the insurance and investment contracts and our operating results, financial condition and prospects.

It is difficult to predict with any accuracy changes in market conditions, and such changes may have a material adverse effect on our operating results, financial condition and prospects.

Liquidity, or ready access to funds, is essential to our businesses

Our ability to borrow on a secured or unsecured basis and the cost of so doing can be affected by increases in interest rates or credit spreads, the availability of credit, regulatory requirements relating to liquidity or the market perceptions of risk relating to us or the banking sector, including our perceived or actual creditworthiness.

Current accounts and savings deposits payable on demand or at short notice form a significant part of our funding, and we place considerable importance on maintaining their stability. For deposits, stability depends upon preserving investor confidence in our capital strength and liquidity, and on comparable and transparent pricing. Although

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HSBC HOLDINGS PLC

Report of the Directors: Overview (continued)

deposits have been, over time, a stable source of funding, this may not continue.

We also access professional markets in order to provide funding for non-banking subsidiaries that do not accept deposits, to align asset and liability maturities and currencies and to maintain a presence in local money markets. While we continued to have good access to debt capital markets in 2011, market disruption continued to have adverse effects on the liquidity and funding risk profile of the banking system in the year. An inability to obtain financing in the unsecured long-term or short-term debt capital markets, or to access the secured lending markets, could have a substantial adverse effect on our liquidity. In challenging credit markets, our funding costs may increase or we may be unable to raise funds to support or expand our businesses, adversely affecting our results of operations. Even though we continued to have good access to debt capital markets during 2011 at competitive prices, the costs of liquidity have risen, and we expect to incur additional costs as a result of regulatory requirements for increased liquidity and the challenging economic environment in Europe, the US and elsewhere.

If we are unable to raise funds through deposits and/or in the capital markets, our liquidity position could be adversely affected and we might be unable to meet deposit withdrawals on demand or at their contractual maturity, to repay borrowings as they mature, to meet our obligations under committed financing facilities and insurance contracts, or to fund new loans, investments and businesses. We may need to liquidate unencumbered assets to meet our liabilities. In a time of reduced liquidity, we may be unable to sell some of our assets, or we may need to sell assets at depressed prices, which in either case could adversely affect our results of operations and financial condition.

Any reduction in the credit rating assigned to HSBC Holdings, any subsidiaries of HSBC Holdings or any of their respective debt securities could increase our cost or availability of funding and adversely affect our liquidity position and interest margins

Credit ratings affect the cost and other terms upon which we are able to obtain funding. Rating agencies regularly evaluate HSBC Holdings and certain of its subsidiaries, as well as their respective debt securities. Their ratings are based on a number of factors, including their assessment of the relative

financial strength of HSBC or of the relevant entity, as well as conditions affecting the financial services industry generally. There can be no assurance that the rating agencies will maintain HSBC s or the relevant entity s current ratings or outlook, especially in light of the difficulties in the financial services industry and the financial markets. HSBC Holdings long-term credit rating was recently downgraded by Standard & Poor s, after the rating agency applied its new rating methodology to banks globally. HSBC experienced no change in market demand or the cost of issuing liabilities and negligible changes in its collateral requirements arising from this change in rating. Further reductions in those ratings and outlook could increase the cost of our funding, limit access to capital markets and require additional collateral to be placed and, consequently, adversely affect our interest margins and/or our liquidity position.

Risks concerning borrower credit quality are inherent in our businesses

Risks arising from changes in credit quality and the recoverability of loans and amounts due from borrowers and counterparties (e.g. reinsurers and counterparties in derivative transactions) are inherent in a wide range of our businesses. Adverse changes in the credit quality of our borrowers and counterparties as a consequence of a general deterioration in economic conditions, or arising from systemic risks in the financial systems, could reduce the recoverability and value of our assets and require an increase in our loan impairment charges.

