HSBC

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PRESENTATION

Operator

Good morning, ladies and gentlemen. This is the HSBC Holdings plc call; Trading Update on the Mortgage Services Operations of HSBC Finance Corporation. I would like to hand over to Mr Douglas Flint.

Douglas Flint

Thank you very much. I am here in London with Michael Geoghehan. Before we start, can we just do the normal forward-looking statement disclosure? This presentation and subsequent discussion may contain certain forward-looking statements with respect to the financial condition, results of operations and business of the group. These forward-looking statements represent the group's expectations or beliefs concerning future events and involve known and unknown risks and uncertainties that could cause actual results, performance or events to differ materially from those expressed or implied in such statements. Additional detailed information concerning important factors that could cause actual results to differ materially is available in our annual report.

This call is focused exclusively on the release that we made late last night, which you have before you, which is in respect of the US Mortgage Services business of the Finance Corporation and therefore this call is in respect of that single matter. You will all appreciate that we are in a closed period and we're due to release full results and annual reporting account on 5 March, so please, if you can respect the fact that this conference call is solely about the single matter on which we released a statement late last night, UK time.

The way we'd like to conduct the call – there is no point in us making any remarks – I think the statement speaks for itself. In relation to issues that arise on financial aspects of that, I will do my best to answer your questions and then the more general issues around our business in the US and the actions that we're taking, Michael will be very pleased to respond to those questions.

So at this point I can hand it over to the co-ordinator and let him filter the questions to us. Thank you very much indeed.

QUESTION AND ANSWER

Operator:

Thank you. Ladies and gentleman, if you would like to ask a question, please press 7 on your telephone keypad. If you change your mind and want to withdraw your question, just press 7 again. All questions will be asked in the order received and you will be advised when to ask your question. The first question we have is from the line of Alex Rushing from Bear Stearns in London. Mr Rushing, please go ahead. Hello, Mr Rushing, your line is open, please go ahead with your question. It appears we have no person on that line at the moment. The next question comes through from the line of Mr Ian Smillie of ABN Amro. Mr Smillie, please go ahead.

Ian Smillie:

Good morning, Douglas. Two questions, please. The first one – on the extra $1.8 billion of bad debt which you've indicated today, could you give some sense, please, how much of that is to increase the credit loss reserves coverage ratio on existing delinquent mortgages and how much of that is in anticipation of mortgages which are currently performing, but which you expect could become non-performing at some stage this year? And I've got a follow-up question.

Douglas Flint:

There are two aspects. As you are aware, the provisioning model is a portfolio roll rate model and therefore each time the model runs, we are effectively inputing factors assessing the extent to which loans that are showing delinquency will move through the buckets and then assessing the severity, should be moved through all the buckets and go to charge-off. So every time you run the model, you are indeed assessing both the likelihood of loans not previously – or elements in the portfolio – to fall through it and also adjusting for severity and what proportion will fall through of the existing portfolio. So it's a factor of both.

It's fair to say that what caused us to look again at our numbers, and in fact running our numbers again, was two factors. One was looking at the evidence of higher severity and higher incidents of lower rates as we went into January and February and therefore we factored the most recent elements into the models that we run and we also made an assessment of the impact of forward resets on adjustable rate mortgages, to assess the embedded impairment on mortgages that have adjustable rates or are second lien to an adjustable rate mortgage and we factored that into the provision that we're taking at December 2006.

Ian Smillie:

So just to be clear, that second point that you've described will relate to mortgages which are not yet showing up as delinquent in your numbers, but which you anticipate will do?

Douglas Flint:

Yes. Our assessment would be, these mortgages are impaired because our best assessment is that when the payment shock flows through on that as regards payments, or in the underlying first lien has a payment shock it will cause us to have a delinquent mortgage at that point in time, and therefore we think that is embedded and we have recognised that.

Ian Smillie:

So your sense is it's delinquent but it's not showing up in the delinquent mortgage numbers that you have reported, or that you will report for Q4?

Douglas Flint:

It hasn't flowed to the roll rates, but we believe the mortgage is impaired for the reasons that I explained.

