NUST INSTITUTE OF MANAGEMENT SCIENCES

MONEY & BANKING

PROJECT: Bank Management & Financial Analysis of HSBC - USA

Associate Professor: HAROON RASHID

Submitted by: **AMINA SHAHBAZ CHEEMA**

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ACKNOWLEDGMENTS

First of all, I would like to thank Allah Almighty without whose Will it is not possible to do anything at all in this world.

At the outset, I feel obliged to express my profound gratitude to my respected teacher Mr. Haroon Rashid who has throughout the course provided me with valuable guidance and encouragement. His experience, expertise, flexibility and ability to open new vistas of knowledge have contributed much in my educational pursuit.

This project was of a very different kind as compared to what I have done before, without the help of Sir. Haroon I would never have learned so much, he actually taught me through this project about how a bank operates practically.

ASSIGNMENT # 3

PART: B.

REPORT OF CONDITION & REPORT OF INCOME

The total assets of HSBC HOLDING PLC have increased from year 2005 to year 2006 to $167,990,065. Cash due from depository institutions was 4.84% of assets which has decreased to 3.34% of assets. Securities have also decreased from 14.06% to 13.78% of assets. But otherwise securities have increased by 1,629,429 in FY 2006. Fed funds sold and Repo's have increased to 8.21% of assets in FY 2006. Gross loans and leases have decreased to 53.65% of assets from 58.93% of assets. There is almost a similar %age decrease in case of net loans and leases. Trading account assets have increased to 14.73% of assets. Bank premises and fixed assets decreased from 0.35% of assets to 0.32% of assets. Other real estate owned has increased by 0.01% of assets. Goodwill and other intangibles: 2.54% of assets in FY 2005 and 2.25% of assets in FY 2006. All other assets increased to 4.225 of assets in 2006. There is no significant increase in the liabilities and the equity capital has decreased from 9.26% of assets to 8.37% of assets.

Net interest income has decreased to 1.97% of assets in 2006 from 2.11% of assets in 2005. Total non interest income has increased to 2.58% of assets in 2006 from 2.29% of assets in 2005. Total non interest expense has increased by 2.56% from 2.42% of assets. The pre-tax net operating income has slightly decreased from 1.54% of assets in 2005 to 1.50% of assets in 2006. There was a security gain of $29342 in year 2006. There were net extraordinary losses of $3814 in 2006 which was nil in 2005. The net income in 2005 was 0.99% of assets and in 2006 it was 0.98% of assets whereas numerically it was $1645928 in 2006 and $1516811 in 2005.

HSBC's growth strategy is built around deposit gathering through selective branch expansion, competitive pricing, in part enabled by increasing internet delivery, and improved marketing and customer analytics. All these strands to the strategy were developed during 2006.

- Driven by the success of the online savings product and branch expansion, deposit balances in the US grew by 25 per cent in 2006. US$9 billion of deposits have been attracted since the launch of the deposit gathering strategy there in 2005, of which US$718 million have been generated from new branches since the expansion programme began in the same year.
- The integration of the credit card business of Metris Companies Inc. ('Metris'), acquired in 2005 for approximately US$1.6 billion, was completed. The business performed above expectations, generating US$233 million of profit before tax.
- HSBC Finance Corporation ('HSBC Finance') completed the acquisition of the Champion Mortgage portfolio during 2006, adding US$2.5 billion in mostly first lien sub-prime mortgages.
- In the US, HSBC entered into an agreement which extended the brands under which it is able to offer cards, uniquely, to American Express, Discover Network, MasterCard and Visa. The retail services business launched cobranded initiatives with Saks, Neiman Marcus and Best Buy. HSBC is now the seventh largest card issuer in the US.

- Asset growth continued in Canada with strong consumer spending resulting in higher personal lending and mortgage balances. Led by the success of new products such as the High Rate Savings Account, deposit balances rose.

ASSIGNMENT # 4

Write approximately one page comparing the assets, half page comparing the source of funds and one page comparing income and expenses:

REPORT OF CONDITION

Assets

Cash and Due from Depository Institutions in 2005 for HSBC was approximately the same as that of the peer group but in 2006 for HSBC it was 3.34% and for the peer it was 4.45% showing that HSBC had lesser cash assets as compared to the peer in 2006.
Securities: HSBC performed much better than the peer in 2005 as its percentage was 2.2% higher than the peer, whereas in 2006 it was almost 2% lower than the peer.
As far as the Fed Funds sold and repo's are concerned; HSBC's performance exceeded the peer's by almost 2% and in 2006 it further improved and exceeded the peer by almost 3%. Net loans and leases for HSBC in 2005 lagged behind the peer by 2% and in 2006 the net loans and leases further lagged the peer by 3% which means that HSBC needs to do more business in loans and leases if it wants to defeat the peer. Trading account assets for the peer in 2005 were 12.94% whereas HSBC only had trading account assets of 7.33%, in 2006 the trend was opposite with HSBC at 14.73% and the peer at 7.92%.

REPORT OF INCOME

In 2006 for HSBC the net interest income was 2% whereas for the peer it was 2.73%, in 2005 NII was 2.23% for HSBC and 2.93% for the peer. In both the years the peer performance is better for NII than HSBC. The total non interest income for both banks in both years is approximately the same which shows a similar performance trend for non interest income. In 2005 the peer had non interest expenses of 3.21% & HSBC had 2.56% showing HSBC doing better at expense management in 2005 than the peer. Whereas in 2006 HSBC was at 2.62% and the peer was at 2.97%, which means that the peer is also trying to manage expenses. As far as the pre-tax net operating income is concerned, the percentage of HSBC was slightly lower than the peer. HSBC had securities gains in both the financial years whereas the peer had nil performance in 2005 and a negative rate in 2006. Income taxes for both banks in both years almost had the same rate whereas the HSBC had no extraordinary gains in both years with the peer performing better in 2006. Finally the net income for 2006 was 1% for HSBC and 1.35% for the peer; in 2005 it was 1.05% for HSBC and 1.33% for the peer which shows a trend of the peer performing better than HSBC as far as net income is concerned.

