

17 Equity shares

	1998		1997	
	<i>Book value</i>	<i>Market valuation</i>	<i>Book value</i>	<i>Market valuation</i>
	US\$m	US\$m	US\$m	US\$m
Investment securities				
— listed on a recognised UK exchange.....	45	84	44	133
— listed in Hong Kong	306	623	356	697
— listed elsewhere.....	122	170	206	380
— unlisted	667	852	438	583
	<u>1,140</u>	<u>1,729</u>	<u>1,044</u>	<u>1,793</u>
Other securities				
— listed on a recognised UK exchange.....	1,400		1,107	
— listed in Hong Kong	14		80	
— listed elsewhere.....	1,550		822	
— unlisted	117		175	
	<u>4,221</u>		<u>3,228</u>	

Where securities are carried at market value, and the market value is higher than cost, the difference between cost and market value is not disclosed as it cannot be determined without unreasonable expense.

Included in the above are 152,955 (1997: 249,440) shares in HSBC Holdings held by subsidiary undertakings as equity market-makers.

Investment securities:

	<i>Cost</i>	<i>Provisions</i>	<i>Book value</i>
	US\$m	US\$m	US\$m
At 1 January 1998.....	1,168	(124)	1,044
Additions	223	—	223
Disposals	(92)	13	(79)
Provisions made	—	(68)	(68)
Provisions released	—	6	6
Provisions written off	(3)	3	—
Exchange and other movements	25	(11)	14
At 31 December 1998.....	<u>1,321</u>	<u>(181)</u>	<u>1,140</u>

The following table provides an analysis of gross unrealised gains and losses as at 31 December for the past two years:

	<i>Carrying value</i>	<i>Gross unrealised gains</i>	<i>Gross unrealised losses</i>	<i>Market valuation</i>
	US\$m	US\$m	US\$m	US\$m
31 December 1998.....	<u>1,140</u>	<u>611</u>	<u>(22)</u>	<u>1,729</u>
31 December 1997	<u>1,044</u>	<u>790</u>	<u>(41)</u>	<u>1,793</u>

The book value of investment securities as at 31 December 1996 was US\$1,288 million.

Proceeds from the sales of investment securities were US\$217 million (1997: US\$819 million). Gross realised gains of US\$145 million (1997: US\$499 million) and gross realised losses of US\$7 million (1997: US\$5 million) were recorded on those sales. Realised gains and losses are computed using the weighted average

Notes on the Financial Statements (continued)

cost method. There were no gains recorded on securities transferred from the investment book to the trading book.

The cost of investment securities purchased during the year ended 31 December 1998 was US\$223 million (1997: US\$115 million).

18 Interests in associated undertakings

At 1 January 1998.....	1998 US\$m
Additions	899
Retained profits	48
Disposals	37
Deficit on revaluation of property	(14)
Exchange and other movements	(94)
At 31 December 1998.....	13
	<u>889</u>

	1998 US\$m	1997 US\$m
(a) Shares in banks	647	562
Other	242	337
	<u>889</u>	<u>899</u>
Listed shares (all listed outside the United Kingdom and Hong Kong)	427	408
Unlisted shares	462	491
	<u>889</u>	<u>899</u>

(b) The principal associated undertakings of HSBC are:

	Financial Statements made up to	Country of incorporation	Principal activity	HSBC's interest in equity capital	Issued equity capital
Barrowgate Limited.....	31.12.98	Hong Kong	Property	25%	#
British Arab Commercial Bank Limited.....	31.12.98	England	Banking	47%	US\$81m
British Interactive Broadcasting Limited.....	31.12.98	England	Digital interactive services	20%	£32m fully paid, £5m nil paid *
The Cyprus Popular Bank Limited.....	31.12.98	Cyprus	Banking	22%	C£75m
Egyptian British Bank S.A.E.	31.12.98	Egypt	Banking	40%	££101m
Máxima S.A. A.F.J.P.....	30.6.98	Argentina	Pension fund management	35%	ARS98m
Mondex Holdings Limited.....	31.12.98	England	Electronic cash	50%	*
The Saudi British Bank.....	31.12.98	Saudi Arabia	Banking	40%	SR1,600m
Wells Fargo HSBC Trade Bank, N.A.	31.12.98	United States	Trade finance	20%	+
World Finance International Limited	30.6.98	Bermuda	Shipping	38%	US\$58m

issued equity capital is less than HK\$1 million.

* issued equity capital is less than £1 million.

+ issued equity capital is less than US\$1 million.

All the above interests in associated undertakings are owned by subsidiaries of HSBC Holdings.

The principal countries of operation are the same as the countries of incorporation, except for World Finance International Limited which operates worldwide.

- (c) The associated undertakings listed above have no loan capital, except for British Arab Commercial Bank Limited which has issued US\$44.5 million of subordinated unsecured loan stock in which HSBC has a 34.7% interest; Barrowgate Limited which has HK\$845 million of loan capital in which HSBC has a 25% interest; and The Cyprus Popular Bank Limited which has issued C£15 million of convertible debentures in which HSBC has a 43.5% interest. HSBC also has a 100% interest in the issued preferred stock (less than US\$1 million) of Wells Fargo HSBC Trade Bank, N.A. HSBC has a 40% economic interest in Wells Fargo HSBC Trade Bank, N.A. by virtue of the joint agreement under which HSBC's equity capital and preferred stock interests are held.

19 Other participating interests

	1998 US\$m	1997 US\$m
Listed other than on a recognised UK exchange or in Hong Kong	4	5
Unlisted	305	315
	<u>309</u>	<u>320</u>
	6	8
Market value of listed securities	<u>287</u>	<u>292</u>
Other participating interests in banks		<i>Carrying value</i>
	<i>Cost</i>	<i>Provisions</i>
	US\$m	US\$m
At 1 January 1998	350	(30)
Additions	7	—
Disposals	(4)	—
Transfers	(7)	—
Provisions made	—	(4)
Provisions written off	(6)	6
Exchange and other movements	(4)	1
At 31 December 1998	<u>336</u>	<u>(27)</u>
		<u>309</u>

20 Intangible fixed assets

	<i>Cost</i> US\$m
<i>Goodwill</i>	—
Cost at 1 January 1998	160
Additions	(4)
Exchange movements	156
Cost at 31 December 1998	<u>156</u>
	<i>Accumulated Amortisation</i>
	US\$m
Accumulated amortisation at 1 January 1998	—
Charge to the profit and loss account	(10)
Accumulated amortisation at 31 December 1998	<u>(10)</u>
Net book value at 31 December 1998 (1997: US\$nil)	<u>146</u>

Additions represent goodwill arising on acquisitions of subsidiaries during 1998 which is being amortised over periods of between 5 and 15 years.

Notes on the Financial Statements (continued)

21 Tangible fixed assets

(a)

	Freehold land and buildings	Long leasehold land and buildings*	Short leasehold land and buildings	Equipment, fixtures and fittings	Equipment on operating leases	Total
	US\$m	US\$m	US\$m	US\$m	US\$m	US\$m
Cost or valuation at 1 January 1998	2,327	3,919	3,070	3,678	3,374	16,368
Additions	119	717	639	603	459	2,537
Disposals	(101)	(9)	(23)	(382)	(253)	(768)
Reclassification	—	243	4	(247)	—	—
Transfer of accumulated depreciation arising on revaluation	(32)	(190)	(55)	—	—	(277)
Impairment of land and buildings	(38)	—	—	—	—	(38)
Deficit on revaluation	(81)	(1,355)	(858)	—	—	(2,294)
Exchange and other movements	17	(11)	1	50	24	81
Cost or valuation at 31 December 1998	2,211	3,314	2,778	3,702	3,604	15,609
Accumulated depreciation at 1 January 1998	—	—	(435)	(2,187)	(712)	(3,334)
Disposals	6	1	16	340	167	530
Reclassification	—	(161)	—	161	—	—
Transfer of accumulated depreciation arising on revaluation	32	190	55	—	—	277
Charge to the profit and loss account	(41)	(45)	(92)	(501)	(225)	(904)
Exchange and other movements	(2)	15	(3)	(56)	(24)	(70)
Accumulated depreciation at 31 December 1998	(5)	—	(459)	(2,243)	(794)	(3,501)
Net book value at 31 December 1998	2,206	3,314	2,319	1,459	2,810	12,108
Net book value at 31 December 1997	2,327	3,919	2,635	1,491	2,662	13,034

* Included in the cost and net book value of long leasehold land and buildings is a payment on account in respect of a long leasehold interest of US\$695 million (1997: US\$nil).

(b) Valuations

	1998 US\$m	1997 US\$m
Cost or valuation of freehold and long and short leasehold land and buildings (excluding investment properties):		
At 1998 valuation (1997: at 1997 valuation)	7,039	7,840
At cost	676	732
	7,715	8,572
On the historical cost basis, freehold and long and short leasehold land and buildings would have been included as follows (excluding investment properties):		
Cost	6,190	4,867
Accumulated depreciation	(863)	(776)
	5,327	4,091

HSBC values its non-investment properties on an annual basis. In November 1998, HSBC's freehold and long leasehold properties, together with all leasehold properties in Hong Kong, were revalued on an existing use basis or open market value as appropriate or, in the case of a few specialised properties, at depreciated replacement cost. The properties were valued either by professional external valuers or by professionally qualified staff.

As a result of the revaluation, the net book value of land and buildings (excluding investment properties) decreased by US\$2,005 million (1997: decrease US\$127 million). A deficit of US\$1,787 million (net of minority interest of US\$218 million) (1997: deficit of US\$112 million, net of minority interest of US\$15 million) was charged to reserves at 31 December 1998.

Included within 'Short leasehold land and buildings' are the following amounts in respect of assets classed as improvements to buildings, which are carried at depreciated historical cost:

	<u>Cost</u>	<u>Accumulated depreciation</u>
	US\$m	US\$m
At 1 January 1998.....	738	(448)
Additions	23	—
Disposals	(120)	114
Charge for the year.....	—	(42)
Exchange and other movements	35	20
At 31 December 1998.....	<u>676</u>	<u>(356)</u>
Net book value at 31 December 1998 (1997: US\$290 million)	<u>320</u>	

(c) *Investment properties*

The valuation at which investment properties are included in HSBC tangible fixed assets, together with the net book value of these properties calculated under the historical cost basis, is as follows:

	1998		1997	
	<u>At valuation</u>	<u>At cost</u>	<u>At valuation</u>	<u>At cost</u>
	US\$m	US\$m	US\$m	US\$m
Freehold land and buildings.....	41	41	41	41
Short and long leasehold land and buildings.....	546	147	699	99
	<u>587</u>	<u>188</u>	<u>740</u>	<u>140</u>

Investment properties are valued on an open market value basis at 31 December annually by professional valuers. Investment properties in Hong Kong, Macau and mainland China, which represent 90% by value of HSBC's properties subject to revaluation, were valued by C Y Leung & Company Limited. The valuations were carried out by qualified valuers who are members of the Hong Kong Institute of Surveyors.

As a result of the revaluation, the net book value of investment properties has decreased by US\$289 million (1997: surplus of US\$2 million). A deficit of US\$190 million (1997: deficit US\$3 million), net of minority interests of US\$99 million (1997: US\$5 million), has been charged to reserves at 31 December 1998.

(d) *HSBC properties leased to customers*

HSBC properties leased to customers included US\$483 million at 31 December 1998 (1997: US\$692 million) let under operating leases, net of accumulated depreciation of US\$21 million (1997: US\$21 million).

(e) *Land and buildings occupied for own activities*

	1998	1997
	US\$m	US\$m
Net book value.....	<u>6,420</u>	<u>7,883</u>

Notes on the Financial Statements (continued)

22 Principal subsidiary undertakings of HSBC Holdings

(a) The principal subsidiary undertakings of HSBC Holdings are:

	Country of incorporation or registration	Principal activity	Issued equity capital
Europe			
HSBC Bank Middle East (formerly The British Bank of the Middle East).....	England	Banking	£150m
Forward Trust Group Limited.....	England	Finance	£265m
HSBC Insurance Brokers Limited (formerly HSBC Gibbs Limited).....	England	Insurance	£3m
HSBC Investment Bank plc.....	England	Investment banking	£180m
Midland Bank plc.....	England	Banking	£797m
Midland Life Limited.....	England	Insurance	£14m
Samuel Montagu & Co. Limited.....	England	Private banking	£112m
HSBC Guyerzeller Bank AG (formerly Guyerzeller Bank AG) (indirect minority)*.....	Switzerland	Banking	SFr5m
HSBC Trinkaus & Burkhardt KGaA (formerly Trinkaus & Burkhardt KGaA) (partnership limited by shares, 73.47% owned).....	Germany	Banking	DM131m
Hong Kong			
Hang Seng Bank Limited (62.14% owned).....	Hong Kong	Banking	HKS9,566m
The Hongkong and Shanghai Banking Corporation Limited.....	Hong Kong	Banking	HKS16,254m
HSBC Insurance Limited.....	Hong Kong	Insurance	HKS125m
HSBC Investment Bank Asia Limited.....	Hong Kong	Investment banking	HKS770m
Wayfoong Finance Limited.....	Hong Kong	Finance	HKS300m
Rest of Asia-Pacific			
HSBC Bank Australia Limited (formerly Hongkong Bank of Australia Limited).....	Australia	Banking	A\$500m
HSBC Bank Malaysia Berhad (formerly Hongkong Bank Malaysia Berhad).....	Malaysia	Banking	MS100m
North America			
HSBC Bank Canada (formerly Hongkong Bank of Canada).....	Canada	Banking	C\$75m
HSBC Americas, Inc.....	United States	Holding company	—#
HSBC Securities, Inc.....	United States	Investment banking	—#
HSBC Bank USA (formerly Marine Midland Bank).....	United States	Banking	US\$185m
Latin America			
Banco HSBC Bamerindus S.A.....	Brazil	Banking	BRL875m
HSBC Bank Argentina S.A. (formerly HSBC Banco Roberts S.A.).....	Argentina	Banking	ARS220m
HSBC Bamerindus Seguros S.A. (99.64% owned)....	Brazil	Insurance	BRL244m
La Buenos Aires Compañía Argentina de Seguros S.A. (98.68% owned).....	Argentina	Insurance	ARS21m

* 15.82% owned by HSBC Trinkaus & Burkhardt KGaA

Issued equity capital is less than US\$1 million

Details of all HSBC companies will be annexed to the next Annual Return of HSBC Holdings.

Except where indicated otherwise, the issued equity capital of the above undertakings is wholly-owned by HSBC and, except for Midland Bank plc, is held by subsidiaries of HSBC Holdings. All the above make their financial statements up to 31 December (including HSBC Bank Canada, which in previous years has had a 31 October year-end), except for HSBC Roberts, whose financial statements are made up to 30 June annually.

The principal countries of operation are the same as the countries of incorporation except for HSBC Bank Middle East which operates mainly in the Middle East. All the above subsidiaries are included in the consolidation.

(b) *Acquisitions*

The fair value adjustments made in 1997 in respect of the acquisition of selected assets, liabilities and subsidiaries of Banco Bamerindus do Brasil were provisional pending completion of the intervention period. On 25 March 1998, the final date of completion of the intervention period, Banco HSBC Bamerindus S.A. assumed pension plan and life and health insurance provisions previously the responsibility of Banco Bamerindus do Brasil until that date.

Cash of US\$377 million, being the fair value of these liabilities (Note 28(b)) was transferred to Banco HSBC Bamerindus S.A. from the Central Bank to meet the obligations. No other significant adjustments to the fair values have been made. No adjustment was required to goodwill.

23 Other assets

	1998 US\$m	1997 US\$m
Bullion.....	309	324
Assets, including gains, resulting from off-balance-sheet interest rate, exchange rate and equities contracts which are marked-to-market.....	18,206	21,669
Current taxation recoverable	140	115
Deferred taxation (Note 28).....	195	96
Long-term assurance assets attributable to policyholders (Note 27).....	7,582	6,741
Other accounts	5,920	4,310
	<u>32,352</u>	<u>33,255</u>

Included in the above are 2,489,911 (1997: 2,458,506) shares in HSBC Holdings held by subsidiary undertakings, as part of their insurance and retirement funds for the benefit of the policyholders.

The composition of the net tangible assets relating to long-term assurance and retirement funds is analysed as follows:

	1998 US\$m	1997 US\$m
Loans and advances to banks — with HSBC companies.....	261	296
Debt securities	2,757	2,660
Equity shares.....	2,811	2,513
Other assets	2,354	2,352
Prepayments and accrued income	40	40
Other liabilities	(641)	(1,120)
	<u>7,582</u>	<u>6,741</u>

Notes on the Financial Statements (continued)

24 Deposits by banks

	1998 US\$m	1997 US\$m
Repayable on demand.....	12,599	11,498
With agreed maturity dates or periods of notice, by remaining maturity:		
— 3 months or less but not repayable on demand.....	17,298	21,847
— 1 year or less but over 3 months.....	3,282	4,798
— 5 years or less but over 1 year.....	1,061	700
— over 5 years.....	102	104
	<u>34,342</u>	<u>38,947</u>
Amounts include:		
Due to associated undertakings.....	47	79
Due to other participating interests.....	4	—

The composition of deposits by banks on a geographical basis is set out below:

	1998			1997		
	<i>Interest-bearing</i>	<i>Non interest-bearing</i>	<i>Total</i>	<i>Interest-bearing</i>	<i>Non interest-bearing</i>	<i>Total</i>
	US\$m	US\$m	US\$m	US\$m	US\$m	US\$m
Europe.....	15,821	3,641	19,462	17,453	2,843	20,296
Hong Kong.....	2,352	265	2,617	4,730	335	5,065
Rest of Asia-Pacific.....	5,345	22	5,367	5,457	51	5,508
North America.....	5,569	90	5,659	6,746	212	6,958
Latin America.....	1,227	10	1,237	1,117	3	1,120
	<u>30,314</u>	<u>4,028</u>	<u>34,342</u>	<u>35,503</u>	<u>3,444</u>	<u>38,947</u>

The geographical analysis of deposits is based on the location of the office in which the deposits are recorded and excludes balances with HSBC companies.

25 Customer accounts

	1998 US\$m	1997 US\$m
Repayable on demand.....	136,722	134,988
With agreed maturity dates or periods of notice, by remaining maturity:		
— 3 months or less but not repayable on demand.....	148,597	140,278
— 1 year or less but over 3 months.....	16,417	14,103
— 5 years or less but over 1 year.....	5,136	3,459
— over 5 years.....	2,038	1,361
	<u>308,910</u>	<u>294,189</u>
Amounts include:		
Due to associated undertakings.....	29	40

Notes on the Financial Statements (continued)

24 Deposits by banks

	1998 US\$m	1997 US\$m
Repayable on demand.....	12,599	11,498
With agreed maturity dates or periods of notice, by remaining maturity:		
— 3 months or less but not repayable on demand.....	17,298	21,847
— 1 year or less but over 3 months.....	3,282	4,798
— 5 years or less but over 1 year.....	1,061	700
— over 5 years.....	102	104
	<u>34,342</u>	<u>38,947</u>
Amounts include:		
Due to associated undertakings.....	47	79
Due to other participating interests.....	4	—

The composition of deposits by banks on a geographical basis is set out below:

	1998			1997		
	<i>Interest-bearing</i>	<i>Non interest-bearing</i>	<i>Total</i>	<i>Interest-bearing</i>	<i>Non interest-bearing</i>	<i>Total</i>
	US\$m	US\$m	US\$m	US\$m	US\$m	US\$m
Europe.....	15,821	3,641	19,462	17,453	2,843	20,296
Hong Kong.....	2,352	265	2,617	4,730	335	5,065
Rest of Asia-Pacific.....	5,345	22	5,367	5,457	51	5,508
North America.....	5,569	90	5,659	6,746	212	6,958
Latin America.....	1,227	10	1,237	1,117	3	1,120
	<u>30,314</u>	<u>4,028</u>	<u>34,342</u>	<u>35,503</u>	<u>3,444</u>	<u>38,947</u>

The geographical analysis of deposits is based on the location of the office in which the deposits are recorded and excludes balances with HSBC companies.

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— 5 years or less but over 1 year.....	5,136	3,459
— over 5 years.....	2,038	1,361
	<u>308,910</u>	<u>294,189</u>
Amounts include:		
Due to associated undertakings.....	29	40

The composition of customer accounts on a geographical basis is set out below:

	1998			1997		
	<i>Interest-bearing</i>	<i>Non interest-bearing</i>	<i>Total</i>	<i>Interest-bearing</i>	<i>Non interest-bearing</i>	<i>Total</i>
	US\$m	US\$m	US\$m	US\$m	US\$m	US\$m
Europe	97,957	12,240	110,197	89,852	11,614	101,466
Hong Kong	115,903	4,552	120,455	100,698	5,166	105,864
Rest of Asia-Pacific	32,051	3,421	35,472	29,971	3,691	33,662
North America	26,448	6,953	33,401	34,743	7,627	42,370
Latin America	8,727	658	9,385	9,795	1,032	10,827
	<u>281,086</u>	<u>27,824</u>	<u>308,910</u>	<u>265,059</u>	<u>29,130</u>	<u>294,189</u>

The geographical analysis of deposits is based on the location of the office in which the deposits are recorded and excludes balances with HSBC companies.