Ian Smillie:

Thank you. The second question is the read through to the unsecured – and in particular here I guess I'm thinking about the stand-alone unsecured product, where we saw the NPL ratio tick-up quite sharply in Q3. Can you give us any sense of what is happening to that part of the portfolio and whether today's number includes any impact of improving coverage ratios there, in anticipation of further deterioration through this year, because I note in the statement you say that the major factor of the charge is the mortgage services bit, but I guess that doesn't mean it's entirely mortgage services?

Douglas Flint:

Yes. We're really only talking about the single issue. To deal with the major element, obviously what we've done is compare consensus estimate for the impairment charge with where we think we're going to come out and therefore there's difference, we can isolate what element – we know the difference on mortgage services and that's the vast majority of it – the rest of it, goodness knows, we don't have a break-down of consensus by country or product or portfolio and so on., so it's not possible to say what that element is. But the vast majority of the difference between consensus and where we are is in mortgage services. And indeed that is the only issue that we're talking about today, of course. The rest of the business is the guidance that we gave in the December Trading Update in terms of that portfolio and the fact that we said that in the third quarter of 06 there was just general – it was generally getting slightly weaker as the economy was slightly weaker and as we came off a very, very good first half of the year, which was the reciprocal of the accelerated charge-offs in 2005. So there's nothing else to say on that portfolio.

Ian Smillie:

Thank you, Douglas.

Operator:

The next question we have comes from Mr Jon Kirk of Redburn. Mr Kirk, please go ahead with your question.

Jon Kirk:

Good morning, guys. My first question, basically, if you could give us some indication of just how conservative you think you've been in this additional provisioning that you're making now. So perhaps with reference to what your assumptions are regarding the macro outlook for the US? And I have a second question, please.

Michael Geoghehan:

Firstly, where are we seeing the deterioration? We're basically seeing it in the ARMs and in the second lien in particular. There's enough industry information out there, not to dwell on that too much, but the reality is, what we've looked at – and this is in some depth; my hands are all over this and we have been sort of focusing on this all the time since we gave you our last trading update, both with the HSBC Finance and with our investment bank, and myself involved, directly – where we see the situation is that we are looking at different areas and where we believe that the first lien mortgagee will foreclose – and we're seeing a lot of that going on – we are then saying, well, it's unlikely we'll get anything for the second lien. Obviously that needs to be analysed street by street, state by state and we're doing all of that, and we're also talking to customers and saying look, what's it likely – what is your cash flow going to look like in the second half of 2007 when you've got this jump in interest rate payments? And all of that goes on. So we've been as conservative as we can be from an accounting perspective. We have taken provisions, as Douglas has explained, and we feel comfortable that where we are and where the data is in the market today, that we are well provided, where in 2007 we'll update you at our Trading Statement, but as we are today, we feel that we have covered all the risks that we know today.

Jon Kirk:

So, just to be clear, you haven't necessarily downgraded your outlook for the US economy or unemployment and interest rates, that sort of thing?

Michael Geoghehan:

No. As you know yourself, the economy is strong – I mean, this is a particular thing in regard to adjustable rate mortgages and in particular, second lien adjustable rate mortgages.

Jon Kirk:

Ok, great. And just a quick second question – has this influenced your appetite for sub-prime mortgage lending in the US on a more medium-term basis?

Michael Geoghehan:

Sub-prime lending is a key good business and I think your question here is, why didn't you spot this with your analytics, etc. I mean, our analytics are good – in our car business they're very strong; in our auto finance business strong; in our mortgage book they could be stronger, but we're working on that. But the reality is, when you look at analytics in regard to a product – and this is adjustable rate mortgages – you've got to have history for analytics and the fact of the matter is, there wasn't history – adjusting after something like – was it 17 times interest rate climbs in the US? Our appetite for the business is there.

I think we will be focusing it much more toward the emerging markets. Let me explain that. Our business in South America has a phenomenal ability to attract business that goes into the United States, both remittances out of the US and people – immigrants – going into the US. We expect to move this business gradually to where those communities are; where the immigrants are coming into the US; you know, Texas; Florida – attracting businesses/people who know the HSBC brand and then offering them consumer finance products. And it's not just Latin America, obviously – you've got the Asian influx coming in; you've got the Eastern Europe influx – and making sure that we are giving a consumer product to those people who will be part of our moving the strategy in that direction.