We estimate and recognise impairment allowances for credit losses inherent in our credit exposure. This process, which is critical to our results and financial condition, requires difficult, subjective and complex judgements, including forecasts of how these economic conditions might impair the ability of our borrowers to repay their loans and the ability of other counterparties to meet their obligations. As is the case with any such assessments, we may fail to estimate accurately the effect of factors that we identify or fail to identify relevant factors. Further, the information we use to assess the creditworthiness of our counterparties may be inaccurate or incorrect. Any failure by us to accurately estimate the ability of our counterparties to meet their obligations may have a material adverse impact on our business, financial condition and/or results of operations. For further information on the nature of our credit risk, see Credit risk on page 104.

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HSBC HOLDINGS PLC

Report of the Directors: Overview (continued)

Our insurance businesses are subject to risks relating to insurance claim rates and changes in insurance customer behaviour

We provide various insurance products for customers with whom we have a banking relationship, including several types of life insurance products. The cost of claims and benefits can be influenced by many factors, including mortality and morbidity rates, lapse and surrender rates and, if the policy has a savings element, the performance of assets to support the liabilities. Adverse developments in any of these factors may adversely affect our financial condition and results of operations.

Our general insurance businesses are exposed to the risk of uncertain insurance claim rates. For example, extreme weather conditions can result in high property damage claims, higher levels of theft can increase claims on home insurance and changes to unemployment levels can increase claims on loan protection insurance. These claims rates may differ from business assumptions and negative developments may adversely affect our financial condition and results of operations.

HSBC Holdings is a holding company and as a result, is dependent on dividends from its subsidiaries to meet its obligations including its obligations with respect to its debt securities, and to provide profits for payment of future dividends to shareholders.

HSBC Holdings is a non-operating holding company and as such the principal sources of its income are from operating subsidiaries which hold the principal assets of HSBC. As a separate legal entity, HSBC Holdings relies on remittance of its subsidiaries profits and other funds in order to be able to pay obligations to shareholders and debt holders as they fall due. The ability of HSBC s subsidiaries and affiliates to pay dividends could be restricted by changes in official banking measures, exchange controls and other requirements.

We may be required to make substantial contributions to our pension plans.

We operate a number of pension plans throughout the world, including defined benefit plans. Pension scheme obligations fluctuate with changes in long-term interest rates, inflation, salary levels and the longevity of scheme members. The level of contributions we make to our pension plans has a direct impact on our cash flow. To the extent plan assets are insufficient to cover existing liabilities higher levels of contributions will be required. As a result, deficits in those pension plans may have a material adverse impact on our business, financial condition and/or results of operations.

Report of the Directors: Overview (continued)

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:

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

During 2011 our senior management paid particular attention to a number of top and emerging risks which are summarised below:

Macro-economic and geopolitical risk

- Eurozone risk of sovereign defaults
- Eurozone member departing from the currency union
- 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 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

- Challenges to achieving our strategy in a downturn
- Internet crime and fraud
- Social media risk
- Level of change creating operational complexity and heightened operational risk
- Information security risk

All of the above risks are regarded as top risks with the exception of social media risk which is an emerging risk.

A detailed account of these risks is provided on page 99. Further comments on expected risks and uncertainties are made throughout the *Annual Report and Accounts 2011*, particularly in the section on Risk, pages 98 to 210.

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. It is discussed further on page 234.

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

HSBC Values

The role of HSBC Values in daily operating practice is significant in the context of the financial services sector and the wider economy, particularly 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 through the personal sponsorship of the Group Chief Executive and senior executives. These initiatives will continue in 2012 and beyond.

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.

Following a review of our high-level key performance indicators (KPI s) and reflecting the increased focus on the quality of the capital base, the GMB decided to adopt a core tier 1 capital ratio instead of a tier 1 capital ratio as the primary indicator of the strength of our capital base and its ability to support the growth of the business and meet regulatory requirements.

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 five filter analysis across the portfolio of businesses. We will continue to evaluate our businesses in 2012 using this methodology.