PROFITABILITY RATIOS

Return on equity is primarily a measure of the rate of return flowing to the banks shareholders. It approximates the net benefit the stockholders have received from investing their capital in the financial firm (i.e. placing the funds at risk in the hope of earning a suitable profit). This ratio is usually more important to the shareholders than any other stakeholders as it capitalizes their investments and shows what they have been able to earn on their investment. This ratio for HSBC is 0.1343 in year 2005 and 0.12195 in 2006 which shows that the investors i.e. the shareholders were better off in the year 2005 on a comparative basis.

Return on assets is the indicator to managerial efficiency; it shows how capably the management of the bank has been converting the bank's assets into net earnings. As far as HSBC is concerned, the ROA was 0.0135 in FY 2005 and 0.01 in 2006 which indicates that the net earnings on assets were almost constant between the two years.

The higher efficiency ratio of 2006 was primarily due to increased operating expenses, which were partially offset by increased non-interest revenues and, to a lesser extent, increased net interest income. For the first nine months of 2006, the higher efficiency ratio was due to increased operating expenses and decreased net interest income, partially offset by increased other revenues, primarily trading revenues.

Net Interest Margin measures how large a spread between interest revenues and interest expenses or costs has the management been able to achieve by close control over earning assets and the pursuit of the cheapest sources of funds. In HSBC the NIM shows that it was well covering the assets and the bank had sufficient interest income to cover the expenses; also the ratio slightly decreased 2006 which means that there was a less marginal return in 2006 as compared to 2005. Net interest income associated with core banking activities was higher for 2006 due primarily to the impact of a growing personal deposit base. Personal deposits are the primary, and relatively low cost, funding source for the PFS segment. Customers have migrated to higher yielding deposit products in 2006, such as the internet savings product, leading to a change in product mix and resulting in narrowing of deposit spreads, which partly offset the benefit of higher deposit balances.

Net Non-Interest margin measures the amount of non interest revenues stemming from deposit service charges and other service fees the bank or the firm has been able to collect relative to the amount of non interest costs (i.e. wages & salaries, repair and maintenance, loan loss expense). This ratio for HSBC is negative in 2005 i.e. non interest costs out strip fee income, though fee income has been rising rapidly in recent years as a percentage of all HSBC revenues. Whereas in 2006 this ratio is positive which means that the HSBC deposit service charges and the other service fees were able to cover the non interest costs; this is a good indication because usually this ratio is negative for most banks.

Net Operating Margin is the combined effect of both NIM and Net non interest margin i.e. it includes both the interest and non interest revenues and costs as a measure of assets. In HSBC, the FY 2006 has a positive NOM of 0.0202 which means that the overall HSBC operating revenues were able to cover the operating costs quiet well. HSBC had a slightly higher NOM in 2005 i.e. 0.0226 which means that HSBC was performing slightly better in 2005 in terms of NOM as compared to 2006.

Overall the profitability ratios show that the overall performance of HSBC was better in 2005 than 2006, the shareholders return was better in 2005, the net earning upon assets were slightly better in 2005 and same goes for NIM & NOM but NNM was positive in 2006 only.

BREAK-DOWN OF ROE

Net Profit Margin reflects the effectiveness of expense management (cost control) and service pricing policies. The Net Profit Margin for HSBC in 2005 was 0.2464 and in 2006 was 0.133386. Now there is a fall of NPM in 2006 as compared to 2005 with a difference of 0.1125 which means that HSBC was more efficient in 2005 at cost controls, management of expenses and service pricing policies as compared to 2006 because either they were spending more or there could be a change in the service policy which led to a lower NPM in 2006. Also they might have introduced some new service which needed more expenses and probably more return on these new services will be reflected in the up-coming year. (HSBC introduced Islamic Banking called ‘Amanah’).

Asset Utilization Ratio is degree of assets utilized; it reflects the portfolio management policies, especially the mix and yield on assets. For HSBC the AUR increased in 2006 as compared to 2005. In 2005 it was 0.0548 and in 2006 it was 0.0747. The increase in AUR is with a difference of 0.0199. In simple words, this ratio shows how much the bank earned for its total assets i.e. cash, securities, repo’s, fed funds, loans and leases and so and so forth. Therefore in 2006 the bank earned at a higher rate upon its assets than in 2005, the bank is highly leveraged.

Equity Multiplier reflects the leverage or financing policies: the sources chosen to fund the financial institution (debt or equity). Banks with greater equity components in their asset base are considered more insulated from interest rate shifts bacause they can use equity to buffer market shocks. EM is 9.9 in 2005 and 12.195 in 2006; now this ratio shows a significant increase in the EM which means that HSBC is highly leveraged in 2006 as compared to 2005. HSBC’s EM shows that the bank was able to make use of the equity of $13769123 and converted this equity into assets of $167990065 i.e. the equity multiplier effect was 12 times in 2006 and 9.9 times in 2005. Therefore the bank was able to well capitalize on its equity.

BREAK-DOWN OF NPM

Tax Management Efficiency Ratio reflecting the use of security gains or losses and other tax management tools (such as buying tax-exempt i.e. municipal bonds) to minimize tax exposure. HSBC was better able to minimize tax exposure in 2005 than in 2006 by a slight difference only; HSBC had a tax management efficiency ratio of 0.6818 in 2005 & 0.6536 in 2006. This ratio basically shows that how much the bank was able to save on tax for its income.

Expense Control Efficiency Ratio reflects the ratio of before tax income to total revenues as an indicator of how many $ of revenue service after operating expenses are removed. For HSBC this ratio in FY 2005 is 0.3613 and in FY 2006 is 0.2048 which shows that the bank was better managing expenses in 2005 than 2006 as the ratio of expense control efficiency is lower in 2006 as compared to 2005.