And, equally, as we said at the Trading Statement in December, we don't see a real place for us in the brokerage business. We will only take business from brokers that we can take straight into our investment bank for them to parcel and sell on. And that's what we are focused on. The only thing we will take through brokers to our core business is anything that we see that (a) has that immigrant profile and has the cross-sell to it. And if we can't cross-sell to it within a 12 month period, we'll sell it down. A far more aggressive approach is being taken to the management of this business, and working closely with our investment bank.

Jon Kirk:

Ok, thank you.

Operator:

The next question we have comes from the line of Mike Trippitt of Oriel Securities in London. Please go ahead.

Mike Trippitt:

Good morning. I actually wanted to come back to Ian's question at the start, because I'm not sure we've still got a clear split of this 1.8 billion between the two factors that you mentioned in the statement. One is the increased delinquencies on the existing book, because of the effectively – you're sort of running out of equity headroom on that book – and then, secondly, the ARMs resetting – I wonder if I could just come back and ask you whether you can give us a seal of that split of the 1.8 between those two factors?

Douglas Flint:

The 1.8 as I said to the other questioner, Mike, is the difference between consensus and where we are. Not all of that, but the vast majority of it is in relation to the Mortgage Services business. Within that, a major element is the impact of ARMs. Without that, the major impact on our revised provisioning is taking into account adjustable rate mortgage resets on our own ARMs and the impact of the primary ARM resetting where we have a second behind us; so it's a big part of the adjustment.

Mike Trippitt:

Ok, then just as a follow-up, at the – well, both the half-year and third quarter figures – I think in the correspondent channel, the second lien portfolio was about US$11 billion-ish. Is this increase – is it essentially on that second lien book, or is it across the correspondent channel, which is more like 50 billion?

Douglas Flint:

It's across the channel, but the vast majority of the provisioning by value is against the second lien.

Michael Geoghehan:

Sorry, Douglas, it's in the vintages of 2005 and 2006 where the issues are.

Operator:

The next question we have comes from Mr Alastair Ryan of UBS in London. Mr Ryan, please go ahead.

Alastair Ryan:

Thanks. I'm actually at the train station, so I apologise for the quality. I just want to understand whether, in the book outside of those correspondent moves you've booked, you're happy to still be writing business? So, for example, fixed rate, debt consolidation products, your other branches – are you happy still to be writing that? One of the things that strikes us is, consolidation's coming through quite quickly in sub-prime and some margins may actually be widening in quite a lot of the other products and if your models are still working there, are you finding those attractive to still be writing?Thanks**.**

Michael Geoghegan:

Well, clearly we look at this from State to State and obviously certain markets of the US are going very strongly and consolidation is a core business and we look at the fico scores, adjusting those as we see a deterioration or other in the markets, but there is a core suite of products that we will continue to offer. But where I'm putting the line down is that we're going strong into the brokerage channels. We want to know our customer and we certainly see that when we deal with our customer direct to our own outlets, we have a much better quality customer. So that will continue with a suite of products. There are certain products that we have stopped doing, like self-certification – those type of products – stated income products; and clearly we'll reduce back on second lien. I would like to stress that over 90% of the portfolio is actually performing, so this is not a case of everything is not there. It's actually well there – working well – but we believe that there's potential risk in the adjustable risk mortgage portfolios and we're taking provisions for those in regard to what may happen in the future.

Alastair Ryan:

Thanks. I'm not sure whether you can include this within the scope of this call, but are you starting to see origination spreads improve, as many of your less liquid peers in the industry are having sort of even worse problems than you are in these books?

Douglas Flint:

In all situations where you're still in the market and you can price up, I mean, we are focusing on quality rather than volume, so I'll leave it at that.

Alastair Ryan:

Thank you.

Operator:

The next question we have comes from the line of Mr Simon Samuels of Citigroup.

Simon Samuels:

Thanks very much. Good morning. Just going back to some of the questions already raised, by way of clarification first of all, Douglas, did I understand you correctly that the vast majority of the difference between what was the consensus and the number that you're now going to be reporting, which is obviously just short of $2 billion, that is just in that second lien portfolio, the 11.1 billion that was last reported in September?

