HSBC HOLDINGS PLC

RECONCILIATIONS OF NON-GAAP FINANCIAL MEASURES

31 December 2012

Constant currency and underlying reconciliations

Use of non-GAAP financial measures

Use of non-GAAP financial measures

Our reported results are prepared in accordance with IFRSs as detailed in the Financial Statements starting on page 372 of the *Annual Report and Accounts 2012*. There are times when we measure our performance internally, using financial measures which have been derived from our reported results, in order to eliminate factors which distort year-on-year comparisons so we can view our results on a more like-for-like basis; these are considered non-GAAP measures. 'Constant currency' and 'underlying' performance are non-GAAP measures that we use throughout our Operating and Financial Review and are described below. Other non-GAAP financial measures are described and reconciled to the closest reported financial measure when used.

Constant currency

The constant currency measure adjusts for the year-on-year effects of foreign currency translation differences by comparing reported results for 2012 with reported results for 2011 retranslated at 2012 exchange rates.

The foreign currency translation differences reflect the movements of the US dollar against most major currencies during 2012.

We exclude the translation differences when monitoring progress against operating plans and past results because management believes the like-for-like basis of constant currency financial measures more appropriately reflects changes due to operating performance.

Constant currency

Constant currency comparatives for 2011 referred to in the commentaries are computed by retranslating into US dollars for non-US dollar branches, subsidiaries, joint ventures and associates:

- the income statements for 2011 at the average rates of exchange for 2012; and
- the balance sheet at 31 December 2011 at the prevailing rates of exchange on 31 December 2012.

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.

Use of non-GAAP financial measures / Underlying performance

Reconciliation of reported and constant currency profit before tax

			2011			
	2011	Currency	at 2012	2012		Constant
	2011 as	translation	exchange	2012 as	Reported	currency
HSBC	reported US\$m	adjustment ¹ US\$m	rates US\$m	reported US\$m	change ² %	change ²
нѕвс	US\$M	US\$M	US\$m	US\$M	%0	%
Net interest income	40,662	(1,151)	39,511	37,672	(7)	(5)
Net fee income	17,160	(436)	16,724	16,430	(4)	(2)
Own credit spread ³	3,933	(35)	3,898	(5,215)		
Gains on disposal of US branch						
network, US cards business and				7.024		
Ping An Other income ⁴	10,525	(446)	- 10,079	7,024 12,419	18	23
_	10,525	(440)	10,079	12,419	10	23
Net operating income ⁵	72,280	(2,068)	70,212	68,330	(5)	(3)
Loan impairment charges and						
other credit risk provisions	(12,127)	277	(11,850)	(8,311)	31	30
Net operating income	60,153	(1,791)	58,362	60,019	-	3
Operating expenses	(41,545)	1,273	(40,272)	(42,927)	(3)	(7)
Operating profit	18,608	(518)	18,090	17,092	(8)	(6)
Share of profit in associates						
and joint ventures	3,264	55	3,319	3,557	9	7
Profit before tax	21,872	(463)	21,409	20,649	(6)	(4)
By global business						
Retail Banking and Wealth						
Management	4,270	(71)	4,199	9,575	124	128
Commercial Banking	7,947	(180)	7,767	8,535	7	10
Global Banking and Markets	7,049	(200)	6,849	8,520	21	24
Global Private Banking	944	(8)	936	1,009	7	8
Other	1,662	(4)	1,658	(6,990)		
Profit before tax	21,872	(463)	21,409	20,649	(6)	(4)
By geographical region						
Europe	4,671	(130)	4,541	(3,414)		
Hong Kong	5,823	20	5,843	7,582	30	30
Rest of Asia-Pacific	7,471	(79)	7,392	10,448	40	41
Middle East and North Africa	1,492	(7)	1,485	1,350	(10)	(9)
North America	100	(14)	86	2,299	2,199	2,573
Latin America	2,315	(253)	2,062	2,384	3	16
Profit before tax	21,872	(463)	21,409	20,649	(6)	(4)

For footnotes, see page 28.

Underlying performance

Underlying performance:

- adjusts for the year-on-year effects of foreign currency translation;
- eliminates the fair value movements on our longterm debt attributable to credit spread ('own credit spread') where the net result of such movements will be zero upon maturity of the debt (see footnote 3 on page 28); and
- adjusts for acquisitions, disposals and changes of ownership levels of subsidiaries, associates and businesses (see footnote 7 on page 28).

For disposals, acquisitions and changes of ownership levels of subsidiaries, associates and businesses, we eliminate the gain or loss on disposal in the period incurred and remove the operating profit or loss of the acquired and disposed of businesses from all periods presented. Previously, this adjustment for the results of operations was effected by removing the time-equivalent component of operating profit or loss from the comparative period. During 2012 we changed this adjustment to better reflect the results of the ongoing business. Had we maintained our previous approach, underlying profit before tax would have been US\$1.7bn higher in 2012. This was mainly due to the elimination of

Underlying performance

the US Card and Retail Services business.

We use underlying performance when monitoring progress against operating plans and past results because we believe that this basis more appropriately reflects operating performance. We use underlying performance in our commentaries to explain year-on-year changes when the effect of fair value movements on own debt, acquisitions, disposals or dilution is significant.

The following acquisitions, disposals and changes to ownership levels affected the underlying performance:

Disposal gains/(losses) affecting underlying performance

	Date	Disposal gain/(loss) US\$m
HSBC Financial Services (Middle East) Limited's disposal of majority stake in HSBC Private Equity Middle East Limited	Jun 2011	(7)
Dilution gain on our holding in Ping An following the issue of share capital to a third party	Jun 2011 Jun 2011	(7) 181
Grupo Financiero HSBC, S.A. de C.V.'s disposal of HSBC Afore S.A. de C.V. ⁶ Dilution gain as a result of the merger between HSBC Saudi Arabia Limited and SABB Securities	Aug 2011	83
Limited	Dec 2011	27
HSBC Bank Canada's disposal of HSBC Securities (Canada) Inc's full service retail brokerage business ⁶	Jan 2012	83
The Hongkong and Shanghai Banking Corporation Limited's disposal of RBWM operations in Thailand ⁶	Mar 2012	108
HSBC Finance Corporation, HSBC USA Inc. and HSBC Technology and Services (USA) Inc.'s	M 2012	2.140
disposal of US Card and Retail Services business ⁶	May 2012 May 2012	3,148 661
HSBC Argentina Holdings S.A.'s disposal of its general insurance manufacturing subsidiary ⁶	May 2012	102
The Hongkong and Shanghai Banking Corporation Limited's disposal of its private banking business	,	
in Japan ⁶	Jun 2012	67
The Hongkong and Shanghai Banking Corporation Limited's disposal of its shareholding in a property		
company in the Philippines	Jun 2012	130
HSBC Bank USA, N.A.'s disposal of 57 non-strategic branches ⁶	Aug 2012	203
Hang Seng Bank Limited's disposal of its general insurance manufacturing subsidiary ⁶	Jul 2012	46
HSBC Asia Holdings B.V.'s investment loss on a subsidiary ⁶	Aug 2012	(85)
HSBC Bank plc's disposal of HSBC Securities SA	Aug 2012	(11)
HSBC Europe (Netherlands) B.V.'s disposal of HSBC Credit Zrt	Aug 2012	(2)
HSBC Europe (Netherlands) B.V.'s disposal of HSBC Insurance (Ireland) Limited	Oct 2012	(12)
HSBC Europe (Netherlands) B.V.'s disposal of HSBC Reinsurance Limited	Oct 2012	7
HSBC Private Bank (UK) Limited's disposal of Property Vision Holdings Limited	Oct 2012	(1)
HSBC Investment Bank Holdings Limited's disposal of its stake in Havas Havalimanlari Yer Hizmetleri		
Yatirim Holding Anonim Sirketi	Oct 2012	18
HSBC Insurance (Asia) Limited's disposal of its general insurance portfolios ⁶	Nov 2012	117
HSBC Bank plc's disposal of HSBC Shipping Services Limited	Nov 2012	(2)
HSBC Bank (Panama) S.A.'s disposal of its operations in Costa Rica, El Salvador and Honduras ⁶	Dec 2012	(62)
disposal of their shares in Ping An ⁶	Dec 2012	3,012
Payments Asia-Pacific Limited ⁶	Dec 2012	212

For footnote, see page 28.