26 Debt securities in issue

	1998 US\$m	1997 US\$m
Bonds and medium-term notes, by remaining maturity:		
— within 1 year	1,895	1,100
— between 1 and 2 years	1,752	468
— between 2 and 5 years	3,409	3,002
— over 5 years	165	231
	<u>7,221</u>	<u>4,801</u>
Other debt securities in issue, by remaining maturity:		
— 3 months or less	10,025	10,933
— 1 year or less but over 3 months	7,537	7,443
— 5 years or less but over 1 year	4,007	4,470
— over 5 years	400	98
	<u>29,190</u>	<u>27,745</u>

Notes on the Financial Statements (continued)

27 Other liabilities

	1998 US\$m	1997 US\$m
Short positions in securities:		
Treasury bills and other eligible bills	1,627	1,729
Debt securities		
— government securities	8,732	7,161
— other public sector securities	94	40
— other debt securities	524	949
Equity shares	674	810
	<u>11,651</u>	<u>10,689</u>
Liabilities, including losses, resulting from off-balance-sheet interest rate, exchange rate and equities contracts which are marked-to-market	19,615	21,959
Current taxation	1,273	1,886
Obligations under finance leases	310	293
Dividend payable by HSBC Holdings	1,499	1,332
Long-term assurance liabilities attributable to policyholders (Note 23)	7,582	6,741
Other liabilities	6,732	6,776
	<u>48,662</u>	<u>49,676</u>
Obligations under finance leases fall due as follows:		
— within 1 year	33	21
— between 1 and 5 years	7	10
— over 5 years	270	262
	<u>310</u>	<u>293</u>

28 Provisions for liabilities and charges

(a) Deferred taxation

(i) Deferred taxation is provided for in accordance with HSBC's accounting policy in Note 2(g).

	US\$m
At 1 January 1998	843
Credit to profit and loss account (Note 6)	(71)
Advance corporation tax utilised	331
Exchange and other movements	(30)
At 31 December 1998	<u>1,073</u>

	1998 US\$m	1997 US\$m
Included in 'Provisions for liabilities and charges'.....	1,268	939
Included in 'Other assets' (Note 23).....	(195)	(96)
Net deferred taxation provision.....	<u>1,073</u>	<u>843</u>
Comprising:		
Short-term timing differences.....	(21)	30
Leasing transactions.....	985	891
Relief for tax losses.....	(11)	(12)
Advance corporation tax on dividends proposed.....	—	(331)
Provision for additional UK tax on profit remittances from overseas.....	232	233
Other items.....	(112)	32
	<u>1,073</u>	<u>843</u>

There is no material deferred taxation liability not provided for.

- (ii) The distribution of the reserves of certain subsidiary and associated undertakings may give rise to additional tax liabilities. Of the US\$304 million provision for a potential UK tax charge established upon the acquisition of Midland, US\$232 million remained at 31 December 1998 (1997: US\$233 million).
- (iii) No provision is made for deferred taxation on revalued premises. The Directors are of the opinion that, in respect of properties occupied for the purposes of HSBC's business, the likelihood of a material taxation liability arising is remote and no useful purpose would be served by attempting to quantify it. In respect of investment and other properties which have been revalued, no material taxation liability is judged likely to arise in the foreseeable future under management's current intentions for these properties.
- (iv) At 31 December 1998, there were potential future tax benefits of approximately US\$380 million (1997: US\$410 million) in respect of trading losses, allowable expenditure charged to the profit and loss account but not yet allowed for tax and capital losses which have not been recognised because recoverability of the potential benefits is not considered certain.
- (b) *Other provisions for liabilities and charges*

	<i>Provisions for pension and other post- retirement obligations</i>	<i>Provisions for contingent liabilities and commitments</i>	<i>Insurance and other provisions</i>	<i>Total</i>
	US\$m	US\$m	US\$m	US\$m
At 1 January 1998.....	326	501	1,306	2,133
Provisions assumed (Note 22(b)).....	377	—	—	377
Charge to the profit and loss account.....	49	144	1,097	1,290
Provisions utilised.....	(36)	(62)	(876)	(974)
Transfers.....	50	(227)	320	143
Exchange and other movements.....	(16)	(61)	14	(63)
At 31 December 1998.....	<u>750</u>	<u>295</u>	<u>1,861</u>	<u>2,906</u>

Pension provisions assumed relate to amounts transferred to Banco HSBC Bamerindus S.A. which were previously the responsibility of Banco Bamerindus do Brasil until 25 March 1998. This transfer arose on completion of the intervention period.

Notes on the Financial Statements (continued)

29 Subordinated liabilities

	1998 US\$m	1997 US\$m
Undated subordinated loan capital:		
— HSBC Holdings	—	—
— other HSBC	3,247	3,245
	<u>3,247</u>	<u>3,245</u>
Dated subordinated loan capital:		
— HSBC Holdings	1,343	1,336
— other HSBC	6,254	5,945
	<u>7,597</u>	<u>7,281</u>
Total subordinated liabilities:		
— HSBC Holdings	1,343	1,336
— other HSBC	9,501	9,190
	<u>10,844</u>	<u>10,526</u>
Dated subordinated loan capital is repayable:		
— within 1 year	624	66
— between 1 and 2 years	266	588
— between 2 and 5 years	2,072	1,509
— over 5 years	4,635	5,118
	<u>7,597</u>	<u>7,281</u>
The total subordinated borrowings of HSBC Holdings are as follows:		
£413m 11.69% subordinated bonds 2002	685	681
£250m 9.875% subordinated bonds 2018	408	405
US\$250m Subordinated collared floating rate notes 2008	250	250
	<u>1,343</u>	<u>1,336</u>
Amounts owed to HSBC undertakings:		
US\$350m 7.525% subordinated loan 2003 — HSBC Finance Nederland B.V....	349	348
	<u>1,692</u>	<u>1,684</u>
HSBC Holdings' dated subordinated loan capital is repayable:		
— between 2 and 5 years	1,034	681
— over 5 years	658	1,003
	<u>1,692</u>	<u>1,684</u>

At 31 December 1998, the following other HSBC subordinated borrowings were US\$200 million or over:

		1998 US\$m	1997 US\$m
US\$1,200m	Primary capital subordinated undated floating rate notes.....	1,200	1,200
US\$750m	Undated floating rate primary capital notes.....	750	750
US\$500m	Undated floating rate primary capital notes.....	500	500
US\$500m	7.625% subordinated notes 2006.....	500	500
£250m	Subordinated unsecured floating rate notes 2001.....	414	412
US\$400m	8.625% subordinated notes 2004.....	400	400
HK\$3,000m	Subordinated collared (7% to 9%) floating rate notes 2003.....	388	388
US\$350m	7.4% subordinated guaranteed notes 2003.....	350	350
£200m	9% subordinated notes 2005.....	332	329
£200m	6.5% subordinated notes 2023*.....	327	—
US\$300m	Undated floating rate primary capital notes (Series 3).....	300	300
US\$300m	6.95% subordinated notes 2011.....	300	300
US\$300m	7.65% subordinated notes 2025.....	300	300
US\$300m	7% fixed rate subordinated notes 2006.....	298	298
£150m	9.25% step-up undated subordinated notes.....	248	247
£150m	8.625% step-up undated subordinated notes.....	248	247
£150m	Subordinated step-up coupon floating rate notes 2007.....	248	247
¥24.8bn	Fixed rate (5.0% to 5.5%) subordinated loans 2004.....	218	189
US\$200m	7.808% capital securities 2026.....	200	200
US\$200m	8.38% capital securities 2027.....	200	200
US\$200m	Guaranteed floating rate notes 1999.....	200	200
US\$200m	Floating rate subordinated notes 2000.....	200	200
	Other subordinated liabilities less than US\$200m.....	1,380	1,433
		<u>9,501</u>	<u>9,190</u>

* The proceeds of the issue of 6.5% subordinated notes 2023 were used to support the development of Midland and to strengthen further Midland's capital base.

Subordinated loan capital is repayable at par on maturity, but some is repayable prior to maturity at the option of the borrower, generally with the consent of the Financial Services Authority, in certain cases at a premium over par. Interest rates on the floating rate loan capital are related to interbank offered rates. On the remaining subordinated loan capital, interest is payable at fixed rates up to 14%.

30 Minority interests — non-equity

Preference shares issued by subsidiaries:

	1998 US\$m	1997 US\$m
US\$875m Non-cumulative preference shares.....	<u>870</u>	<u>850</u>

31 Called up share capital

Authorised:

The authorised ordinary share capital of HSBC Holdings at 31 December 1998, 1997 and 1996 is HK\$20,000 million divided into 2,000 million ordinary shares of HK\$10 each, £1,125 million divided into 1,500 million ordinary shares of 75p each, and £301,500 divided into 301,500 non-voting deferred shares of £1 each. In addition, at 31 December 1998, 1997 and 1996, the authorised preference share capital of HSBC Holdings is £500 million divided into 500 million non-cumulative preference shares of £1 each.

The disclosure in this note has not been restated to reflect the share capital reorganisation. See Note 46 'Subsequent events'.

Notes on the Financial Statements (continued)

	<i>Number of HK\$10 shares</i>	<i>Number of 75p shares</i>	<i>US\$m</i>
Issued:			
At 1 January 1998.....	1,801,612,569	874,130,350	3,406
Shares issued under option schemes	—	2,427,043	3
Shares issued in lieu of dividends.....	14,495,821	6,392,205	27
Exchange movements.....	—	—	7
At 31 December 1998.....	<u>1,816,108,390</u>	<u>882,949,598</u>	<u>3,443</u>
Issued:			
At 1 January 1997.....	1,790,628,607	870,556,852	3,426
Shares issued under option schemes	—	2,197,519	3
Shares issued in lieu of dividends.....	10,983,962	1,375,979	16
Exchange movements.....	—	—	(39)
At 31 December 1997	<u>1,801,612,569</u>	<u>874,130,350</u>	<u>3,406</u>
Issued:			
At 1 January 1996.....	1,774,582,999	860,306,302	3,296
Shares issued under option schemes	—	8,373,419	10
Shares issued in lieu of dividends.....	16,045,608	1,877,131	23
Exchange movements.....	—	—	97
At 31 December 1996	<u>1,790,628,607</u>	<u>870,556,852</u>	<u>3,426</u>

The 301,500 non-voting deferred shares are held by a subsidiary undertaking of HSBC Holdings.

Options outstanding to subscribe for HSBC Holdings' ordinary shares of 75p each under HSBC's Executive and Savings-Related Share Option Schemes and Midland's Executive and Savings-Related Share Option Schemes are as follows:

	<i>Number of shares</i>	<i>Period of exercise</i>	<i>Exercise price</i>
31 December 1998.....	46,150,679	1999 to 2008	£1.1843 to £23.395
31 December 1997	43,496,592	1998 to 2007	£1.1843 to £23.395
31 December 1996	38,376,784	1997 to 2006	£1.1843 to £10.00

32 Reserves

	<i>HSBC</i>	<i>Associated undertakings</i>
	<i>US\$m</i>	<i>US\$m</i>
Share premium account:		
At 1 January 1998.....	489	—
Shares issued under option schemes	14	—
Shares issued in lieu of dividends and associated issue costs.....	(27)	—
Exchange movements.....	4	—
At 31 December 1998.....	<u>480</u>	<u>—</u>

	<i>HSBC</i>	<i>Associated undertakings</i>
	<i>US\$m</i>	<i>US\$m</i>
Revaluation reserves:		
— Investment property revaluation reserve:		
At 1 January 1998	516	104
Unrealised deficit on revaluation of land and buildings	(246)	(56)
Transfer from revaluation reserve	59	—
Realisation on disposal of properties	(1)	—
At 31 December 1998	<u>328</u>	<u>48</u>
— Revaluation reserve:		
At 1 January 1998	3,746	8
Realisation on disposal of properties	(12)	—
Impairment of land and buildings	(38)	—
Unrealised (deficit) on revaluation of HSBC properties	(1,787)	—
Transfer of depreciation from profit and loss account reserve	(52)	—
Transfer to investment property revaluation reserve	(59)	—
Exchange and other movements	(6)	—
At 31 December 1998	<u>1,792</u>	<u>8</u>
Total revaluation reserves	<u>2,120</u>	<u>56</u>
Profit and loss account:		
At 1 January 1998	18,923	163
Retained profit for the year	1,823	126
Transfer of depreciation to revaluation reserve	52	—
Realisation on disposal of properties	13	—
Arising on shares issued in lieu of dividends	584	—
Exchange and other movements	(36)	(42)
At 31 December 1998	<u>21,359</u>	<u>247</u>

The accumulated foreign exchange translation adjustment as at 31 December 1998 reduced HSBC's reserves by US\$448 million (1997: US\$421 million).

Notes on the Financial Statements (continued)

	1997		1996	
	<i>HSBC</i>	<i>Associated undertakings</i>	<i>HSBC</i>	<i>Associated undertakings</i>
	US\$m	US\$m	US\$m	US\$m
Share premium account:				
At 1 January	509	—	476	—
Shares issued under option schemes	14	—	11	—
Shares issued in lieu of dividends and associated issue costs	(16)	—	(23)	—
Exchange movements	(18)	—	45	—
At 31 December	<u>489</u>	<u>—</u>	<u>509</u>	<u>—</u>
Reserves:				
Merger reserve				
At 1 January	44	—	230	—
Goodwill written off on acquisition	(43)	—	(191)	—
Exchange movements	(1)	—	5	—
At 31 December	<u>—</u>	<u>—</u>	<u>44</u>	<u>—</u>
Revaluation reserves:				
— Investment property revaluation reserve				
At 1 January	532	92	528	70
Unrealised surplus on revaluation of land and buildings	10	13	36	20
Transfer to revaluation reserve	(8)	—	(49)	—
Realisation on disposal of properties	(11)	—	(2)	—
Exchange and other movements	(7)	(1)	19	2
At 31 December	<u>516</u>	<u>104</u>	<u>532</u>	<u>92</u>
— Revaluation reserve:				
At 1 January	4,056	5	2,914	3
Realisation on disposal of properties	(29)	—	(2)	—
Unrealised (deficit)/surplus on revaluation of HSBC properties	(112)	—	1,087	2
Transfer of permanent diminution in value of land and buildings to profit and loss reserve	—	—	14	—
Transfer of depreciation from profit and loss account reserve	(55)	—	(58)	—
Transfer from investment property revaluation reserve	8	—	49	—
Exchange and other movements	(122)	3	52	—
At 31 December	<u>3,746</u>	<u>8</u>	<u>4,056</u>	<u>5</u>
Total revaluation reserves	<u>4,262</u>	<u>112</u>	<u>4,588</u>	<u>97</u>

Notes on the Financial Statements (continued)

	1997		1996	
	HSBC US\$m	Associated undertakings US\$m	HSBC US\$m	Associated undertakings US\$m
Share premium account:				
At 1 January	509	—	476	—
Shares issued under option schemes	14	—	11	—
Shares issued in lieu of dividends and associated issue costs	(16)	—	(23)	—
Exchange movements	(18)	—	45	—
At 31 December	<u>489</u>	<u>—</u>	<u>509</u>	<u>—</u>
Reserves:				
Merger reserve				
At 1 January	44	—	230	—
Goodwill written off on acquisition	(43)	—	(191)	—
Exchange movements	(1)	—	5	—
At 31 December	<u>—</u>	<u>—</u>	<u>44</u>	<u>—</u>
Revaluation reserves:				
— Investment property revaluation reserve				
At 1 January	532	92	528	70
Unrealised surplus on revaluation of land and buildings	10	13	36	20
Transfer to revaluation reserve	(8)	—	(49)	—
Realisation on disposal of properties	(11)	—	(2)	—
Exchange and other movements	(7)	(1)	19	2
At 31 December	<u>516</u>	<u>104</u>	<u>532</u>	<u>92</u>
— Revaluation reserve:				
At 1 January	4,056	5	2,914	3
Realisation on disposal of properties	(29)	—	(2)	—
Unrealised (deficit)/surplus on revaluation of HSBC properties	(112)	—	1,087	2
Transfer of permanent diminution in value of land and buildings to profit and loss reserve	—	—	14	—
Transfer of depreciation from profit and loss account reserve	(55)	—	(58)	—
Transfer from investment property revaluation reserve	8	—	49	—
Exchange and other movements	(122)	3	52	—
At 31 December	<u>3,746</u>	<u>8</u>	<u>4,056</u>	<u>5</u>
Total revaluation reserves	<u>4,262</u>	<u>112</u>	<u>4,588</u>	<u>97</u>

	1997		1996	
	<i>HSBC</i>	<i>Associated undertakings</i>	<i>HSBC</i>	<i>Associated undertakings</i>
	US\$m	US\$m	US\$m	US\$m
Profit and loss account:				
At 1 January	17,266	160	13,332	144
Retained profit for the year	3,281	28	3,114	6
Goodwill written off on acquisitions	(1,137)	—	(20)	—
Goodwill written back on part disposal of associated undertakings	—	—	14	—
Transfer of depreciation to revaluation reserve	55	—	58	—
Transfer of permanent diminution in value of land and buildings from revaluation reserve	—	—	(14)	—
Realisation on disposal of properties	40	—	4	—
Arising on shares issued in lieu of dividends	337	—	300	—
Exchange and other movements	(919)	(25)	478	10
At 31 December	<u>18,923</u>	<u>163</u>	<u>17,266</u>	<u>160</u>

In 1998, HSBC adopted FRS 10, 'Goodwill and intangible fixed assets'. Prior to 1 January 1998, goodwill amounting to US\$5,136 million (1996: US\$3,999 million) had been charged against reserves in respect of acquisitions of subsidiaries in prior years. In 1997, goodwill written off includes a write-back of US\$35 million in respect of deferred consideration on the acquisition of J P Morgan's domestic US dollar clearing business.

Many of HSBC's banking subsidiary and associated undertakings operate under local regulatory jurisdictions which could potentially restrict the amount of reserves which can be remitted to HSBC Holdings in order to maintain local regulatory capital ratios. In addition, as stated in Note 28 (a) (ii) above, the remittance of reserves may result in further taxation liabilities.

33 Analysis of total assets and total liabilities

(a) Assets and liabilities denominated in foreign currency

	1998	1997
	US\$m	US\$m
Denominated in US dollars	154,124	169,346
Denominated in currencies other than US dollars	329,004	302,340
Total assets	<u>483,128</u>	<u>471,686</u>
Denominated in US dollars	142,672	172,362
Denominated in currencies other than US dollars	340,456	299,324
Total liabilities	<u>483,128</u>	<u>471,686</u>

(b) Assets subject to sale and repurchase transactions

	1998	1997
	US\$m	US\$m
Total assets subject to sale and repurchase transactions	<u>15,204</u>	<u>10,104</u>

(c) Assets leased to customers

	1998	1997
	US\$m	US\$m
Loans and advances to customers	7,723	7,665
Tangible fixed assets — equipment on operating leases (Note 21(a))	2,810	2,662
	<u>10,533</u>	<u>10,327</u>

Notes on the Financial Statements (continued)

The cost of assets acquired during 1998 for letting to customers under finance leases and hire purchase contracts by HSBC amounted to US\$3,522 million (1997: US\$4,477 million).

(d) Assets charged as security for liabilities

HSBC has pledged assets as security for liabilities included under the following headings:

	<i>Amount of liability secured</i>	
	1998 US\$m	1997 US\$m
Deposits by banks	807	399
Customer accounts	1,678	1,985
Debt securities in issue	1,790	1,125
Other liabilities	1,652	1,650
	<u>5,927</u>	<u>5,159</u>

The amount of assets pledged to secure these amounts is US\$15,196 million (1997: US\$13,685 million). This is mainly made up of items included in 'Debt securities' and 'Treasury bills and other eligible bills' of US\$11,790 million (1997: US\$10,302 million).

34 Memorandum items

(a)

	1998			1997		
	<i>Contract amount</i>	<i>Credit equivalent amount</i>	<i>Risk-weighted amount</i>	<i>Contract amount</i>	<i>Credit equivalent amount</i>	<i>Risk-weighted amount</i>
	US\$m	US\$m	US\$m	US\$m	US\$m	US\$m
Contingent liabilities:						
Acceptances and endorsements ...	4,032	3,202	3,151	4,814	3,498	3,383
Guarantees and assets pledged as collateral security:						
— guarantees and irrevocable letters of credit.	23,686	18,427	16,618	20,563	15,590	13,787
Other contingent liabilities	64	64	54	104	104	79
	<u>27,782</u>	<u>21,693</u>	<u>19,823</u>	<u>25,481</u>	<u>19,192</u>	<u>17,249</u>

	1998			1997		
	<i>Contract amount</i>	<i>Credit equivalent amount</i>	<i>Risk-weighted amount</i>	<i>Contract amount</i>	<i>Credit equivalent amount</i>	<i>Risk-weighted amount</i>
	US\$m	US\$m	US\$m	US\$m	US\$m	US\$m
Commitments:						
Documentary credits and short-term trade-related transactions .	5,927	1,973	1,166	8,396	2,327	1,745
Forward asset purchases and forward deposits placed	893	623	212	1,187	966	445
Undrawn note issuing and revolving underwriting facilities.....	405	203	203	148	74	74
Undrawn formal standby facilities, credit lines and other commitments to lend:						
— over 1 year	27,028	13,505	12,606	26,357	13,171	12,233
— 1 year and under	112,399	—	—	100,200	—	—
	<u>146,652</u>	<u>16,304</u>	<u>14,187</u>	<u>136,288</u>	<u>16,538</u>	<u>14,497</u>

The table above gives the nominal principal amounts, credit equivalent amounts and risk-weighted amounts of off-balance-sheet transactions. The credit equivalent amounts are calculated for the purposes of deriving the risk-weighted amounts. These are assessed in accordance with the Financial Services Authority's guidelines which implement the Basle agreement on capital adequacy and depend on the status of the counterparty and the maturity characteristics.