Douglas Flint:

It's in the mortgage services business and the piece that relates to the mortgage services business, the largest element of impairment is in the second lien books, yes.

Simon Samuels:

A lot of the talk – you said right at the beginning and again, it's a clarification point – sort of beginning, that the large; in fact the majority of this is effective resets impact through the ARMs. Did you say that that was resets that you saw coming in 2006 – is this kind of anticipatory resets? So we're going into '07 and then '08 – in terms of things that you just know people are going to be – rates are going to go up a lot in the next 12 to 24 months and you're basically …

Douglas Flint:

We are looking at rate resets going forward, i.e. into '07 and '08 and looking at what we think that will do to the value, the recoverability of the loans that we've got. So we're looking at the impact of rate resets based on the current payment shock but with the rise in today's interest rate environment and modeling what we think that will do to delinquency

Simon Samuels:

I guess the question a lot of people on this call want to get a sense of is whether you'd like to encourage us to think about your announcement today and effectively your decision really, to recognise reset risk. Would you like us to be thinking about that as a kind of a kitchen sink exercise – I know under IFRS that doesn't really exist really – but whether you want to anticipate this as a change in the way that you provide for a risk in this portfolio, as opposed to a material deterioration in actually what's happened? So, is that the case, that you'd like us to think of this as a kind of a one-off getting the thing over with, or is this harbinger of a deterioration in terms of your provisioning charge into '07 and '08?

Douglas Flint:

I think there are lots of questions subtly woven into that, Simon, but what I think we'd like you to think of is that we have not simply taken the actual delinquency stats at the end of December and said, where does that drive we've said, but we have products that have embedded risk because they sit behind an ARM or they are an ARM and therefore is the historic experience today reflective of what we believe the book will throw out, given the knowledge we've got today including one of the risks embedded in the book, is that as rates reset both on those adjustable rate products that we have and what we set behind an ARM first. There is a much higher risk of loss than there would be if it was fixed rate and we have attempted to quantify that and we have taken that as a provision, and that is one of the big elements – in fact, the largest element – of the revision to the provisioning that we've made. And I think that the reason for doing it now is that there is clear evidence of the market through pre-payments – those lower pre-payments being evidencing the fact that there is less re-financing options available for people and that means the the payment shock within the lenders that exist at the moment; and we've tried to model that. You can make a judgement, I think, whether we want to lead you anywhere other than to understand it – you make the judgement.

Simon Samuels:

Just lastly, in terms of – I mean, I'm trying to think – how could your provision number be wrong from here, because presumably we need to be thinking about things like if the shape of the yield curve changes materially from its current position, or about pricing in the market, or about more generally, the US economy? Are those the kinds of things that are going to damage you from here?

Douglas Flint:

Absolutely. I mean, if the US economy is better it will have an impact, if interest rates at the rate of reset are different from those that are there today, that will have an impact and so on and so forth. If house price appreciation changes upwards or downwards, it will impact. All of these factors are in the future.

Simon Samuels:

I'm sorry, I know I'm hogging, but just, you know, this is the first profits warning really ever from HSBC – I think your Midland bank did one with Crocker many years ago, but I'm considering the significance of what you're doing here. Should we assume that on every single opportunity you jump onto the conservative side? Because I presume this is not a particularly comfortable experience for you as a management team, to be having to communicate to the market that its got its forecast badly wrong?

Douglas Flint:

Let me say something about the forecast element and then I think Mike wants to say something about our conservatism. It terms of forecast, what we're doing is actually responding to new information. You know, we have new information in the market place in relation to trends in January and a little bit into February; we have better analytics or better insights into what we think the impact of ARMs will be, based on what's happening in pre-payments and therefore we don't have the same information we had three months ago or six months ago. We have different information and that different information is current and we're taking that current information and modelling what we think the impact is, and then we're dealing with it.