BREAK-DOWN OF ROA

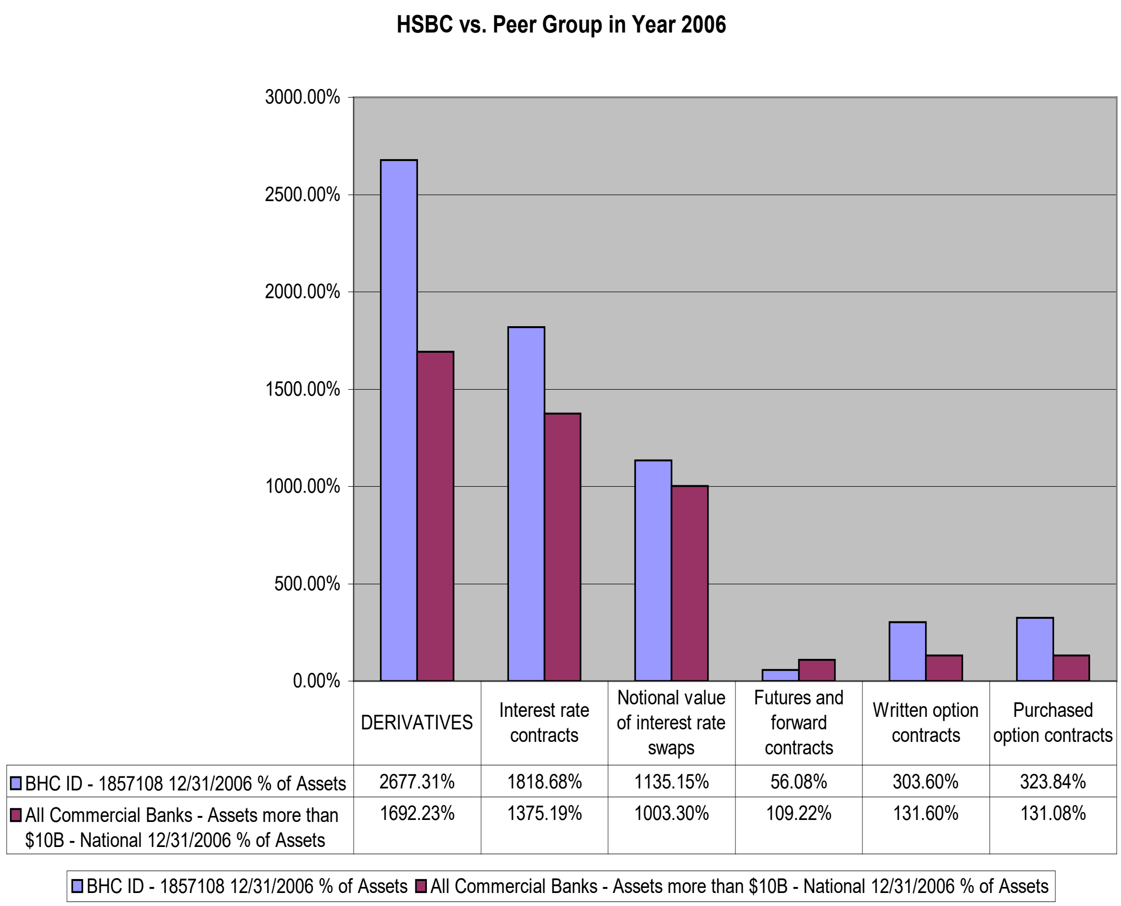
Net Interest Margin measures how large a spread between interest revenues and interest expenses or costs has the management been able to achieve by close control over earning assets and the pursuit of the cheapest sources of funds. For HSBC NIM in 2005 was 0.0273 and NIM in 2006 was 0.0201; which means that HSBC had better marginal earnings in 2005 from interest that 2006 although the difference is not very large or very significant.

Net Non-Interest margin measures the amount of non interest revenues stemming from deposit service charges and other service fees the bank or the firm has been able to collect relative to the amount of non interest costs (i.e. wages & salaries, repair and maintenance, loan loss expense). This ratio for HSBC is negative in 2005 i.e. non interest costs out strip fee income, though fee income has been rising rapidly in recent years as a percentage of all HSBC revenues. Whereas in 2006 this ratio is positive which means that the HSBC deposit service charges and the other service fees were able to cover the non interest costs; this is a good indication because usually this ratio is negative for most banks.

Special Transactions affecting its net income is a ratio of special income and expense items and total assets which shows the effect of special transaction as a measure of assets and also defines the level of earnings and costs attached to special transactions. For HSBC, this ratio is 0.0102 in FY 2006 and 0.0094 in FY 2005 which shows that HSBC earned more in 2006 than 2005 from special transactions such as provision for loan losses, security gains, taxes and extra-ordinary gains.

Assignment # 6: Bank’s use of Interest Rate Derivative Contracts

- ❖ **How has the use of derivative contracts changed across periods? Is your bank more or less involved than the group of comparable institutions?**
- ❖ **Write the above information; write approximately one page about your bank’s usage of interest-rate derivatives and how it compares to its peers.**



Derivatives are financial instruments that derive their value from the price of underlying items such as equities, bonds, interest rates, foreign exchange, credit spreads, commodities and equity or other indices. Derivatives enable users to increase, reduce or alter exposure to credit or market risks. HSBC makes markets in derivatives for its customers and uses derivatives to manage its exposure to credit and market risks.
Derivatives are carried at fair value and as separate totals of assets and liabilities. Asset values represent the cost to HSBC of replacing all transactions with a fair value in HSBC’s favor assuming that all HSBC’s relevant counterparties default at the same time, and that transactions can be replaced instantaneously. Liability values represent the cost to HSBC’s counterparties of replacing all their transactions with HSBC with a fair value in their favor if HSBC were to default. Derivative assets and liabilities on different

transactions are only set off if the transactions are with the same counterparty, a legal right of set-off exists and the cash flows are intended to be settled on a net basis.

Use of derivatives

HSBC transacts derivatives for three primary purposes: to create risk management solutions for clients, for proprietary trading purposes, and to manage and hedge HSBC's own risks. Derivatives (except for derivatives which are designated as effective hedging instruments as defined in IAS 39) are held for trading. The held for trading classification includes two types of derivatives: those used in sales and trading activities, and those used for risk management purposes but which for various reasons do not meet the qualifying criteria for hedge accounting. The second category includes derivatives managed in conjunction with financial instruments designated at fair value. These activities are described more fully below.

HSBC's derivative activities give rise to significant open positions in portfolios of derivatives. These positions are managed constantly to ensure that they remain within acceptable risk levels, with matching deals being utilized to achieve this where necessary. When entering into derivative transactions, HSBC employs the same credit risk management procedures to assess and approve potential credit exposures that are used for traditional lending.