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Report of the Directors: Overview (continued)

Strategy	Capital deployment improving the way we deploy capital		
	Return on average ordinary shareholders equity[3]	**Core tier 1 capital**[8]	**Advances to core funding ratio**[9]
	Measure: (percentage) profit attributable to shareholders divided by average ordinary shareholders equity.	**Measure:** (percentage) core tier 1 capital comprising shareholders equity and related non-controlling interests less regulatory deductions and adjustments.	**Measure:** loans and advances to customers as a percentage of the total of core customer deposits and term funding with a remaining term to maturity in excess of one year.
	Target: to maintain a return in the medium term of between 12% and 15%.	**Target:** to maintain a strong capital base to support the development of the business and meet regulatory capital requirements at all times.	**Target:** to maintain an advances to core funding ratio below limits set for each entity.
	Outcome: return on average ordinary shareholders equity was below the target range, but 1.4 percentage points higher than 2010.	**Outcome:** the decrease in core tier 1 capital to 10.1% reflected an increase in RWAs due to a growth in lending balances, including those held for sale and an increase in the RWAs of our mainland China associates, as well as the introduction of Basel 2.5.	**Outcome:** the strong funding position of HBAP has allowed us to take advantage of loan growth opportunities during the year, while reduced lending in the US resulted in further strengthening of our funding position.

Strategy	Cost efficiency a lean and values-driven organisation	
	Cost efficiency (2011: underlying cost efficiency 61%)	**Employee engagement**
	Measure: (percentage) total operating expenses divided by net operating income before loan impairment and other credit risk provisions.	**Measure:** (percentage) measure of employee s emotional and rational attachment to HSBC, a combination of advocacy, satisfaction, commitment and pride.
	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.	**Target:** to achieve a 72% global rating in 2011, with progressive improvement to best in class.
	Outcome: on a reported and underlying basis the ratio was outside the target range, in part due to notable items including restructuring costs, customer redress programmes and a bank levy introduced by the UK government, but also due to an increase in staff costs reflecting wage inflation in key markets and higher average staff numbers.	**Outcome:** employee engagement behind global best in class. Improvement in 2011 despite a challenging environment.

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HSBC HOLDINGS PLC

Report of the Directors: Overview (continued)

Growth continue to position ourselves for growth **Strategy**

Risk-adjusted revenue growth (2011: underlying growth 2%)	**Basic earnings per ordinary share**	**Dividends per ordinary share growth**
Measure: (percentage) increase in reported net operating income after loan impairment and other credit risk charges since last year.	**Measure:** (US$) level of basic earnings generated per ordinary share.	**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 consistent growth in risk adjusted revenues.	**Target:** to deliver consistent growth in basic earnings per share.	**Target:** to deliver sustained dividend per share growth.
Outcome: reported risk-adjusted revenue increased primarily due to favourable movements on the fair value of own debt due to credit spreads and on an underlying basis due to lower loan impairment charges.	**Outcome:** Earnings per share (EPS) increased in 2011 reflecting significant favourable movements on the fair value of own debt due to credit spreads which resulted in an increase in reported profits.	**Outcome:** dividends per share increased by 14%.

Customer recommendation	**Brand value**
Measure: we measure our customer satisfaction through an independent market research survey of retail banking and business banking customers in selected countries, using a specific metric of customer recommendation (the CRI) to score performance. We benchmark our performance against key competitors in each market and set targets for performance based on our peer group of banks.	**Measure:** in 2011, we moved our brand measure to the Brand Finance valuation method as reported in *The Banker* Magazine. Our previous measure only gave us a score derived from a survey of our personal and small business customers. 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: the Group target is for 75% of all the selected markets (based on their weighted revenue) to meet their CRI targets.	**Target:** a top 3 position in the banking peer group.
Outcome: CMB Business Banking exceeded its target. RBWM experienced a challenging environment in many of its large retail markets, with strong local competition and negative reaction to some strategic portfolio management activity, and only met its target in 35% of the markets by weighted revenue. It got to within 2 percentage points of its target in a further 44% of markets. See page 46 for further details. RBWM had a strong fourth quarter, with 77% of the markets meeting target and it finished the year ranked first in five of the six markets surveyed in Asia.	**Outcome:** HSBC s brand value in 2009 followed a sharp drop in industry brand values in 2008/9 which coincided with the financial crisis. The subsequent increase reflected a general rise in values, with HSBC s brand remaining one of the strongest in the sector.