Acquisition gains/(losses) affecting the underlying performance

	Date	Fair value gain on acquisition US\$m
Our share of the loss recorded by Ping An on re-measurement of its previously held equity interest in Ping		
An bank (formerly known as Shenzhen Development Bank) when Ping An took control and fully		
consolidated Ping An Bank	Jul 2011	(48)
Gain on the merger of Oman International Bank S.A.O.G. and the Omani operations of		
HSBC Bank Middle East Limited	Jun 2012	3
Gain on the acquisition of the onshore retail and commercial banking business of Lloyds Banking Group in		
the UAE by HSBC Bank Middle East Limited	Oct 2012	18

Underlying performance

The following table reconciles our reported revenue, loan impairment charges, operating expenses and profit before tax for 2012 and 2011

to an underlying basis. We reconcile other reported results to underlying results when doing so results in a more useful discussion of operating performance.

Reconciliation of reported and underlying⁷ items

	2012 US\$m	2011 US\$m	Change ²
Revenue ⁵	OSSIII	OSSIII	/0
Reported revenue	68,330	72,280	(5)
Currency translation adjustment ¹		(2,033)	
Own credit spread ³	5,215	(3,933)	
Acquisitions, disposals and dilutions	(10,048)	(6,976)	
Underlying revenue	63,497	59,338	7
Loan impairment charges and other credit risk provisions ('LIC's)			
Reported LICs	(8,311)	(12,127)	31
Currency translation adjustment ¹	338	277	
Acquisitions, disposals and dilutions		1,619	
Underlying LICs	(7,973)	(10,231)	22
Operating expenses			
Reported operating expenses	(42,927)	(41,545)	(3)
Currency translation adjustment ¹ Acquisitions, disposals and dilutions	1,004	1,273 2,666	
Underlying operating expenses	(41,923)	(37,606)	(11)
Underlying cost efficiency ratio	66.0%	63.4%	
Profit before tax			
Reported profit before tax	20,649	21,872	(6)
Currency translation adjustment ¹	5.015	(428)	
Own credit spread ³	5,215 (9,479)	(3,933) (3,650)	
			10
Underlying profit before tax	16,385	13,861	18
By global business			
Retail Banking and Wealth Management	4,001	871	359
Clobal Popling and Markets	7,941	7,691 6.735	3 24
Global Banking and Markets	8,371 954	945	1
Other	(4,882)	(2,381)	(105)
Underlying profit before tax	16,385	13,861	18
By geographical region			
Europe	699	1,629	(57)
Hong Kong	7,162	5,761	24
Rest of Asia-Pacific	6,403	6,249	2
Middle East and North Africa	1,380	1,417	(3)
North America Latin America	(1,499) 2,240	(3,076) 1,881	51 19
Underlying profit before tax	16,385	13,861	18

For footnotes, see page 28.

Reconciliation of reported and underlying average risk-weighted assets ('RWA's)

	Year ended 31 December			
	2012	2011	Change	
	US\$bn	US\$bn	%	
Average reported RWAs	1,172	1,154	2	
Currency translation adjustment ¹	_	(7)		
Acquisitions, disposals and dilutions	(43)	(70)		
Average underlying RWAs	1,129	1,077	5	

Global businesses

Retail Banking and Wealth Management

Reconciliation of reported and constant currency profit/(loss) before tax

	2011 as reported US\$m	Currency translation adjustment ¹ US\$m	2011 at 2012 exchange rates US\$m	2012 as reported US\$m	Reported change ² %	Constant currency change ²
Net interest income Net fee income Gains on disposal of US branch	24,101 8,226	(702) (187)	23,399 8,039	20,298 7,205	(16) (12)	(13) (10)
network and cards business Other income ⁴	1,206	(100)	- 1,106	3,735 2,623	117	137
Net operating income ⁵	33,533	(989)	32,544	33,861	1	4
Loan impairment charges and other credit risk provisions	(9,319)	181	(9,138)	(5,515)	41	40
Net operating income	24,214	(808)	23,406	28,346	17	21
Operating expenses	(21,202)	712	(20,490)	(19,769)	7	4
Operating profit	3,012	(96)	2,916	8,577	185	194
Income from associates	1,258	25	1,283	998	(21)	(22)
Profit before tax	4,270	(71)	4,199	9,575	124	128

Reconciliation of reported and underlying⁷ items

	Year ended 31 December			
	2012	2011	Change ²	
	US\$m	US\$m	%	
Revenue ⁵				
Reported revenue	33,861	33,533	1	
Currency translation adjustment ¹		(989)		
Acquisitions, disposals and dilutions	(6,164)	(6,427)		
Underlying revenue	27,697	26,117	6	
Loan impairment charges and other credit risk provisions ('LIC's)				
Reported LICs	(5,515)	(9,319)	41	
Currency translation adjustment ¹	, , ,	181		
Acquisitions, disposals and dilutions	339	1,616		
Underlying LICs	(5,176)	(7,522)	31	
Operating expenses				
Reported operating expenses	(19,769)	(21,202)	7	
Currency translation adjustment ¹	` ' '	712		
Acquisitions, disposals and dilutions	873	2,429		
Underlying operating expenses	(18,896)	(18,061)	(5)	
Underlying cost efficiency ratio	68.2%	69.2%		
Profit before tax				
Reported profit before tax	9,575	4.270	124	
Currency translation adjustment ¹	2,575	(71)	124	
Acquisitions, disposals and dilutions	(5,574)	(3,328)		
Underlying profit before tax	4,001	871	359	

For footnotes, see page 28.

Retail Banking and Wealth Management - HSBC Finance

Reconciliation of reported and underlying⁷ items

	Year ended 31 December			
	2012	2011	Change ²	
	US\$m	US\$m	%	
Revenue ⁵				
Reported revenue	7,251	7,216	_	
Acquisitions, disposals and dilutions	(4,830)	(5,462)		
Underlying revenue	2,421	1,754	38	
Profit/(loss) before tax				
Reported profit/(loss) before tax	2,443	(2,405)		
Acquisitions, disposals and dilutions	(3,916)	(2,061)		
Underlying loss before tax	(1,473)	(4,466)	(67)	

Commercial Banking

Reconciliation of reported and constant currency profit/(loss) before tax

	2011 as reported US\$m	Currency translation adjustment ¹ US\$m	2011 at 2012 exchange rates US\$m	2012 as reported US\$m	Reported change ² %	Constant currency change ²
Net interest income	9,931	(381)	9,550	10,361	4	8
Net fee income	4,291	(132)	4,159	4,470	4	7
network	_	_	_	277		
Other income ⁴	1,389	(58)	1,331	1,443	4	8
Net operating income ⁵	15,611	(571)	15,040	16,551	6	10
Loan impairment charges and other credit risk provisions	(1,738)	81	(1,657)	(2,099)	(21)	(27)
Net operating income	13,873	(490)	13,383	14,452	4	8
Operating expenses	(7,221)	288	(6,933)	(7,598)	(5)	(10)
Operating profit	6,652	(202)	6,450	6,854	3	6
Income from associates	1,295	22	1,317	1,681	30	28
Profit before tax	7,947	(180)	7,767	8,535	7	10

For footnotes, see page 28.