Contingent liabilities and commitments are credit-related instruments which include acceptances, letters of credit, guarantees and commitments to extend credit. The contractual amounts represent the amounts at risk should the contract be fully drawn upon and the client default. Since a significant portion of guarantees and commitments are expected to expire without being drawn upon, the total of the contract amounts is not representative of future liquidity requirements.

Derivatives contracts

	1998		1997	
	<i>Contract amount</i>	<i>Replacement cost</i>	<i>Contract amount</i>	<i>Replacement cost</i>
	US\$m	US\$m	US\$m	US\$m
Exchange rate contracts.....	765,665	8,899	746,969	14,273
Interest rate contracts	1,060,563	7,297	866,546	5,177
Equities contracts.....	29,799	2,218	21,964	2,017
Total	<u>1,856,027</u>	<u>18,414</u>	<u>1,635,479</u>	<u>21,467</u>

Derivatives are financial instruments whose characteristics are derived from those of underlying assets, interest and exchange rates or indices. They include futures, forwards, swap and options transactions in the foreign exchange, interest rate and equity markets. For further information see Note 35.

Included in the above table, which excludes contracts made with other HSBC counterparties, there are US\$760,725 million (1997: US\$741,692 million) contract amount of exchange rate contracts, US\$1,033,299 million (1997: US\$828,405 million) contract amount of interest rate contracts and US\$29,475 million (1997: US\$21,770 million) contract amount of equities contracts which were made for trading purposes. The remaining exchange rate, interest rate and equities contracts were made for non-

Notes on the Financial Statements (continued)

trading purposes. Non-trading contracts are also made with HSBC counterparties and further analysis of HSBC's trading and non-trading contracts is provided in Note 35.

The notional or contractual amounts of these instruments indicate the volume of transactions outstanding at the balance sheet date; they do not represent amounts at risk.

Replacement cost of contracts represents the mark-to-market assets on all contracts with a positive value i.e. an asset to HSBC. Replacement cost is therefore a close approximation of the credit risk for these contracts as at the balance sheet date. The actual credit risk is monitored internally and is the sum of positive mark-to-market value and an estimate for the future fluctuation risk, using a future risk factor.

(b) Concentrations of contingent liabilities and commitments

HSBC has the following concentrations of exposure to contingent liabilities and commitments and is determined on the basis set out in Note 42:

Contract amounts

	<i>Europe</i>	<i>Hong Kong</i>	<i>Rest of Asia-Pacific</i>	<i>North America</i>	<i>Latin America</i>	<i>Total</i>
	US\$m	US\$m	US\$m	US\$m	US\$m	US\$m
Contingent liabilities						
1998.....	<u>13,607</u>	<u>4,598</u>	<u>6,170</u>	<u>2,858</u>	<u>549</u>	<u>27,782</u>
1997.....	<u>12,410</u>	<u>3,651</u>	<u>6,351</u>	<u>2,782</u>	<u>287</u>	<u>25,481</u>
Commitments						
1998.....	<u>57,880</u>	<u>38,200</u>	<u>20,883</u>	<u>27,363</u>	<u>2,326</u>	<u>146,652</u>
1997.....	<u>53,188</u>	<u>41,623</u>	<u>18,919</u>	<u>21,061</u>	<u>1,497</u>	<u>136,288</u>

35 Derivatives

Derivatives are generally either negotiated over-the-counter (OTC) or dealt through exchanges. OTC traded derivatives are tailored to the requirements of HSBC or its customers although most transactions are carried out under a master agreement which allows legal offset of outstanding balances should a counterparty default. Netting is further discussed under 'Risks associated with derivatives' below. Exchange traded derivatives generally have standardised terms with the exchange acting as a clearing house for the buyer and seller, and gains and losses are subject to daily margining requirements that are settled daily.

Nature and terms of derivatives

The following outlines the nature and terms of the most common types of derivatives used by HSBC.

Exchange rate contracts

Forward foreign exchange contracts are agreements to buy or sell fixed amounts of currency at agreed rates of exchange on a specified future date.

Cross currency swaps are agreements to exchange, and on termination of the swap re-exchange, principal amounts denominated in different currencies. Cross currency swaps may involve the exchange of interest payments in one specified currency for interest payments in another specified currency for a specified period.

Currency futures are typically exchange-traded agreements to buy or sell standard amounts of a specified currency at an agreed exchange rate on a standard future date.

Currency options give the buyer on payment of a premium the right, but not the obligation, to buy or sell specified amounts of currency at agreed rates of exchange on or before a specified future date.

Interest rate contracts

Interest rate swaps involve the exchange of interest rate obligations with a counterparty for a specified period without exchanging the underlying (or notional) principal. HSBC may enter a swap transaction either as an intermediary or as a direct counterparty.

Interest rate futures are typically exchange-traded agreements to buy or sell a standard amount of a specified fixed income security or time deposit at an agreed interest rate on a standard future date.

Forward rate agreements give the buyer the ability to determine the underlying rate of interest for a specified period commencing on a specified future date (the 'settlement date'). There is no exchange of principal and settlement is effected on the settlement date. The settlement amount is calculated by reference to the difference between the contract rate and the market rate prevailing on the settlement date.

Interest rate options give the buyer on payment of a premium the right, but not the obligation, to fix the rate of interest on a future deposit or loan, for a specified period and commencing on a specified future date.

Interest rate caps and floors give the buyer the ability to fix the maximum or minimum rate of interest. There is no facility to deposit or draw down funds; instead the writer pays to the buyer the amount by which the market rate exceeds or is less than the cap rate or the floor rate respectively. A combination of an interest rate cap and floor is known as an interest rate collar.

Equities contracts

Equities options give the buyer on payment of a premium the right, but not the obligation, to buy or sell a specified amount of equities or a basket of equities in the form of published indices.

Equities futures are typically exchange-traded agreements to buy or sell a standard quantity of a specific equity at a future date, at a price decided at the time the contract is made, and may be settled in cash or through delivery.

Uses of derivatives

Users of derivatives typically want to hedge an unwanted risk generated by their business or alter the financial characteristics and risks profile of financial instruments within their business to a more acceptable risk, or convert such risks to cash. Derivatives provide an effective tool for companies to utilise within the management of the financial risks associated with their business and, as a consequence, there has been a significant growth in derivatives transactions in recent years.

HSBC undertakes derivative transactions for both trading and non-trading purposes.

Trading

Trading transactions include transactions, together with any related hedges, undertaken for the following purposes:

- market-making;
- to service customers' needs, including structuring deals to produce risk-management products to suit individual customers; and
- proprietary trading.

Non-trading

Non-trading transactions, primarily interest rate swaps, are undertaken to manage HSBC's own asset and liability portfolios and structural positions. Derivatives are used to hedge exposures to interest rate and currency fluctuations and to modify the interest rate characteristics of other financial instruments.

Derivatives used for trading and non-trading purposes are, where appropriate, discussed separately in the following sections.

Notes on the Financial Statements (continued)

Risks associated with derivatives

Derivative instruments are subject to both market risk and credit risk.

Market risk

Market risk on derivative instruments is the exposure created by potential fluctuations in interest rates, foreign exchange rates and equity prices. The market risk associated with derivatives can be significant since large positions can be accumulated with a substantially smaller initial outlay than required in cash markets. In the event of market illiquidity, price movements can be significant and it may not be possible to liquidate positions at or near the theoretical or indicative prices used to mark positions. Recognising this, only certain offices within major subsidiaries with sufficient derivative product expertise and appropriate control systems are authorised to trade derivative products. The management of market risk arising from derivatives business is monitored, in combination with market risks arising from on-balance-sheet instruments, by Group Market Risk.

Credit risk

The credit risk relative to a derivative is principally the replacement cost of any contract with a positive mark-to-market gain together with an estimate for the potential future change in value, reflecting the volatilities affecting the contract. Credit risk on contracts having a negative mark-to-market value is restricted to the potential future change in value. The credit risk on derivatives is, therefore, small in relation to a comparable balance sheet risk, where the credit risk is typically the full amount of the principal value, together with any unrealised interest accrued or mark-to-market gain.

Through the dealing operations of HSBC, significant open positions in derivative portfolios can be accumulated. These positions are managed constantly to ensure that they are within acceptable risk levels with offsetting deals being undertaken to achieve this where necessary. Credit exposure with individual counterparties can be reduced by close-out netting agreements which allow for positive and negative mark-to-market values on different transactions to be offset and settled by a single payment in the event of default by either party. Such agreements are enforceable in the jurisdictions of the major market makers and HSBC has executed close-out netting agreements with the majority of its counterparties, notwithstanding the fact that HSBC deals only with the most creditworthy counterparties.

To reduce credit risk, management may deem it necessary to obtain collateral. The amount and nature of the collateral obtained is based on management's credit evaluation of the customer. Collateral held varies but will generally be in the form of cash or liquid securities.

HSBC manages its credit exposure on derivatives in a consistent manner to those for other on-balance-sheet items.

Derivatives used for trading purposes

The following table summarises the contract amount and replacement cost of third party trading derivatives by product type. The replacement cost shown is the positive mark-to-market value and represents the accounting loss HSBC would incur if the counterparty to a derivative contract failed to perform according to the terms of the contract and the collateral, if any, for the amount due proved to be of no value.

	1998		1997	
	Contract amount	Replacement cost	Contract amount	Replacement cost
	US\$m	US\$m	US\$m	US\$m
Spot and forward foreign exchange	604,358	6,087	602,593	10,955
Currency swaps, futures and options purchased	97,396	2,715	81,245	3,179
Currency options written	57,034	—	55,313	—
Other contracts.....	1,937	25	2,541	91
Total exchange rate contracts	<u>760,725</u>	<u>8,827</u>	<u>741,692</u>	<u>14,225</u>
Interest rate swaps.....	532,978	5,619	440,553	4,298
Interest rate futures, forward rate agreements and options purchased	423,432	1,265	325,536	707
Interest rate options written	76,889	—	62,316	—
Total interest rate contracts	<u>1,033,299</u>	<u>6,884</u>	<u>828,405</u>	<u>5,005</u>
Equities, futures and options purchased	11,321	2,200	8,518	2,014
Equities options written.....	16,341	—	12,521	—
Other contracts.....	1,813	13	731	2
Total equities contracts	<u>29,475</u>	<u>2,213</u>	<u>21,770</u>	<u>2,016</u>

As all derivative instruments used for trading purposes are marked-to-market, carrying values are equal to mark-to-market values.

Mark-to-market values are determined by reference to market rates prevailing on the date of valuation or by discounting future cash flows.

The positive and negative mark-to-market values of third party trading contracts at 31 December 1998 and 31 December 1997 and the averages for both years are analysed in the following table. Positive amounts represent replacement cost values and are included within 'Other assets' on the balance sheet. Negative amounts represent losses on contracts where the current mark-to-market value is less than the value contracted and are included within 'Other liabilities'. Assets and liabilities are not netted, except where a legal right of set-off exists.

		1998		1997	
		Mark-to-market values at year end	Average mark-to-market values for the year	Mark-to-market values at year end	Average mark-to-market values for the year
		US\$m	US\$m	US\$m	US\$m
Exchange rate	— assets	8,827	11,558	14,225	11,267
	— liabilities	(9,200)	(11,153)	(13,463)	(10,797)
Interest rate	— assets	6,884	5,516	5,005	5,150
	— liabilities	(5,941)	(5,460)	(5,116)	(5,079)
Equities	— assets	2,213	2,189	2,016	1,688
	— liabilities	(2,839)	(2,816)	(2,508)	(2,029)

Notes on the Financial Statements (continued)

Analysis of income from dealing in financial instruments

	1998			1997			1996		
	<i>Dealing profits</i>	<i>Dividend and net interest income</i>	<i>Total</i>	<i>Dealing profits</i>	<i>Dividend and net interest income</i>	<i>Total</i>	<i>Dealing profits</i>	<i>Dividend and net interest income</i>	<i>Total</i>
	US\$m	US\$m	US\$m	US\$m	US\$m	US\$m	US\$m	US\$m	US\$m
Foreign exchange...	953	24	977	998	41	1,039	551	41	592
Interest rate derivatives	67	2	69	78	36	114	82	15	97
Debt securities	116	84	200	(61)	187	126	96	151	247
Equities and other trading	13	77	90	(25)	71	46	71	53	124
	<u>1,149</u>	<u>187</u>	<u>1,336</u>	<u>990</u>	<u>335</u>	<u>1,325</u>	<u>800</u>	<u>260</u>	<u>1,060</u>

The term 'dealing profits' is a prescribed heading under the UK's implementation of the European Union's Bank Accounts Directive; it excludes net interest income, fees and commissions, and the cost of associated staff and other administrative expenses. The table above shows the dividend income and net interest income attributable to dealing activities. The net interest income on securities trading arises on marked-to-market debt securities and treasury bills.

Derivatives used for risk management purposes

The majority of the transactions undertaken for risk management purposes are between business units within HSBC, one of which is a trading desk, which may then lay off the resulting position by trading in the external market. Internal positions are integral to HSBC's asset and liability management and are included within analyses of non-trading positions in the tables below.

The following table summarises the contract amount and replacement cost of derivatives used for risk management purposes by product type. The replacement cost shown represents the accounting loss HSBC would incur if the counterparty to a derivative contract failed to perform according to the terms of the contract and the collateral, if any, for the amount due proved to be of no value.

	1998		1997	
	<i>Contract amount</i>	<i>Replacement cost*</i>	<i>Contract amount</i>	<i>Replacement cost*</i>
	US\$m	US\$m	US\$m	US\$m
Spot and forward foreign exchange	67,749	58	44,196	43
Currency swaps, futures and options purchased	3,260	14	2,645	5
Total exchange rate contracts	<u>71,009</u>	<u>72</u>	<u>46,841</u>	<u>48</u>
Interest rate swaps	73,784	386	87,340	158
Interest rate futures, forward rate agreements and options purchased	10,601	27	10,052	14
Total interest rate contracts	<u>84,385</u>	<u>413</u>	<u>97,392</u>	<u>172</u>
Equities, futures and options purchased	724	5	649	1
Other contracts	18	—	—	—
Total equities contracts	<u>742</u>	<u>5</u>	<u>649</u>	<u>1</u>

* third party contracts only

The table below summarises the carrying value and mark-to-market value of derivative contracts held for risk management purposes. Mark-to-market values for assets and liabilities arising from derivatives held for non-trading purposes are determined in the same way as those set out for trading derivatives above.

		1998		1997	
		Carrying value	Mark-to-market values	Carrying value	Mark-to-market values
		US\$m	US\$m	US\$m	US\$m
Exchange rate	— assets	384	556	665	862
	— liabilities	(339)	(584)	(496)	(1,010)
Interest rate	— assets	1,032	2,578	743	1,154
	— liabilities	(351)	(1,197)	(494)	(695)
Equities	— assets	29	118	22	108
	— liabilities	—	—	—	—

Concentrations of credit risk

Concentrations of credit risk exist if a number of counterparties are engaged in similar activities or activities in the same region or have similar economic characteristics that would cause their ability to meet contractual obligations to be similarly affected by changes in economic or other conditions.

The following table analyses the replacement cost of all third party exchange rate, interest rate and equities contracts with positive mark-to-market gains, after netting where possible, by maturity and by category of counterparty at 31 December 1998 and 31 December 1997. The table shows that the replacement cost of derivatives is predominantly with banks and under five years.

	Residual maturity			1998	1997
	Less than 1 year	1-5 years	Over 5 years	Total	Total
	US\$m	US\$m	US\$m	US\$m	US\$m
Governments	50	49	101	200	193
Banks	7,216	4,400	1,578	13,194	16,559
Non-bank financial institutions					
— exchanges*	272	11	1	284	115
— other	1,359	730	360	2,449	2,169
Other sectors	1,203	691	393	2,287	2,431
Total 1998	10,100	5,881	2,433	18,414	
Total 1997	14,859	5,190	1,418		21,467

* Exchanges with margining requirements.

Notes on the Financial Statements (continued)

The following maturity profile of the notional principal values of third party derivative contracts outstanding as at 31 December 1998 and 1997 shows that the vast majority of contracts are executed over the counter and mature within one year.

	Residual maturity			1998 Total	1997 Total
	Less than 1 year	1-5 years	Over 5 years		
	US\$m	US\$m	US\$m	US\$m	US\$m
Exchange rate, interest rate and equities contracts					
— exchanges*	183,499	38,557	37	222,093	156,948
— other contracts	1,178,685	359,055	96,194	1,633,934	1,478,531
Total 1998	1,362,184	397,612	96,231	1,856,027	
Total 1997	1,214,121	353,446	67,912		1,635,479

* Exchanges with margining requirements.

36 Reconciliation of operating profit to net cash flow from operating activities

	1998 US\$m	1997 US\$m	1996 US\$m
Operating profit	6,185	7,434	6,364
Change in prepayments and accrued income	(667)	(577)	241
Change in accruals and deferred income	220	1,241	(261)
Interest on finance leases and similar hire purchase contracts	26	26	15
Interest on subordinated loan capital	814	753	666
Depreciation and amortisation	914	719	573
Amortisation of discounts and premiums	(53)	(36)	6
Provisions for bad and doubtful debts	2,637	1,014	604
Loans written off net of recoveries	(1,226)	(579)	(772)
Provisions for liabilities and charges	1,290	236	164
Provisions utilised	(974)	(172)	(78)
Provisions assumed	377	—	—
Amounts written off fixed asset investments	85	49	75
Net cash inflow from trading activities	9,628	10,108	7,597
Change in items in the course of collection from other banks	(242)	(569)	(389)
Change in treasury bills and other eligible bills	(4,797)	(2,366)	6,300
Change in loans and advances to banks	(5,418)	7,352	(9,824)
Change in loans and advances to customers	3,731	(35,147)	(24,780)
Change in other securities	(4,442)	(4,001)	(7,714)
Change in other assets	1,027	(5,390)	(197)
Change in deposits by banks	(4,804)	5,063	(1,447)
Change in customer accounts	14,721	25,115	36,532
Change in items in the course of transmission to other banks	161	800	556
Change in debt securities in issue	1,445	6,298	3,653
Change in other liabilities	(295)	5,843	3,186
Elimination of exchange differences*	(1,028)	1,246	216
Net cash inflow from operating activities	9,687	14,352	13,689

* Adjustment to bring changes between opening and closing balance sheet amounts to average rates. This is not done on a line by line basis, as it cannot be determined without unreasonable expense.

37 Changes in financing during the year

	<i>Subordinated loan capital</i>	<i>Preference shares*</i>	<i>Ordinary shares</i>	<i>Share premium</i>
	US\$m	US\$m	US\$m	US\$m
Balance at 1 January 1998	10,526	850	3,406	489
Shares issued in lieu of dividends	—	—	27	(27)
Issued during the year	443	—	3	14
Repaid during the year	(215)	—	—	—
Net cash flow from financing	228	—	3	14
Exchange and other movements	90	20	7	4
Balance as at 31 December 1998	10,844	870	3,443	480
Balance at 1 January 1997	10,163	895	3,426	509
Shares issued in lieu of dividends	—	—	16	(16)
Acquisition of subsidiaries	156	—	—	—
Issued during the year	740	50	3	14
Repaid during the year	(318)	(98)	—	—
Net cash inflow/(outflow) from financing	422	(48)	3	14
Exchange and other movements	(215)	3	(39)	(18)
Balance at 31 December 1997	10,526	850	3,406	489
Balance at 1 January 1996	8,596	702	3,296	476
Shares issued in lieu of dividends	—	—	23	(23)
Issued during the year	1,552	200	10	11
Repaid during the year	(141)	—	—	—
Net cash inflow from financing	1,411	200	10	11
Exchange and other movements	156	(7)	97	45
Balance at 31 December 1996	10,163	895	3,426	509

* Preference shares in issue are in subsidiary undertakings (Note 30).

38 Analysis of cash

- (a) HSBC is required to make deposits with central banks as a result of government regulations in the territories in which it operates. As at 31 December 1998, these amounted to US\$2,557 million (1997: US\$3,027 million; 1996: US\$1,587 million).

Notes on the Financial Statements (continued)

(b) Changes in cash during the year

	1998 US\$m	1997 US\$m	1996 US\$m
Balance at 1 January	20,756	15,105	8,042
Net cash (outflow)/inflow before the effect of foreign exchange movements	(6,595)	6,613	6,862
Effect of foreign exchange movements	42	(962)	201
Balance at 31 December	14,203	20,756	15,105

(c) Analysis of the balances of cash as classified in the consolidated balance sheet

	1998 US\$m	1997 US\$m	1996 US\$m
Cash and balances at central banks	3,048	2,961	3,086
Loans and advances to banks	11,155	17,795	12,019
.....	14,203	20,756	15,105

39 Litigation

HSBC, through a number of its subsidiary undertakings, is named in and is defending legal actions in various jurisdictions arising from its normal business. No material adverse impact on the financial position of HSBC is expected to arise from these proceedings.