Trading derivatives

Most of HSBC's derivative transactions relate to sales and trading activities. Sales activities include the structuring and marketing of derivative products to customers to enable them to take, transfer, modify or reduce current or expected risks. Trading activities in derivatives are entered into principally for the purpose of generating profits from short-term fluctuations in price or margin. Positions may be traded actively or be held over a period of time to benefit from expected changes in exchange rates, interest rates, equity prices or other market parameters. Trading includes market-making, positioning and arbitrage activities. Market-making entails quoting bid and offer prices to other market participants for the purpose of generating revenues based on spread and volume; positioning means managing market risk positions in the expectation of benefiting from favorable movements in prices, rates or indices; arbitrage involves identifying and profiting from price differentials between markets and products.

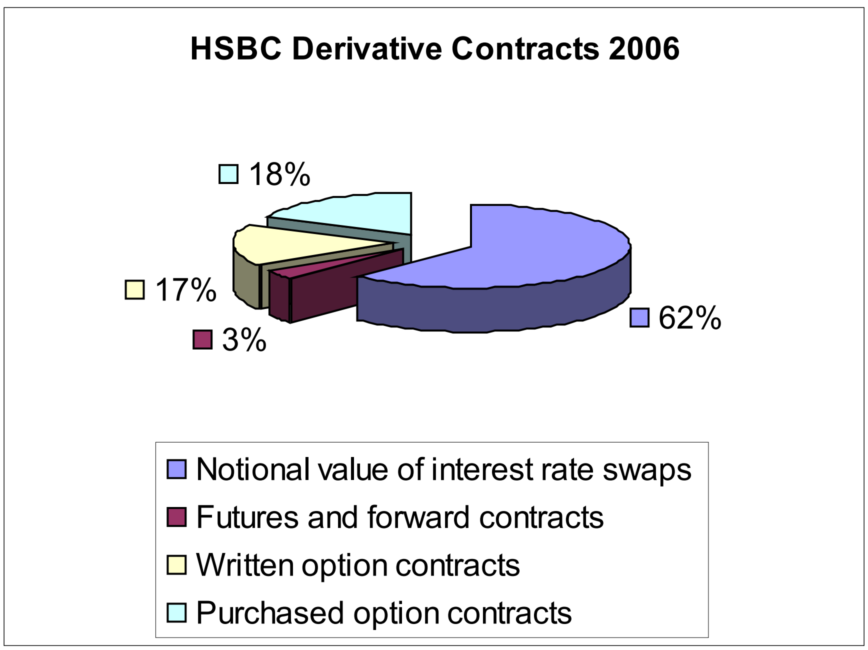
As mentioned above, other derivatives classified as held for trading include non-qualifying hedging derivatives, ineffective hedging derivatives and the components of hedging derivatives that are excluded from assessing hedge effectiveness. Non-qualifying hedging derivatives are entered into for risk management purposes but do not meet the criteria for hedge accounting. These include derivatives managed in conjunction with financial instruments designated at fair value.

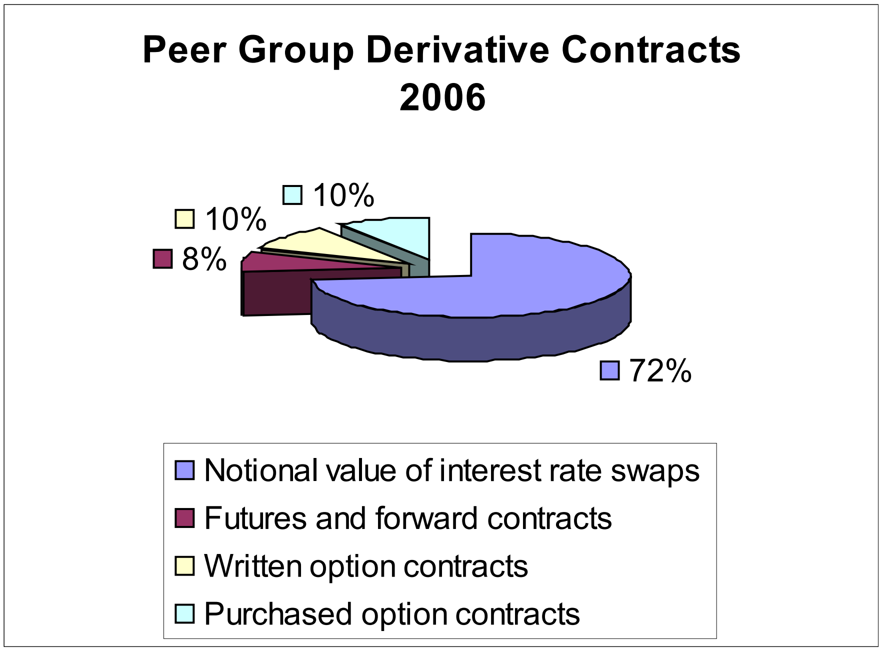
Gains and losses from changes in the fair value of derivatives that do not qualify for hedge accounting are reported in 'Net trading income', except for derivatives managed in conjunction with financial instruments designated at fair value, where gains and losses are reported in 'Net income from financial instruments designated at fair value', together with the gains and losses on the hedged items. Changes in the fair values of trading derivatives are inclusive of contractual interest. Changes in the fair value of derivatives managed in conjunction with financial instruments designated at fair value are included in 'Net income from financial instruments designated at fair value' inclusive of contractual interest unless the derivatives are managed with debt securities in issue, in which case the contractual interest is shown in interest payable with the interest payable on the issued debt. Substantially all of HSBC Holdings' derivatives entered into with HSBC undertakings are managed in conjunction with financial liabilities designated at fair value.