For footnotes, see page 95.

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HSBC HOLDINGS PLC

Report of the Directors: Operating and Financial Review

Financial summary

The management commentary included in the Report of the Directors: Overview and Operating and Financial Review, together with the Employees and Corporate sustainability sections of Corporate Governance and the Directors Remuneration Report is presented in compliance with the IFRS Practice Statement Management Commentary *issued by the IASB.*

Reconciliation of reported and underlying profit before tax

In addition to results reported on an IFRSs basis, we measure our performance internally on a like-for-like basis by eliminating the effects of foreign currency translation differences, acquisitions and disposals of subsidiaries and businesses, and fair value movements on own debt attributable to credit spread where the net result of such movements will be zero upon maturity of the debt; all of which distort year-on-year comparisons. We refer to this as our underlying performance.

Reported results include the effects of the above items. They are excluded when monitoring progress against operating plans and past results because management believes that the underlying basis more accurately reflects operating performance.

Constant currency

Constant currency comparatives for 2010 referred to in the commentaries are computed by retranslating into US dollars for non-US dollar branches, subsidiaries, joint ventures and associates:

the income statements for 2010 at the average rates of exchange for 2011; and

the balance sheet at 31 December 2010 at the prevailing rates of exchange on 31 December 2011.

Constant currency comparatives for 2009 referred to in the 2010 commentaries are computed on the same basis, by applying average rates of exchange for 2010 to the 2009 income and rates of exchange on 31 December 2010 to the balance sheet at 31 December 2009.

No adjustment has been made to the exchange rates used to translate foreign currency denominated assets and liabilities into the functional currencies of any HSBC branches, subsidiaries, joint ventures or associates. When reference is made to constant currency in tables or commentaries, comparative data reported in the functional currencies of HSBC s operations have been translated at the appropriate exchange rates applied in the current period on the basis described above.

Underlying performance

The following tables compare our underlying performance in 2011 and 2010 with reported profits in those years. Equivalent tables are provided for each of HSBC s global businesses and geographical segments in the Form 20-F filed with the SEC, which is available on www.hsbc.com.

The foreign currency translation differences reflect the relative weakening of the US dollar against most major currencies during 2011.

The following acquisitions and disposals affected both comparisons:

the gain of US$62m on reclassification of Bao Viet Holdings (Bao Viet) from an available-for-sale asset to an associate in January 2010;

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

the gain of US$66m on sale of our stake in Wells Fargo HSBC Trade Bank in March 2010;

the gain of US$107m on disposal of HSBC Insurance Brokers Limited in April 2010;

the dilution gains which arose on our holding in Ping An Insurance (Group) Company of China, Limited (Ping An) following the issue of share capital to third parties in May 2010 and June 2011 of US$188m and US$181m, respectively;

the loss of US$42m on the sale of our investment in British Arab Commercial Bank plc in October 2010;

the gain of US$74m on the deconsolidation of private equity funds following the management buy-out of Headland Capital Partners Ltd (formerly known as HSBC Private Equity (Asia) Ltd) in November 2010;
the gain of US$255m on the sale of Eversholt Rail Group in December 2010;

the gain of US$83m on the sale of HSBC Afore S.A. de C.V. (HSBC Afore) in August 2011;

a loss of US$48m being our share of the loss recorded by Ping An on remeasurement of its previously held equity interest in Shenzen Development Bank (SDB) when Ping An took control and fully consolidated SDB in July 2011; and

the dilution gain of US$27m in December 2011 as a result of the merger between HSBC Saudi Arabia Limited and SABB Securities Limited.

