

Report of the Directors: Overview
 (continued)



Financial highlights

For the year

Profit before taxation US\$19,037m – up 169% 2009: US\$7,079m 2008: US\$9,307m	Underlying profit before taxation US\$18,366m – up 36% 2009: US\$13,482m	Total operating income US\$80,014m – up 2% 2009: US\$78,631m 2008: US\$88,571m
Net operating income before loan impairment charges and other credit risk provisions US\$68,247m – up 3% 2009: US\$66,181m 2008: US\$81,682m	Profit attributable to shareholders of the parent company US\$13,159m – up 126% 2009: US\$5,834m 2008: US\$5,728m	

Earnings per share and dividends per share

Earnings per share US\$0.73 – up 115% 2009: US\$0.34 2008: US\$0.41	Dividends per share¹ US\$0.34 2009: US\$0.34 2008: US\$0.93
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At the year-end

Loans and advances to customers US\$958bn – up 7% 2009: US\$896bn 2008: US\$933bn	Customer accounts US\$1,228bn – up 6% 2009: US\$1,159bn 2008: US\$1,115bn	Ratio of customer advances to customer accounts 78.1% 2009: 77.3% 2008: 83.6%
Total equity US\$155bn – up 14% 2009: US\$136bn 2008: US\$100bn	Average total shareholders’ equity to average total assets 5.5% 2009: 4.7% 2008: 4.9%	Risk-weighted assets US\$1,103bn – down 3% 2009: US\$1,133bn 2008: US\$1,148bn

Capital ratios

Core tier 1 ratio 10.5% 2009: 9.4% 2008: 7.0%	Tier 1 ratio 12.1% 2009: 10.8% 2008: 8.3%	Total capital ratio 15.2% 2009: 13.7% 2008: 11.4%
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Performance ratios

Credit coverage ratios

Loan impairment charges to
total operating income

16.9%

2009: 31.7%
2008: 27.2%

Loan impairment charges to
average gross customer advances

1.5%

2009: 2.8%
2008: 2.5%

Total impairment allowances to
impaired loans at year-end

71.6%

2009: 83.2%
2008: 94.3%

Return ratios

Return on average
invested capital²

8.7%

2009: 4.1%
2008: 4.0%

Return on average
shareholders' equity³,

9.5%

2009: 5.1%
2008: 4.7%

Post-tax return on
average total assets

0.6%

2009: 0.3%
2008: 0.3%

Post-tax return on average
risk-weighted assets

1.3%

2009: 0.6%
2008: 0.6%

Efficiency and revenue mix ratios

Cost efficiency ratio⁴

55.2%

2009: 52.0%
2008: 60.1%

Net interest income to
total operating income

49.3%

2009: 51.8%
2008: 48.1%

Net fee income to
total operating income

21.7%

2009: 22.5%
2008: 22.6%

Net trading income to
total operating income

9.0%

2009: 12.5%
2008: 7.4%

Share information at the year-end

US\$0.50 ordinary
shares in issue

17,686m

2009: 17,408m
2008: 12,105m

Market
capitalisation

US\$180bn

2009: US\$199bn
2008: US\$114bn

Closing market price

London

£6.51

2009: £7.09
2008: £5.77

Hong Kong

HK\$79.70

2009: HK\$89.40
2008: HK\$67.81

American
Depositary Share⁵

US\$51.04

2009: US\$57.09
2008: US\$44.15

Total shareholder return⁶

Over 1 year

95.3

112.6
115.9
103.7

Over 3 years

103.4

102.8
111.0
81.9

Over 5 years

103.4

126.3
127.0
79.0

To 31 December 2010

Benchmarks:

- FTSE 100⁷
- MSCI World⁷
- MSCI Banks⁷

For footnotes, see page 83.

Report of the Directors: Overview (continued)

Cautionary statement regarding forward-looking statements

The *Annual Report and Accounts 2010* 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 similar 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, and it should not be assumed that they have been revised or updated in the light of new information or future events.

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**

When I took on the role of Chairman less than 90 days ago, I was acutely aware of the challenges facing our industry. I was conscious too of the need to demonstrate to all of our stakeholders that HSBC understands the responsibilities that accompany the systemic significance which continued success has built for HSBC in many of the markets in which we operate, not least those in Asia, given their historical significance to the Group. 145 years after we were founded, Hong Kong and the rest of Asia remain at the heart of HSBC's strength and identity and our commitment to the region is unwavering.

I fully acknowledge that our scale, the trust that our depositors place in us and our relevance to our personal and corporate clients – for their financing, banking, investment and risk management needs – all depend upon our maintaining our reputation and our integrity.