40 Capital commitments

	1998 US\$m	1997 US\$m
Expenditure contracted for	576	163
Expenditure authorised by Directors but not contracted for	115	124
.....	691	287

41 Lease commitments

At the year-end, annual commitments under non-cancellable operating leases were:

	1998 US\$m	1997 US\$m
Leasehold land and buildings		
Operating leases which expire:		
— within 1 year	33	38
— between 1 and 5 years	149	145
— over 5 years	125	122
.....	307	305
Equipment		
Operating leases which expire:		
— within 1 year	6	8
— between 1 and 5 years	21	17
.....	27	25

42 Segmental analysis

As HSBC is not required to disclose turnover, no segmental analysis of turnover is included. Turnover of non-banking businesses is included in other operating income above. The allocation of earnings reflects the benefit of shareholders' funds to the extent that these are actually allocated to businesses in the segment by way of intra-HSBC capital and funding structures. Common costs are included in segments on the basis of the actual recharges made.

(a) By geographic region

Geographical information has been classified by the location of the principal operations of the subsidiary undertaking, or in the case of The Hongkong and Shanghai Banking Corporation Limited, Midland and HSBC Bank Middle East operations, by the location of the branch responsible for reporting the results or for advancing the funds. Due to the nature of HSBC's structure, the analysis of profits and net assets shown below includes intra-HSBC items between geographic regions. The 'Rest of Asia-Pacific' geographical segment includes the Middle East, India, and Australasia.

Total assets:

	At 31 December 1998		At 31 December 1997		At 31 December 1996	
	US\$m	%	US\$m	%	US\$m	%
Europe	190,823	40.2	178,581	38.6	163,311	41.4
Hong Kong	149,127	31.3	140,204	30.2	122,521	31.1
Rest of Asia-Pacific	57,253	12.0	57,325	12.4	49,948	12.7
North America	63,903	13.4	70,598	15.2	58,428	14.8
Latin America	14,614	3.1	16,835	3.6	122	—
	<u>475,720</u>	<u>100.0</u>	<u>463,543</u>	<u>100.0</u>	<u>394,330</u>	<u>100.0</u>
Add: Hong Kong SAR Government certificates of indebtedness	7,408		8,143		8,047	
Total assets	<u>483,128</u>		<u>471,686</u>		<u>402,377</u>	

Net assets:

	At 31 December 1998		At 31 December 1997		At 31 December 1996	
	US\$m	%	US\$m	%	US\$m	%
Europe	12,098	44.2	9,744	36.0	10,204	39.5
Hong Kong	9,427	34.4	11,555	42.7	10,000	38.7
Rest of Asia-Pacific	2,186	8.0	2,202	8.1	2,686	10.4
North America	2,494	9.1	2,892	10.7	2,843	11.0
Latin America	1,197	4.3	687	2.5	100	0.4
Total net assets	<u>27,402</u>	<u>100.0</u>	<u>27,080</u>	<u>100.0</u>	<u>25,833</u>	<u>100.0</u>

Notes on the Financial Statements (continued)

Profit on ordinary activities before tax:

	<i>Europe</i>	<i>Hong Kong</i>	<i>Rest of Asia-Pacific</i>	<i>North America</i>	<i>Latin America</i>	<i>Total</i>
	US\$m	US\$m	US\$m	US\$m	US\$m	US\$m
Year ended 31 December 1998						
Interest receivable	11,762	10,934	4,196	5,121	2,839	34,852
Interest payable	(7,755)	(7,462)	(2,941)	(3,503)	(1,644)	(23,305)
Net interest income	4,007	3,472	1,255	1,618	1,195	11,547
Dividend income	79	44	2	14	9	148
Net fees and commissions	3,095	836	566	596	643	5,736
Dealing profits	342	310	413	76	8	1,149
Other operating income	853	383	33	185	252	1,706
Operating income	8,376	5,045	2,269	2,489	2,107	20,286
Operating expenses	(5,197)	(1,851)	(1,052)	(1,424)	(1,711)	(11,235)
Operating profit before provisions	3,179	3,194	1,217	1,065	396	9,051
Provisions for bad and doubtful debts	(369)	(747)	(1,219)	(109)	(193)	(2,637)
Provisions for contingent liabilities and commitments	(96)	—	(37)	(10)	(1)	(144)
Amounts written off fixed asset investments	(16)	(57)	(11)	—	(1)	(85)
Operating profit	2,698	2,390	(50)	946	201	6,185
Share of operating profit in associated undertakings	—	23	91	2	20	136
Gains/(losses) on disposal of investments and tangible fixed assets	186	14	(2)	39	13	250
Profit on ordinary activities before tax	<u>2,884</u>	<u>2,427</u>	<u>39</u>	<u>987</u>	<u>234</u>	<u>6,571</u>

Profit on ordinary activities before tax:

	<i>Europe</i>	<i>Hong Kong</i>	<i>Rest of Asia-Pacific</i>	<i>North America</i>	<i>Latin America</i>	<i>Total</i>
	US\$m	US\$m	US\$m	US\$m	US\$m	US\$m
Year ended 31 December 1997						
Interest receivable	9,883	9,225	3,857	4,804	1,895	29,664
Interest payable	(6,052)	(5,771)	(2,589)	(3,155)	(1,153)	(18,720)
Net interest income.....	3,831	3,454	1,268	1,649	742	10,944
Dividend income	77	59	3	9	8	156
Net fees and commissions.....	2,761	1,099	654	583	372	5,469
Dealing profits	420	203	319	47	1	990
Other operating income.....	594	295	36	83	227	1,235
Operating income.....	7,683	5,110	2,280	2,371	1,350	18,794
Operating expenses.....	(4,688)	(1,915)	(1,077)	(1,360)	(1,201)	(10,241)
Operating profit before provisions	2,995	3,195	1,203	1,011	149	8,553
Provisions for bad and doubtful debts.....	(69)	(223)	(615)	(79)	(28)	(1,014)
Provisions for contingent liabilities and commitments	(22)	(12)	(12)	(6)	(4)	(56)
Amounts written off fixed asset investments.....	15	(41)	(5)	—	(18)	(49)
Operating profit.....	2,919	2,919	571	926	99	7,434
Share of operating profit in associated undertakings	14	31	74	—	(7)	112
Gains/(losses) on disposal of investments and tangible fixed assets	268	296	6	24	(10)	584
Profit on ordinary activities before tax.....	<u>3,201</u>	<u>3,246</u>	<u>651</u>	<u>950</u>	<u>82</u>	<u>8,130</u>

Notes on the Financial Statements (continued)

Profit on ordinary activities before tax:

	<i>Europe</i>	<i>Hong Kong</i>	<i>Rest of Asia-Pacific</i>	<i>North America</i>	<i>Latin America</i>	<i>Total</i>
	US\$m	US\$m	US\$m	US\$m	US\$m	US\$m
Year ended 31 December 1996						
Interest receivable	8,659	7,832	3,424	3,873	6	23,794
Interest payable	(5,218)	(4,705)	(2,323)	(2,451)	(5)	(14,702)
Net interest income	3,441	3,127	1,101	1,422	1	9,092
Dividend income	95	50	10	4	6	165
Net fees and commissions	2,389	939	559	409	—	4,296
Dealing profits/(losses)	324	203	201	73	(1)	800
Other operating income	493	238	74	122	3	930
Operating income	6,742	4,557	1,945	2,030	9	15,283
Operating expenses	(4,383)	(1,757)	(881)	(1,206)	(2)	(8,229)
Operating profit before provisions	2,359	2,800	1,064	824	7	7,054
Provisions for bad and doubtful debts	(292)	(227)	(30)	(55)	—	(604)
Provisions for contingent liabilities and commitments	—	—	(13)	2	—	(11)
Amounts written off fixed asset investments	(65)	(10)	(1)	1	—	(75)
Operating profit	2,002	2,563	1,020	772	7	6,364
Share of operating profit in associated undertakings	38	33	55	2	9	137
Gains on disposal of investment and tangible fixed assets	328	179	26	18	—	551
Profit on ordinary activities before tax	<u>2,368</u>	<u>2,775</u>	<u>1,101</u>	<u>792</u>	<u>16</u>	<u>7,052</u>

Total interest receivable and total interest payable include intra-HSBC interest of US\$1,232 million (1997: US\$993 million; 1996: US\$1,472 million). Other operating income and operating expenses include intra-HSBC items of US\$231 million (1997: US\$185 million; 1996: US\$310 million).

(b) By country of domicile

HSBC Holdings is registered and domiciled in the United Kingdom.

(i) Profit on ordinary activities before tax in the United Kingdom

	1998 US\$m	1997 US\$m	1996 US\$m
Operating income	<u>7,620</u>	<u>7,109</u>	<u>6,204</u>
Profit on ordinary activities before tax	<u>2,542</u>	<u>2,959</u>	<u>2,231</u>

Operating income includes intra-HSBC income of US\$270 million (1997: US\$275 million; 1996: US\$171 million). Profit on ordinary activities before tax includes profit arising on intra-HSBC transactions of US\$235 million (1997: US\$261 million; 1996: US\$128 million).

(ii) Geographic analysis of fixed assets

	1998	1997	1996
	US\$m	US\$m	US\$m
United Kingdom.....	5,538	4,690	2,687
Other	6,716	8,344	7,924
Total	<u>12,254</u>	<u>13,034</u>	<u>10,611</u>

Other includes assets held in Hong Kong amounting to US\$4,792 million (1997: US\$6,541 million; 1996: US\$ 6,858 million).

(c) By class of business

	1998	1997	1996
	US\$m	US\$m	US\$m
<i>Commercial banking</i>			
Gross income	<u>40,989</u>	<u>35,463</u>	<u>27,144</u>
Profit on ordinary activities before tax.....	<u>6,190</u>	<u>7,733</u>	<u>6,587</u>
Total assets.....	<u>459,681</u>	<u>451,864</u>	<u>383,445</u>
Net assets.....	<u>25,772</u>	<u>25,566</u>	<u>24,351</u>
<i>Investment banking</i>			
Gross income	<u>2,776</u>	<u>2,458</u>	<u>1,985</u>
Profit on ordinary activities before tax.....	<u>381</u>	<u>397</u>	<u>465</u>
Total assets.....	<u>23,447</u>	<u>19,822</u>	<u>18,932</u>
Net assets.....	<u>1,630</u>	<u>1,514</u>	<u>1,482</u>
<i>Total</i>			
Gross income	<u>43,765</u>	<u>37,921</u>	<u>29,129</u>
Profit on ordinary activities before tax.....	<u>6,571</u>	<u>8,130</u>	<u>7,052</u>
Total assets.....	<u>483,128</u>	<u>471,686</u>	<u>402,377</u>
Net assets.....	<u>27,402</u>	<u>27,080</u>	<u>25,833</u>

Gross income includes intra-HSBC income of US\$403 million (1997: US\$432 million; 1996: US\$266 million).

Notes on the Financial Statements (continued)

43 Related party transactions

(a) Transactions, arrangements and agreements involving Directors and others

Particulars of transactions, arrangements and agreements entered into by subsidiary undertakings of HSBC Holdings with Directors and connected persons and companies controlled by them and with officers of HSBC Holdings disclosed pursuant to section 232 of the Companies Act 1985 are as follows:

	1998		1997	
	Number	US\$m	Number	US\$m
Directors and connected persons and companies controlled by them:				
Loans and credit card transactions (including US\$159,000 in credit card transactions (1997: US\$61,000) and US\$57,900,000 in guarantees (1997: US\$52,034,000))	<u>82</u>	<u>871</u>	<u>62</u>	<u>639</u>
Officers:				
Loans and credit card transactions (including US\$104,000 in credit card transactions (1997: US\$99,000) and US\$nil in guarantees (1997: US\$ nil))	<u>29</u>	<u>15</u>	<u>19</u>	<u>10</u>

Particulars of Directors' transactions are recorded in a register held at the Registered Office of HSBC Holdings which is available for inspection by members.

(b) Transactions with other related parties of HSBC

Associated undertakings

Information relating to associated undertakings can be found in the 'Notes on the Financial Statements' where the following are disclosed:

- Notes 12 and 13: amounts due from associated undertakings;
- Note 18: investments in associated undertakings; principal associated undertakings and interests in loan capital; and
- Notes 24 and 25: amounts due to associated undertakings.

Pension funds

At 31 December 1998, US\$12.7 billion (1997: US\$11.0 billion) of HSBC pension fund assets were under management by HSBC companies of which US\$989 million (1997: US\$842 million) is included in HSBC's balance sheet under 'Other assets' in 'Long-term assurance assets attributable to policyholders'. Fees to HSBC companies in connection with such management amounted to US\$23 million (1997: US\$18 million). HSBC's pension funds had deposits of US\$343 million (1997: US\$152 million) with banking subsidiaries within HSBC.

44 UK and Hong Kong accounting requirements

The financial statements have been prepared in accordance with UK accounting requirements; there would be no material differences had they been prepared in accordance with Hong Kong Accounting Standards, except as set out below.

The preparation of the cash flow statement is in accordance with FRS 1 (revised 1996) 'Cash Flow Statements' rather than Hong Kong Statement of Standard Accounting Practice 15 'Cash Flow Statements'.

In accordance with FRS 11 'Impairment of Fixed Assets and Goodwill', no charge has been made in the profit and loss account in respect of those decreases in the valuation of HSBC properties that do not represent impairments. If HSBC had prepared its financial statements under Hong Kong Statement of Standard Accounting Practice 17 'Property, plant and equipment', US\$150 million would have been charged to the profit and loss account in respect of valuations below depreciated historical cost (of which US\$15 million relates to minority interests).

45 Differences between UK GAAP and US GAAP

The consolidated financial statements of HSBC are prepared in accordance with UK GAAP which differs in certain significant respects from US GAAP. The following is a summary of the significant differences applicable to HSBC:

UK GAAP

Leasing

Finance lease income is recognised so as to give a constant rate of return on the net cash investment in the lease, taking into account tax payments and receipts associated with the lease.

Leases are categorised as finance leases when the substance of the agreement is that of a financing transaction and the lessee assumes substantially all of the risks and benefits relating to the asset. All other leases are categorised as operating leases.

Operating leased assets are depreciated over their useful lives such that, for each asset, rentals less depreciation are recognised at a constant periodic rate of return on the net cash invested in that asset. Rentals receivable under operating leases are accounted for on a straight line basis over the lease term.

Debt swaps

Assets acquired in exchange for other advances in order to achieve an orderly realisation are reported as advances. The assets acquired are recorded at the carrying value of the advances disposed of at the date of the exchange, with any provision having been duly updated. Any subsequent deterioration in their value will be recorded as an additional provision.

Shareholders' interest in the long-term assurance fund

The shareholders' interest in the in-force life assurance and fund pensions policies of the long-term assurance fund is valued at the net present value of the profits inherent in such policies.

US GAAP

Unearned income on finance leases is taken to income at a rate calculated to give a constant rate of return on the investment in the lease, but no account is taken of the tax flows generated by the lease.

Leases are classified as capital leases when any of the criteria outlined under Statement of Financial Accounting Standards ('SFAS') No. 13 'Accounting for Leases' are met.

Operating leased assets are depreciated such that in each period the depreciation charge is at least equal to that which would have arisen on a straight line basis.

Under SFAS No. 15 'Accounting by Debtors and Creditors for Troubled Debt Restructurings', debt securities and equity shares acquired in exchange for advances in order to achieve an orderly realisation are required to be accounted for at their fair value, usually their secondary market value, at the date of exchange. Under SFAS No. 115 'Accounting for Certain Investments in Debt and Equity Securities', certain of these debt swaps qualify as securities and accordingly are classified as available for sale.

The net present value of these profits is not recognised. An adjustment is made to amortise acquisition costs and fees in accordance with SFAS No. 97 'Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments'.

Notes on the Financial Statements (continued)

UK GAAP

Pension costs

Pension costs, based on actuarial assumptions and methods, are charged so as to allocate the cost of providing benefits over the average remaining service lives of employees.

Share compensation schemes

For executive share option schemes, such options are granted at fair value and no compensation costs recognised under the 'intrinsic value method'.

For Save-As-You-Earn schemes, employees are granted shares at a 15 per cent discount to fair value at the date of grant. No compensation cost is recognised for such awards.

For longer term and other restricted share award schemes, the fair value of the shares awarded is charged to compensation cost over the period in respect of which performance conditions apply. To the extent the award is adjusted by virtue of performance conditions being met or not, the compensation cost is adjusted in line with this.

Property

HSBC values its properties on an annual basis and adjustments arising from such revaluations are taken to reserves.

HSBC depreciates non-investment properties based on cost or the revalued amounts. No depreciation is charged on investment properties other than leaseholds with 20 years or less to expiry.

US GAAP

SFAS No. 87 'Employers' Accounting for Pensions' prescribes a similar method of actuarial valuation but requires assets to be assessed at fair value and the assessment of liabilities to be based on current settlement rates. Certain variations from regular cost are allocated in equal amounts over the average remaining service lives of current employees.

SFAS No. 123 'Accounting for Stock Based Compensation' encourages a fair value based method of accounting for stock based compensation plans. However, entities are permitted to continue with the Accounting Principles Board opinion ('APB') No. 25 'Accounting for Stock Issued to Employees' intrinsic value method where compensation cost is based on the difference between the market value of the stock and any contribution made by the employee.

US GAAP does not permit revaluations of property although it requires recognition of asset impairment. Any realised surplus or deficit is therefore reflected in income on disposal of the property.

Under US GAAP, depreciation is charged on all properties based on cost.

UK GAAP

Goodwill

For acquisitions prior to 1998, goodwill arising on the acquisition of subsidiary or associated undertakings is charged against reserves in the year of acquisition.

In 1998, HSBC has adopted FRS 10, 'Goodwill and intangible assets'. For acquisitions made on or after 1 January 1998, goodwill is included in the balance sheet and amortised over its estimated useful life on a straight line basis. FRS 10 allows goodwill previously eliminated against reserves to be reinstated, but does not require it. In common with many other UK companies, HSBC elected not to reinstate such goodwill. HSBC considered whether reinstatement would materially assist the understanding of readers of its accounts who were already familiar with UK GAAP and decided that it would not.

At the date of disposal of subsidiary or associated undertakings, any unamortised goodwill or goodwill charged directly against reserves is included in HSBC's share of total net assets of the undertaking in the calculation of the profit on disposal of the undertaking.

Investment securities

Debt securities and equity shares intended to be held on a continuing basis are disclosed as investment securities and are included in the balance sheet at cost less provision for any permanent diminution in value. Other participating interests are accounted for on the same basis. Where dated investment securities are purchased at a premium or discount, these premiums and discounts are amortised through the profit and loss account over the period from date of purchase to date of maturity and included in 'interest income'. Any profit or loss on realisation of these securities is recognised in the profit and loss account as it arises and included in 'Gains on disposal of investment securities'.

Other debt securities, including treasury bills and other eligible bills, and equity shares are included in the balance sheet at market value; changes in the market value of such assets are recognised in the profit and loss account as 'Dealing profits'.

US GAAP

Goodwill is capitalised and amortised over its estimated useful life but not more than 25 years. Goodwill is written off when judged to have no recoverable value.

Under SFAS No. 115 'Accounting for Certain Investments in Debt and Equity Securities' all debt securities and equity shares are classified and disclosed within one of the following three categories: held-to-maturity; available for sale; or trading. Held-to-maturity debt securities are measured at amortised cost. Available for sale securities are measured at fair value with unrealised holding gains and losses excluded from earnings and reported net of applicable taxes and minority interests in a separate component of shareholders' funds. Trading securities are measured at fair value with unrealised holding gains and losses included in earnings.

Notes on the Financial Statements (continued)

UK GAAP

Deferred taxation

Deferred taxation is provided on timing differences using the liability method to the extent that it is probable that an actual liability or asset will crystallise.

Dividends paid

Dividends declared after the period end are recorded in the period to which they relate.

Sale and repurchase transactions ('Repos') and reverse repos

Repos and reverse repos are accounted for as if the collateral involved remains with the transferor. On the balance sheet, repos are included within 'Deposits by banks' and 'Customer accounts' and reverse repos are included within 'Loans and advances to banks' or 'Loans and advances to customers'.

Acceptances

Acceptances outstanding are not included in the consolidated balance sheet.

Profit and loss presentation

The following items are separately disclosed in the profit and loss account:

Provisions for contingent liabilities and commitments.

Amounts written off fixed asset investments.

Gains on disposal of investments and tangible fixed assets.

US GAAP

As provided by SFAS No. 109 'Accounting for Income Taxes', deferred tax liabilities and assets are recognised in respect of all temporary differences. A valuation allowance is raised against any deferred tax asset where it is more likely than not that the asset, or a part thereof, will not be realised.

Dividends are recorded in the period in which they are declared.

Under SFAS No. 125 'Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities', repos and reverse repos transacted under agreements that give the transferee the right to resell or repledge the securities are accounted for as if the collateral involved has been transferred by the transferor. For repos, the securities involved would be reported separately in the Statement of financial position from other securities not so encumbered. For reverse repos, the securities transferred would be recognised within 'Debt securities' and the corresponding liability would be recognised in 'Obligation to return debt securities'.

Acceptances outstanding and the matching customer liabilities are included in the consolidated balance sheet.

Classified as 'Operating expenses'.

Classified as 'Other operating income'.

Classified as 'Other operating income'.