Reconciliation of reported and underlying⁷ items

	Year ended 31 December			
	2012	2011	Change ²	
	US\$m	US\$m	%	
Revenue ⁵				
Reported revenue	16,551	15,611	6	
Currency translation adjustment ¹		(571)		
Acquisitions, disposals and dilutions	(605)	(232)		
Underlying revenue	15,946	14,808	8	
Loan impairment charges and other credit risk provisions ('LIC's)				
Reported LICs	(2,099)	(1,738)	(21)	
Currency translation adjustment ¹		81		
Acquisitions, disposals and dilutions	(1)	3		
Underlying LICs	(2,100)	(1,654)	(27)	
Operating expenses				
Reported operating expenses	(7,598)	(7,221)	(5)	
Currency translation adjustment ¹		288		
Acquisitions, disposals and dilutions	100	162		
Underlying operating expenses	(7,498)	(6,771)	(11)	
Underlying cost efficiency ratio	47.0%	45.7%		
Profit before tax				
Reported profit before tax	8,535	7,947	7	
Currency translation adjustment ¹		(180)		
Acquisitions, disposals and dilutions	(594)	(76)		
Underlying profit before tax	7,941	7,691	3	

Global businesses

Global Banking and Markets

Reconciliation of reported and constant currency profit/(loss) before tax

	2011 as reported US\$m	Currency translation adjustment ¹ US\$m	at 2011 at 2012 exchange rates US\$m	2012 as reported US\$m	Reported change ²	Constant currency change ²
Net interest income	7,263	(197)	7,066	6,960	(4)	(2)
Net fee income	3,227	(92)	3,135	3,329	3	6
Net trading income	5,204	(116)	5,088	5,690	9	12
Other income ⁴	1,363	(26)	1,337	2,294	68	72
Net operating income ⁵ Loan impairment charges and other	17,057	(431)	16,626	18,273	7	10
credit risk provisions	(984)	14	(970)	(670)	32	31
Net operating income	16,073	(417)	15,656	17,603	10	12
Operating expenses	(9,722)	208	(9,514)	(9,907)	(2)	(4)
Operating profit	6,351	(209)	6,142	7,696	21	25
Income from associates	698	9	707	824	18	17
Profit before tax	7,049	(200)	6,849	8,520	21	24

For footnotes, see page 28.

Reconciliation of reported and constant currency management view of total operating income of Global Banking and Markets

	2011 as reported US\$m	Currency translation adjustment ¹ US\$m	2011 at 2012 exchange rates US\$m	2012 as reported US\$m	Reported change ² %	Constant currency change ²
Global Markets ⁸	8,098	(206)	7,892	8,733	8	11
Credit	335	(9)	326	779	133	139
Rates	1,341	(14)	1,327	1,771	32	33
Foreign Exchange	3,272	(77)	3,195	3,215	(2)	1
Equities	961	(36)	925	679	(29)	(27)
Securities Services	1,673	(43)	1,630	1,663	(1)	2
Asset and Structured Finance	516	(27)	489	626	21	28
Global Banking	5,401	(132)	5,269	5,568	3	6
Financing and Equity Capital Markets	3,233	(87)	3,146	3,071	(5)	(2)
Payments and Cash Management ⁹	1,534	(19)	1,515	1,744	14	15
Other transaction services ¹⁰	634	(26)	608	753	19	24
Balance Sheet Management ¹¹	3,488	(74)	3,414	3,738	7	9
Principal Investments	209	(8)	201	125	(40)	(38)
Debit valuation adjustment	_	_	_	518	_	_
Other ¹²	(139)	(11)	(150)	(409)	(194)	(173)
Total operating income	17,057	(431)	16,626	18,273	7	10

Reconciliation of reported and underlying⁷ items

	Year ended 31 December				
	2012	2011	Change ²		
	US\$m	US\$m	%		
Revenue ⁵					
Reported revenue	18,273	17,057	7		
Currency translation adjustment ¹		(431)			
Acquisitions, disposals and dilutions	(107)	(81)			
Underlying revenue	18,166	16,545	10		
Loan impairment charges and other credit risk provisions ('LIC's)					
Reported LICs	(670)	(984)	32		
Currency translation adjustment ¹		14			
Underlying LICs	(670)	(970)	31		
Operating expenses					
Reported operating expenses	(9,907)	(9,722)	(2)		
Currency translation adjustment ¹		208			
Acquisitions, disposals and dilutions	21	34			
Underlying operating expenses	(9,886)	(9,480)	(4)		
Underlying cost efficiency ratio	54.4%	57.3%			
Profit before tax					
Reported profit before tax	8,520	7,049	21		
Currency translation adjustment ¹		(200)			
Acquisitions, disposals and dilutions	(149)	(114)			
Underlying profit before tax	8,371	6,735	24		

Global Private Banking

Reconciliation of reported and constant currency profit/(loss) before tax

	2011 as reported US\$m	Currency translation adjustment ¹ US\$m	2011 at 2012 exchange rates US\$m	2012 as reported US\$m	Reported change ² %	Constant currency change ²
Net interest income	1,439	(12)	1,427	1,294	(10)	(9)
Net fee income	1,382	(19)	1,363	1,232	(11)	(10)
Other income ⁴	471	(4)	467	646	37	38
Net operating income ⁵ Loan impairment charges and other	3,292	(35)	3,257	3,172	(4)	(3)
credit risk provisions	(86)	11	(85)	(27)	69	68
Net operating income	3,206	(34)	3,172	3,145	(2)	(1)
Operating expenses	(2,266)	26	(2,240)	(2,143)	5	4
Operating profit	940	(8)	932	1,002	7	8
Income from associates	4		4	7	75	75
Profit before tax	944	(8)	936	1,009	7	8

For footnotes, see page 28.

Reconciliation of reported and underlying⁷ items

	Year ended 31 December			
	2012	2011	Change ²	
	US\$m	US\$m	%	
Revenue ⁵				
Reported revenue	3,172	3,292	(4)	
Currency translation adjustment ¹	_	(35)		
Acquisitions, disposals and dilutions	(65)	(28)		
Underlying revenue	3,107	3,229	(4)	
Loan impairment charges and other credit risk provisions ('LIC's)				
Reported LICs	(27)	(86)	69	
Currency translation adjustment ¹		1		
Underlying LICs	(27)	(85)	68	
Operating expenses				
Reported operating expenses	(2,143)	(2,266)	5	
Currency translation adjustment ¹	,	26		
Acquisitions, disposals and dilutions	10	37		
Underlying operating expenses	(2,133)	(2,203)	3	
Underlying cost efficiency ratio	68.7%	68.2%		
Profit before tax				
Reported profit before tax	1,009	944	7	
Currency translation adjustment ¹		(8)		
Acquisitions, disposals and dilutions	(55)	9		
Underlying profit before tax	954	945	1	

Other

Reconciliation of reported and constant currency profit/(loss) before tax

	2011 as reported US\$m	Currency translation adjustment ¹ US\$m	at 2011 at 2012 exchange rates US\$m	2012 as reported US\$m	Reported change ² %	Constant currency change ²
Net interest income	(911)	35	(876)	(730)	20	17
Net fee income	34	(6)	28	194	471	593
Own credit spread ³	3,933	(35)	3,898	(5,215)		
Gains on disposal of Ping An Other income ⁴	6,089	(119)	5 070	3,012	(17)	(15)
_	0,089	(119)	5,970	5,071	(17)	(15)
Net operating income ⁵	9,145	(125)	9,020	2,332	(74)	(74)
Loan impairment charges and other credit risk provisions			_	<u> </u>		
Net operating income	9,145	(125)	9,020	2,332	(74)	(74)
Operating expenses	(7,492)	122	(7,370)	(9,369)	(25)	(27)
Operating profit/(loss)	1,653	(3)	1,650	(7,037)		
Income from associates	9	(1)	8	47	422	488
Profit/(loss) before tax	1,662	(4)	1,658	(6,990)		

For footnotes, see page 28.