Michael Geoghehan:

On the broader question, firstly we've got to bear in mind, in previous periods of downturn in any economy, there was the accounting capability to take very significant one-off provisions, but that's not there in accounting treatments this year or going forward, so there will always be volatility in earnings of any financial corporation in regard to credit being granted. We're obviously on top of the situation and there have been changes of management; we are bringer a much closer team together; we're looking at all abilities to refinance [inaudible] and all different things that you'd expect us to do. I don't think this is an issue, as a profit warning, as an issue to HSBC it's 6% of our total assets, the whole of this portfolio worldwide and we're managing this business as you expect us to. Have we had mistakes? Yes. Are we learning? Yes, of course we are. Are we on top of it? Yes, we are, and we'll resolve it.

Simon Samuels:

Thank you.

Operator:

The next question we have comes from Mr Paul Crutchley of Merrill Lynch in London. Please go ahead.

John-Paul Crutchley:

Good morning all, JP here. Two questions, if I may. I just really wanted to go back to what you were saying back on the last call in terms of the overall wholesale broker introduced mortgage portfolio, which I think at the time then you said that essentially the portfolio was ring-fenced and you weren't growing it. I'm just wondering how you see the entirety of the portfolio now. Is it now essentially ring-fenced and being run down over time? I'm just trying to get a feel for what the revenue implications may well be of a refocus of that business. And then a second question in terms of management as well.

Michael Geoghegan:

Well, let's just take the broker business going forward, since we last spoke. The broker business is just being channelled to source products for our investment bank or for our consumer business if it shows a profile capable of having an immigrant profile, or has a cross-sell capability. If it can't do that within 12 months, that's also sold, so let's get that out of the way. You know, the business itself is, what we don't think is quality business, as from the 2005/2006 portfolios; we've ring-fenced it and we believe – well, we know that is running off as we speak now and we project it to run off in sort of two years. That's the average life of that type of client. Will that happen? Obviously we are beholden to – economy and everything else is out there, but if it follows that classic style, that will run down over the two year period.

John-Paul Crutchley:

Thank you. Secondly, I guess I'm concluding from the statement and the way you're talking that you've taken a fairly direct control over what's gone wrong here. I just wonder if you can comment on what, if any, management or procedural changes you've had to introduce to that business, because clearly this has been a mishap in a fairly short order in terms of business written to going wrong, and what that's actually done in terms of executive accountability down the line?

Michael Geoghehan:

Well, as you'd expect, at that company I'm looking at right now, but the reality is, there have been some changes. Brendan McDonagh went in as Chief Operating Officer and that was announced two days ago – he's gone in from being Chief Operating Officer of the US Bank; he's gone into the Finance Company and a new Chief Operating Officer has been appointed for the bank there as well. We've put in people on the risk profile side; we're putting in caps, all those types of things and bringing a more consistent HSBC quality lining in regard to credit generally and the investments banks in there – there will be other changes as we move forward, as we consolidate this business much more under the HSBC model. We'll bring all that together. You've said it yourself – the buck stops at my door; I'm very hands-on to this – I used to live in the States; I've been through this in the early '90s; I've seen similar things like this; you'd expect me to respond to it and I am responding and more action will be taken.

John-Paul Crutchley:

Thank you.

Operator:

The next question we have comes from Mr Michael Helsby of Fox Pitt. Please go ahead.

Michael Helsby:

Good morning. I've just got three short questions, if I may. You just mentioned that the book from 05 and 06 being in run-off. Can you tell us what the revenue contribution was of the – or is – of the '05 book and '06 book in 2006, please?

Douglas Flint:

Not very easily – I don't have that information – but you can see from our historic filings in the Finance Company what the average yield on the real estate secured book is and that would be as good a method as any to - and we've actually split in the portfolio what the size of the '05 and '06 book was in the Q3 filings for the Finance Company, so you've got the size of the book and if you just take the average yield in that, you'll get the information. Obviously, as the book runs off, we will run off commensurate capital and we will run off commensurate expenses. So it will have an impact on the earning profile, but will also have an impact on the capital absorbed in the business, which we'll redeploy to something else.

Michael Helsby:

Ok, that's fair enough. Just on the assumptions that you've made in terms of the top-up provision, can you tell me what assumptions you've made on the house price growth estimates of losses, if you like, in the US?

Douglas Flint:
We have taken a higher severity than was evidenced last year in '06, because the more recent indications or foreclosures have shown higher severity, and we've stretched that a little bit beyond that, but it's essentially based on the severity we're seeing currently as opposed to historically and we are using that with a bit of stretch to it for severity when we get the charge-off.