The following tables summarise the significant adjustments to consolidated net income and shareholders' equity which would result from the application of US GAAP.

		1998		1997	
	Note	US\$m	US\$m	US\$m	US\$m
NET INCOME					
Attributable profit of HSBC (UK GAAP)			4,318		5,487
Lease financing			(93)		(62)
Debt swaps	a		3		39
Shareholders' interest in long-term assurance fund			(93)		(4)
Pension costs	b		(47)		(39)
Stock-based compensation	c		(31)		(20)
Goodwill	d		(320)		(272)
Revaluation of property			79		141
Purchase accounting adjustments	e		—		(74)
Deferred taxation	f				
— US GAAP		68		161	
— on reconciling items		68		(20)	
			136		141
Minority interest in reconciling items			(18)		(31)
Estimated net income (US GAAP)			3,934		5,306
			US\$		US\$
Basic earnings per ordinary share	j		0.49		0.66
Diluted earnings per ordinary share	j		0.48		0.66
SHAREHOLDERS' EQUITY					
	Note	US\$m	US\$m	US\$m	US\$m
Shareholders' funds (UK GAAP)			27,402		27,080
Lease financing			(184)		(91)
Debt swaps	a		(66)		(69)
Shareholders' interest in long-term assurance fund			(473)		(380)
Pension costs	b		(945)		(840)
Goodwill	d		3,640		3,930
Revaluation of property			(2,507)		(4,960)
Fair value adjustment for securities available for sale	h		742		891
Dividend payable			1,499		1,332
Deferred taxation	f				
— US GAAP		661		593	
— on reconciling items		318		164	
			979		757
Minority interest in reconciling items			264		590
Estimated shareholders' equity (US GAAP) .			30,351		28,240

Notes on the Financial Statements (continued)

The following table provides a summarised balance sheet for HSBC which incorporates the adjustments arising from the application of US GAAP:

	1998 US\$m	1997 US\$m
ASSETS		
Cash and balances at central banks	3,048	2,961
Items in the course of collection from other banks	5,911	5,669
Treasury bills and other eligible bills	21,980	17,183
Hong Kong SAR Government certificates of indebtedness	7,408	8,143
Loans and advances to banks	85,315	86,522
Loans and advances to customers	235,267	240,492
Debt securities and equity shares	78,351	59,740
Interests in associated undertakings and other participating interests	1,144	1,110
Intangible and tangible fixed assets	13,443	12,116
Due from customers on acceptances	4,018	4,808
Other assets (including prepayments and accrued income)	37,214	37,439
Total assets	493,099	476,183
LIABILITIES		
Hong Kong SAR currency notes in circulation	7,408	8,143
Deposits by banks	34,342	38,947
Customer accounts	308,910	294,189
Items in the course of transmission to other banks	4,206	4,045
Debt securities in issue	29,190	27,745
Acceptances outstanding	4,018	4,808
Other liabilities (including accruals and deferred income)	56,395	53,096
Provisions for liabilities and charges		
— deferred taxation	663	459
— other provisions for liabilities and charges	3,851	2,973
Subordinated liabilities	10,844	10,526
Minority interests	2,921	3,012
Shareholders' funds	30,351	28,240
Total liabilities	493,099	476,183

Assets arising due to reverse repo transactions of US\$7,411 million (1997: US\$13,751 million) and US\$2,951 million (1997: US\$9,971 million) are included under 'Loans and advances to banks' and 'Loans and advances to customers' respectively.

Liabilities arising due to repo transactions of US\$7,614 million (1997: US\$7,906 million) and US\$5,441 million (1997: US\$13,339 million) are included in 'Deposits by banks' and 'Customer accounts' respectively. Average repo liabilities during the year were US\$21,615 million (1997: US\$20,288 million). The maximum quarter-end repo liability outstanding during the year was US\$20,416 million (1997: US\$21,245 million).

HSBC has reviewed the requirements of SFAS No. 125 and has determined that the impact on the balance sheet as at 31 December 1998 was to increase 'Debt securities and equity shares' and 'Other liabilities' by US\$4,243 million relating to reverse repos.

Under SFAS No. 125 securities subject to certain types of repo transactions would be classified within 'Debt securities and equity shares' as encumbered. As at 31 December 1998, the impact on 'Debt securities and equity shares' would be to reclassify securities amounting to US\$4,747 million as 'encumbered'.

(a) *Debt swaps*

Under UK GAAP, assets acquired in exchange for advances in order to achieve an orderly realisation are included at the net book value of the advance disposed of at the date of exchange, with any provision having been duly updated. Under SFAS 15 such assets are included at the fair value at the date of acquisition. Under US GAAP, shareholders' funds would decrease by US\$66 million (1997: US\$69 million) and profit attributable would increase by US\$3 million (1997: US\$39 million) to show such assets at their fair value at the date of acquisition.

(b) *Pension costs*

For the purpose of the above reconciliations, the provisions of SFAS No. 87, 'Employers' Accounting for Pensions', have been applied to HSBC's main pension plans, which make up 84% of all HSBC's schemes in terms of plan assets. HSBC has applied SFAS No. 87 'Employers' Accounting for Pensions' with effect from 30 June 1992 as it was not feasible to apply it as of January 1989, the date specified in the standard.

The projected benefit obligation in excess of plan assets at 30 June 1992 for the Midland Bank pension scheme has been recognised as a liability under the purchase accounting requirements of APB No. 16 'Business Combinations'. For other pension plans, the excess of the projected benefit obligation over plan assets at 30 June 1992 is recognised as a charge to pension expense over 15 years.

On 25 March 1998, Banco HSBC Bamerindus S.A. assumed liability for pension schemes which were previously the responsibility of Banco Bamerindus do Brasil. This transfer arose on completion of the intervention period. The projected benefit obligation in excess of plan assets at that date has been recognised as a liability under the purchase accounting adjustments of APB No. 16.

Estimated pension costs for these plans computed under SFAS No. 87 are as follows:

	1998 US\$m	1997 US\$m	1996 US\$m
Components of net periodic benefit cost			
Service cost	353	328	277
Interest cost	705	697	603
Expected return on plan assets.....	(698)	(707)	(622)
Amortisation of prior service cost.....	3	3	3
Amortisation of unrecognised net liability at 30 June 1992.....	4	4	4
Amortisation of recognised net actuarial (gain)/loss	(15)	2	(10)
Net periodic pension cost.....	352	327	255
Employee contributions.....	(2)	(2)	(2)
Net periodic pension cost.....	<u>350</u>	<u>325</u>	<u>253</u>

The US GAAP pension cost of US\$350 million (1997: US\$325 million; 1996: US\$253 million) compares with US\$303 million for these plans under UK GAAP (1997: US\$286 million; 1996: US\$282 million) for the schemes included in the SFAS No. 87 calculation.

Notes on the Financial Statements (continued)

	1998 US\$m	1997 US\$m
Change in projected benefit obligation		
Projected benefit obligation as at 1 January.....	10,178	9,101
Service cost	353	328
Interest cost	705	697
Employee contributions.....	2	2
Net actuarial loss	1,257	726
Acquisition	435	—
Benefits paid	(443)	(426)
Exchange movements	48	(250)
Projected benefit obligation as at 31 December	<u>12,535</u>	<u>10,178</u>
Change in plan assets		
Plan assets at fair value as at 1 January.....	10,266	8,811
Actual return on plan assets.....	(107)	1,527
Employer contributions	306	595
Employee contributions.....	2	2
Benefits paid	(443)	(426)
Exchange movements	61	(243)
Plan assets at fair value as at 31 December.....	<u>10,085</u>	<u>10,266</u>
Funded status	<u>(2,450)</u>	<u>88</u>
Unrecognised net obligation existing at 30 June 1992.....	29	33
Unrecognised net actuarial loss/(gain)	1,083	(994)
Unrecognised prior service cost	30	33
Accrued pension cost	<u>(1,308)</u>	<u>(840)</u>
Amounts recognised in the statement of financial position consist of:		
Prepaid benefit cost	78	52
Accrued benefit liability	<u>(1,386)</u>	<u>(892)</u>
Accrued pension cost	<u>(1,308)</u>	<u>(840)</u>
US GAAP adjustment:		
Accrued net pension cost under US GAAP	(1,308)	(840)
Pension liability recognised for these schemes under UK GAAP	363	—
	<u>(945)</u>	<u>(840)</u>

Plan asset valuations are as at 31 December with the exception of the Midland Bank Pension Scheme plan assets which are valued as at 30 September.

In 1998, plans with an aggregate accumulated benefit obligation of US\$9,428 million (1997: US\$nil) and assets with an aggregate fair value of US\$8,533 million (1997: US\$nil) had an accumulated benefit obligation in excess of plan assets.

Plans with an aggregate projected benefit obligation of US\$12,535 million (1997: US\$1,563 million) and assets with an aggregate fair value of US\$10,085 million (1997: US\$1,339 million) had a projected benefit obligation in excess of plan assets.

Plan assets are invested primarily in equities, fixed interest securities and property.

The projected benefit obligation at 30 September 1998 and 1997 for the Midland Bank Pension Scheme and at 31 December 1998 and 1997 for the remainder of HSBC's main pension plans has been calculated using the following financial assumptions:

		1998	1997
		% per annum	% per annum
Discount rate	United Kingdom.....	5.5	6.5
	Hong Kong.....	8.0	8.5
	Jersey.....	5.5	6.5
	Brazil.....	7.6	—
Return on assets	United Kingdom.....	5.5	6.5
	Hong Kong.....	10.0	10.0
	Jersey.....	5.5	6.5
	Brazil.....	7.6	—
Rate of pay increase	United Kingdom.....	4.5	4.5
	Hong Kong.....	7.5	8.5
	Jersey.....	3.0	3.0
	Brazil.....	4.6	—

(c) *Stock-based compensation*

SFAS No. 123 encourages the adoption of accounting for share compensation schemes based on their estimated fair value at the date of grant. The disclosure requirements are only applicable to options and other awards granted from 1 January 1995 onwards and, in the initial phase-in period, the amounts reported will not be representative of the effect on reported net income for future years.

The SFAS No. 123 charge for the fair value of options granted since 1 January 1997 is US\$31 million (1997: US\$20 million).

The Executive Share Option Scheme, Savings-Related Share Option Scheme and Restricted Share Plan fall within the scope of SFAS No. 123. The disclosures of options outstanding only relate to those granted from 1995 onwards.

Analysis of the movement in the number and weighted average exercise price of options is set out below:

Executive Share Option Scheme

The Executive Share Option Scheme is a long-term incentive scheme available to certain HSBC employees with grants usually made each year. Options are granted at the market value at the date of grant and are exercisable between the third and tenth anniversaries of the date of grant, subject to vesting conditions.

	1998		1997	
	Number	Weighted average exercise price	Number	Weighted average exercise price
	(000's)	£	(000's)	£
Outstanding at beginning of year.....	4,101	10.53	2,870	8.32
Granted in the year.....	1,499	18.83	1,362	15.11
Exercised in the year.....	(513)	6.87	(46)	8.03
Less: Forfeited in the year.....	(56)	13.47	(85)	10.52
Outstanding at end of year.....	<u>5,031</u>	<u>13.34</u>	<u>4,101</u>	<u>10.53</u>

The weighted average fair value of options granted in the year as at the date of grant is £7.10 (1997: £5.53).

The weighted average exercise price of options granted in 1996 was £10.00 (1995: £6.52).

Notes on the Financial Statements (continued)

Savings-Related Share Options Scheme

The Savings-Related Options Scheme invites eligible employees to enter into savings contracts to save up to £250 per month, with the option to use the savings to acquire shares. The options are exercisable within six months following the fifth anniversary of the commencement of the savings contract, at a 15 per cent discount to the market value at the date of grant.

	1998		1997	
	Number	Weighted average exercise price	Number	Weighted average exercise price
	(000's)	£	(000's)	£
Outstanding at beginning of year	25,921	8.40	19,501	6.26
Granted in the year	6,936	15.66	7,819	13.51
Exercised in the year	(248)	6.34	(219)	5.82
Less: Forfeited in the year	(2,691)	11.36	(1,180)	7.26
Outstanding at end of year	29,918	9.84	25,921	8.40

The maximum term of options granted in the year is 5½ years from the date of grant (1997: 5½ years).

The options granted in 1997 and 1998 were granted at a 15 per cent discount to the market value at the date of grant.

The weighted average fair value of options granted in the year as at the date of grant is £6.80 (1997: £6.23).

The weighted average exercise price of options granted in 1996 was £9.18 (1995: £5.42).

The range of exercise prices, weighted average fair values at the date of grant and the weighted average remaining contractual life for options outstanding at the balance sheet date are as follows:

	1998			1997		
	Exercise price range	Fair value	Weighted average remaining life	Exercise price range	Fair value	Weighted average remaining life
	£	£	Years	£	£	Years
Executive Share						
Option Scheme	6.52-23.395	4.92	2.93	6.52-23.395	3.80	1.49
Savings-Related Share						
Option Scheme	5.42-19.56	4.48	2.44	5.42-19.56	3.91	2.99

Fair values of share options are calculated at the date of grant using a binomial model which produces similar results to the Black-Scholes model. The significant weighted-average assumptions used to estimate the fair value of the options granted in 1998 and 1997 are as follows:

	Executive Share Option Scheme	Savings-Related Share Option Scheme
Risk-free interest rate	5.36%	5.37%
Expected life (years)	10	5½
Expected volatility	32%	36%

Restricted Share Plan

The Restricted Share Plan has been in operation since 1996. It is intended to align the interests of executives to the creation of shareholder value. This is achieved by setting certain Total Shareholder Return targets which must normally be attained in order for the awards to vest.

	1998 <i>Number</i>	1997 <i>Number</i>
	(000's)	(000's)
Outstanding at beginning of year	69	—
Purchased in the year	96	69
Less: Forfeited in the year	(2)	—
Outstanding at end of year	<u>163</u>	<u>69</u>

The weighted average purchase price for shares purchased by HSBC under the Restricted Share Plan is £17.77 (1997: £15.63).

The weighted average remaining vesting period as at 31 December 1998 was 3.47 years (1997: 4 years).

The 1999 awards from the Restricted Share Plan in respect of 1998 will have an aggregate value at the date of award of £3.025 million.

Share capital reorganisation

At the Annual General Meeting on 28 May 1999, the shareholders of HSBC Holdings approved the cancellation of the existing HSBC shares (75p ordinary shares and HK\$10 ordinary shares) and the issuance of three new US\$0.50 ordinary shares for each old share. This share capital reorganisation will not become effective until it is confirmed by the High Court of Justice in England and Wales and a copy of the court order is filed with the Registrar of Companies in England and Wales. The court order is expected to be filed on 2 July 1999. If the Court confirms the share capital reorganisation, trading in the new US\$0.50 ordinary shares on the London and Hong Kong Stock Exchanges is expected to commence on 5 July 1999.

If the share capital reorganisation is effected, the Share Option Schemes will be adjusted, subject to approval by the Inland Revenue, to increase by a factor of three the number of shares under option or subject to award, and to reduce by two-thirds the option price payable per share.

This note has not been restated to reflect the share capital reorganisation described above.

(d) Goodwill

On 1 January 1998, HSBC adopted FRS 10, 'Goodwill and intangible assets'. In respect of acquisitions since 1 January 1998, goodwill is included in the consolidated balance sheet under 'Intangible fixed assets' and amortised over periods of not more than 15 years on a straight line basis. Prior to 1 January 1998, HSBC charged goodwill directly against reserves.

Under US GAAP, goodwill on acquisition both pre and post 1 January 1998 would have been capitalised and amortised over its estimated useful life. At 31 December 1998 the cost of goodwill acquired on a US GAAP basis was US\$5,316 million (1997: US\$5,127 million) and accumulated amortised goodwill was US\$1,530 million (1997: US\$1,197 million). Amortisation periods applied to purchased goodwill range from 5 to 20 years.

(e) Purchase accounting adjustments

Under UK GAAP, adjustments to allowances for credit losses and insurance claim reserves on acquisition are included as part of the fair value adjustment on acquisition. Under US GAAP, these adjustments are accounted for on a post-acquisition basis through the income statement.

Notes on the Financial Statements (continued)

(f) *Deferred taxation*

The components of the net deferred tax liability calculated under SFAS No. 109 'Accounting for Income Taxes', are as follows:

	1998 US\$m	1997 US\$m
Deferred tax liabilities:		
Leasing transactions.....	1,008	919
Capital allowances	94	85
Provision for additional UK tax on overseas dividends.....	232	233
Reconciling items	141	230
Other.....	144	257
Total deferred tax liabilities.....	1,619	1,724
Deferred tax assets:		
Provisions for bad and doubtful debts	872	660
Advance corporation tax.....	—	331
Tax losses	688	522
Reconciling items	459	394
Other	352	323
Total deferred tax assets before valuation allowance	2,371	2,230
Less: valuation allowance	(846)	(592)
Deferred tax assets less valuation allowance.....	1,525	1,638
Net deferred tax liability under SFAS No. 109.....	94	86
Included within 'other assets' under US GAAP	(569)	(373)
Included within 'deferred tax liabilities' under US GAAP.....	663	459

The valuation allowance against deferred tax assets principally relates to trading and capital losses carried forward which have not been recognised due to uncertainty as to when and if they will be utilised.

(g) *Loans and advances*

SFAS No. 114 'Accounting by Creditors for Impairment of a Loan' as amended by SFAS No. 118 'Accounting by Creditors for Impairment of a Loan — Income Recognition and Disclosures' is effective for accounting periods beginning after 15 December 1994. SFAS No. 114 addresses accounting by creditors for impairment of a loan by specifying how allowances for credit losses for certain loans should be determined. A loan is impaired when it is probable that the creditor will be unable to collect all amounts in accordance with the contractual terms of the loan agreement. Impairment is measured based on the present value of expected future cash flows discounted at the loan's effective rate or, as an expedient, at the fair value of the loan's collateral. Leases, smaller-balance homogeneous loans and debt securities are excluded from the scope of SFAS No. 114.

At 31 December 1998, HSBC estimated that the difference between the carrying value of its loan portfolio on the basis of SFAS No. 114 and its value in HSBC's UK GAAP financial statements was such that no adjustment to net income or shareholders' equity was required.

Impaired loans are those reported by HSBC as non-performing; the value of such loans at 31 December 1998 amounted to US\$8,913 million (1997: US\$5,468 million). Of this total, loans which were included within the scope of SFAS No. 114 and for which a provision has been established amounted to US\$7,300 million (1997: US\$4,555 million). The impairment reserve in respect of these loans estimated in accordance with the provisions of SFAS No. 114 was US\$3,618 million (1997: US\$2,466 million). During the year ended 31 December 1998, impaired loans, including those excluded from SFAS No. 114, averaged US\$6,746 million (1997: US\$5,803 million) and interest income recognised on these loans was US\$192 million (1997: US\$232 million).

(h) *Investment securities*

Under UK GAAP, debt securities and equity shares intended to be held on a continuing basis are classified as investment securities and are included in the balance sheet at cost less provision for any permanent diminution in value. Other participating interests are accounted for on the same basis. Where dated investment securities have been purchased at a premium or discount, these premiums and discounts are amortised through the profit and loss account over the period from the date of purchase to the date of maturity and included in 'interest income'. These securities are included in the balance sheet at cost adjusted for the amortisation of premium and discounts arising on acquisition. Any profit or loss on realisation of these securities is recognised in the profit and loss account as it arises and included in 'Gains on disposal of investments'.

Other debt securities and equity shares are included in the balance sheet at market value. Changes in the market value of such assets are recognised in the profit and loss account as 'Dealing profits' as they arise. Debt securities and listed equity shares which were acquired in exchange for advances in order to achieve an orderly realisation continue to be reported as advances under UK GAAP.

Under SFAS No. 115 'Accounting for Certain Investments in Debt and Equity Securities', all the above debt securities and equity shares, with the exception of equity investments without a readily determinable market value, are classified and disclosed within one of the following three categories: held-to-maturity; available for sale; or trading. Held-to-maturity securities are measured at amortised cost less provision for any permanent diminution in value. Available for sale securities are measured at fair value with unrealised holding gains and losses excluded from earnings and reported net of applicable taxes and minority interests in a separate component of shareholders' funds. Trading securities are measured at fair value with unrealised holding gains and losses included in earnings.

Under US GAAP, HSBC's investment securities, other participating interests, and debt securities and equity shares with a readily determinable market value acquired in exchange for advances are classified as available for sale securities. All other debt and equity shares are categorised as trading securities.

The book and market values of these debt securities and equity shares with a readily determinable market value are analysed as follows:

	1998		1997	
	<i>Book value</i>	<i>Market valuation</i>	<i>Book value</i>	<i>Market valuation</i>
	US\$m	US\$m	US\$m	US\$m
Trading	56,752	56,752	47,514	47,514
Available for sale.....	38,721	39,463	29,019	29,910

Notes on the Financial Statements (continued)

Trading Assets

The following table provides an analysis of trading assets, which are valued at market value and the net gains/ (losses) resulting from trading activities:

	1998		1997	
	Market valuation	Gains/(losses)	Market valuation	Gains/(losses)
	US\$m	US\$m	US\$m	US\$m
US Treasury/ government agency	9,140	73	4,466	40
UK Government	5,421	21	2,420	(3)
Hong Kong Government	4,408	10	3,609	(1)
Other government	13,891	68	12,065	(3)
Asset-backed securities	599	(4)	2,614	(4)
Corporate debt and other securities	20,212	(52)	20,156	(90)
Equities	3,081	74	2,184	(27)
	<u>56,752</u>	<u>190</u>	<u>47,514</u>	<u>(88)</u>

Trading assets are marked to market and all profits and losses are deemed realised.