Reconciliation of reported and underlying⁷ items

	Year ended 31 December			
	2012	Change ²		
	US\$m	US\$m	%	
Revenue ⁵				
Reported revenue	2,332	9,145	(74)	
Currency translation adjustment ¹		(90)		
Own credit spread ³	5,215	(3,933)		
Acquisitions, disposals and dilutions	(3,107)	(208)		
Underlying revenue	4,440	4,914	(10)	
Operating expenses				
Reported operating expenses	(9,369)	(7,492)	(25)	
Currency translation adjustment ¹		122	` /	
Acquisitions, disposals and dilutions	_	4		
Underlying operating expenses	(9,369)	(7,366)	(27)	
Underlying cost efficiency ratio	211.0%	149.9%		
Profit/(loss) before tax				
Reported profit/(loss) before tax	(6,990)	1,662		
Currency translation adjustment ¹		31		
Own credit spread ³	5,215	(3,933)		
Acquisitions, disposals and dilutions	(3,107)	(141)		
Underlying loss before tax	(4,882)	(2,381)	(105)	

Geographical regions

Europe

Reconciliation of reported and constant currency profit/(loss) before tax

	2011 as reported US\$m	Currency translation adjustment ¹ US\$m	2011 at 2012 exchange rates US\$m	2012 as reported US\$m	Reported change ² %	Constant currency change ²
Net interest income	11,001	(325)	10,676	10,394	(6)	(3)
Net fee income	6,236	(205)	6,031	6,169	(1)	2
Own credit spread ³	2,947	(35)	2,912	(4,110)		
Other income ⁴	4,062	(17)	4,045	5,155	27	27
Net operating income ⁵	24,246	(582)	23,664	17,608	(27)	(26)
Loan impairment charges and other credit risk provisions	(2,512)	54	(2,458)	(1,921)	24	22
Net operating income	21,734	(528)	21,206	15,687	(28)	(26)
Operating expenses	(17,069)	406	(16,663)	(19,095)	(12)	(15)
Operating profit/(loss)	4,665	(122)	4,543	(3,408)		
Income/(loss) from associates	6	(8)	(2)	(6)		(200)
Profit/(loss) before tax	4,671	(130)	4,541	(3,414)		

For footnotes, see page 28.

Reconciliation of reported and underlying⁷ items

	Year ended 31 December				
	2012	2012 2011			
	US\$m	US\$m	%		
Revenue ⁵					
Reported revenue	17,608	24,246	(27)		
Currency translation adjustment ¹		(547)			
Own credit spread ³	4,110	(2,947)			
Acquisitions, disposals and dilutions	3				
Underlying revenue	21,721	20,752	5		
Loan impairment charges and other credit risk provisions ('LIC's)					
Reported LICs	(1,921)	(2,512)	24		
Currency translation adjustment ¹		54			
Underlying LICs	(1,921)	(2,458)	22		
Operating expenses					
Reported operating expenses	(19,095)	(17,069)	(12)		
Currency translation adjustment ¹		406			
Underlying operating expenses	(19,095)	(16,663)	(15)		
Underlying cost efficiency ratio	87.9%	80.3%			
Profit/(loss) before tax					
Reported profit/(loss) before tax	(3,414)	4,671			
Currency translation adjustment ¹		(95)			
Own credit spread ³	4,110	(2,947)			
Acquisitions, disposals and dilutions	3				
Underlying profit before tax	699	1,629	(57)		

Hong Kong

Reconciliation of reported and constant currency profit/(loss) before tax

	2011 as reported US\$m	Currency translation adjustment ¹ US\$m	2011 at 2012 exchange rates US\$m	2012 as reported US\$m	Reported change ² %	Constant currency change ²
Net interest income	4,691	20	4,711	5,316	13	13
Net fee income	3,097	11	3,108	3,335	8	7
Other income ⁴	2,894	8	2,902	3,771	30	30
Net operating income ⁵	10,682	39	10,721	12,422	16	16
Loan impairment charges and other credit risk provisions	(156)	(1)	(157)	(74)	53	53
Net operating income	10,526	38	10,564	12,348	17	17
Operating expenses	(4,758)	(18)	(4,776)	(4,848)	(2)	(2)
Operating profit	5,768	20	5,788	7,500	30	30
Income from associates	55		55	82	49	49
Profit before tax	5,823	20	5,843	7,582	30	30

For footnotes, see page 28.

Reconciliation of reported and underlying⁷ items

	Year ended 31 December			
	2012	2011	Change ²	
	US\$m	US\$m	%	
Revenue ⁵				
Reported revenue	12,422	10,682	16	
Currency translation adjustment ¹		39		
Acquisitions, disposals and dilutions	(445)	(109)		
Underlying revenue	11,977	10,612	13	
Loan impairment charges and other credit risk provisions ('LIC's)				
Reported LICs	(74)	(156)	53	
Currency translation adjustment ¹	. ,	<u>(1)</u>		
Underlying LICs	(74)	(157)	53	
Operating expenses				
Reported operating expenses	(4,848)	(4,758)	(2)	
Currency translation adjustment ¹		(18)		
Acquisitions, disposals and dilutions	34	40		
Underlying operating expenses	(4,814)	(4,736)	(2)	
Underlying cost efficiency ratio	40.2%	44.6%		
Profit before tax				
Reported profit before tax	7,582	5,823	30	
Currency translation adjustment ¹		20		
Acquisitions, disposals and dilutions	(420)	(82)		
Underlying profit before tax	7,162	5,761	24	

Rest of Asia-Pacific

Reconciliation of reported and constant currency profit/(loss) before tax

	2011 as reported US\$m	Currency translation adjustment ¹ US\$m	2011 at 2012 exchange rates US\$m	2012 as reported US\$m	Reported change ² %	Constant currency change ²
Net interest income	5,102	(111)	4,991	5,391	6	8
Net fee income	2,111	(57)	2,054	2,083	(1)	1
Own credit spread ³	2	_	2	(3)		
Gains on disposal of Ping An	_	_	_	3,012		
Other income ⁴	3,498	(148)	3,350	3,101	(11)	(7)
Net operating income ⁵	10,713	(316)	10,397	13,584	27	31
Loan impairment charges and other credit risk provisions	(267)	1	(266)	(436)	(63)	(64)
Net operating income	10,446	(315)	10,131	13,148	26	30
Operating expenses	(5,806)	173	(5,633)	(5,806)	-	(3)
Operating profit	4,640	(142)	4,498	7,342	58	63
Income from associates	2,831	63	2,894	3,106	10	7
Profit before tax	7,471	(79)	7,392	10,448	40	41

For footnotes, see page 28.

Reconciliation of reported and underlying⁷ items

	Year ended 31 December			
	2012	2011	Change ²	
	US\$m	US\$m	%	
Revenue ⁵				
Reported revenue	13,584	10,713	27	
Currency translation adjustment ¹		(316)		
Own credit spread ³	3	(2)		
Acquisitions, disposals and dilutions	(3,342)	(295)		
Underlying revenue	10,245	10,100	1	
Loan impairment charges and other credit risk provisions ('LIC's)				
Reported LICs	(436)	(267)	(63)	
Currency translation adjustment ¹	, ,	1	` ′	
Acquisitions, disposals and dilutions	(2)	4		
Underlying LICs	(438)	(262)	(67)	
Operating expenses				
Reported operating expenses	(5,806)	(5,806)	_	
Currency translation adjustment ¹	, ,	173		
Acquisitions, disposals and dilutions	60	96		
Underlying operating expenses	(5,746)	(5,537)	(4)	
Underlying cost efficiency ratio	56.1%	54.8%		
Profit before tax				
Reported profit before tax	10,448	7,471	40	
Currency translation adjustment ¹	,	(79)		
Own credit spread ³	3	(2)		
Acquisitions, disposals and dilutions	(4,048)	(1,141)		
Underlying profit before tax	6,403	6,249	2	

Middle East and North Africa

Reconciliation of reported and constant currency profit/(loss) before tax

	2011 as reported US\$m	Currency translation adjustment ¹ US\$m	at 2011 at 2012 exchange rates US\$m	2012 as reported US\$m	Reported change ² %	Constant currency change ²
Net interest income	1,432 627 14 534	(9) (4) - (1)	1,423 623 14 533	1,470 595 (12) 377	3 (5) (29)	3 (4) (29)
Net operating income ⁵	2,607	(14)	2,593	2,430	(7)	(6)
Loan impairment charges and other credit risk provisions	(293)	1	(292)	(286)	2	2
Net operating income	2,314	(13)	2,301	2,144	(7)	(7)
Operating expenses	(1,159)	6	(1,153)	(1,166)	(1)	(1)
Operating profit	1,155	(7)	1,148	978	(15)	(15)
Income from associates	337		337	372	10	10
Profit before tax	1,492	(7)	1,485	1,350	(10)	(9)

For footnotes, see page 28.