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HSBC HOLDINGS PLC

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

Reconciliation of reported and underlying profit before tax

	2011 compared with 2010								
HSBC	**2010 as reported US$m**	**2010 adjust-ments[10] US$m**	**Currency translation[11] US$m**	**2010 at 2011 exchange rates[12] US$m**	**2011 as reported US$m**	**2011 adjust-ments[10] US$m**	**2011 under-lying US$m**	**Re-ported change[13] %**	**Under-lying change[13] %**
Net interest income	39,441	48	781	40,270	40,662		40,662	3	1
Net fee income	17,355	(55)	349	17,649	17,160		17,160	(1)	(3)
Changes in fair value[14]	(63)	63			3,933	(3,933)			
Other income[15]	11,514	(847)	284	10,951	10,525	(291)	10,234	(9)	(7)
Net operating income[16]	68,247	(791)	1,414	68,870	72,280	(4,224)	68,056	6	(1)
Loan impairment charges and other credit risk provisions	(14,039)		(206)	(14,245)	(12,127)		(12,127)	14	15
Net operating income	54,208	(791)	1,208	54,625	60,153	(4,224)	55,929	11	2
Operating expenses	(37,688)	220	(842)	(38,310)	(41,545)		(41,545)	(10)	(8)
Operating profit	16,520	(571)	366	16,315	18,608	(4,224)	14,384	13	(12)
Income from associates	2,517		93	2,610	3,264	48	3,312	30	27
Profit before tax	19,037	(571)	459	18,925	21,872	(4,176)	17,696	15	(6)
By geographical region									
Europe	4,302	(88)	167	4,381	4,671	(2,947)	1,724	9	(61)
Hong Kong	5,692	(130)	(10)	5,552	5,823		5,823	2	5
Rest of Asia-Pacific	5,902	(187)	227	5,942	7,471	(135)	7,336	27	23
Middle East and North Africa	892	42	(10)	924	1,492	(41)	1,451	67	57
North America	454	(208)	39	285	100	(970)	(870)	(78)	
Latin America	1,795		46	1,841	2,315	(83)	2,232	29	21
Profit before tax	19,037	(571)	459	18,925	21,872	(4,176)	17,696	15	(6)
By global business									
Retail Banking and Wealth Management[17]	3,839	(3)	126	3,962	4,270	(83)	4,187	11	6
Commercial Banking	6,090	(119)	126	6,097	7,947		7,947	30	30
Global Banking and Markets[17]	9,215	(262)	198	9,151	7,049		7,049	(24)	(23)
Global Private Banking	1,054		6	1,060	944		944	(10)	(11)
Other	(1,161)	(187)	3	(1,345)	1,662	(4,093)	(2,431)		(81)
Profit before tax	19,037	(571)	459	18,925	21,872	(4,176)	17,696	15	(6)

For footnotes, see page 95.

Additional information is available on the HSBC website www.hsbc.com.

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

Consolidated income statement

Five-year summary consolidated income statement

	2011	2010	2009	2008	2007
	US$m	US$m	US$m	US$m	US$m
Net interest income	**40,662**	39,441	40,730	42,563	37,795
Net fee income	**17,160**	17,355	17,664	20,024	22,002
Net trading income	**6,506**	7,210	9,863	6,560	9,834
Net income/(expense) from financial instruments designated at fair value	**3,439**	1,220	(3,531)	3,852	4,083
Gains less losses from financial investments	**907**	968	520	197	1,956
Dividend income	**149**	112	126	272	324
Net earned insurance premiums	**12,872**	11,146	10,471	10,850	9,076
Gains on disposal of French regional banks				2,445	
Other operating income	**1,766**	2,562	2,788	1,808	2,531
Gains arising from dilution of interests in associates and joint ventures	**208**	188			1,092
Other	**1,558**	2,374	2,788		