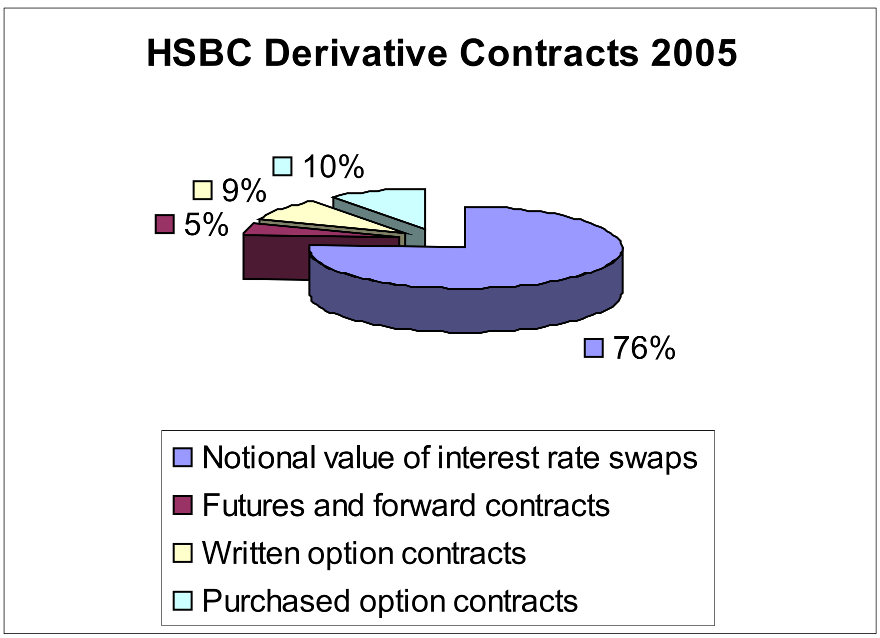
Higher derivatives trading revenues during the third quarter and the first nine months of 2006 primarily resulted from increased revenue from credit derivatives trading and structured transactions businesses, which were significantly expanded during the last half of 2005 and the first half of 2006.

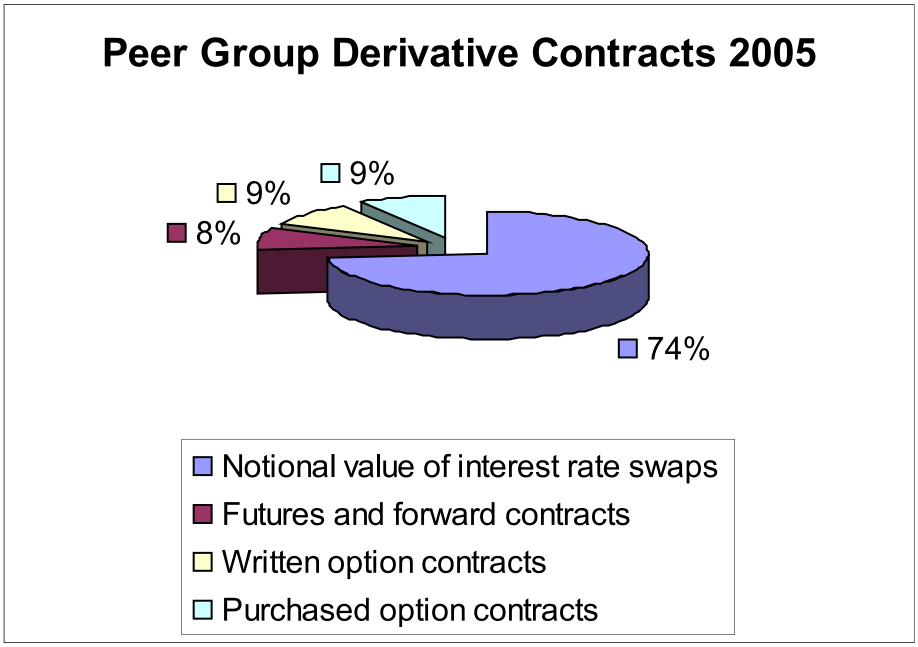
Net interest income related to derivatives businesses decreased $18 million and $69 million for the third quarter and for the first nine months of 2006 respectively, as compared with the same 2005 periods, due to the rising short-term interest rate environment.

Overall HSBC had a higher level of derivative trading in both the years as compared to the peers.




Peer Group Derivative Contracts 2006
10%
10%
8%
72%
Notional value of interest rate swaps
Futures and forward contracts
Written option contracts
Purchased option contracts


HSBC Derivative Contracts 2005
10%
9%
5%
76%
Notional value of interest rate swaps
Futures and forward contracts
Written option contracts
Purchased option contracts