Reconciliation of reported and underlying⁷ items

	Year ended 31 December			
	2012	2011	Change ²	
	US\$m	US\$m	%	
Revenue ⁵				
Reported revenue	2,430	2,607	(7)	
Currency translation adjustment ¹		(14)		
Own credit spread ³	12	(14)		
Acquisitions, disposals and dilutions	3	(79)		
Underlying revenue	2,445	2,500	(2)	
Loan impairment charges and other credit risk provisions ('LIC's)				
Reported LICs	(286)	(293)	2	
Currency translation adjustment ¹		1		
Underlying LICs	(286)	(292)	2	
Operating expenses				
Reported operating expenses	(1,166)	(1,159)	(1)	
Currency translation adjustment ¹		6		
Acquisitions, disposals and dilutions	15	25		
Underlying operating expenses	(1,151)	(1,128)	(2)	
Underlying cost efficiency ratio	47.1%	45.1%		
Profit before tax				
Reported profit before tax	1,350	1,492	(10)	
Currency translation adjustment ¹	,	(7)	(-)	
Own credit spread ³	12	(14)		
Acquisitions, disposals and dilutions	18	(54)		
Underlying profit before tax	1,380	1,417	(3)	

North America

Reconciliation of reported and constant currency profit/(loss) before tax

	2011 as reported US\$m	Currency translation adjustment ¹ US\$m	2011 at 2012 exchange rates US\$m	2012 as reported US\$m	Reported change ² %	Constant currency change ²
Net interest income	11,480	(17)	11,463	8,117	(29)	(29)
Net fee income Own credit spread ³	3,308 970	(7)	3,301 970	2,513	(24)	(24)
Gains on disposal of US branch	970	_	970	(1,090)		
network and cards business	_	_	_	4,012		
Other income ⁴	242		242	1,141	371	371
Net operating income ⁵	16,000	(24)	15,976	14,693	(8)	(8)
Loan impairment charges and other						
credit risk provisions	(7,016)	1_	(7,015)	(3,457)	51	51
Net operating income	8,984	(23)	8,961	11,236	25	25
Operating expenses	(8,919)	9	(8,910)	(8,940)	-	-
Operating profit	65	(14)	51	2,296	3,432	4,402
Income from associates	35		35	3	(91)	(91)
Profit before tax	100	(14)	86	2,299	2,199	2,573

For footnotes, see page 28.

Reconciliation of reported and underlying⁷ items

	Year ended 31 December		
	2012	2011	Change ²
	US\$m	US\$m	%
Revenue ⁵			
Reported revenue	14,693	16,000	(8)
Currency translation adjustment ¹	4 000	(24)	
Own credit spread ³	1,090	(970)	
Acquisitions, disposals and dilutions	(5,924)	(6,001)	
Underlying revenue	9,859	9,005	9
Loan impairment charges and other credit risk provisions ('LIC's)			
Reported LICs	(3,457)	(7,016)	51
Currency translation adjustment ¹		1	
Acquisitions, disposals and dilutions	324	1,599	
Underlying LICs	(3,133)	(5,416)	42
Operating expenses			
Reported operating expenses	(8,940)	(8,919)	_
Currency translation adjustment ¹		9	
Acquisitions, disposals and dilutions	712	2,210	
Underlying operating expenses	(8,228)	(6,700)	(23)
Underlying cost efficiency ratio	83.5%	74.4%	
Profit/(loss) before tax			
Reported profit before tax	2,299	100	2,199
Currency translation adjustment ¹	,	(14)	,
Own credit spread ³	1,090	(970)	
Acquisitions, disposals and dilutions	(4,888)	(2,192)	
Underlying loss before tax	(1,499)	(3,076)	51

Latin America

Reconciliation of reported and constant currency profit/(loss) before tax

	2011 as reported US\$m	Currency translation adjustment ¹ US\$m	2011 at 2012 exchange rates US\$m	2012 as reported US\$m	Reported change ² %	Constant currency change ²
Net interest income	6,956	(709)	6,247	6,984	-	12 8
Net fee income Other income ⁴	1,781 2,716	(174) (333)	1,607 2,383	1,735 2,232	(3) (18)	8 (6)
Net operating income ⁵	11,453	(1,216)	10,237	10,951	(4)	7
Loan impairment charges and other credit risk provisions	(1,883)	221	(1,662)	(2,137)	(13)	(29)
Net operating income	9,570	(995)	8,575	8,814	(8)	3
Operating expenses	(7,255)	742	(6,513)	(6,430)	11	1
Operating profit	2,315	(253)	2,062	2,384	3	16
Income from associates					-	-
Profit before tax	2,315	(253)	2,062	2,384	3	16

For footnotes, see page 28.

$Reconciliation \ of \ reported \ and \ underlying ^{7} \ items$

	Year ended 31 December			
	2012	2011	Change ²	
	US\$m	US\$m	%	
Revenue ⁵				
Reported revenue	10,951	11,453	(4)	
Currency translation adjustment ¹		(1,216)		
Acquisitions, disposals and dilutions	(343)	(492)		
Underlying revenue	10,608	9,745	9	
Loan impairment charges and other credit risk provisions ('LIC's)				
Reported LICs	(2,137)	(1,883)	(13)	
Currency translation adjustment ¹		221		
Acquisitions, disposals and dilutions	16	16		
Underlying LICs	(2,121)	(1,646)	(29)	
Operating expenses				
Reported operating expenses	(6,430)	(7,255)	11	
Currency translation adjustment ¹		742		
Acquisitions, disposals and dilutions	183	295		
Underlying operating expenses	(6,247)	(6,218)	_	
Underlying cost efficiency ratio	58.9%	63.8%		
Profit before tax				
Reported profit before tax	2,384	2,315	3	
Currency translation adjustment ¹		(253)		
Acquisitions, disposals and dilutions	(144)	(181)		
Underlying profit before tax	2,240	1,881	19	

Countries

Reconciliation of reported and underlying⁷ profit before tax ('PBT') – country highlights

	Reported	Acquisitions,	Own	Underlying	
	PBT at	disposals,	credit	PBT at	2
	31 Dec 2012	and dilutions	spread ³	31 Dec 2012	Change ²
Country	US\$m	US\$m	US\$m	US\$m	%
Hong Kong and Rest of Asia-Pacific					
Hong Kong	7,582	(420)	-	7,162	24
India	809	-	_	809	14
China HSBC ¹³	792	-	-	792	10
Singapore	668	-	-	668	12
Malaysia	564	-	-	564	8
Indonesia	306	-	_	306	28
Taiwan	234	-	_	234	12
Australia	275	-	3	278	(9)
Vietnam	120	-	-	120	(23)
Europe					
France	578	-	152	730	1,337
Germany	344	_	_	344	6
Turkey	144	_	_	144	(1)
Switzerland	136	_	_	136	(38)
UK	(5,056)	14	3,958	(1,084)	(253)
Middle East and North Africa					
UAE	464	(21)	12	455	(19)
Saudi Arabia	377	_	_	377	13
Egypt	290	-	-	290	31
North America					
Canada	1,081	(83)	29	1,027	7
USA	1,215	(4,805)	1,061	(2,529)	39
Latin America					
Brazil	1,123	-	_	1,123	6
Mexico	699	-	-	699	47
Argentina	506	(122)	_	384	39

Countries

Reconciliation of reported and underlying profit¹ before tax ('PBT') – country highlights (continued)