I also understand how important it is for you, our shareholders, that HSBC builds sustainable long-term value that is reflected through the share price and rebuilds, as quickly as competing regulatory demands allow, the dividend that was reduced during the financial crisis.

I firmly believe that HSBC has the people, the financial strength and the organisational structure best able to deliver all of the above and it is a privilege to have the opportunity to serve as Group Chairman as we enter a fresh chapter in our history.

Before I go any further, I want to pay tribute to both Stephen Green and Michael Geoghegan, who stepped down at the end of last year from their roles as Group Chairman and Group Chief Executive after, respectively, 28 and 37 years' service to HSBC. It fell to them to be at the helm as HSBC

navigated its way through the worst financial crisis since the 1930s. Mike led from the front in addressing the problems in our consumer finance subsidiary in the United States and in reshaping HSBC's organisational structure and operational practices in order to better and more efficiently serve an increasingly interconnected world. Stephen's personal reputation for integrity and probity stood out and distinguished HSBC during a period of intense disaffection with the banking industry. For their contribution over many years we owe them a deep debt of gratitude and wish them both well.

Our performance in 2010

The Group Chief Executive's Business Review sets out clearly how HSBC delivered a much improved balance of profits in 2010. It is reassuring to see our Personal Financial Services businesses returning to profitability in aggregate and Commercial Banking growing significantly, largely in emerging markets. These achievements augmented another year of strong performance in Global Banking and Markets.

Earnings per share improved strongly, rising by 115% to reach US\$0.73 per share.

The Group's capital position also strengthened with the core tier 1 ratio, the ratio most favoured by regulators as it comprises equity capital after regulatory adjustments and deductions, increasing from 9.4% to 10.5%, largely due to profit retention throughout the year.

As a consequence of this strong capital generation, together with greater clarity on the direction of regulatory reform of capital requirements and an improving economic backdrop in the developed world – particularly in the United States – the Board has approved increases in both the final dividend payment in respect of 2010 and the planned quarterly dividends for 2011. The final dividend for 2010, payable on 5 May 2011 to shareholders on the register on 17 March 2011, will be 12 cents per ordinary share, up from 10 cents at the same point last year. For the remainder of 2011 we plan to pay quarterly dividends of nine cents for each of the first three quarters compared with eight cents in respect of the equivalent quarters of 2010.

A new leadership team

We enter 2011 with a new leadership team, but only in the sense of changed roles. Everyone has worked together over many years and there is immense experience to draw on both from within HSBC and from earlier careers at peer organisations. Stuart Gulliver is leading the management team as Group Chief Executive. His clear objective is to deliver

Report of the Directors: Overview (continued)

sustainable long-term value for shareholders consistently in a manner that maintains the confidence of all other key stakeholders in our businesses including depositors, counterparties, long-term creditors, customers, employees, regulators and governments. His review on pages 7 to 9 gives an insight into his immediate priorities.

Everything we do is governed by the imperative of upholding HSBC's corporate reputation and character at the highest level and adding further strength to our brand; we deeply regret that a number of weaknesses in regulatory compliance were highlighted in 2010 and we are resolved to remedy these and reinforce the high standards we demand of ourselves.

For my part, I shall be focusing on engaging at the highest level in the regulatory reform debates that will, in large part, shape our future. I shall also lead the Board in the stewardship and review of performance of our financial and human resources.

In the interest of full transparency, we have today published on our website the respective roles and responsibilities of the Group Chairman, the Deputy Chairman and Senior Independent Director and the Group Chief Executive.

Board changes

I have already paid tribute to the contributions of Stephen Green and Michael Geoghegan. Vincent Cheng has indicated that he will step down at the next AGM and on behalf of the Board I want to thank him for his immense contribution in many roles over 33 years. Vincent will retain an association with the Group by taking on an advisory role to the Group Chief Executive on regional matters. Laura Cha will join the Board on 1 March; Laura has been Deputy Chair of The Hongkong and Shanghai Banking Corporation Limited for four years and brings a wealth of experience of China; fuller details of her background and experience are set out in the Directors' Report.

Regulatory update

There was much progress made during 2010 on the regulatory reform agenda. Although there is still a great deal to do, the shape of capital requirements was broadly clarified and an implementation timetable stretching out to 2019 was agreed to allow time for the industry to adjust progressively. A minimum common equity tier 1 ratio of 7%, including a capital conservation buffer, has been agreed. HSBC already meets this threshold requirement. The Group Chief Executive's Business Review addresses how these revised requirements

will impact our targeted return on equity.