Michael Helsby:

Ok, thank you that is clear. Clearly you've talked about the '06 provision today – you must have looked at the '07 consensus provision number one when you've gone through the same exercise. Is the fact that you've not referenced to 2007, is that to say that you're comfortable with that number or have you just not commented?

Douglas Flint:

We're just not commenting.

Michael Helsby:

Ok. Fair enough. Ok. Thank you.

Operator:

Ok. Thank you. The next question we have comes through from the line of Sunil Garg of JP Morgan. Mr Garg, please go ahead.

Sunil Garg:

Hi. Doug, just going back to a question which I guess has been sort of slightly asked before. If I go back a couple of months, the indication was this is a second lien problem which now is getting extended into a much bigger book, which is the ARM book, [identified sort of through your Group] disclosure at over $50 billion. What's the risk that this going to spill over into other forms of credit? Because there will be, you know, multiple borrowing by the same borrower across product lines. Can you give me some colour on that?

Douglas Flint:

I'm not sure I quite agree your numbers. I mean the ARM provisions that we're taking are reflecting the ARMs we have in the first lien book and in the second lien and then, as I said, predicting or projecting what the impact on second liens might be that's set behind the first lien not from us. So the $50 billion number is the entire portfolio and that's not all in ARM portfolio.

In relation to looking more generally, when we set our provisioning rates on the other portfolios, the non-real estate secured portfolio, we have put some factors into our assessment for what the general impact will be of ARM resets in the market place because clearly there will be a diversion of cash flow from consumption to debt service but it's, if you like, it's a background factor rather than a specific factor because frankly we don't know if we simply have an auto loan or an unsecured loan. We don't know explicitly whether that customer has an ARM with someone else.

Sunil Garg:

But could the customer potentially have other products with you, maybe in Auto Finance, Customer, or maybe a credit card or unsecured loan customer? That's what I'm referring to. And just going back to sort of the question of the…

Douglas Flint:

We've done some estimates based on looking at the proportion of the population who have ARMs and therefore saying statistically we can model what proportion of our customers, but we don't necessarily know specifically whether customer A has an ARM or what kind of ARM he's got, but we can model across the portfolio what proportion of our customers might - would have if they are statistically represented.

Sunil Garg:

Ok. And just really follow on from the part about the exposure itself. We're talking HFC? What's the risk in the HSBC USA book that is really different to the entire North American book?

Douglas Flint:

HSBC US?

Sunil Garg:

Yes.

Douglas Flint:

It's a prime book. I mean this call is exclusively on mortgage services. We have nothing to add to what we said in 3rd quarter – in the trading statement for HBUS [HSBC USA Inc]. But HBUS is a prime book and the market data on prime mortgages in the US shows very low delinquency.

Sunil Garg:

Ok. Thank you very much sir.

Operator:

Thank you. The next question we have comes through from the line of Amit Rajpal of Morgan Stanley in Hong Kong. Mr Rajpal, please go ahead.

Amit Rajpal:

Thank you and good morning. Douglas, Mike, I had a couple of questions. The first one relates to whether you could give us some idea relating to the scale of delinquencies and severity of losses on the second lien mortgage services portfolio? So I know that is the portfolio which is causing the most amount of stress, but how does it compare to the broader portfolio in terms of scale of delinquencies and severity of losses right now?

Douglas Flint:

We'll produce detailed statistics when we produce our detailed financial results at the beginning of March. It's clearly obvious that the second lien portfolio has higher delinquency and in terms of severity, essentially the severity on the second lien will model and if it gets the charge off, it is close to 100% because there is very little equity available for the second lien on foreclosure.

Amit Rajpal:

Ok. And as a follow on, are you seeing on knock-on effect of the second lien portfolio that is being run through the bank channels? I know there is about 11 billion within the correspont, but about 5 million as well within the bank channels. Is that seeing the same effect as you're seeing the corresponding channel?

Douglas Flint:

Again I say we're only talking about mortgage services, but the branch channel is much more consolidation, lending and the dynamics of that business have been much more stable.