	Reported PBT at	Currency translation	Acquisitions, disposals,	Own credit	Underlying PBT at
	31 Dec 2011	adjustment1	and dilutions	spread ³	31 Dec 2011
Country	US\$m	US\$m	US\$m	US\$m	US\$m
Hong Kong and Rest of Asia-Pacific					
Hong Kong	5,823	20	(82)	_	5,761
India	813	(103)	_	_	710
China HSBC ¹³	706	14	_	_	720
Singapore	595	4	_	_	599
Malaysia	529	(7)	_	_	522
Indonesia	259	(19)	_	_	240
Taiwan	210	(1)	_	_	209
Australia	307	1	_	(2)	306
Vietnam	154	1	_	_	155
Europe					
France	101	12	_	(172)	(59)
Germany	352	(27)	_	_	325
Turkey	158	(13)	_	_	145
Switzerland	217	3	_	_	220
UK	3,521	(39)	_	(2,775)	707
Middle East and North Africa					
UAE	575	_	_	(14)	561
Saudi Arabia	361	_	(27)	_	334
Egypt	225	(4)	_	-	221
North America					
Canada	965	(13)	16	(11)	957
USA	(998)	_	(2,208)	(959)	(4,165)
Latin America					
Brazil	1,230	(170)	_	_	1,060
Mexico	626	(47)	(104)	_	475
Argentina	344	(36)	(31)	_	277

Global businesses

Reconciliation of reported to underlying average risk-weighted assets

Global businesses			
Retail Banking and Wealth Management			
	2012 US\$bn	2011 US\$bn	Change ² %
Average reported RWAs	313.8 (25.2)	356.1 (1.9) (58.5)	(12)
Average underlying RWAs	288.6	295.7	(2)
		_	
Commercial Banking			
	2012 US\$bn	2011 US\$bn	Change ²
Average reported RWAs Currency translation adjustment ¹ Acquisitions, disposals and dilutions	396.8 (15.9)	360.2 (2.0) (9.3)	10
Average underlying RWAs	380.9	348.9	9
Global Banking and Markets			
	2012 US\$bn	2011 US\$bn	Change ² %
Average reported RWAs	412.4	382.2 (2.7)	8
Acquisitions, disposals and dilutions	(2.2)	(1.1) 378.4	8
Global Private Banking			
	2012 US\$bn	2011 US\$bn	Change ²
Average reported RWAs	22.1	23.9	(8)
Acquisitions, disposals and dilutions	(0.1)	(0.5)	
Average underlying RWAs	22.0	23.4	(6)
Other			
	2012 US\$bn	2011 US\$bn	Change ² %
Average reported RWAs	27.3	31.5 (0.2)	(13)
Acquisitions, disposals and dilutions	(0.2)	(0.6)	/4 6 1
Average underlying RWAs	27.1	30.7	(12)

Geographical regions

Europe

	2012 US\$bn	2011 US\$bn	Change %
Average reported RWAs	329.8	317.0	4
Currency translation adjustment ¹		(1.8)	
Acquisitions, disposals and dilutions			
Average underlying RWAs	329.8	315.2	5
Hong Kong			
	2012 US\$bn	2011 US\$bn	Change %
Average reported RWAs	107.9	109.4	(1)
Currency translation adjustment ¹		0.3	()
Acquisitions, disposals and dilutions			
Average underlying RWAs	107.9	109.7	(2)
Rest of Asia-Pacific			
	2012	2011	Change
	US\$bn	US\$bn	%
Average reported RWAs	298.9	242.7	23
Currency translation adjustment Acquisitions, disposals and dilutions	(18.6)	1.0 (10.0)	
Average underlying RWAs	280.3	233.7	20
Middle East and North Africa	2012	2011	CI
	2012 US\$bn	2011 US\$bn	Change %
Average reported RWAs	61.2	56.9	8
Currency translation adjustment ¹	(0. 5)	(0.3)	
Acquisitions, disposals and dilutions	(0.7)	(1.1)	
Average underlying RWAs	60.5	55.5	9
North America			
	2012 US\$bn	2011 US\$bn	Change %
A DWA			
Average reported RWAs	293.3	331.5 (0.1)	(12)
Acquisitions, disposals and dilutions	(21.3)	(54.9)	
Average underlying RWAs	272.0	276.5	(2)
Latin America			
	2012	2011	Change
	US\$bn	US\$bn	%
Average reported RWAs	101.2	102.5	(1)
Currency translation adjustment ¹	(3.0)	(6.1)	
		(4.0)	_
Average underlying RWAs	98.2	92.4	6

Basel III and its implementation in Europe

Basel III and its implementation in Europe

In July 2011, the European Commission published proposals for a new Regulation and Directive, known collectively as CRD IV, to give effect to the Basel III framework in the EU. The majority of the Basel III proposals are in the Regulation, removing national discretion. However, capital buffers such as those for countercyclical and capital conservation are in the Directive and are subject to transposition into national law by member states. CRD IV implementation has been delayed and the timetable for finalisation is uncertain.

In October 2012, the FSA wrote to large firms to set out the disclosures they are required to make of capital resources on a first year transitional basis under CRD IV. We have made these disclosures in appendix III of the *Pillar 3 Disclosures 2012* report.

Following the FSA's setting of a Capital Resources Floor, and in order to manage our transition to Basel III under CRD IV, we provide below some insight for investors of the possible effects of these rules on our capital position. We have estimated our pro-forma CET1 ratio by applying our interpretation of the CRD IV draft July 2011 text post the transition period (end point CRD IV) to our balance sheet position at 31 December 2012.

In managing our capital position to meet our internal CET1 target, we consider management actions resulting from our six filters strategy that we either have already taken or would take, if the CRD IV rules were to be finalised in the July 2011 form. These are reflected in the table below under 'Estimated regulatory impact of management actions'. Other management actions could be taken depending upon the finalised rules and timing of implementation but, as such, have not been included.

The application of the CRD IV rules on this basis would translate into an estimated CET1 ratio of 9.0% before management actions and 10.3% after such actions, as detailed in the table below.

Constant currency and underlying reconciliations (continued) **Basel III and its implementation in Europe**

Estimated effect of CRD IV end point rules applied to the 31 December 2012 position

	At 31 Dece	mber 2012
	RWAs	Capital
	US\$m	US\$m
Reported core tier 1 capital under the current regime		138,789
Regulatory adjustments applied to core tier 1 in respect of amounts subject to CRD IV treatment		
Investments in own shares through the holding of composite products of which HSBC is a component		
(exchange traded funds, derivatives, and index stock)		(1,322)
Surplus non-controlling interest disallowed in CET1		(2,299)
Removal of filters under current regime		(2,2))
Unrealised gains/(losses) on available-for-sale debt securities		(1,223)
Unrealised gains on available-for-sale equities		2,088
Reserves arising from revaluation of property		1,202
Defined benefit pension fund liabilities		(1,596)
Excess of expected losses over impairment allowances deducted 100% from CET1		(3,084)
Removal of 50% of tax credit adjustment for expected losses		(111)
Securitisations positions risk-weighted under CRD IV		1,776
Deferred tax liabilities on intangibles		267
Deferred tax assets that rely on future profitability (excluding those arising from temporary differences)		(456)
Additional valuation adjustment (referred to as PVA)		(1,720)
Debit valuation adjustment		(372)
Individually immaterial holdings in CET1 capital of banks, financial institutions and insurance in		ζ- /
aggregate above 10% of HSBC CET1		(5,994)
Deductions under threshold approach		() /
Amount exceeding the 10% threshold:		
Significant investments in CET1 capital of banks, financial institutions and insurance		(6,697)
Amount in aggregate exceeding the 15% threshold:		
Significant investments in CET1 capital of banks, financial institutions and insurance		(2,265)
- Deferred tax assets		(1,532)
Estimated CET1 capital under CRD IV		115,451
Reported total RWAs	1,123,943	
Cl		
Changes to capital requirements introduced by CRD IV	(0.2(0	
Credit valuation adjustment	60,360	
Counterparty credit risk (other than credit valuation adjustment)	25,682	
Amounts in aggregate below 15% threshold and therefore subject to 250% risk weight	43,295	
Securitisation positions and free deliveries risk-weighted under CRD IV	44,513 393	
Deferred tax assets moved to threshold deduction under CRD IV		
Deterred tax assets moved to till eshold deduction under CRD TV	(8,976)	
Estimated total RWAs under CRD IV	1,289,210	
Estimated CET1 ratio		9.0%
Estimated regulatory impact of management actions		
Management actions completed in 2013:		
Dilution of our shareholding in Industrial Bank and the subsequent change in accounting treatment	(38,880)	(2,150)
Completion of the second tranche of the sale of Ping An	3,522	9,393
Estimated total after management actions completed in 2013	1,253,852	122,694
Estimated CET1 ratio after management actions completed in 2013		9.8%
Planned short-term management actions if rules are finalised in their current form: Mitigation of immaterial holdings ¹⁴	2,645	7.052
		7,052
Estimated total after planned management actions	1,256,497	129,746
Estimated CET1 ratio after planned management actions		10.3%

Basel III and its implementation in Europe

For the detailed basis of preparation, see page 298 of the Appendix to Capital in the *Annual Report and Accounts 2012*.