During 2011, the debate will be dominated by consideration of the calibration of minimum liquidity standards. Although it is clear that liquidity and funding weaknesses were key elements contributing to the crisis, HSBC agrees with the industry consensus that the revised requirements in these areas are overly conservative and could lead to unnecessary deleveraging at a time of fragile economic recovery in much of the developed world. It will be a near impossibility for the industry to expand business lending at the same time as increasing the amount of deposits deployed in government bonds while, for many banks but not HSBC, reducing dependency on central bank liquidity support arrangements. It is to be hoped that the observation period, which starts this year and precedes the formal introduction of the new requirements, will inform a recalibration of these minimum liquidity standards.

A second debate of importance to HSBC's shareholders in 2011 will concern the designation of 'Systemically Important Financial Institutions' ('SIFI's). Consideration is being given in the regulatory community to mandating higher capital requirements, together with more intense supervision, for institutions classified as SIFIs. We agree with heightened supervision but it is not clear that the reduced shareholder returns that would follow the imposition of incremental capital would be compensated for by improved stability. Classification as a SIFI with a requirement to hold incremental capital would, however, probably lead others to favour SIFIs as counterparties, and may therefore have the unintended consequence of further concentrating the industry.

HSBC's position is that systemic importance should not be determined by size alone. It is clear, however, that, on almost any basis, HSBC would be classified as systemically important. For this reason we are engaging fully in the debate around the consequences of designation as a SIFI. In particular, we draw attention to the benefits of our corporate organisation through separate subsidiaries in mitigation against the imposition of incremental capital for SIFIs based on size alone.

In October 2010, the UK government confirmed its intention to raise the sum of £2.5bn (US\$3.9bn) through a levy on bank balance sheets, and recently announced it will accelerate the full impact of this levy to 2011. We take no issue with the right of the UK government to raise a levy on the banking industry, particularly when having had to risk taxpayers' money to rescue a number of important UK institutions. However, as the proposed levy is to

Report of the Directors: Overview (continued)

be applied to the consolidated balance sheet, it applies beyond the legal boundary of the domestic institution to include overseas operations conducted through separately capitalised subsidiaries. This therefore constitutes an additional cost of basing a growing multinational banking group in the UK.

We intend to clarify in each set of results going forward the impact of the levy, split between UK and overseas operations, and Stuart Gulliver covers this in more detail in his review. We regard the levy, which is not tax deductible, as akin to a distribution of profits. For this reason, we intend to add to future shareholder dividends that would otherwise be paid, any amount saved in the event that the levy is restructured or relieved in due course.

The role of banks in society

The recent crisis has caused a proper introspection as to the role that banks play in society and at HSBC we welcome this. Banking is not simply about money. It is about helping individuals and organisations within society to meet personal and corporate objectives by facilitating access to financial capital and protecting value for those who make capital available. Payment mechanisms, the provision of long-term credit, trade finance, hedging and other risk management products, deposit, investment and retirement services are but a few of the activities through which banking groups contribute to today's financial system. Society cannot function without an effective financial system that delivers value to those it serves at an intermediation cost that is proportionate to the value created. Somehow, many participants and not just banks, lost sight of this basic principle in the run-up to the recent financial crisis and the consequences for all have, inevitably, been far reaching. There is no doubt that the scale of regulatory reform will bring many challenges, but it will also open new opportunities.

At HSBC, we shall not forget what happened to precipitate the scale of reform now underway. Although the financial turmoil arising from the events of 2007-2008 has largely moderated, in large part as a result of co-ordinated government action and support to the financial system, we enter 2011 with humility, ready to apply right across HSBC all of the lessons learned, notwithstanding that HSBC itself neither sought nor received support from any government.

Society has a right to ask if banks 'get it'. At HSBC, we do – and we are focused on embedding the necessary changes in our business model for long-term sustainable value creation. But we also do not forget that value creation depends upon HSBC recruiting, training and retaining the right talent in

order to manage the risks we accept through intermediating customer flows; design solutions to address complex financial problems; build enduring relationships with core customers; build confidence in the Group's financial strength; and create the strategic options that offer the next generation fresh opportunities to continue building sustainable value.

In this globalised world, there is intense competition for the best people and, given our long history within and connections into the faster-growing developing markets, our best people are highly marketable. It would be irresponsible to allow our comparative advantages to wither by ignoring the market forces that exist around compensation, even though we understand how sensitive this subject is. Reform in this area can only be achieved if there is concerted international agreement on limiting the quantum of pay as well as harmonising pay structures but there appears to be no appetite to take the initiative on this. Our duty to shareholders is to build sustainable value in the economic and competitive environment in which we operate and our principal resource for achieving this is human talent. Under the governance of the Board, we will continue to operate and apply remuneration policies and practices that take full recognition of best practice and are aligned with the long-term interests of shareholders.