Amit Rajpal:

Ok. Thank you.

Operator:

Thank you. Our next question we return to the line of Mr Mike Trippitt at Oriel Securities. Mr Trippitt, please go ahead.

Mike Trippitt:

Morning again. I have to say, I think that's was a pretty sort of catastrophic announcement, we're still lacking a lot of detail. On the mortgage services book and the trading statement you talked about delinquencies in the third quarter going from 295 in June to 374 in September. Can you give what the figure is as at the end of the year? And secondly, on the 11.3 billion second lien portfolio and the broker channels, about 70% of that was generated in the first half of '06, second half of '05, and that clearly, so we'll talking around about 7 billion, looks as if it is very, very risky. You've taken a provision to there of about, if we believe it's all applying to this channel, of about 1.8. I just wonder if you can comment on how much now of that 11 billion is actually … what the actual provision cover is on the 11 billion.

Douglas Flint:

I think to get a … the 11 billion you're referring to is … you're looking at the originations in the first of '06 and the second half of '05?

Mike Trippitt:

What I'm looking at is the balances of 11 billion at the end of the third quarter, and in the third quarter figures you actually gave a, page 13 of the 8K, you gave a break down of the originations.

Douglas Flint:

Yes, we did.

Mike Trippitt:

32% in the first half of '06, 39 in the second half of '05. So, broadly you've got sort of 7 billion that was generated in the first half of '06, second half of '05 that looks to be very, very high risk.

Douglas Flint:

Yes. I'm not sure I can answer that too specifically in terms of as to what proportion of the 11 billion is covered. In relation to our coverage of currently delinquent loans, it is a very high percentage cover. Indeed it's over 100% of [2+] delinquents because we're providing in relation to that which we think we flow through too. I think its better we wait until March and we can set this out in much more detail in relation to the granularity of it.

There was a second question you were asking?

Mike Trippitt:

Well, it was really just was the delinquency rate on the mortgage services book?

Douglas Flint:

Well, I can answer that. In relation to what we said in the third quarter and with the trading update we indicated the rate of movement in 2+ delinquency and projected that the 2+ delinquency would move in a similar way to the end of the year. That in fact was the case. It did move in the same trend as it had down between second and third quarter so that the trend in delinquency that we thought we were going to see in relation to the fourth quarter movement did in fact eventuate. Having said that, the provision that we're taking at the end of '06 takes not only that into account but takes into account higher severity, greater incidence of delinquency in the first quarter of '07 and also takes into account our estimate of the impact of adjustable rate mortgage resets. The flow rate into 2+ delinquency was as we predicted it in the third quarter trading statement.

Mike Trippitt:

So that will be up another 80 basis points, is that essentially what you are saying?

Douglas Flint:

That's exactly what I'm saying.

Mike Trippitt:

Ok. Great, thank you Douglas.

Operator:

Thanks. The next question we have comes through from the line of Mr Robert Law of Lehman Brothers. Mr Law, please go ahead.

Robert Law:

Good morning, I've got three points I would like to raise. Firstly, in answer to future credit costs, perhaps I can ask it this way – when you're pricing your current new business flow, have the credit cost assumptions you're making for new business future credit costs changed from where they were last year?

Douglas Flint:

Yes, and we're also writing to a much more restricted product set.

Robert Law:

Secondly, when we look at the market's views of likely losses on the mortgage assets, as measured by the secondary market, would you vindicate it as an external data point for us in the past? Because it looks to me as though the secondary market is implying something like a 4% write down on sub-prime US mortgages, whereas you're taking here what appears to be something like a 2% write down. Could you help us on the difference?

Douglas Flint:

I think it's not really relevant. I think I would need to do a lot more analytical, and what pools you're looking at to get the 2% figure and benchmark that against the profile that we've got. I can't quite recognise the numbers that you've got so we can try and address that in March, but at this stage I can't off the top answer the difference between the two figures you've calculated.

Michael Geoghehan:

Douglas, I mean I could add there. I mean obviously when you see mark to market pricing on the street and what we're doing ourselves, we're obviously going to be managing this portfolio up. There's a profit margin in the street, working it out and we're going to work it out internally. I'm not saying were not going to use the street, but we're moving some of these assets, but it's a mixture of strategies that we are going to take. So yes, there is some of that calculation into our provisions.