Available for sale

The following table provides an analysis of available for sale securities:

	Book value	Market valuation	Gross SFAS No. 115 adjustment	Tax and minority interests	Net SFAS No. 115 adjustment
	US\$m	US\$m	US\$m	US\$m	US\$m
As at 31 December 1998					
Investment securities (excluding investments with no readily determinable market value)	37,967	38,793	826	(332)	494
Other participating interests	4	6	2	—	2
Brady bonds ⁽ⁱ⁾	720	715	(5)	5	—
Other debt securities and equity shares acquired in exchange for advances ⁽ⁱ⁾	30	73	43	(13)	30
Derivatives used to hedge investment securities classified as available for sale ⁽ⁱⁱ⁾	—	(124)	(124)	27	(97)
Securities available for sale at 31 December 1998	<u>38,721</u>	<u>39,463</u>	<u>742</u>	<u>(313)</u>	<u>429</u>
Securities available for sale at 31 December 1997	<u>29,019</u>	<u>29,910</u>	<u>891</u>	<u>(364)</u>	<u>527</u>
Movement in the year ended 31 December 1998			<u>(149)</u>	<u>51</u>	<u>(98)</u>

(i) Debt securities and equity shares with a readily determinable market value that have been acquired through debt swaps (which under UK GAAP are included as loans and advances) would qualify as available for sale securities. The book value of these securities already incorporates a SFAS No. 15 adjustment of US\$66 million at 31 December 1998 (1997: US\$69 million) as discussed in (a) above.

(ii) Unrealised gains and losses on financial instruments which hedge securities classified as available for sale under SFAS No. 115 should be reported in a separate component of shareholders' funds, consistent with the reporting of securities classified as available for sale. The market value of derivatives entered into to hedge the value of debt securities classified as available for sale, amounting to a negative mark-to-market value of US\$124 million at 31 December 1998 (1997: US\$76 million), has been included in the above table.

(i) *Fair value of financial instruments*

SFAS No. 107 'Disclosures about Fair Value of Financial Instruments' requires disclosure of the estimated fair values of certain financial instruments, both on-balance-sheet and off-balance-sheet, where it is practicable to do so.

Where possible, fair values have been estimated using market prices for the financial instruments. Where market prices are not available, fair values have been estimated using quoted prices for financial instruments with similar characteristics, or otherwise using a suitable valuation technique where practicable to do so. The fair value information presented represents HSBC's best estimate of those values and may be subject to certain assumptions and limitations.

The fair values presented in the table on page 186 are at a specific date and may be significantly different from the amounts which will actually be paid or received on the maturity or settlement date. In many cases, the estimated fair values could not be realised immediately and accordingly do not represent the value of these financial instruments to HSBC as a going concern.

HSBC has excluded the fair value of intangible assets, such as values placed on its portfolio of core deposits, credit card relationships and customer goodwill, as these are not considered to constitute financial instruments for the purposes of SFAS No. 107. HSBC believes such items to be significant and essential to the overall evaluation of HSBC's worth.

In view of the above, comparisons of fair values between financial institutions may not be meaningful and users are advised to exercise caution when using this data.

Financial instruments for which fair value is equal to carrying value

The following table lists those financial instruments, within the scope of SFAS No. 107, where carrying value is an approximation of fair value because they are either (i) carried at market value or (ii) short term in nature or reprice frequently. By definition, the fair value of trading account assets and liabilities, including derivative instruments, equals carrying value. Carrying values of these instruments are presented on the balance sheets and related notes on pages 113 to 189.

Assets

Cash and balances at central banks

Items in the course of collection

Hong Kong SAR Government certificates of indebtedness

Trading debt securities and equity shares

Treasury bills and other eligible bills

Other assets

Prepayments and accrued income

Off-balance-sheet trading instruments

Liabilities

Deposits by banks repayable on demand or that mature / reprice within six months

Customer accounts repayable on demand or that mature / reprice within six months

Hong Kong SAR currency notes in circulation

Short-term positions in treasury bills, debt securities and equity shares

Items in the course of transmission

Other liabilities

Accruals and deferred income

Provisions for liabilities and charges

Off-balance-sheet trading instruments

Other financial instruments

The fair value of other financial instruments within the scope of SFAS No. 107 is set out in the table on page 186. The valuation technique adopted for each major category is discussed below:

Loans and advances to banks and customers

For personal and commercial loans and advances which mature or reprice after six months, fair value is principally estimated by discounting anticipated cash flows (including interests at contractual rates).

Notes on the Financial Statements (continued)

Performing loans are grouped, to the extent possible, into homogenous pools segregated by maturity and the coupon rates of the loans within each pool. In general, cash flows are discounted using current market rates for instruments with similar maturity, repricing and credit risk characteristics.

The fair value for residential mortgages may be treated differently where there is an established market value for asset-backed securities, such as in the United States. In such situations, the fair value is estimated by reference to quoted market prices for loans with similar characteristics and maturities.

For non-performing uncollateralised commercial loans, an estimate is made of the time period to realise these cash flows and the fair value is estimated by discounting these cash flows at a risk-free rate of interest. For non-performing commercial loans where collateral exists, the fair value is the lesser of the carrying value of the loans, net of specific provisions, or the fair value of the collateral, discounted where appropriate. General provisions are deducted from the fair values of these non-performing loans.

Debt securities and equity shares held for investment purposes, and other participating interests

Listed investment securities are valued at middle market prices and unlisted investment securities at management's valuation which takes into consideration future earnings streams, valuations of equivalent quoted securities and other relevant techniques.

Deposits by banks and customer accounts

Deposits by banks and customer accounts which mature or reprice after six months are grouped by residual maturity. Fair value is estimated using discounted cash flows, applying either market rates, where applicable, or current rates offered for deposits of similar remaining maturities.

Debt securities in issue and subordinated liabilities

Fair value is estimated using quoted market prices at the balance sheet date.

The following table presents the carrying value and fair value for those financial instruments whose fair value is derived using these various estimation techniques:

	1998		1997	
	<i>Carrying value</i>	<i>Fair value</i>	<i>Carrying value</i>	<i>Fair value</i>
	US\$m	US\$m	US\$m	US\$m
Assets				
Loans and advances to banks and customers				
— Hong Kong and Rest of Asia-Pacific.....	153,058	152,731	150,198	*
— Other	167,552	168,307	176,745	177,068
Debt securities — non-trading	37,494	37,916	27,617	27,836
Equity shares — non-trading.....	1,140	1,729	1,044	1,793
Other participating interests	309	346	320	403
Liabilities				
Deposits by banks and customer accounts.....	343,252	343,185	333,136	333,163
Debt securities in issue	29,190	29,312	27,745	27,675
Subordinated liabilities.....	10,844	10,775	10,526	10,483

The carrying and fair values of non-trading derivative financial instruments are disclosed on page 161.

* The fair value of loans and advances for Hong Kong and Rest of Asia-Pacific was not collected prior to 31 December 1998. There are no traded loan markets in Asia and only very thin bond markets. This, together with the highly illiquid and unusual conditions prevailing in the region at the end of 1997, has meant that it has not been possible to calculate retrospectively a fair value for the Hong Kong and Rest of Asia-Pacific loan book as at 31 December 1997.

(j) *Earnings per share*

Basic earnings per share under US GAAP, SFAS No. 128 'Earnings per share', is calculated by dividing net income of US\$3,934 million (1997: US\$5,306 million) by the weighted average number of ordinary shares in issue in 1998 of 8,067 million (1997: 8,007 million).

Diluted earnings per share under US GAAP is calculated by dividing net income, which requires no adjustment for the effects of dilutive ordinary potential shares, by the weighted average number of shares outstanding plus the weighted average number of ordinary shares that would be issued on conversion of all the dilutive potential ordinary shares in 1998 of 8,124 million (1997: 8,070 million), as shown in Note 8.

Earnings per share information has been restated to reflect the share reorganisation (see Note 46 'Subsequent events').

(k) *Consolidated cash flow statement*

HSBC prepares its cash flow in accordance with the UK Financial Reporting Standard 1 (revised), 'Cash flow statements'. Its objectives and principles are similar to those set out in SFAS No. 95 'Statement of cash flows', as amended by SFAS No. 104 'Statement of cash flows — Net reporting of certain cash receipts and cash payments and classification of cash flows from hedging transactions'.

FRS 1 (revised) defines cash as cash and balances at central banks and advances to banks payable on demand. Under US GAAP, *Cash equivalents* are defined as short-term highly liquid investments that are both:

- convertible to known amounts of cash; and
- so near their maturity that they present insignificant risk of changes in value because of fluctuations in interest rates.

The other principal differences between US and UK GAAP are in respect of classification. Under UK GAAP, HSBC presents its cash flows by: (a) Operating activities; (b) Dividends received from associated undertakings; (c) Returns on investment and servicing of finance; (d) Taxation paid; (e) Capital expenditure and financial investments; (f) Acquisitions and disposals; (g) Equity dividends paid; and (h) Financing. Under US GAAP, only three categories are required. These are: (a) Operating; (b) Investing; and (c) Financing.

<i>Cash Flow</i>	<i>Classification Under FRS 1 (Revised)</i>	<i>Classification Under SFAS No. 95/104</i>
Taxation paid	Taxation paid	Operating activities
Dividends received from associated undertakings	Dividends received from associated undertakings	Investing activities
Equity dividends paid	Equity dividends paid	Financing activities
Non-equity dividends paid and dividends to minority interests	Returns on investments and servicing of finance	Financing activities
Capital expenditure and financial investment	Capital expenditure and financial investment	Investing activities
Transfers of subsidiaries and other associated interests	Acquisitions and disposals	Investing activities
Net changes in loans and advances including finance lease payables	Operating activities	Investing activities
Net changes in deposits	Operating activities	Financing activities

Under FRS 1 (revised), hedges are reported under the same heading as the related assets or liabilities.

Notes on the Financial Statements (continued)

For the purposes of the following table, HSBC have defined cash and cash equivalents as the sum of the following balance sheet categories:

	1998 US\$m	1997 US\$m
Cash and balances at central banks	3,048	2,961
Items in the course of collection from other banks	5,911	5,669
Loans and advances to banks repayable on demand	11,155	17,795
Less:		
Items in the course of transmission to other banks	(4,206)	(4,045)
	<u>15,908</u>	<u>22,380</u>

Set out below is a summary combined statement of cash flows under US GAAP.

	Year ended 31 December	
	1998 US\$m	1997 US\$m
Cash flows from operating activities	6,601	9,577
Cash flows from investing activities	(18,132)	(34,014)
Cash flows from financing activities	5,017	30,818
Effect of exchange rate changes on cash and cash equivalents	42	(943)
Net movement in cash and cash equivalents under US GAAP	(6,472)	5,438
Cash and cash equivalents at beginning of year	<u>22,380</u>	<u>16,942</u>
Cash and cash equivalents at the end of the year	<u>15,908</u>	<u>22,380</u>

The total interest paid by HSBC during the year was US\$21,500 million (1997: US\$16,706 million).

(1) Future developments

SFAS No. 133 'Accounting for Derivative Instruments and for Hedging Activities' was issued in June 1998. The Statement is effective for fiscal years beginning after 15 June 2000 and may not be retroactively applied to financial statements of prior periods. Initial application shall be at the beginning of an entity's fiscal year and on that date, hedging relationships shall be designated anew. At the date of initial application, an entity shall recognise all derivatives as either assets or liabilities in the statement of financial position and measure them at fair value. The entity also shall recognise offsetting gains and losses on hedged assets, liabilities and firm commitments by adjusting their carrying amount at the balance sheet date. Transition adjustments resulting from adopting this Statement shall be reported in net income or other comprehensive income, as appropriate based on the hedging relationship, if any, that had existed for that derivative. HSBC is currently reviewing the likely impact of this Statement.

Statement of Position ('SOP') 98-1 'Accounting for the costs of computer software developed or obtained for internal use', was issued in March 1998 and requires internal and external costs incurred to develop internal-use computer software to be capitalised from the application development stage through to the point at which the project is substantially complete. The SOP is effective for fiscal years beginning after 15 December 1998 and retroactive application is not permitted. HSBC is currently reviewing the likely impact of this Statement.

46 Subsequent events

(a) Share capital reorganisation

On 22 February 1999, the Board announced that it proposed to consolidate the two existing classes of ordinary shares of HK\$10 each and 75p each into one class of ordinary share denominated in United States dollars.

As part of the share capital reorganisation, it is also intended to capitalise certain reserves and subdivide the new United States dollar shares, so that the shareholder will receive three new ordinary shares of

US\$0.50 each for each existing ordinary share of HK\$10 or 75p. The proposal will be effected by the cancellation of existing ordinary shares of HK\$10 each and the ordinary shares of 75p each and the issue in their place of new ordinary shares denominated in United States dollars.

The share capital reorganisation was approved at the Annual General Meeting on 28 May 1999, but is still subject to approval of the High Court of Justice in England and Wales in accordance with the Companies Act. It is intended that the existing ordinary shares of HK\$10 each and 75p each will cease to be valid on 2 July 1999, and that trading in the new ordinary shares will commence, in Hong Kong and London, on 5 July 1999.

This has been reflected in the financial statements as follows:

- earnings and other amounts expressed on a per share basis have been restated as if the US\$0.50 ordinary shares had been in issue throughout all periods presented; and
- other references to shares are to the HK\$10 or 75p ordinary shares actually in issue at the appropriate date.

(b) *Acquisitions*

On 10 May 1999, HSBC announced that it had entered agreements with Republic New York Corporation ('RNYC') and Safra Republic Holdings S.A. ('Safra') to acquire the entire share capital of both companies for an aggregate consideration of approximately US\$10.3 billion. These transactions, which include a plan of merger under which RNYC will be merged with a wholly-owned subsidiary of HSBC and a tender offer for Safra, are subject to the approval of the RNYC shareholders and a variety of regulatory bodies.

On 11 May 1999, HSBC raised approximately US\$3.0 billion of the consideration through an equity issuance and expects to fund the remainder from cash on hand and debt and preference share issuances.

Notes on the Financial Statements (continued)

Signatures

Pursuant to the requirements of Section 12 of the Securities Exchange Act of 1934, the registrant certifies that it meets all of the requirements for filing on Form 20-F and has duly caused this registration statement to be signed on its behalf by the undersigned, thereunto duly authorised.

HSBC Holdings plc
Registrant

Date: 18 June 1999

/s/ D J FLINT

D J Flint
Group Finance Director

Glossary

GLOSSARY OF TERMS

Terms Used

Advance Corporation Tax

Allotted

Articles of Association

Associated undertakings

Attributable profit

Balance sheet

Bills

Called-up share capital

Capital allowances

Creditors

Dealing

Debtors

Deferred tax

De-mutualising

Depreciation

Fees and commissions payable

Fees and commissions receivable

Finance lease

Freehold

Interest payable

Interest receivable

Interests in associated undertakings

Loans and advances

Loan capital

Memorandum items

Nominal value

One-off

Ordinary shares

Other participating interests

Overdraft

Preference shares

Premises

Profit & loss account

Profit & loss account reserve

Provisions

Revaluation reserve

Share capital

Shareholders' funds

Share premium account

Shares in issue

Tangible fixed assets

Undistributable reserves

Write-offs

US Equivalent or Brief Description

Tax paid on company distributions offsettable

against UK taxes due on income (repealed with effect from 6 April 1999)

Issued

Bylaws

Long-term equity investments accounted for by the equity method

Net income

Statement of financial position

Notes

Ordinary shares, issued and fully paid.

Tax depreciation allowances

Payables

Trading

Receivables

Deferred income tax

Process by which a mutual society is converted into a public limited company

Amortisation

Fees and commissions expense

Fees and commissions income

Capital lease

Ownership with absolute rights in perpetuity

Interest expense

Interest income

Long-term equity investments accounted for by the equity method

Lendings

Long-term debt

Contingencies and commitments; off-balance-sheet items

Par value

Non-recurring

Common stock

Long-term equity investments accounted for by the cost method

A line of credit, contractually repayable on demand unless a fixed-term has been agreed, established through a customer's current account

Preferred stock

Real estate

Income statement

Retained earnings

Allowances

Increase or temporary decrease in the valuation of certain assets as compared with historical cost

Ordinary shares or common stock issued and fully paid

Stockholders' equity

Additional paid-in capital

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Charge-offs

Cross reference

CROSS REFERENCE SHEET

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ANNEX B

DESCRIPTION OF THE SUBORDINATED NOTES

The US\$1,350,000,000 9.547% Subordinated Step-up Cumulative Notes due 30 June 2040 (the "Series A Notes") and the US\$900,000,000 10.176% Subordinated Step-up Cumulative Notes due 30 June 2040 (the "Series B Notes", and together with the Series A Notes, the "Notes") of HSBC Holdings plc (the "Issuer") are the subject of a fiscal agency agreement dated 17 April 2000 (as amended or supplemented from time to time, the "Fiscal Agency Agreement") between the Issuer, HSBC Bank plc as fiscal agent (the "Fiscal Agent", which term includes any successor fiscal agent appointed from time to time in connection with the Notes) and the paying agents named therein (together with the Fiscal Agent, the "Paying Agents", which expression includes any successor or additional paying agents appointed from time to time in connection with the Notes). Certain provisions of these Conditions are summaries of the Fiscal Agency Agreement and subject to its detailed provisions. The holders of the Notes (the "Noteholders") and the holders of the related interest coupons (the "Couponholders" and the "Coupons", respectively) are bound by, and are deemed to have notice of, all the provisions of the Fiscal Agency Agreement applicable to them. Copies of the Fiscal Agency Agreement are available for inspection by Noteholders during normal business hours at the Specified Offices of each of the Paying Agents, the initial Specified Offices of which are set out below.

1. FORM, DENOMINATION AND TITLE

The Notes are in bearer form in the denomination of US\$1,000 with Coupons and talons (each, a "Talon") for further Coupons attached at the time of issue. Title to the Notes, the Coupons and the Talons will pass by delivery. The holder of any Note, Coupon or Talon shall (except as otherwise required by law) be treated as its absolute owner for all purposes (whether or not it is overdue and regardless of any notice of ownership, trust or any other interest therein, any writing thereon or any notice of any previous loss or theft thereof) and no person shall be liable for so treating such holder.

Interests in the Subordinated Notes will not be delivered or otherwise made available in any form to holders of the Preferred Securities, and the rights of such holders shall be represented solely by Preferred Securities in registered form.

2. STATUS

- (a) The Notes constitute direct, unsecured obligations of the Issuer ranking *pari passu* without any preference among themselves. The rights of holders of the Notes will, in the event of the winding up of the Issuer, be subordinated in right of payment to the claims of all other creditors of the Issuer other than creditors in respect of Subordinated Indebtedness whose claims rank or are expressed to rank *pari passu* with or junior to (i) the Notes or (ii) any other of the Issuer's obligations which rank *pari passu* with or junior to the Notes. For the avoidance of doubt the rights of the holders of the Notes will in the event of the winding up of the Issuer be subordinated to the claims of creditors in respect of the 11.69% Subordinated Bonds due 2002 of the Issuer referred to in paragraph (iii) of the proviso to the definition of Subordinated Indebtedness in Condition 2(d), creditors in respect of the guarantee given by the Issuer for the benefit of the holders of the 9.547% Non-cumulative Step-up Perpetual Preferred Securities, Series 1 and the 10.176% Non-cumulative Step-up Perpetual Preferred Securities, Series 2 both of HSBC Capital Funding (Dollar 1) L.P. (the "Guarantee") and, in each case, creditors ranking *pari passu* therewith.
- (b) The Issuer's obligation to make any payment of principal or interest in respect of any Note (including any Arrears of Interest and Additional Interest Amounts (each as defined in Condition 3) and any additional amounts payable under Condition 6) is conditional upon the Issuer being able to make such payment and be Solvent immediately thereafter.

(c) In the event of the winding up of the Issuer in England and Wales, any claim of a Noteholder for payment of principal and Accrued Interest (as defined in Condition 4) in respect of any Note shall be treated as if, on the day preceding the commencement of the winding up of the Issuer, the amount payable had been converted into such number of preference shares of US\$1 each in the capital of the Issuer (forming or being part of a class having a preferential right to a return of capital in the winding up over the holders of all other classes of shares in the capital of the Issuer, and entitled to receive in such winding up the amount credited as paid up in respect of such shares) credited as fully paid up, as is equal to the principal amount of the Notes together with interest accrued to that date and Accrued Interest, rounded down to the nearest whole U.S. dollar.