The table above presents a reconciliation of our reported core tier 1 capital and RWAs position at 31 December 2012 to the pro-forma estimated CET1 end point capital and estimated RWAs based on our interpretation of the July 2011 draft CRD IV regulation, supplemented by FSA guidance and, in lieu of guidance, our expectation of how these draft rules will be updated following EU negotiations.

CRD IV is not yet in law and its provisions are subject to ongoing negotiation and amendment. As such, the finalised rules could have a materially different effect on CET1 and RWAs.

The CRD IV rule changes introduce a revised definition of regulatory capital, primarily focused on CET1 capital as the predominant form of going concern capital, with a greater quantum to be held by banks. There are increased capital deductions and new regulatory adjustments affecting this higher tier of capital. The new rules also introduce increased RWA requirements, mainly for CCR.

The largest impact on our CET1 capital is the deduction of unconsolidated significant investments in banks, financial institutions and insurance entities of US\$9.0bn (shown as US\$6.7bn and US\$2.3bn in the table above). This results from a reallocation of current deductions to this higher tier of capital and new rules for calculating the amounts to be deducted.

Adding to the above, the regulatory treatment applied to immaterial unconsolidated investments in banks, financial institutions and insurance entities, whereby a maturity restriction does not recognise the netting of long and short positions when the short position is less than one year residual maturity, even though they are hedged from a market risk

perspective. This results in an estimated deduction of US\$6.0bn. The effect on capital is exacerbated by its impact on the threshold for other deductions.

The rules are currently in draft and subject to ongoing negotiation. If they were to be finalised in their current form, the holdings of such positions would generate a disproportionate capital cost and potentially the relevant business could be curtailed, closed or our hedging would be adjusted to negate the impact.

Capital management initiatives and management actions already adopted by the Group, in accordance with our six filters strategic framework, have contributed to mitigating the effect of the future rules. In 2012, this included the continuing run-off of capital intensive portfolios including the US CML and the GB&M legacy credit portfolios and the sale of the Card and Retail Services business. Post year-end, we sold our remaining investment in Ping An and reduced our percentage holding in Industrial Bank following a private placement by the company.

Although the effect of the future CRD IV rules is shown above on an end point basis, the rules allow for a transition period of six years to phase in the new deductions and regulatory adjustments. On a CRD IV first year transitional basis, our CET1 ratio, if applied to our year-end 2012 position, would be 11.5% before management actions.

As a result of the capital resources floor, we currently manage our capital position to meet an internal target CET1 ratio on an end point basis for year end 2013. We will continue to manage our capital position to ensure that it exceeds current regulatory requirements and is well placed to meet expected future regulatory requirements. We will review our capital target ratios on an ongoing basis, reflecting any changes in the regulatory environment as they develop.

Basis of preparation of the estimated effect of the CRD IV end point applied to the 31 December 2012 position

Basis of preparation of the estimated effect of the CRD IV end point applied to the 31 December 2012 position.

The table on page 23 presents a reconciliation of our reported core tier 1 and RWA position at 31 December 2012 to the pro-forma estimated CET1 and estimated RWAs based on the Group's interpretation of the draft July 2011 CRD IV legislation and/or guidance provided by the FSA and, in lieu of guidance, our current expectation of how these draft 2011 rules will be updated by subsequent EU deliberations.

CRD IV has not yet become law and its provisions are subject to on-going negotiation and amendment. In addition, formal Implementing Technical Standards ('ITS') due for issue by the EBA are still to be drafted and finalised, leaving the CRD IV rules subject to significant interpretation. Despite the uncertainty around a number of areas in the rules, our disclosures are based on the draft July 2011 CRD IV text. Pending finalisation of CRD IV, we have not definitively upgraded the models and systems used to calculate capital numbers in a CRD IV environment which, as a consequence, are subject to change. Consequently, the final CRD IV impact on the Group's CET1 and RWAs may be different from our current estimates.

The detailed basis of preparation is described below for items that are different from our current treatment under Basel II. For individual immaterial holdings in banks, financial institutions and insurance that are, in aggregate, above 10% of the Group's CET1 capital, we have included specific short term management actions that could be taken to negate the capital deduction. For other CRD IV proposals, additional management actions could also be taken dependent upon the finalised rules and timing of implementation but, as such, have not been included.

Regulatory adjustments applied to core tier 1 in respect of amounts subject to CRD IV treatment

Investments in own shares through the holding of composite products of which HSBC is a component (exchange traded funds, derivatives, and index stock): the value of our holdings of own CET1 instruments, where it is not already deducted under IFRSs, is deducted from CET1. Under CRD IV, deduction comprises not only direct but also indirect, actual and contingent, banking and trading book gross long positions. Trading book positions are calculated net of short positions only where there is no counterparty credit risk on these short positions (this restriction does not apply to index positions). We have not recognised the benefit of non-index short positions, even where they are executed with central counterparties or are fully collateralised. Under current rules, there is no regulatory adjustment made on the amounts already deducted under IFRS rules.

Surplus non-controlling interest disallowed in CET1: non-controlling interests arising from the issue of common shares by our banking subsidiaries receive limited recognition. The excess over a minimum of 7% of the CET1 of the relevant subsidiary is not allowable in the Group's CET1 to the extent it is attributable to minority shareholders. Under current rules, there is no regulatory restriction applied to these items.

Unrealised gains/(losses) on available-for-sale debt securities: under CRD IV, there is no adjustment to remove from CET1 capital unrealised gains and losses on available-for-sale debt securities. Under current FSA rules, these are removed from capital (net of tax).

Unrealised gains on available-for-sale equities and reserves arising from revaluation of property: there is no adjustment for unrealised gains and losses on reserves arising from the revaluation of property and on available-for-sale equities. Under current FSA rules, unrealised net gains on these items are included in tier 2 capital (net of deferred tax) and net losses are deducted from tier 1 capital.

Defined benefit pension fund liabilities: the amount of retirement benefit liabilities as reported on the balance sheet is fully recognised in CET1 rather than being replaced by any committed funding plans as current FSA rules permit.

Excess of expected losses over impairment allowances deducted 100% from CET1: the amount of excess expected loss over impairment allowance is deducted 100% from CET1. Under current FSA rules, this amount is deducted 50% from CT1 and 50% from total capital.

Removal of 50% of tax credit adjustment for expected losses: the amount of expected losses in excess of impairment allowances that is deducted from CET1 capital is not reduced for any related tax effects. Under current FSA rules, any related tax credit offset is recognised 50% in CT1 and 50% in tier 1 capital.

Securitisation positions risk-weighted under CRD IV: securitisation positions that were deducted from core tier 1 under current rules have been included in RWAs at 1,250%.

Deferred tax liabilities on intangibles: the amount of intangible assets deducted from CET1 has been reduced by

Basis of preparation of the estimated effect of the CRD IV end point applied to the 31 December 2012 position

the related deferred tax liability. Under current rules, the goodwill and intangibles are deducted at their accounting value.

Deferred tax assets that rely on future profitability (excluding those arising from temporary differences): the deferred tax assets that rely on future profitability and do not arise from temporary differences are deducted 100% from CET1. The deferred tax assets that rely on future profitability and arise from temporary differences are subject to the separate threshold deduction approach detailed separately. Under current rules, these items receive a risk weighting of 100%.

Additional valuation adjustment (referred to as prudent valuation adjustment or 'PVA'): under current FSA rules, banks are required to comply with requirements for prudent and reliable valuation of any balance sheet position measured at market or fair value. Under CRD IV, all assets and derivatives measured at fair value are subject to specified standards for prudent valuation, covering uncertainty around the input factors into the fair value valuation models – namely, uncertainty around the mark to market of positions, model risk, valuation of less liquid positions and credit valuation adjustments ('CVA').