HSBC's people

Finally, I want to pay tribute to my 307,000 colleagues. So many of HSBC's people have exemplified commitment and endeavour again in 2010, helping our customers and clients to meet their financial objectives while taking on the additional burden of preparing for regulatory change. This has been done against a backdrop of continuing broad-based fiscal support to many economies, with public opinion consistently and highly critical of our industry. As I look forward, it is the combination of the capabilities of HSBC's people, their determination to do the right thing for our customers and their deep sense of responsibility to the communities they serve that makes me confident that HSBC will play a leading role in rebuilding the trust that our industry has lost and, by doing so, will build sustainable value for you, our shareholders.



D J Flint, *Group Chairman*
28 February 2011

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

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

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

Group performance headlines¹

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

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

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

Report of the Directors: Overview (continued)

- Total loans and advances to customers increased by 7% to US\$958bn while deposits rose by 6% to US\$1.2 trillion.

Impact of the evolving regulatory environment on the business

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

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

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

We have estimated the pro forma common equity tier 1 ratio of the Group based on our interpretation of the new Basel III rules as they will apply from 1 January 2019, based on the position of the Group at year-end 2010. The rules will be phased in from 2013 with a gradual impact and we have estimated that their full application, on a proforma basis, would result in a common equity tier 1 ratio which is lower than the Basel II core tier 1 ratio by some 250–300 basis points. The changes relate to increased capital deductions, new regulatory adjustments and increases in risk-weighted assets. However, as the changes will progressively take effect over six years leading up to 2019 and as HSBC has a strong track record of capital generation and actively manages its risk-weighted assets, we are confident in our ability to mitigate the effect of the new rules before they come into force.

Last year, HSBC committed to reviewing its target shareholder return on equity once the effects of new regulation became clearer. Now that we have better visibility on the impact of increased capital requirements, we believe that higher costs of the

evolving regulatory framework will, all other things being equal, depress returns for shareholders of banks. We will therefore target a return on average shareholders' equity of 12–15% in the future.

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

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

Outlook

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

In the short term, risks to global growth remain, not least from an elevated oil price. We therefore expect cyclical volatility to continue – including in emerging markets – and progress is unlikely to be linear. In the longer term, we believe that growth

Report of the Directors: Overview (continued)

rates in many Western markets will continue to significantly underperform those of the emerging world. Emerging markets are no longer simply leading the recovery from a Western crisis; the growth gap has become a sustained secular trend.

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

HSBC's balance sheet remains strongly positioned to benefit from future interest rate rises. We are realistic that, in many developed countries at least, historically low rates may continue to constrain income growth in the near-term. Nevertheless, maintaining a conservative liquidity position is core to our proposition and to our funding strength. In our risk appetite statement approved by the Board we have set a maximum advances-to-deposits ratio for the Group of 90%. This underlines our continuing commitment to a high level of liquidity and reflects our philosophy that HSBC should not be reliant on wholesale markets for funding. Even with a ratio currently slightly below 80%, we have capacity for further lending growth.

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

At the same time, with demand in many developed markets constrained and interest spreads

remaining compressed, we fully recognise the importance of ever more robust cost management discipline and the need to continue re-engineering the business to improve efficiency.

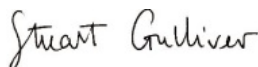
Furthermore, capital is becoming a scarcer resource and, as a new regulatory environment evolves, I am committed to making capital allocation a more disciplined and rigorous process at HSBC in order to drive the correct investment decisions for the future.

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

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

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

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



S T Gulliver, *Group Chief Executive*
28 February 2011

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\$180bn at 31 December 2010. We are headquartered in London.

As ‘The world’s local bank’, we combine the largest global emerging markets banking business and a uniquely cosmopolitan customer base with an extensive international network and substantial financial strength.

HSBC operates through long-established businesses and has an international network of some 7,500 offices in 87 countries and territories in six geographical regions; Europe, Hong Kong, Rest of Asia-Pacific, the Middle East, North America and Latin America.

Our products and services are delivered through two customer groups, Personal Financial Services (‘PFS’) and Commercial Banking (‘CMB’), and two global businesses, Global Banking and Markets (‘GB&M’), and Global Private Banking (‘GPB’). PFS incorporates the Group’s consumer finance businesses, the largest of which is HSBC Finance Corporation (‘HSBC Finance’).

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.

There were no significant acquisitions during the year (for details of acquisitions see page 340).

Strategic direction

Our objective is to deliver sustainable long-term value to shareholders through consistent earnings and superior risk-adjusted returns.

Our strategy is to be the world’s leading international bank, by:

- leveraging the HSBC brand and our network of businesses which covers the world’s most relevant geographies. This network provides access to the world’s fastest growing economies, for example Greater China. We serve companies as they grow and become more international and individuals as they become wealthier and require more sophisticated financial services, such as wealth management; and
- competing as a universal bank across the full financial services spectrum only where we have scale and can achieve appropriate returns. This implies building scale in attractive geographical regions and businesses where we can be competitive and reviewing businesses which do not meet our financial hurdles.