(d) For the purpose of this Condition 2:

"Solvent" means, in relation to the Issuer, that its Assets exceed its Liabilities (in each case, as defined below) including its Liabilities to creditors in respect of the 11.69% Subordinated Bonds due 2002 of the Issuer referred to in paragraph (iii) of the proviso to the definition of Subordinated Indebtedness below, creditors in respect of the Guarantee and, in each case, creditors ranking *pari passu* therewith but excluding its Liabilities to persons in respect of Subordinated Indebtedness whose claims rank or are expressed to rank *pari passu* with, or junior to, the Notes or any other of its obligations which rank *pari passu* with the Notes; and "Insolvent" shall be construed accordingly, and for the purposes hereof, "Assets" means the unconsolidated gross assets (including contingencies) of the Issuer and "Liabilities" means the unconsolidated gross liabilities (including contingencies) of the Issuer, all as shown in the latest published balance sheet having the benefit of an unqualified Auditors' report but with such adjustments as the auditors of the Issuer or, if the Issuer is in winding up, the liquidator shall determine in any report of such auditor issued on the request of the Issuer or of such liquidator prepared in connection with the liquidation of the Issuer and in either case relating to the solvency of the Issuer.

"Subordinated Indebtedness" means any liability of the Issuer howsoever arising for the payment of money the right to payment of which by the Issuer by the terms thereof is, or is expressed to be, subordinated in the event of a winding up of the Issuer to the claims of all or any of the creditors of the Issuer Provided that the term "Subordinated Indebtedness" shall include, without limitation, any liability of the Issuer to any creditor of the Issuer:

- (i) whose right to payment ranks or is expressed to rank postponed or subordinated to that of unsubordinated creditors (such unsubordinated creditors not being creditors whose right to payment is preferred by operation of law);
- (ii) whose right to payment is made subject to a condition or is restricted (whether by operation of law or otherwise) or is expressed to be restricted in each case such that the amount which may be claimed for his own retention by such creditor in the event that the Issuer is not solvent is less than in the event that the Issuer is solvent; or
- (iii) whose debt is irrecoverable or expressed to be irrecoverable unless the persons entitled to payment of principal and interest in respect of the 11.69% Subordinated Bonds due 2002 of the Issuer constituted by a Trust Deed dated 10 July 1992 made between the Issuer and The Law Debenture Trust Corporation p.l.c. recover the amount of such principal and interest which such persons would be entitled to recover if payments of such principal and interest to such persons were not subject to any condition.

NB: If the Issuer would not otherwise be Solvent (including liabilities to creditors other than senior creditors) interest on the Notes may be used to absorb further losses.

(e) Claims in respect of any Notes or Coupons may not be set off, or be the subject of a counterclaim, by the holder against or in respect of any obligations of his to the Issuer or any other person.

3. INTEREST

- (a) The Series A Notes bear interest (from and including) 17 April 2000 (the "Issue Date") to (but excluding) 30 June 2010 (the "Series A Re-set Date") at the rate of 9.547% per annum and from (and including) the Series A Re-set Date at the rate of 4.06% per annum above the Reference Rate (the "Series A Rate of Interest") and the Series B Notes bear interest from (and including) the Issue Date to (but excluding) 30 June 2030 (the "Series B Re-set Date" and each of the Series A Re-set Date and Series B Re-set Date being a "Re-set Date") at the rate of 10.176% per annum and from (and including) the Series B Re-set Date at the rate of 4.98% per annum above the Reference Rate (the "Series B Rate of Interest") in each case payable on 30 June and 31 December in each year commencing on 31 December 2000 and ending on the relevant Re-set Date and 31 March, 30 June, 30 September and 31 December thereafter, subject as provided in Condition 2 (*Status*) and Condition 5 (*Payments*). Each date for the payment of interest is herein called an "Interest Payment Date" and each period beginning on (and including) the Issue Date or any Interest Payment Date and ending on (but excluding) the next Interest Payment Date is herein called an "Interest Period". The "Reference Rate" in respect of any Interest Period means the three month rate for deposits in U.S. dollars determined by the Fiscal Agent which appears on page 3750 of Telerate as of approximately 11 a.m., London time, on the fifth Business Day prior to the first day of the relevant Interest Period provided that, if, at such time, no such rate appears or the relevant Telerate page is unavailable, the Fiscal Agent will request appropriate quotations and will determine the arithmetic mean of the rates at which deposits in U.S. dollars are offered by three major banks (or, if fewer than three rates are so quoted, two major banks, or, if fewer than two rates are so quoted, one major bank) in the London interbank market, selected by the Fiscal Agent, at approximately 11 a.m. London time on the fifth Business Day prior to the first day of the relevant period to prime banks in the London interbank market for a period of three months and in an amount that is representative for a single transaction in the relevant market at the relevant time.
- (b) Each Note will cease to bear interest from the due date for redemption of such Note unless, upon due presentation, payment of principal is improperly withheld or refused or is not made by reason of the provisions of Condition 2(b), in which case it will continue to bear interest at the relevant rate specified in Condition 3(a) (as well after as before judgment) until whichever is the earliest of (i) the day on which all sums due in respect of such Note up to that day are received by or on behalf of the relevant Noteholder, (ii) the day which is seven days after the Fiscal Agent has notified the Noteholders that it has received all sums due in respect of the Notes up to such seventh day (except to the extent that there is any subsequent default in payment) or (iii) in the event of the winding up of the Issuer in England and Wales, the day preceding the commencement of winding up of the Issuer.
- (c) The amount of interest payable in respect of each Note for any Interest Period up to the applicable Re-set Date shall be calculated by applying the Series A Rate of Interest (in the case of the Series A Notes) and the Series B Rate of Interest (in the case of the Series B Notes) to the principal amount of such Note, dividing the product by two and rounding the resulting figure to the nearest cent (half a cent being rounded upwards). If interest is required to be calculated for any other period prior to the relevant Re-set Date, it will be calculated on the basis of a year of 360 days consisting of 12 months of 30 days each and, in the case of an incomplete month, the actual number of days elapsed.

The amount of interest payable in respect of each Note for any Interest Period after the applicable Re-set Date shall be calculated by applying the Series A Rate of Interest (in the case of Series A Notes) and Series B Rate of Interest (in the case of Series B Notes) to the principal amount of such Note, multiplying the product by the actual number of days in the Interest Period concerned divided by 360 and rounding the resulting figure to the nearest cent (half a cent being rounded upwards). If interest is required to be

calculated for any other period after the relevant Interest Re-set Date, it will be calculated on the basis of a year of 360 days and the actual number of days elapsed.

- (d) Any interest in respect of the Notes not paid on an Interest Payment Date due to the provisions of Condition 2(b) shall, so long as the same remains outstanding, constitute "Arrears of Interest" and, subject to Condition 2(b), shall be payable (together with the corresponding Additional Interest Amount (as defined below)) on the next Interest Payment Date but Arrears of Interest (together with the corresponding Additional Interest Amount) in respect of all Notes for the time being outstanding shall become due on whichever is the earlier of:
- (i) any date fixed for redemption of the Notes; and
 - (ii) an order being made or an effective resolution being passed for the winding up of the Issuer in England and Wales (otherwise than in connection with a scheme of reconstruction or amalgamation the terms of which shall previously have been approved by an Extraordinary Resolution of the Noteholders).

Each amount of Arrears of Interest shall bear interest (as if it constituted the principal of the Notes) and the amount of such interest (the "Additional Interest Amount") with respect to Arrears of Interest shall (subject always to Condition 2(b)) be due and payable pursuant to this Condition 3(d) and shall be calculated by the Fiscal Agent applying the rate of interest then applicable to the relevant Notes to the amount of the Arrears of Interest and otherwise *mutatis mutandis* as provided in the foregoing provisions of this Condition 3. The Additional Interest Amount accrued up to any Interest Payment Date shall, to the extent unpaid, be added, for the purpose only of calculating the Additional Interest Amount accruing thereafter, to the amount of Arrears of Interest remaining unpaid on such Interest Payment Date so that it will itself become Arrears of Interest.

- (e) If amounts in respect of Arrears of Interest and Additional Interest Amounts are at any time only partially payable:
- (i) all unpaid amounts of Arrears of Interest shall be payable before any Additional Interest Amounts;
 - (ii) Arrears of Interest accrued for any period shall not be payable until full payment has been made of all Arrears of Interest that have accrued during any earlier period and the order of payment of Additional Interest Amounts shall follow that of the Arrears of Interest to which they relate; and
 - (iii) the amount of Arrears of Interest or Additional Interest Amounts payable in respect of any Note in respect of any period shall be *pro rata* to the total amount of all unpaid Arrears of Interest or, as the case may be, Additional Interest Amounts accrued in respect of that period to the date of payment.

4. REDEMPTION AND PURCHASE

- (a) *Scheduled redemption:* Unless previously redeemed, or purchased and cancelled, the Notes will be redeemed at their principal amount together with interest accrued to the date fixed for redemption (including Arrears of Interest and any Additional Interest Amount (each as defined in Condition 3(d)) ("Accrued Interest") on 30 June 2040 (the "Maturity Date"), subject as provided in Conditions 2(b) and 2(c) and Condition 5 (Payments).
- (b) *Redemption for tax reasons:* The Notes may be redeemed at the option of the Issuer in whole but not in part, at any time, on giving not less than 30 nor more than 60 days' notice to the Noteholders (which notice shall be irrevocable) at the principal amount of the Notes to be redeemed together with Accrued Interest, if there is more than an insubstantial risk that:

- (i) on any Interest Payment Date subsequent to the giving of such notice the Issuer would be required to pay any additional amounts in accordance with the provisions of Condition 6; or
- (ii) if the Issuer were to seek to redeem the Notes (for which purpose no regard shall be had as to whether or not the Issuer would otherwise be entitled to redeem such Notes), the Issuer would be required to pay any additional amounts in accordance with the provisions of Condition 6.

In either case as a result of a change in any law or regulation of the United Kingdom, or in any treaty to which the United Kingdom is a party, or in the official interpretation or application of any law, regulation or treaty by any relevant body in the United Kingdom.

Prior to the publication of any notice of redemption pursuant to this paragraph, the Issuer shall deliver to the Fiscal Agent an opinion of an independent legal adviser or accountant of recognised standing to the effect that there has been such a change and there is such a risk the Issuer would become obliged to pay such additional amounts.

- (c) *Par Redemption at the option of the Issuer:* The Series A Notes may be redeemed at the option of the Issuer in whole but not in part on the Series A Re-set Date or any Interest Payment Date thereafter and the Series B Notes may be redeemed at the option of the Issuer in whole but not in part on the Series B Re-set Date or any Interest Payment Date thereafter in either case at a price equal to the nominal amount of the Notes to be redeemed together with Accrued Interest on the Issuer giving not less than 30 nor more than 60 days' notice to the Noteholders (which notice shall be irrevocable and shall oblige the Issuer to redeem such Notes on the relevant Re-set Date or Interest Payment Date at such price.
- (d) *Make Whole Redemption at the option of the Issuer:* The Series A Notes may be redeemed at the option of the Issuer in whole but not in part at any time prior to the Re-set Date and the Series B Notes may be redeemed at the option of the Issuer in whole but not in part at any time prior to the Re-set Date, in either case at an amount equal to the higher of (i) the nominal amount of the Notes to be redeemed together with Accrued Interest and (ii) the Make Whole Amount on the Issuer giving not less than 30 nor more than 60 days' notice to the Noteholders (which notice shall be irrevocable and shall oblige the Issuer to redeem such Notes on the date specified in such notice (the "Call Settlement Date"));

For the purpose of this Condition 4(d):

"Make Whole Amount" in respect of a Note means, at any time prior to the relevant Re-set Date for such Subordinated Note, an amount equal to the sum of

- (i) the present value of the principal amount plus
- (ii) the present value of each remaining scheduled payment of interest to and including the relevant Re-set Date,

discounted from (i) in relation to the nominal amount, the First Optional Redemption Date and (ii) in relation to each such remaining scheduled payment, the relevant Interest Payment Date to, in each case, the Call Settlement Date at a rate equal to the sum of (x) 1.77% in the case of a Series A Note and 2.07% in the case of a Series B Note until the first anniversary of the Issue Date and thereafter in each case 0.50% and (y) the U.S. Treasury Yield on a semi-annual compounding basis (rounded to four decimal places) at 3.00 p.m. (London time) on the fifth Business Day prior to the Call Settlement Date and at any time after the Relevant Re-set Date the nominal amount of such Note; and

"US Treasury Yield" means the yield calculated by the Fiscal Agent, under the heading which represents the average for the immediately prior week, appearing in the most recently published statistical release designated "H.15(519)" or any successor publication which is published weekly by the Federal Reserve and which establishes yields on actively traded U.S. Treasury securities adjusted to constant maturity under the caption

"Treasury Constant Maturities," for the maturity most closely corresponding to 30 June 2010 in the case of Series A Notes and 30 June 2030 in the case of Series B Notes.

- (e) *Regulatory consent:* Any optional redemption or other purchase by the Issuer of the Series A Notes or Series B Notes, is subject to the prior consent of the Financial Services Authority (which term includes any successor thereto), if required.
- (f) *No other redemption:* The Issuer shall not be entitled to redeem the Notes otherwise than as provided in paragraphs (a) to (d) above.
- (g) *Purchase:* The Issuer or any of its subsidiaries may at any time purchase Notes in the open market or otherwise and at any price, provided that all unmatured Coupons and unexchanged Talons are attached thereto or surrendered therewith.
- (h) *Cancellation:* All Notes so redeemed or purchased by the Issuer or any of its subsidiaries and any unmatured Coupons or unexchanged Talons attached to or surrendered with them will be cancelled and may not be reissued or resold. References in this Condition 4 to the purchase of Notes shall not include the purchase of Notes in the ordinary course of business in dealing in securities or the purchase of Notes otherwise than as beneficial owner.

5. PAYMENTS

- (a) *Principal:* Payments of principal shall be made only against and (provided that payment is made in full) surrender of Notes at the Specified Office of any Paying Agent by U.S. dollar cheque drawn on, or by transfer to a U.S. dollar account maintained by the payee with, a bank in New York City.
- (b) *Interest:* Payments of interest shall, subject to paragraph (f) below, be made only against presentation and (provided that payment is made in full) surrender of the appropriate Coupons at the Specified Office of any Paying Agent in the manner described in paragraph (a) above.
- (c) *Payments subject to fiscal laws:* All payments in respect of the Notes are subject in all cases to any applicable fiscal or other laws and regulations, but without prejudice to the provisions of Condition 6 (Taxation). No commissions or expenses shall be charged to the Noteholders or Couponholders in respect of such payments.
- (d) *Deduction for unmatured Coupons:* If a Note is presented without all unmatured Coupons relating thereto, then:
 - (i) If the aggregate amount of the missing Coupons is greater than the principal amount of such Note, so many of such missing Coupons shall become void (in inverse order of maturity) as will result in the aggregate amount of the remainder of such missing Coupons (the "Relevant Coupons") being equal to the principal amount of such Note; *provided, however, that*, where this sub-paragraph would otherwise require a fraction of a missing Coupon to become void, such missing Coupon shall become void in its entirety; and
 - (ii) A sum equal to the aggregate amount of the Relevant Coupons (or, if less, the principal amount of such Note) will be deducted from the amount of principal due for payment; *provided, however, that*, if the gross amount available for payment is less than the principal amount of such Note, the sum deducted will be that proportion of the aggregate amount of the Relevant Coupons (or, as the case may be, the principal amount of such Note) which the gross amount actually available for payment bears to the principal amount of such Note.

Each sum of principal so deducted shall be paid in the manner provided in paragraph (a) above against presentation and (provided that payment is made in full) surrender of the relevant missing Coupons. No payments will be made in respect of void Coupons.

- (e) *Payments on business days:* If the due date for payment of any amount in respect of any Note or Coupon is not a business day in the place of presentation, the holder shall

not be entitled to payment in such place of the amount due until the next succeeding business day in such place and shall not be entitled to any further interest or other payment in respect of any such delay. In this paragraph, "business day" means, in respect of any place of presentation, any day on which banks are open for business (including dealings in US dollars) in (a) London, (b) New York City and (c) such place of presentation (if not London or New York City).

- (f) *Payments other than in respect of matured Coupons:* Payments of interest other than in respect of matured Coupons shall be made only against presentation of the relevant Notes at the Specified Office of any Paying Agent.
- (g) *Partial payments:* If a Paying Agent makes a partial payment in respect of any Note or Coupon presented to it for payment, such Paying Agent will endorse thereon a statement indicating the amount and date of such payment.
- (h) *Exchange of Talons:* On or after the maturity date of the final Coupon which is (or was at the time of issue) part of a coupon sheet relating to the Notes (each, a "Coupon Sheet"), the Talon forming part of such Coupon Sheet may be exchanged at the Specified Office of the Fiscal Agent for a further Coupon Sheet (including a further Talon but excluding any Coupons in respect of which claims have already become void pursuant to Condition 8 (*Prescription*)). Upon the due date for redemption of any Note, any unexchanged Talon relating to such Note shall become void and no Coupon will be delivered in respect of such Talon.

6. TAXATION

All payments of principal and interest in respect of the Notes and the Coupons by or on behalf of the Issuer shall be made without withholding or deduction for or on account of any taxes, duties, assessments or governmental charges of whatever nature, present or future, imposed or levied by or on behalf of the United Kingdom (or any authority or political subdivision therein or thereof having power to tax), unless the Issuer is required by law to withhold or deduct any such taxes, duties, assessments or governmental charges.

In that event, the Issuer will pay such additional amounts as may be necessary in order that the net amounts receivable by the Noteholders or Couponholders, as the case may be, after such withholding or deduction shall equal the respective amounts of principal and interest which would have been receivable in respect of the Notes and/or, as the case may be, Coupons, in the absence of such withholding or deduction; except that no such additional amounts shall be payable with respect to any Note or Coupon presented for payment:

- (a) in the United Kingdom; or
- (b) to, or to a third party on behalf of, a holder of a Note or Coupon who is liable to such taxes, duties, assessments or governmental charges in respect of such Note or Coupon by reason of his having some connection with the United Kingdom other than the mere holding of such Note or Coupon; or
- (c) unless it is proved to the satisfaction of the Fiscal Agent or the Paying Agent to whom the same is presented, that the holder is unable to avoid such withholding or deduction by satisfying any statutory requirement or by making a declaration of non-residence or other similar claim for exemption to a Paying Agent or the relevant tax authorities (as applicable) or by notifying (and/or presenting evidence of such notification to) any tax authorities of such payment of principal or interest or by presenting the relevant Note or Coupon at the specified office of another Paying Agent provided that the Issuer or its agent has provided the Holder with at least 60 days prior written notice of the opportunity to make such declaration or claim; or
- (d) more than 30 days after the Relevant Date (defined below) except to the extent that the holder thereof would have been entitled to such additional amounts on presenting the same for payment on the last day of such period of 30 days; or

- (e) to, or to a third party on behalf of, a holder who is not the sole beneficial owner of the Note or any Coupon, or a portion of either, or that is a fiduciary or partnership, but only to the extent that a beneficiary or settlor with respect to the fiduciary, a beneficial owner or member of the partnership would not have been entitled to the payment of an additional amount had the beneficiary, settlor, beneficial owner or member received directly its beneficial or distributive share of the payment.

As used herein the "Relevant Date" means the date on which such payment first becomes due and payable but if the full amount of the money payable has not been received by the Fiscal Agent on or prior to such due date, it means the date on which, the full amount of such money having been so received, notice to that effect shall have been duly given to the relevant Noteholders in accordance with Condition 12.

Any reference in these Conditions to principal or interest or both in respect of the relevant Notes shall be deemed to include, as applicable, any additional amounts which may be payable under this Condition 6.

7. ENFORCEMENT

- (a) Subject to Condition 2(b), if default is made for a period of 7 days or more in the repayment of any principal due on the Notes or any of them or if default is made for a period of 14 days or more in the payment of any interest due in respect of the Notes or any of them, then any Noteholder or Noteholders holding not less than one-tenth of the aggregate principal amount of the outstanding Notes may, in order to enforce payment, at its discretion and without further notice, institute proceedings for the winding up of the Issuer in England and Wales,

Provided that it shall not be such a default to withhold or refuse any such payment (i) in order to comply with any fiscal or other law or regulation or with the order of any court of competent jurisdiction, in each case applicable to such payment or (ii) in cases of doubt as to the validity or applicability of any such law, regulation or order, in accordance with advice given at any time during the said period of 7 or 14 days, as the case may be, by independent legal advisers acceptable to the Fiscal Agent as to such validity or applicability.

- (b) In the event of an order being made or an effective resolution being passed for the winding up of the Issuer in England (otherwise than in connection with a solvent scheme of reconstruction or amalgamation or a scheme of reconstruction or amalgamation the terms of which shall previously have been approved by an Extraordinary Resolution of the Noteholders) any Noteholder may declare its Notes to be due and redeemable immediately (and such Notes shall thereby become so due and redeemable) at the amount calculated in accordance with Condition 2(c).
- (c) No remedy against the Issuer (including any right of set off) other than as specifically provided by this Condition 7 shall be available to Noteholders or Couponholders whether for the recovery of amounts owing in respect of such Notes or the Coupons appertaining thereto or in respect of any breach by the Issuer of any obligation, condition or provision under such Notes or Coupons or otherwise.

8. PRESCRIPTION

Claims for principal shall become void unless the relevant Notes are presented for payment within ten years of the appropriate Relevant Date. Claims for interest shall become void unless the relevant Coupons are presented for payment within five years of the appropriate Relevant Date.

9. REPLACEMENT OF NOTES, COUPONS AND TALONS

If any Note, Coupon or Talon is lost, stolen, mutilated, defaced or destroyed, it may be replaced at the Specified Office of the Fiscal Agent and the Paying Agent having its Specified Office in London, subject to all applicable laws and stock exchange requirements, upon

payment by the claimant of the expenses incurred in connection with such replacement and on such terms as to evidence, security, indemnity and otherwise as the Issuer may reasonably require. Mutilated or defaced Notes, Coupons or Talons must be surrendered before replacements will be issued.