Where the accounting fair value calculated under IFRS is higher than the valuation amount resulting from the application of the prudential adjustments, this would result in an additional valuation adjustment or PVA deduction from common equity tier 1 capital.

Following FSA direction, we have included an estimate of the impact of PVA, although there is guidance outstanding following a recent consultation on a related EBA draft regulatory technical standard issued on 13 November 2012. Further clarity on the requirements following finalisation of the EBA process and discussions with our regulator could potentially change this figure.

Debit valuation adjustment ('DVA'): the amount of gains and losses on OTC derivative liabilities that results from changes to our own credit spread are derecognised from CET1.

Individually immaterial holdings in CET1 capital of banks, financial institutions and insurance in aggregate above 10% of HSBC CET1: under CRD IV, the investments in CET1 instruments of banks, financial institutions and insurance entities, where we have a holding of not more than 10% of the CET1 instruments issued by those entities, are deducted from CET1, to the extent the aggregate amount of such holdings exceeds 10% of our CET1 (calculated before any threshold deductions).

The estimated deduction follows the draft July 2011 CRD IV rules and guidance provided by the FSA, which impose a restriction on the netting of long and short positions held in the trading book, whereby the maturity of the short positions has to match the maturity of the long position, or have a residual maturity of no less than a year.

While rules are in draft and this aspect is still being debated, we have disclosed the impact of the rules as written. However, a range of management actions from adjustment to the hedging strategy, curtailment or closure of the business could be applied to mitigate the capital deduction.

Deductions under threshold approach: under CRD IV, where we have a holding of more than 10% of the CET1 instruments issued by banks, financial institutions and insurance entities which is not part of our regulatory consolidation, that holding is subject to a threshold deduction approach. Under current rules, these exposures are deducted 50% from tier 1 capital and 50% from total capital, except for certain insurance holdings that met the requirements under the transitional provision of the current rules and until 31 December 2012 were allowed to be deducted 100% from total capital.

Deferred tax assets that rely on the future profitability of the bank to be realised and which arise from temporary differences are also subject to this threshold deduction approach. Under current rules, these assets would be subject to 100% risk weighting.

Under CRD IV, the amount of such deferred tax assets and significant investments which individually and in aggregate exceed 10% and 15%, respectively, of our CET1 are fully deducted from CET1 capital. Amounts falling below the 10% and 15% thresholds are risk weighted at 250%.

Changes to capital requirements introduced by CRD IV

Credit valuation adjustment: introduced as a new requirement under CRD IV rules, this is a capital charge to cover the risk of mark-to-market losses on expected counterparty risk and referred to as a regulatory CVA risk capital charge.

Basis of preparation of the estimated effect of the CRD IV end point applied to the 31 December 2012 position

We have estimated our regulatory CVA risk capital charge based on the draft July 2011 CRD IV text, calculated on a full range of OTC derivative counterparties without exemptions that may be available under the final CRD IV text. Where we have both specific risk VAR approval and internal model method approval for a product, the CVA VAR approach has been used to calculate the CVA capital charge. Where we do not hold both approvals, the standardised approach has been applied.

Counterparty credit risk (other than credit valuation adjustment): the additional requirements introduced by CRD IV and included in the CCR charge include: the increase in the asset value correlation multiplier for financial counterparties, additional requirements for collateralised counterparties, margin period of risk and new requirements for exposures to central clearing counterparties ('CCPs').

In estimating the amount included for CCPs, we have assumed that all our CCPs are 'qualifying' under the requirements of CRD IV, although this will ultimately depend on confirmation from the competent regulatory authority of the CCP in question that the CCP complies with all the recommendations for CCPs published by the Committee on payment and settlement systems and by the technical committee of the International Organisation of Securities Commissions. Where we do not have full data disclosed for a given CCP, we have assumed full deduction of default fund exposures.

Amounts in aggregate below 15% threshold and therefore subject to 250% risk weight: as explained above, items that fall under the threshold approach treatment under CRD IV, and which are below the 10% and 15% thresholds, are risk-weighted at 250%.

Securitisation positions and free deliveries risk-weighted under CRD IV: securitisation positions which were deducted 50% from core tier 1 and 50% from total capital, and free deliveries that were deducted from total capital under current rules, are now included in RWAs at 1,250%.

Investment in commercial entities now risk-weighted: under CRDIV investments in commercial entities that are not qualifying holdings are risk weighted. These were deducted under the current rules.

Deferred tax assets moved to threshold approach or deduction under CRD IV: deferred tax assets, which were risk-weighted at 100% under the standardised approach under current rules, are treated as a capital deduction from CET1 to the extent they rely on the future profitability of the bank to be realised. Those that do not rely on future profitability shall continue to be risk weighted.

Footnotes

Footnotes

- 1 'Currency translation on adjustment' is the effect of translating the results of subsidiaries and associates for the previous year at the average rates of exchange applicable in the current year.
- 2 Positive numbers are favourable: negative numbers are unfavourable.
- 3 Changes in fair value due to movements in own credit spread on long-term debt issued. This does not include the fair value changes due to own credit spread on structured notes issued, derivatives and other hybrid instruments included within trading liabilities.
- 4 Other income in this context comprises where applicable net trading income, net income/(expense) from other financial instruments designated at fair value, gains less losses from financial investments, dividend income, net earned insurance premiums and other operating income less net insurance claims incurred and movement in liabilities to policyholders.
- 5 Net operating income before loan impairment charges and other credit risk provisions, also referred to as 'revenue'.
- 6 In addition, the operating results of these disposals were removed from underlying profits.
- 7 Underlying performance eliminates the effects of acquisitions, disposals and changes of ownership levels of subsidiaries, associates and businesses so we can view results on a like-for-like basis. We achieve this by eliminating gains and losses on disposal or dilution in the year incurred and by removing material results of operations from all the years presented. For example, if a disposal was made in the current year after four months of operations, the results of the disposed of business would be removed from the results of the current year and the previous year as if the disposed of business did not exist in those years.
- 8 In 2012, Global Markets included an adverse fair value movement of US\$629m on the widening of credit spreads on structured liabilities (2011: favourable fair value movement of US\$458m).
- 9 Total income earned on payments and cash management products in the Group amounted to US\$6.2bn (2011: US\$5.6bn), of which US\$4.5bn was in CMB (2011: US\$4.0bn) and US\$1.7bn was in GB&M (2011: US\$1.5bn).
- 10 Total income earned on other transaction services in the Group amounted to US\$3.5bn (2011: US\$3.2bn), of which US\$2.8bn was in CMB relating to trade and receivables finance (2011: US\$2.6bn) and US\$753m was in GB&M of which US\$738m related to trade and receivables finance (2011: US\$601m) and US\$15m related to banknotes and other (2011: US\$33m).
- 11 In each Group entity, Balance Sheet Management is responsible for managing liquidity and funding under the supervision of the local Asset and Liability Management Committee. Balance Sheet Management also manages the structural interest rate position of the entity within a Global Markets limit structure. Balance Sheet Management revenues include notional tax credits on income earned from tax-exempt investments of US\$116m in 2012 and US\$85m in 2011, which are offset within 'Other'.
- 12 'Other' in GB&M includes net interest earned on free capital held in the global business not assigned to products allocated funding costs and gains resulting from business disposals. Within the management view of total operating income, notional tax credits are allocated to the businesses to reflect the economic benefit generated by certain activities which is not reflected within operating income, for example notional credits on income earned from tax-exempt investments where the economic benefit of the activity is reflected in tax expense. In order to reflect the total operating income on an IFRS basis, the offset to these tax credits are included within 'Other'.
- 13 'China HSBC' is referred to as 'other Mainland China' on page 94 in the Annual Report and Accounts 2012.
- 14 This management action potentially arises only under rules on a CRD IV basis and has therefore not been included in the composition of regulatory capital table, which is drawn up on the basis of the current rules.