The strategy reflects the key trends which are shaping the global economy. In particular, we recognise that over the long term, developing markets are growing faster than mature economies and connectivity continues to increase as world trade is expanding at a greater rate than gross domestic product, generating increased demand for financial services. We are, therefore, continuing to direct incremental investment primarily to the faster growing markets and client segments which have international connectivity. In order to deliver this strategy we pursue a series of initiatives, reflected in the Group’s key performance indicators:

- enhance efficiency by taking full advantage of local, regional and global economies of scale, in particular by adopting a common systems architecture wherever possible;
- maintain capital strength and a strong liquidity position. Capital and liquidity are critical for our strategy and are the foundation of decisions about the pace and direction of investment; and
- align objectives and incentives to motivate and reward staff for being fully engaged in delivering the strategy.

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Top and emerging risks

All of our activities involve, to varying degrees, the measurement, evaluation, acceptance and management of risk or combinations of risks. We classify risks as ‘top’ and ‘emerging’. A ‘top risk’ is a current, visible risk with the potential to have a material effect on our financial results or our reputation. An ‘emerging risk’ is one which has large unknown components which could have a material impact on our long-term strategy. Top and emerging risks are viewed as falling under the following four broad categories:

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

The top and emerging risks are summarised below:

Challenges to our business operations

- Challenges to our operating model in an economic downturn (in developed countries) and rapid growth (in emerging markets)
- Internet crime and fraud

Challenges to our governance and internal control systems

- Level of change creating operational complexity
- Information security risk

Macro-economic and geopolitical risk

- Potential emerging markets asset bubble
- Increased geopolitical risk in Asia-Pacific and Middle East regions

Macro-prudential and regulatory risks to our business model

- Regulatory change impacting our business model and Group profitability
- Regulatory requirements affecting conduct of business

Key performance indicators

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

Following a review of our high-level key performance indicators (‘KPI’s), the GMB decided to make the following changes to the Group’s published indicators in order to restrict their number to those which most accurately reflect its management priorities. The Group now has seven financial and three non-financial KPIs.

- the ratio of advances to core funding has been added to highlight the relationship between loans and advances to customers and core customer deposits in our principal banking entities;
- tier 1 capital has been added as a primary indicator of the strength of our capital base, and its ability to support the growth of the business and meet regulatory capital requirements;
- revenue growth, revenue mix factors and credit performance as measured by risk-adjusted margin have been replaced with risk-adjusted revenue growth;
- the GMB will prioritise return on average total shareholders’ equity in place of return on average invested capital, which has therefore been excluded; and
- customer transactions processed and percentage of information technology (‘IT’) services meeting targets form part of management information within our IT function. However, the GMB decided that these measures, which we have previously disclosed, were not appropriate proxies for assessing efficiencies and progress with implementing standard systems architecture.

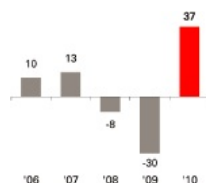
Report of the Directors: Overview (continued)

Strategic objectives

Deliver consistent earnings and superior risk-adjusted returns

Risk-adjusted revenue growth

(2010: underlying growth 15%)

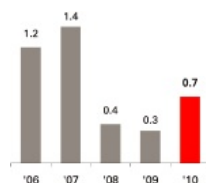


Measure: (percentage) increase in reported net operating income after loan impairment and other charges since last year.

Target: to deliver consistent growth in risk adjusted revenues.

Outcome: reported risk-adjusted revenue increased, primarily due to a reversal of adverse movements in previous years on the fair value of own debt designated at fair value and lower loan impairment charges. The latter also drove the increase in underlying risk-adjusted revenue.

Basic earnings per ordinary share

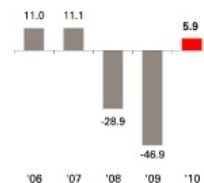


Measure: (US\$) level of basic earnings generated per ordinary share.

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

Outcome: Earnings per share ('EPS') increased in 2010, reflecting significantly lower adverse movements on the fair value of own debt due to credit spreads and lower loan impairment charges, which resulted in an increase in reported profit.

Dividends per share growth



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

Target: to deliver sustained dividend per share growth.

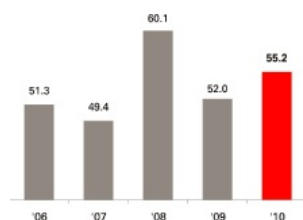
Outcome: dividends per share increased by 5.9%.