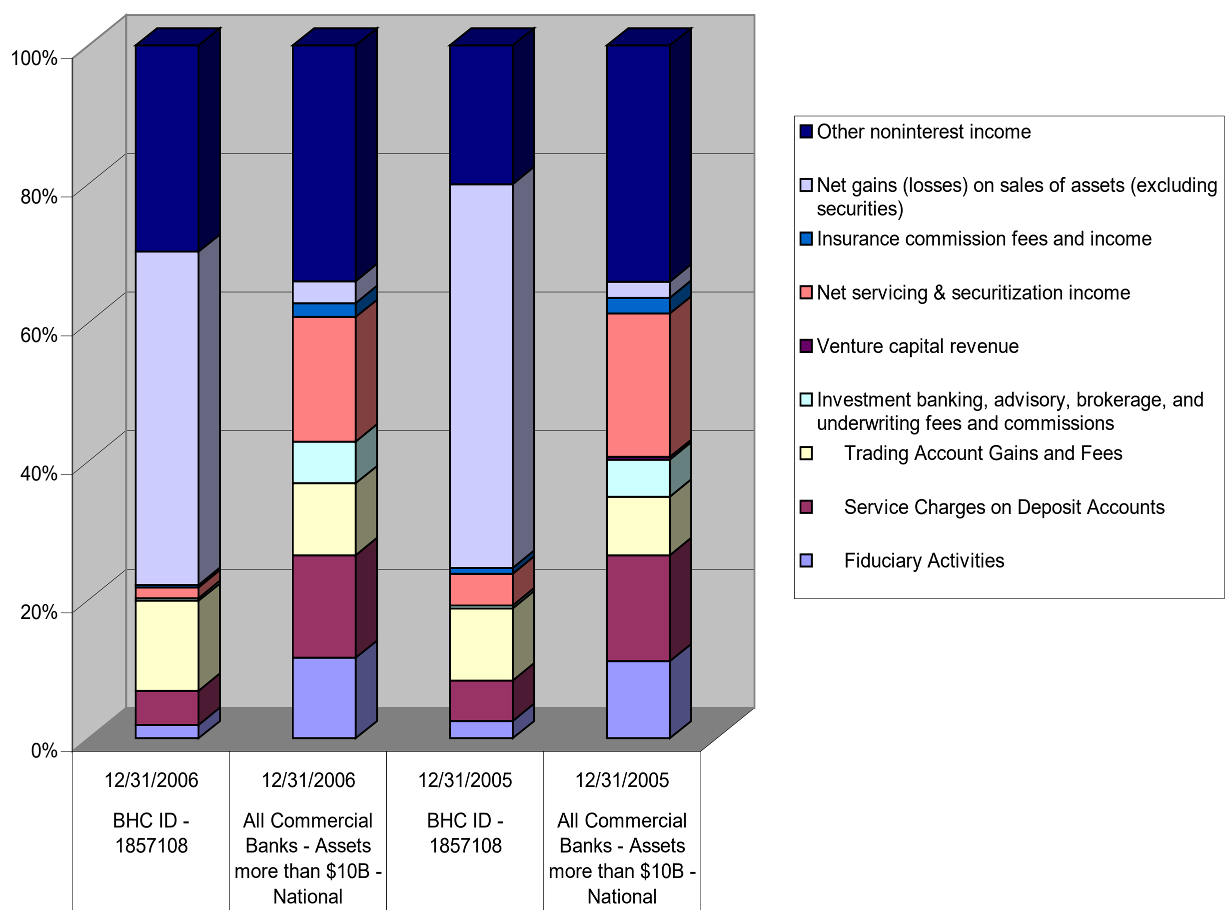


Peer Group Derivative Contracts 2005
9%
9%
8%
74%
Notional value of interest rate swaps
Futures and forward contracts
Written option contracts
Purchased option contracts

Assignment # 10: Your Bank's Generation of Fee Income

- **Write one paragraph interpreting your data & discussing your bank's generation of fee income relative to other large institutions across the two year period.**

The data shows that HSBC has a very high level of 'net gain/loss on sale of assets' as compared to the peers in both the years; now this means that HSBC has been doing a lot of asset sales to temporarily bolster its earnings as compared to the peers. 'Net servicing & securitization income' is very high for peers as compared to HSBC, means that HSBC is not investing in securities as much the peers are generating income form the securities.
Lower securitization revenue for the third quarter and for the first nine months of 2006 is attributable to steadily decreasing levels of receivables required to be maintained within existing securitized trusts. As the balance requirements of these trusts have decreased, receivables maintained on HSBC's consolidated balance sheet have increased, resulting in increased net interest income and increased credit card fee income.
Venture capital revenue is low for both types of banks as banks usually find it risky to go for venture capital. Investment banking, advisory, brokerage, and underwriting fees and commissions is high for peers and almost negligible for HSBC. Service charges for deposit accounts are high for peers as compared to HSBC which means that HSBC is charging less for deposit accounts than the peers. The percentage of fiduciary activities in other banks is higher than HSBC.



Assignment # 11: Your Bank's Loan Portfolio: Loans Classified By Purpose

- **Write approximately one page about the composition of your bank's loan portfolio.**

In year 2006, the peer group and HSBC has shown similar performance in terms of real estate loans, farm loans, loan to depository institutions and acceptances of other banks, commercial and industrial loans & loans to individuals; except for lease financing receivables which are 0% for HSBC and 3 % for the peer group which shows that the lease financing customers are paying HSBC regularly therefore HSBC doesn't have any receivables.

In the year 2005, the trend was different as compared to 2006. The real estate loans were 10% higher for HSBC than the peer group which means that HSBC's loan portfolio's 60% was real estate loans which makes it the most important loan category for HSBC. Real estate loans are loans secured by first mortgage or interim construction loans. Commercial & industrial loans were lower than the peers in 2005, which means that other banks are fulfilling customers or firm's working capital needs, equipment purchases and plant expansions more than HSBC. Loans to individuals have a similar trend in both HSBC & the peer group.

Higher quality nonconforming residential mortgage loans were acquired from originating lenders pursuant to HSBC Finance Corporation correspondent loan programs from December 2003 until September 2005. Purchases of these loans were discontinued as a result of strategic balance sheet initiatives to enhance HSBC's liquidity position and to address interest rate risk.

Residential mortgage loan originations generally declined during 2006 and 2005 due to a rising interest rate environment. In addition, originations of various adjustable rate residential mortgage loan products that would have been retained on the balance sheet prior to 2005 were being sold in the secondary market beginning in 2005 and throughout 2006, also as a result of strategic balance sheet initiatives to enhance liquidity and to address interest rate risk. These factors contributed to the overall decrease in residential mortgage loans during 2006.

HUSI has loans outstanding to certain executive officers and directors. The loans were made on substantially the same terms, including interest rates and collateral, as those prevailing at the same time for comparable transactions with other persons and do not involve more than normal risk of collectibility. The aggregate amount of such loans did not exceed 5% of shareholders' equity at December 31, 2006 and 2005.

The pie charts on the previous page show how the composition has changed over the two years and which loans dominate the banks.

Assignment # 12: Your bank's capital: The cushion for Losses and Funds for Growth

- **Write one or two paragraphs about your bank's capital adequacy & any changes you have observed between the two years.**

PART 1

HSBC is a well capitalized bank according to the standards of FDIC because it is not only meeting but exceeding the requirements for a well-capitalized bank which are 10% total risk based capital ratio as HSBC has 12%, tier-1 risk based capital ratio requirement is 6% whereas HSBC has 8.88%. When a bank lies under the category of 'well capitalized' then the bank performance is exceptional as this is the highest category.
The ratios for the two years have generally slightly decreased, with a slight increase in tier-1 risk based capital ratio. CAR shows whether the bank has enough capital to survive or not, whether its capital needs are adequately met or not. An 11% ratio for HSBC for the two years shows that the bank has a substantial capital. Tier one core capital is also almost the same for both the years. The risk based capital ratio is almost same also; this ratio basically shows the level of risk attached with the capital of the bank.

PART 2

The retention ratio shows how much money is being retained; it is 'retained earnings' for future use. This ratio for HSBC is 1.7 for 2005 & 1.4 for 2006 approximately, which means that the level of retained earnings has decreased over the two years. The reduction in the retention ratio can be attributable to fact that either the bank is taking out money form the retained earnings and paying as dividend or the bank has invested it in some asset. ICGR has increased meaning an increase in the capital of the bank. The assets have not shown a substantial growth though.

Assignment: 5

Part One: NIM-a comparison to peers
Write one paragraph discussing interest rate sensitivity for your bank relative to the peer group across the two time periods based on the NIM. Discuss what is revealed by the variation of NIM across time.