10. PAYING AGENTS

In acting under the Fiscal Agency Agreement and in connection with the Notes and Coupons, the Paying Agents act solely as agents of the Issuer and do not assume any obligations towards or relationship of agency or trust for or with any of the Noteholders or Couponholders.

The initial Paying Agents and their initial Specified Offices are listed below. The Issuer reserves the right at any time to vary or terminate the appointment of any Paying Agent and to appoint a successor fiscal agent and additional or successor paying agents; *provided, however, that* the Issuer shall at all times maintain a paying agent in London (which may be the fiscal agent), a paying agent having its specified office in a city outside the European Union and a fiscal agent. Notice of any change in any of the Paying Agents or in their Specified Offices shall promptly be given to the Noteholders.

11. MEETINGS OF NOTEHOLDERS; MODIFICATION AND WAIVER

- (a) *Meetings of Noteholders:* The Fiscal Agency Agreement contains provisions for convening meetings of Noteholders to consider matters relating to the Notes, including the modification of any provision of these Conditions. Any such modification may be made if sanctioned by an Extraordinary Resolution. Such a meeting may be convened by the Issuer and shall be convened by it upon the request in writing of Noteholders holding not less than one-tenth of the aggregate principal amount of the outstanding Notes. The quorum at any meeting convened to vote on an Extraordinary Resolution will be two or more persons holding or representing one more than half of the aggregate principal amount of the outstanding Notes or, at any adjourned meeting, two or more persons being or representing Noteholders whatever the principal amount of the Notes held or represented; *provided, however, that* certain proposals (including any proposal to change any date fixed for payment of principal or interest in respect of the Notes, to reduce the amount of principal or interest payable on any date in respect of the Notes, to alter the method of calculating the amount of any payment in respect of the Notes or the date for any such payment, to change the currency of payments under the Notes or to change the quorum requirements relating to meetings or the majority required to pass an Extraordinary Resolution (each, a "Reserved Matter")) may only be sanctioned by an Extraordinary Resolution passed at a meeting of Noteholders at which two or more persons holding or representing not less than three-quarters or, at any adjourned meeting, one quarter of the aggregate principal amount of the outstanding Notes form a quorum. Any Extraordinary Resolution duly passed at any such meeting shall be binding on all the Noteholders and Couponholders, whether present or not.
- (b) *Modification:* The Notes and these Conditions may be amended without the consent of the Noteholders or the Couponholders to correct a manifest error or by way of a modification which is of a formal, minor or technical nature. In addition, the parties to the Fiscal Agency Agreement may agree to modify any provision thereof, but the Issuer shall not agree, without the consent of the Noteholders, to any such modification unless it is of a formal, minor or technical nature, it is made to correct a manifest error or it is, in the opinion of such parties, not materially prejudicial to the interests of the Noteholders.
- (c) *Substitution:* Any subsidiary of the Issuer or any holding company of the Issuer or any subsidiary of such holding company may be substituted at any time or times as the principal debtor under the Notes and the Coupons. Such substitution shall be subject to the provision by the Issuer of an irrevocable guarantee in respect of the Notes on a subordinated basis and so that the claims of the Noteholders and the Couponholders may, in the case of the substitution of a banking company (being a company having as

its principal business the business of banking (which shall be deemed to include the business of term deposit-taking or merchant banking) or any banking activity which is, at the relevant time, generally recognised as an integral part of the business of banking) or a holding company of a banking company in the place of the Issuer, be subordinated to the rights of creditors other than some or all of its creditors in respect of Subordinated Indebtedness (as defined in Condition 2(b) but with the substitution of references to that banking company in place of references to the Issuer).

12. LISTING

So long as any Note remains outstanding, the Issuer will use its reasonable endeavours to procure and maintain a listing of the Notes on the London Stock Exchange Limited or any other recognised stock exchange.

13. NOTICES

Notices to the Noteholders shall be valid if published in a leading English language daily newspaper published in London (which is expected to be the *Financial Times*) or, if such publication is not practicable, in a leading English language daily newspaper having general circulation in Europe. Any such notice shall be deemed to have been given on the date of first publication. Couponholders shall be deemed for all purposes to have notice of the contents of any notice given to the Noteholders.

14. GOVERNING LAW

The Notes are governed by, and shall be construed in accordance with, English law.

ANNEX C

DESCRIPTION OF THE PREFERENCE SHARES

It is intended that the Series 1 Preference Shares to be issued upon substitution of the Series 1 Preferred Securities and the Series 2 Preference Shares to be issued a substitution of the Series 2 Preferred Securities (together, the "Preference Shares") will have the principal share rights described below.

HSBC is not currently authorised to issue the Preference Shares. HSBC has undertaken in the Guarantee to take all reasonable steps to propose and recommend to its shareholders at or prior to its annual general meeting in 2001 one or more resolutions amending the articles of association of HSBC in order to enable it to create preference shares denominated in U.S. dollars and having in all material respects terms equivalent to the Preferred Securities and the Guarantee taken together. In addition, HSBC has undertaken in the Guarantee to take all reasonable steps, *inter alia*, (i) to ensure that all other corporate authorisations required to be taken to enable substitution of the Preferred Securities with the Preference Shares to occur are taken and (ii) to cause the Preference Shares to be listed on a recognised international stock exchange.

HSBC contemplates that at the same time it will propose to its shareholders resolutions to create Preference Shares denominated in Euro (the "Euro Preference Shares") and in sterling (the "Sterling Preference Shares").

Subject to the above, the rights attaching to the Series 1 Preference Shares and the Series 2 Preference Shares will be contained in HSBC's latest Articles of Association (the "Articles") and in the resolutions to be passed by the Board of Directors of HSBC or a duly constituted committee thereof at or before the time of issue of the relevant Preference Shares. In addition, a detailed description of the rights attaching to the Preference Shares will be included in the Partnership Agreement.

Denomination

The par value of each Preference Share will be US\$0.01 which together with the premium on issue will aggregate to US\$1,000 or such lesser amount as is equal to the nominal amount of one Preferred Security (the "Principal Amount"). The premium applicable to each Preference Share will be determined by the Board of Directors of HSBC or a duly constituted committee thereof at or before the issue of the Preference Shares. The Preference Shares will be issued credited as fully paid.

Dividends

- (a). Subject to sub-paragraphs (e) and (f) below, each Preference Share will entitle the holder thereof to receive a non-cumulative preferential dividend on the Principal Amount thereon calculated on the bases set out in sub-paragraphs (b) and (c) below. The dividend will be payable semi-annually in arrear on 30 June and 31 December in each year up to and including the relevant Dividend Reset Date and thereafter quarterly in arrear on 31 March, 30 June, 30 September and 31 December in each year (each a "Dividend Payment Date") when, as and if declared by the Board of Directors, provided that the first dividend will be paid on a *pro rata* basis in respect of the period from, and including, the date of the Distribution Date (as defined in the Partnership Agreement) immediately preceding the date on which the Preference Shares are substituted for the Preferred Securities (the "Substitution Date") to, but excluding, the first such Dividend Payment Date after issue. If any Dividend Payment Date after the Dividend Re-set Date (as defined below) would otherwise fall on a day which is not a Business Day payment of the Dividend otherwise payable on such date will be postponed to the next day which is a Business Day.

"Dividend Re-set Date" means 30 June 2010 in respect of the Series 1 Preference Shares (the "Series 1 Dividend Re-set Date") and 30 June 2030 in respect of the Series 2 Preference Shares (the "Series 2 Dividend Re-set Date")

Such dividends will only be payable to the extent that payment of the same can be made out of profits available for distribution (the "distributable profits") under the provisions of the United Kingdom Companies Act as at each Dividend Payment Date.

The Preference Shares will rank as regards participation in profits *pari passu inter se* and *pari passu* with the Euro Preference Shares and the Sterling Preference Shares and with all other shares to the extent that they are expressed to rank *pari passu* therewith and in priority to HSBC's ordinary shares and to any other class of shares of HSBC issued after the date of issue of the Preference Shares.

For the purposes of this Description of the Preference Shares, "Dividend Period" means the period from the date of the Distribution Date immediately preceding the Substitution Date to the first Dividend Payment Date and each successive period from, and including, a Dividend Payment Date to, but excluding, the next succeeding Dividend Payment Date and "Business Day" means a day other than a Saturday or Sunday on which commercial banks and foreign exchange markets settle payments in US dollars and are open for general business in London and New York City.

- (b) Each Preference Share in issue prior to the Dividend Re-set Date will entitle the holder thereof to receive on each Dividend Payment Date falling on or prior to the Dividend Re-set Date dividends payable in US dollars at a fixed rate per annum of 9.547% in respect of the Series 1 Preference Shares and 10.176% in respect of the Series 2 Preference Shares, in each case of the Principal Amount thereof calculated on the basis of the number of days in the relevant period divided by 360 (the number of days to be calculated on the basis of a year of 360 days with 12 30-day months and in the case of an incomplete month the number of days elapsed).
- (c) Each Preference Share in issue on or after the relevant Dividend Re-set Date will entitle the holder thereof to receive dividends payable in US dollars at the rate equal to the Reference Rate in effect during the relevant Dividend Period plus the Margin, applied to the Principal Amount thereof calculated on the basis of the actual number of days in the relevant period divided by 360.

The Reference Rate from time to time in respect of each Preference Share will be determined in the manner and on the same basis as the Distribution Rate applicable to the Series 1 Preferred Securities (in respect of the Series 1 Preference Shares) and the Series 2 Preferred Securities (in case of the Series 2 Preference Shares) for such period provided, however, that all calculations relating to the Reference Rate will be made by HSBC.

- (d) Any decision regarding the declaration or payment of any dividend on the Preference Shares will be at the sole discretion of the Directors and nothing herein contained will impose on the Directors any requirement or duty to resolve to distribute in respect of any financial year or period the whole or any part of the profits of HSBC available for distribution.
- (e) Without prejudice to paragraph (d) above, if, in the opinion of the Directors, the distributable profits of HSBC are insufficient to cover both the payment in full of dividends payable on the Preference Shares on any Dividend Payment Date and on all other dividends stated to be payable on such date on any other shares expressed to rank *pari passu* with the Preference Shares as regards participation in profits, then, subject to paragraph (f) below, dividends may be declared by the Directors *pro rata* on such Preference Shares and on such other shares to the extent of the available distributable profits (if any) to the extent that the amount of dividend declared per share on each such Preference Share and on each such other share will bear to each other the same ratio as the dividends payable on each such Preference Share and on each such other share bear to each other.

- (f) If, in the opinion of the Directors, the declaration or payment of any dividend on any Preference Shares would breach or cause a breach of the FSA's capital adequacy requirements from time to time applicable to HSBC and/or any of its subsidiary undertakings, then no such dividend will be declared or paid.
- (g) Payments of preferential dividends shall be made to holders on the register at any date selected by the directors up to 42 days prior to the relevant Dividend Payment Date. The Preference Shares will carry no further right as regards participation in the profits of HSBC.
- (h) If for two consecutive Dividend Periods ending on or before the Dividend Re-set Date, or for any four consecutive Dividend Periods thereafter the dividend is not paid in full HSBC will not (a) declare or pay any dividends or other distributions in respect of its ordinary stock or any other security of HSBC ranking junior to the Preference Shares or (if permitted) effect any repurchase or redemption of its ordinary stock or any other preference shares of HSBC ranking junior to the Preference Shares (or contribute any moneys to a sinking fund for the redemption of such stock or preference shares) until after the next following Dividend Payment Date on which a dividend in respect of the Preference Shares is paid in full (or an amount equivalent to the dividend to be paid in respect of the next Dividend Payment Period has been paid or set aside for payment to the holders of the Preference Shares) or (b) (if permitted) repurchase or redeem any other preference shares which rank *pari passu* with the Preference Shares until after the next following Dividend Payment Date on which a dividend in respect of the Preference Shares is paid in full (or an amount equivalent to the dividend to be paid in respect of the next Dividend Period has been paid or set aside for payment to the holders).
- (i) Any dividend unclaimed after a period of 12 years from the date of declaration of such dividend will be forfeited and revert to HSBC. No dividends or other moneys payable on or in respect of a Preference Share shall bear interest against HSBC.

Return of Capital

- (a) On a return of capital in a winding up (but not on a redemption, reduction of capital or purchase of any shares by HSBC) the Preference Shares will rank, *pari passu inter se* and *pari passu* with the Euro Preference Shares and the Sterling Preference Shares and with any other shares of HSBC that are expressed to rank *pari passu* therewith as regards participation in the capital, and otherwise in priority to its ordinary shares and any other class of shares of HSBC ranking junior to the Preference Shares. On such a return of capital, each Preference Share will be entitled to receive in US dollars an amount equal to the Principal Amount together with, subject to the restrictions in paragraphs (e) and (f) under "Dividends" above, the amount of (i) any unpaid dividend for any Dividend Period ending on or before the date of commencement of the winding up or other return of capital (the "relevant date") and (ii) a pro rated dividend (calculated on the basis mentioned in (c) under "Dividends" above) in respect of the period, if any, from and including the last Dividend Payment Date prior to the relevant date down to but excluding the relevant date.
- (b) If, upon any such return of capital, the amounts available for payment are insufficient to cover the amounts payable in full on the Preference Shares and on any other shares expressed to rank *pari passu* therewith as regards participation in assets, then the holders of the Preference Shares and such other shares will share rateably and proportionately in such return of capital.
- (c) No Preference Share will confer any further right to participate on a return of capital of HSBC.

Redemption

- (a) Subject to paragraph (f) below, HSBC may, at its option, redeem (i) all, but not merely some, of the Series 1 Preference Shares for the time being issued and outstanding on the Series 1 Dividend Re-set Date, and/or (ii) all, but not merely some, of the Series 2

Preference Shares for the time being issued and outstanding on the Series 2 Dividend Re-Set Date, and in each case, on each Dividend Payment Date thereafter (each a "Redemption Date") provided that if either of the restrictions mentioned in paragraphs (e) and (f) under "Dividends" above applies to the dividend on the selected Redemption Date, HSBC may not redeem any of the Preference Shares on that Redemption Date.

- (b) Any redemption of the Preference Shares will be for cash.
- (c) If Preference Shares are to be redeemed, a notice of redemption (a "Redemption Notice") will be mailed to each holder of Preference Shares to be redeemed, not less than 30 Business Days nor more than 60 Business Days prior to the relevant Redemption Date. Each Redemption Notice will specify, *inter alia*, (i) the Redemption Date, (ii) the particular Preference Shares to be redeemed on the Redemption Date, (iii) the Redemption Price and (iv) the place or places where holders may surrender share certificates (if applicable) in respect of such Preference Shares and obtain payment of the Redemption Price. No defect in the Redemption Notice or in its mailing will affect the validity of the redemption proceedings.

The cash amount payable on Redemption (the "Redemption Price") will equal the Principal Amount of such Preference Share. Any such Redemption will not prejudice the rights of the holder of any Preference Share to be so redeemed to receive any accrued but unpaid dividend on that Preference Share payable on the Redemption Date.

- (d) Payments in respect of the amount due on redemption of a Preference Share will be made by cheque or upon the written request of the holder or all joint holders not later than the date specified for the purpose in the Redemption Notice by transfer to a US dollar account maintained by the payee with a bank in New York or such other method as the directors may specify in the Redemption Notice. Payment will be made against presentation and surrender of the relative share certificate (if any) at the place or one of the places specified in the Redemption Notice.
- (e) A receipt given by the holder for the time being of any Preference Share (or in the case of joint holders by the first-named joint holder) in respect of the amount payable on redemption of such Preference Share will constitute an absolute discharge to HSBC.
- (f) Any redemption of the Preference Shares will be made in compliance with the provisions of the United Kingdom Companies Act, the Uncertificated Securities Regulations and every other statute for the time being in force concerning bodies corporate and affecting HSBC (the "Statutes") and the Articles. No redemption of any Preference Shares may be made by HSBC without the prior consent of the FSA (for so long as HSBC is required to obtain such consent) and subject to such conditions as the FSA may impose at the time of any consent.
- (g) The Series 1 Preference Shares may be redeemed without redeeming the Series 2 Preference Shares and vice versa.

Voting

Except as provided below, holders of Preference Shares will not be entitled to attend and vote at general meetings of HSBC. Holders will be entitled to attend and vote at a class meeting of holders of Preference Shares. Every holder of Preference Shares who is present in person at a class meeting of holders of Preference Shares will have one vote on a show of hands and on a poll every holder of Preference Shares who is present in person or by proxy will have one vote for every Preference Share of which he is the holder.

If prior to any general meeting of shareholders of HSBC, dividends in respect of two consecutive Dividend Periods have not been paid in full, then the holders of the Preference Shares shall have the right to receive notice of, attend, speak and vote at such general meeting on all matters and such right shall continue until after the next following Dividend Payment Date on which a dividend in respect of the Preference Shares is paid in full (or an amount equivalent to the dividend to be paid in respect of the next Dividend Payment Period has been paid or set aside for payment to the holders of the Preference Shares).

Purchases

HSBC may at any time and from time to time exercise any powers conferred by the Statutes in purchasing the Preference Shares. No repurchase of any Preference Shares will be made without the prior consent of the FSA (for so long as HSBC is required to obtain such consent).

Variations of Rights and Further Issues

Subject to the provisions of the Statutes, the special rights attached to any class of shares may be varied or abrogated with the consent in writing of the holders of three-quarters in nominal value of the issued shares of that class or with the sanction of an extraordinary resolution passed at a separate meeting of the holders of shares of that class. For this purpose, the Series 1 Preference Shares and the Series 2 Preference Shares shall be treated as one class if the variation affects them in the same manner. At any such separate meeting, the provisions of the Articles relating to general meetings will apply, but the necessary quorum at any such meeting will be two persons at least holding or representing by proxy at least one-third in nominal value of the issued shares of that class (but so that at any adjourned meeting any holders of shares of the class present in person or by proxy shall be a quorum) and any such person may demand a poll.

The special rights or privileges attached to the Preference Shares will not be deemed to be varied, modified or abrogated by the creation or issue of further shares ranking *pari passu* therewith, or by the purchase or redemption by HSBC of its own shares.

Transfer of Shares

An instrument of transfer of a share which is in certificated form must be in writing in any usual form or other form approved by the directors of HSBC and must be executed by or on behalf of the transferor and (except in the case of fully-paid shares) by or on behalf of the transferee. The transferor will remain the holder of the shares transferred until the name of the transferee is entered in the register of members of HSBC in respect thereof.

The directors of HSBC may in the case of shares in certificated form, in their absolute discretion and without assigning any reason therefor, refuse to register any transfer of a share (not being a fully paid share) provided that, where any such shares are listed on the London Stock Exchange, such discretion may not be exercised in such a way as to prevent dealings in the shares of that class from taking place on an open and proper basis, and any transfer of a share on which HSBC has a lien. The directors of HSBC may also decline to register a transfer unless (i) the instrument of transfer is duly stamped (if so required), (ii) the transfer is in respect of only one class of shares and (iii) the transfer is in favour of not more than four persons as the transferee.

HSBC shares are in registered form. The registration of share transfers may be suspended at such times and for such periods as the directors may determine not exceeding 30 days in any year.

Notices or Other Documents

- (a) Any notice or other document may be served by HSBC upon any holder of the Preference Shares, *inter alia*, personally, by sending it through the post in a prepaid envelope to such holder at its registered address, by leaving it at that address in accordance with Articles or by advertisement in one leading daily newspaper published in the United Kingdom and one leading English language daily newspaper and one leading Chinese language daily newspaper printed and circulated in Hong Kong. Holders who (having no registered address within the United Kingdom or Hong Kong) have not supplied to HSBC an address within the United Kingdom or Hong Kong for the service of notices shall not be entitled to receive notices from HSBC.
- (b) Holders of the Preference Shares with a registered address or address for correspondence within the United Kingdom will have the right to have sent to them (at the same time as the same are sent to the holders of Ordinary Shares) all notices of general meetings of HSBC and a copy of every circular or other like document sent out by HSBC to the holders of Ordinary Shares.

No person has been authorized to give any information or to make any representation not contained in this document and, if given or made, such information or representation must not be relied upon as having been authorised by the Issuer, the General Partner, HSBC or the Managers. This Offering Circular does not constitute an offer to sell or the solicitation of an offer to buy any securities other than the securities to which it relates or an offer to sell or the solicitation of an offer to buy such securities in any circumstances in which such offer or solicitation is unlawful. Neither the delivery of this Offering Circular nor any subscription, sale or purchase made in connection herewith shall, in any circumstances, create any implication that there has been no change in the affairs of the Issuer, the General Partner, HSBC or the HSBC Group since the date hereof.

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HSBC Capital Funding (Dollar 1) L.P.

US\$1,350,000,000

9.547% Non-cumulative Step-up Perpetual Preferred Securities, Series 1

and

US\$900,000,000

10.176% Non-cumulative Step-up Perpetual Preferred Securities, Series 2

each having the benefit of a subordinated guarantee of

HSBC Holdings plc

HSBC

Goldman, Sachs & Co.

Lehman Brothers

Merrill Lynch & Co.

Morgan Stanley Dean Witter