Key Performance Indicators

Strategic objectives

Enhance efficiency using economies of scale

Cost efficiency



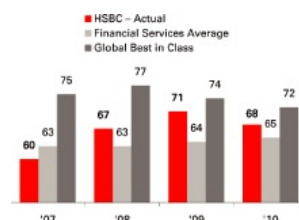
Measure: (percentage) total operating expenses divided by net operating income before loan impairment and other credit risk provisions.

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

Outcome: the ratio was outside the target range in part due to one-off costs, but also increased investment in operational infrastructure and strategic initiatives.

Motivate staff to deliver strategy

Employee engagement



Measure: (percentage) measure of employee's emotional and rational attachment to HSBC, a combination of advocacy, satisfaction, commitment and pride.

Target: to achieve a 72% global rating in 2010, with progressive improvement to best in class by 2011.

Outcome: 68%, mirroring the fall in global best in class but remaining well above the financial services average.

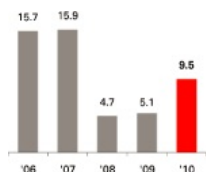
Key Performance Indicators

Report of the Directors: Overview (continued)

Maintain capital strength and strong liquidity

Strategic objectives

Return on average total shareholders' equity

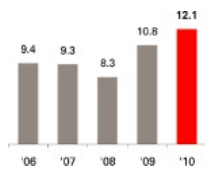


Measure: (percentage) profit attributable to ordinary shareholders divided by average total shareholders' equity.

Target: to maintain a return in the medium term of between 15% and 19%. In 2011, we intend to replace the target with one in the 12% to 15% range over the normal cycle.

Outcome: return on equity was below the target range, but 4.4 percentage points higher than in 2009.

Tier 1 capital

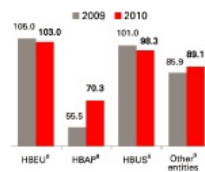


Measure: component of regulatory capital comprising core tier 1 and other tier 1 capital.

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

Outcome: the increase in tier 1 capital to 12.1% reflected the contribution of profit to capital, the issue of hybrid capital securities during the year and careful management of RWAs.

Advances to core funding ratio



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

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

Outcome: ratio within the limits set by the Risk Management Meeting for each site.

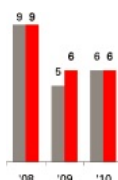
Key Performance Indicators

Reach new customers and expand services to existing customers using the HSBC brand and global network

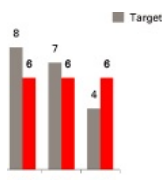
Strategic objectives

Brand perception

PFS



Business Banking



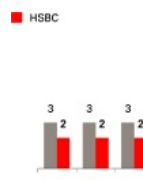
Measure: an independent survey of brands around the world which judges their relative strength. The results are used to form a brand perception index, where the industry average is zero.

Target: to meet or exceed targets based on performance against key competitors and the industry average.

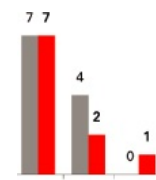
Outcome: PFS and Business Banking customers judged HSBC's brand to be six points stronger than the competitor average. Our ratings met or exceeded our targets in 2010.

Customer recommendation

PFS



Business Banking



Measure: an independent survey of customers in up to 15 countries which judges how likely they are to recommend a particular brand. The results are used to create a customer recommendation index, where the industry average is zero.

Target: to meet or exceed targets based on performance against key competitors and the industry average.

Outcome: Business Banking exceeded its target. Personal Financial Services fell short of its challenging target, but remained well above the competitor average.

Key Performance Indicators

For footnotes, see page 83.

Report of the Directors: Operating and Financial Review

Financial summary

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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 ‘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

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 2009 referred to in the commentaries are computed by retranslating into US dollars for non-US dollar branches, subsidiaries, joint ventures and associates:
<ul style="list-style-type: none">the income statements for 2009 at the average rates of exchange for 2010; andthe balance sheet at 31 December 2009 at the prevailing rates of exchange on 31 December 2010.
Constant currency comparatives for 2008 referred to in the 2009 commentaries are computed on the same basis, by applying average rates of exchange for 2009 to the 2008 income statement and rates of exchange on 31 December 2009 to the balance sheet at 31 December 2008.
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 tables below compare our underlying performance in 2010 and 2009 with reported profits in those years.

The foreign currency translation differences reflect the relative strengthening of the US dollar against the euro and sterling, which offset its relative weakness against currencies in Asia, Mexico and Brazil during 2010.