Answer: Interest Rate Sensitivity
HUSI (HSBC USA Inc.) is subject to interest rate risk associated with the repricing characteristics of its balance sheet assets and liabilities. Specifically, as interest rates change, amounts of interest earning assets and liabilities fluctuate, and interest earning assets reprice at intervals that do not correspond to the maturities or repricing patterns of interest bearing liabilities. This mismatch between assets and liabilities in repricing sensitivity results in shifts in net interest income as interest rates move. To help manage the risks associated with changes in interest rates, and to manage net interest income within ranges of interest rate risk that management considers acceptable, HUSI uses derivative instruments such as interest rate swaps, options, futures and forwards as hedges to modify the repricing characteristics of specific assets, liabilities, forecasted transactions or firm commitments.
There was a decline in net loans because of an increase in loan losses and decrease in loans from year 2005 to 2006. Therefore this led to an increase in interest expense and a decrease in interest income which led to a lower NIM in 2006 with respect to the peers. NIM using earning assets as denominator shows sharper declines in the overall ratio from 2005 to 2006 as the loans are part of earning assets. Also there has been a long run of increasing interest rates in the year 2006 putting more burden on the consumers of loans and is seen as a cause of lower interest income and fewer loans. There has been a long run of increasing interest rates in the year 2006 putting more burden on the consumers of loans and is seen as a cause of lower interest income and fewer loans.
There was a decline in net loans because of an increase in loan losses and decrease in loans from year 2005 to 2006. Therefore this led to an increase in interest expense and a decrease in interest income which led to a lower NIM in 2006 with respect to the peers.
Part Two: Interest Sensitivity Gaps & Ratios
Write one paragraph discussing the interest rate risk exposure for your BHC. Is it asset or liability sensitive at the conclusion of each year? What are the implications of the changes occurring across the years? Discuss the effects on net interest income if market interest rates increase or decrease by one full percentage point.

Answer: Interest rate risk exposure & GAP analysis
In the course of managing interest rate risk, a combination of risk assessment techniques, including dynamic simulation modeling, gap analysis, and capital at risk analysis are employed. The combination of these tools enables management to identify and assess the potential impact of interest rate movements and take appropriate action.
HSBC's exposure to the effect of movements in interest rates on its net interest income arise in three main areas: core deposit franchises, HSBC Finance and Global Markets.

- Core deposit franchises: These are exposed to changes in the value of deposits raised and spreads on wholesale funds. In a low interest rate environment, the value of core deposits increases as interest rates rise and decreases as interest rates fall. This risk is asymmetrical in a very low interest rate environment, however, as there is limited room to lower deposit pricing in the event of interest rate reductions.

- HSBC Finance offsets the sensitivity of the core deposit franchises to interest rate reductions. This arises from the fact that HSBC Finance has a substantial fixed rate, real estate secured, lending portfolio which is primarily funded with interest rate sensitive short-term liabilities.
- Residual interest rate risk is managed within Global Markets. This reflects the Group's policy of transferring all interest rate risk to Global Markets to be managed within defined limits and with flexibility as to the instruments used.

The main influences on the sensitivity of the Group's net interest income to the changes in interest rates tabulated above are as follows:

- Global Markets decreased its exposure to US dollar assets in non-trading portfolios and the average life of certain assets in HSBC Finance fell as they neared expected maturity, both of which contributed to the decreased sensitivity in this currency to both rising and falling rates.
- Growth in sterling net trading assets, the funding for which is generally sourced from short-term retail deposits and recorded in net interest income but the income from which is recorded in net trading income, has contributed to the increased sensitivity to both rising and falling rates in this currency.
- Global Markets also reduced its exposure to euro assets in non-trading portfolios which decreased the net interest income sensitivity in this currency. However, this decrease was offset by an increase in euro net trading assets.

In a rising rate environment, the most critical exposures are those managed within Global Markets. HSBC monitors the sensitivity of reported reserves to interest rate movements on a monthly basis by assessing the expected reduction in valuation of available-for-sale portfolios and cash flow hedges due to parallel movements of plus or minus 100 basis points in all yield curves.[1]

HSBC has a positive GAP in both the financial years 2005 and 2006 which shows that the rate sensitive assets are sufficient to cover the RS liabilities; but the GAP ratio has decreased in 2006 which means that the RS assets increased but the RS liabilities increased more than the RSA.

A positive GAP shows that HSBC has more RSA's than RSL's across year 2006 & 2005. When rates rise, interest income increases more than interest expense i.e. more assets are repriced-NIM increases.

[1] Annual reports and accounts HSBC Holdings Plc.2006

CAMEL RATING SYSTEM

The CAMEL rating system is based upon an evaluation of five critical elements of a credit union's operations: Capital Adequacy, Asset Quality, Management, Earnings and Asset/Liability Management. This rating system is designed to take into account and reflect all significant financial and operational factors examiners assess in their evaluation of a credit union's performance. Credit unions are rated using a combination of financial ratios and examiner judgment.

Since the composite CAMEL rating is an indicator of the viability of a credit union, it is important that the examiner rate credit unions based on their performance in absolute terms rather than against peer averages or predetermined benchmarks. The examiner must use professional judgment and consider both qualitative and quantitative factors when analyzing a credit union's performance. Since numbers are often lagging indicators of a credit union's condition, the examiner must also conduct a qualitative analysis of current and projected operations when assigning CAMEL ratings.

Although the CAMEL composite rating should normally bear a close relationship to the component ratings, the examiner should not derive the composite rating merely by computing an arithmetic average of the component ratings. Following are general definitions the examiner should use for assigning the credit union's CAMEL composite rating:

Rating 1 - Indicates strong performance that consistently provides for safe and sound operations. The historical trend and projections for key performance measures are consistently positive. Credit unions in this group are resistant to external economic and financial disturbances and capable of withstanding the unexpected actions of business conditions more ably than credit unions with a lower composite rating. Such institutions give no cause for supervisory concern.

Rating 2 - Reflects satisfactory performance that consistently provides for safe and sound operations. Both historical and projected key performance measures should generally be positive with any exceptions being those that do not directly affect safe and sound operations. Credit unions in this group are stable and able to withstand business fluctuations quite well; however, areas of weakness can be seen which could develop into conditions of greater concern. The supervisory response is limited to the extent that minor adjustments are resolved in the normal course of business and that operations continue to be satisfactory.