The following acquisitions and disposals affected both comparisons:

- the acquisition of PT Bank Ekonomi Raharja Tbk (‘Bank Ekonomi’) in May 2009;
- the gain on sale of our 49% interest in a joint venture for a UK merchant acquiring business in June 2009 of US\$280m;
- 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;
- the gain on sale of our stake in Wells Fargo HSBC Trade Bank in March 2010 of US\$66m;
- the gain on disposal of HSBC Insurance Brokers Limited of US\$107m in April 2010;
- the dilution gain of US\$188m which arose on our holding in Ping An Insurance (Group) Company of China, Limited (‘Ping An Insurance’) following the issue of shares by the company in May 2010;

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

- the loss of US\$42m on the completion of the sale of our investment in British Arab Commercial Bank plc in October 2010;
- the gain on sale of Eversholt Rail Group of US\$255m in December 2010; and
- the gain of US\$74m on the deconsolidation of private equity funds following the management buy-out of Headland Capital Partners Ltd (formally known as HSBC Private Equity (Asia) Ltd) in November 2010.

Reconciliation of reported and underlying profit before tax

	2010 compared with 2009								
	2009 as reported US\$m	2009 adjust- ments ¹⁰ US\$m	Currency translation ¹¹ US\$m	2009 at 2010 exchange rates ¹² US\$m	2010 as reported US\$m	2010 adjust- ments ¹⁰ US\$m	2010 under- lying US\$m	Re- ported change ¹³ %	Under- lying change ¹³ %
HSBC									
Net interest income	40,730	(1)	642	41,371	39,441	(31)	39,410	(3)	(5)
Net fee income	17,664	(210)	182	17,636	17,355	(3)	17,352	(2)	(2)
Changes in fair value ¹⁴	(6,533)	6,533	-	-	(63)	63	-	99	-
Other income	14,320	(283)	228	14,265	11,514	(719)	10,795	(20)	(24)
Net operating income ¹⁵	66,181	6,039	1,052	73,272	68,247	(690)	67,557	3	(8)
Loan impairment charges and other credit risk provisions	(26,488)	-	(330)	(26,818)	(14,039)	-	(14,039)	47	48
Net operating income	39,693	6,039	722	46,454	54,208	(690)	53,518	37	15
Operating expenses	(34,395)	200	(568)	(34,763)	(37,688)	19	(37,669)	(10)	(8)
Operating profit	5,298	6,239	154	11,691	16,520	(671)	15,849	212	36
Income from associates	1,781	(1)	11	1,791	2,517	-	2,517	41	41
Profit before tax	7,079	6,238	165	13,482	19,037	(671)	18,366	169	36
By geographical region									
Europe	4,009	2,546	(152)	6,403	4,302	(164)	4,138	7	(35)
Hong Kong	5,029	1	(10)	5,020	5,692	(130)	5,562	13	11
Rest of Asia-Pacific	4,200	3	205	4,408	5,902	(211)	5,691	41	29
Middle East	455	-	(2)	453	892	42	934	96	106
North America	(7,738)	3,688	46	(4,004)	454	(208)	246		
Latin America	1,124	-	78	1,202	1,795	-	1,795	60	49
Profit before tax	7,079	6,238	165	13,482	19,037	(671)	18,366	169	36
By customer group and global business									
Personal Financial Services	(2,065)	(2)	(70)	(2,137)	3,518	(10)	3,508		
Commercial Banking	4,275	(306)	64	4,033	6,090	(133)	5,957	42	48
Global Banking and Markets	10,481	13	173	10,667	9,536	(342)	9,194	(9)	(14)
Global Private Banking	1,108	-	1	1,109	1,054	1	1,055	(5)	(5)
Other	(6,720)	6,533	(3)	(190)	(1,161)	(187)	(1,348)	83	(609)
Profit before tax	7,079	6,238	165	13,482	19,037	(671)	18,366	169	36

For footnotes, see page 83.

Additional information is available on pages 47(a) to 47(f) and 80(b) to 80(g).

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

Consolidated income statement

Five-year summary consolidated income statement

	2010 US\$m	2009 US\$m	2008 US\$m	2007 US\$m	2006 US\$m
Net interest income	39,441	40,730	42,563	37,795	34,486
Net fee income	17,355	17,664	20,024	22,002	17,182
Net trading income	7,210	9,863	6,560	9,834	8,222
Net income/(expense) from financial instruments designated at fair value	1,220	(3,531)	3,852	4,083	657
Gains less losses from financial investments	968	520	197	1,956	969
Gains arising from dilution of interests in associates	188	-	-	1,092	-
Dividend income	112	126	272	324	340
Net earned insurance premiums	11,146	10,471	10,850	9,076	5,668
Gains on disposal of French regional banks	-	-	2,445	-	-
Other operating income	2,374	2,788	1,808	1,439	2,546
Total operating income	80,014	78,631	88,571	87,601	70,070
Net insurance claims incurred and movement in liabilities to policyholders	(11,767)	(12,450)	(6,889)	(8,608)	(4,704)
Net operating income before loan impairment charges and other credit risk provisions	68,247	66,181	81,682	78,993	65,366
Loan impairment charges and other credit risk provisions	(14,039)	(26,488)	(24,937)	(17,242)	(10,573)
Net operating income	54,208	39,693	56,745	61,751	54,793
Total operating expenses ¹⁷	(37,688)	(34,395)	(49,099)	(39,042)	(33,553)
Operating profit	16,520	5,298	7,646	22,709	21,240
Share of profit in associates and joint ventures	2,517	1,781	1,661	1,503	846
Profit before tax	19,037	7,079	9,307	24,212	22,086
Tax expense	(4,846)	(385)	(2,809)	(3,757)	(5,215)
Profit for the year	14,191	6,694	6,498	20,455	16,871
Profit attributable to shareholders of the parent company	13,159	5,834	5,728	19,133	15,789
Profit attributable to non-controlling interests	1,032	860	770	1,322	1,082