Rating 3 - Represents performance that is flawed to some degree and is of supervisory concern. Performance is marginal. Both historical and projected key performance measures may generally be flat or negative to the extent that safe and sound operations may be adversely affected. Credit unions in this group are only nominally resistant to the onset of adverse business conditions and could easily deteriorate if concerted action is not effective in correcting certain identifiable areas of weakness. Overall strength and financial capacity is present so as to make failure only a remote probability. Such credit unions require more than normal supervisory attention to address deficiencies.

Rating 4 - Refers to poor performance that is of serious supervisory concern. Key performance measures are likely to be negative. Such performance, if left unchecked, would be expected to lead to conditions that could threaten the viability of the credit union. A high potential for failure is present but is not yet imminent or pronounced. Credit unions in this group require close supervisory attention.

Rating 5 - Considered unsatisfactory performance that is critically deficient and in need of immediate remedial attention. Such performance, by itself or in combination with other weaknesses, directly impairs the viability of the credit union. Credit unions in this group have a high probability of failure and will likely require liquidation and the payoff of shareholders, or some other form of emergency assistance, merger, or acquisition.

Examiners will have the optional use of assigning plus (+) or minus (-) CAMEL ratings to signify improving or declining trends.

Financial ratios will continue to be provided for the capital, asset quality, earnings, and asset/liability management components to guide examiners in assigning the appropriate ratings. It is important that examiners rate credit unions based on their performance in absolute terms rather than against national peer averages or predetermined benchmarks. Peer averages or benchmarks do not necessarily reflect credit unions that are being operated in a safe and sound manner. The CAMEL ratings should accurately reflect the condition of the credit union regardless of peer performance.

CAMELS for HSBC

The rating assigned to HSBC is ‘2’, Rating 2 - Reflects satisfactory performance that consistently provides for safe and sound operations. Both historical and projected key performance measures are generally positive with any exceptions being those that do not directly affect safe and sound operations. The supervisory response is limited to the extent that minor adjustments are resolved in the normal course of business and that operations continue to be satisfactory.

HSBC is a well capitalized bank according to the standards of FDIC because it is not only meeting but exceeding the requirements for a well-capitalized bank which are 10% total risk based capital ratio as HSBC has 12%, tier-1 risk based capital ratio requirement is 6% whereas HSBC has 8.88%. When a bank lies under the category of ‘well capitalized’ then the bank performance is exceptional as this is the highest category.

Adequate liquidity is critical to HSBC’s ability to operate its businesses, grow and be profitable. A compromise to liquidity could therefore have a negative effect on HUSI. Potential conditions that could negatively affect HSBC’s liquidity include:

- ✓ diminished access to capital markets;
- ✓ unforeseen cash or capital requirements;

- ✓ an inability to sell assets; and
- ✓ an inability to obtain expected funding from HSBC affiliates and clients.

HSBC's credit ratings are an important part of maintaining liquidity. Any downgrade in credit ratings could potentially increase borrowing costs, limit access to capital markets, require cash payments or collateral posting, and permit termination of certain contracts material to HSBC.

At September 30, 2006	Moody's	S&P	Fitch
HUSI:			
Short-term borrowings	P-1	A-1+	F1+
Long-term debt	Aa3	AA-	AA
Preferred stock	A2	A	AA-
HBUS:			
Short-term borrowings	P-1	A-1+	F1+
Long-term debt	Aa2	AA	AA

HSBC AND THE FOCUS OF ITS OPERATIONS

WHO IS HSBC?

HSBC is called the world's local bank. It is headquartered in London. HSBC is one of the largest banking and financial services organisations in the world. HSBC's international network is made up of around 10,000 offices in 82 countries and territories in Europe, the Asia-Pacific region, the Americas, the Middle East and Africa.

With listings on the London, Hong Kong, New York, Paris and Bermuda stock exchanges, shares in HSBC Holdings plc are held by nearly 200,000 shareholders in some 100 countries and territories. The shares are traded on the New York Stock Exchange in the form of American Depositary Receipts.[1]

OPERATIONS

HSBC is headquartered in London and provides worldwide a range of financial services including personal financial services; commercial banking; corporate, investment banking and markets; and private banking. HSBC - North America is one of the ten largest banking organizations in the United States. HSBC - North America is the holding company for all of HSBC's U.S. and Canadian businesses, and our over 50,000 employees serve more than 60 million customers in the United States and Canada.

Specific to consumer finance businesses -- these businesses operate under HSBC Finance Corporation, and serve consumers – with non-prime to prime credit characteristics -- with products including real estate secured loans, auto finance loans, MasterCard® and Visa® credit cards, and personal non-credit card loans. HSBC Finance Corporation is an SEC reporting entity.

In the area of real estate lending, HSBC Finance is a large player in the subprime mortgage market. HSBC Finance Corporation's consumer and mortgage lending business originates and services loans originated through retail (branch and direct) and wholesale (broker) channels, as well as portfolio acquisitions.

HSBC originate or purchase a variety of real estate secured and unsecured loans to primarily sub-prime customers. As one of the nation's largest consumer finance companies, HSBC haS more than 1,350 branches in 46 states and 11 servicing facilities across the US.

Through an international network linked by advanced technology, including a rapidly growing e-commerce capability, HSBC provides a comprehensive and detailed range of financial services: personal financial services; business and commercial banking; corporate and institutional banking, investment banking and markets; private banking; and other activities such as internet banking.

Share price of HSBC[2]

London GBP	9.09	-0.02
New York USD	88.37	+0.18
Paris EUR	13.40	+0.06
Hong Kong HKD	137.10	-0.40

[1] www.hsbc.com/history

[2] www.hsbc.com

INTRODUCTION

FINANCIALS & EVALUATION OF BANK’S PROFITABILITY

INTEREST RATE SENSITIVITY

CAMELS RATING

BANK’S USE OF INTEREST RATE DERIVATIVES CONTRACT

BANK'S GENERATION OF FEE INCOME

LOAN PORTFOLIO: LOANS CLASSIFIED BY PURPOSE

BANK’S CAPITAL: CUSHION FOR LOSSES AND FUND’S GROWTH

MERGERS & AQUISITIONS