	US\$	US\$	US\$	US\$	US\$
Basic earnings per share ¹⁸	0.73	0.34	0.41	1.44	1.22
Diluted earnings per share ¹⁸	0.72	0.34	0.41	1.42	1.21
Dividends per share ¹	0.34	0.34	0.93	0.87	0.76
	%	%	%	%	%
Dividend payout ratio ¹⁹	46.6	100.0	226.8	60.4	62.3
Post-tax return on average total assets	0.57	0.27	0.26	0.97	1.00
Return on average total shareholders' equity	9.5	5.1	4.7	15.9	15.7

Average foreign exchange translation rates to US\$:					
US\$1: £	0.648	0.641	0.545	0.500	0.543
US\$1: €	0.755	0.719	0.684	0.731	0.797

For footnotes, see page 83.

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

Reported profit before tax of US\$19.0bn in 2010 was 169% higher than in 2009, and 36% higher on an underlying basis. The difference between reported and underlying results is explained on page 14. Except where stated otherwise, the commentaries in the Financial Summary are on an underlying basis and references to HSBC Finance and HSBC Bank USA are on a management basis, rather than a legal entity basis (for details see page 37).

Net operating income before loan impairment charges and other credit risk provisions ('revenue') was lower than in 2009, notably due to a decline in balances in North America, lower trading income from adverse movements on non-qualifying hedges and a fall in revenue from GB&M. In the former, we continued to reposition our core businesses and we remained focused on managing down our run-off portfolios. As a consequence, revenue fell, reflecting declining balances in the run-off portfolios and in the Card and Retail Services business, where revenue was also adversely affected by new regulations. In GB&M, lower revenue was generated in Balance Sheet Management as higher yielding positions matured and funds were invested in lower yielding assets. Trading income declined driven by increased competition and reduced margins across core products, and less favourable market conditions caused by the European sovereign debt crisis. These factors were partly offset by increased CMB revenue from balance sheet growth, particularly in Asia, and higher trade-related fees.

Loan impairment charges were significantly lower than in 2009, with decreases across all regions and customer groups as economic conditions improved. The most significant decline in loan impairment charges was in North America, reflecting lower balances due to increased repayments, an improvement in delinquency rates in Card and Retail Services, and the continued run-off of balances in the Consumer Finance business. There were also marked declines in the Middle East and in

Latin America, primarily in Mexico and Brazil, reflecting a reduction in personal lending balances as selected portfolios were managed down, and an improvement in credit quality as origination criteria were tightened and collection practices improved. In GB&M, loan impairment charges were significantly lower, reflecting the improvement in the credit environment which resulted in fewer significant charges than those taken in 2009 in relation to a small number of clients, notably in Europe and other credit risk provisions fell in the available-for-sale asset-backed securities ('ABS') portfolio due to a slowing in the rate of anticipated losses in the underlying collateral pools.

Underlying profit before tax rose by 36% as a significant fall in impairment charges offset a decline in revenue.

Operating expenses were higher than in 2009, in part due to specific one-off items such as a US\$0.3bn charge for UK bank payroll tax in 2010 and the non-recurrence of a pension accounting gain of US\$0.5bn in 2009 relating to the treatment of staff benefits. Excluding these items, operating expenses rose in support of strategic growth initiatives in our target markets to invest in operational infrastructure and the selective recruitment of customer-facing staff.

Income from associates increased, driven by strong results in Asia which reflected robust economic growth in mainland China.

In 2010, taxable profits were achieved in the US, principally as the result of a gain from an internal reorganisation that was not recognised for accounting purposes which increased the effective tax rate by 6.4 percentage points. If this were excluded, the effective tax rate would be 19.1% which is in line with our geographical range of business activities. Reported profit after tax was US\$7.5bn higher than in 2009.