Robert Law:

We'll I'm just trying to ask the kitchen sink question in a different way.

Michael Geoghehan:

Yes, I think obviously we know you want to ask that question, we want to answer it best we possibly can. The reality is we can only take as we can on the accounting standard and we have taken that and as Douglas has alluded to you, we've looked long into the future to see what is the likely trends and we've looked at. Clearly if those trends were to significantly change, then we would have to look again. But we are looking at that and there's obviously roll rates we're taking into consideration all the time and we're happy to update you in the March statement where we are in this regard for 2007.

Robert Law:

Thanks. And the final area I wanted to talk about was the impact of future profitability, or operating profitability at HSBC Finance and it's presumably the areas that you're now ring fencing must have been higher margin products. Can you help us on the kind of proportion of profitability that say generated, or were projected to generate, prior to obviously the additional reserve that you're now taking?

Michael Geoghehan:

Well, the reality – you know, it wasn't high margin and the fact is, we've said that we're not going to do this unless we can tie it into our investment banking strategy. And you've seen people out there buying brokerage businesses in the last 12 months, so there is value in this business. All we've got to do is redirect it so that it sources products for our investment bank to package themselves, and that's what we're going to do and in regard to contribution – whether that comes through the finance company or comes through the bank where the investment bank is based, that is an internal thing. I think we'll get this absolutely right; we'll source the type of product from the core brokers that HSBC Finance have got, but it won't stay on the books of HSBC Finance that we've packaged and sold through the investment bank, in generating a revenue stream that I think you would like us to produce. And also, as we move forward, obviously if our revenue moves from one end to the other, we'll adjust our profit as well and work those through; and that's happening right now.

Douglas Flint:

Robert, as Mike says, this business actually had a lower return, but had a lower return justified because it was written as less volatile and that of course turned out to be completely wrong. So it's a lower margin than when it was written.

Robert Law:

So if one looks at second lien and correspondent respectively, it's about something like 10% and 30% of your main assets on the HSBC Finance balance sheet, but there's less than those proportions of revenue and therefore, assumed profitability?

Douglas Flint:

Yes.

Operator:

The next question we have comes from Mamoun Tazi of the Man Group. Please go ahead.

Mamoun Tazi:

Three questions, if I may. The first one is, what do you think, in your view, could make the situation worse for sub-prime lending for Household? The second question is that within dropping capacity within the sub-prime lending area in the US – and I'm wanting to know what you think the impact would be on your business. The third question – I'm wondering whether I should ask it or not, but I'll go ahead anyway – why aren't you considering selling Household at this stage? I know that you're saying you're not selling it, but it seems to me that it has put a dent on your ratings – on your PE ratings - and it's problematic. Isn't it time for you to sell it?

Douglas Flint:

Well first let's take the question, what could go forward that could impact us. There are two things that really impact this business: one is unemployment; the second is house prices. We're feeling the house price impact in certain areas, I want to stress, this is not across the United States in all areas, 90% of our customers are paying us, obviously unemployment is an issue, we don't see that in the numbers coming out of the U.S. at the present time and what we're seeing here is a jump in, well a shortfall in cash flow, household cash flow caused by a jump in interest rate payments and their mortgages and that's going to work it's way through the system, people will adjust their spending pattern and change. The second thing, sorry what was the second question?

Mamoun Tazi:

It's the dropping capacity.

Michael Geoghegan:

This will play to an extent. Clearly we have a very strong relationship with our customers, the brand is strong, we told you that we're going to point it towards the immigrant markets, we're going to join it up with the rest of our group worldwide and getting that integrated into HSBC culture and brand will be a significant part of the project going forward and we've got no doubts there is a customer base that wants a consumer product in the United States and HSBC will be there to serve it. So in a way that answers your third question, it's not for sale.

Mamoun Tazi:

Ok, on the issue of capacity though, I mean can you be a little more specific, I mean you mentioned that the HSBC brand is attracting new business, but do you see any improvement in margins on the back of the drop of capacity, that's what I was trying to get more at.

Michael Geoghegan:

Well I mean, clearly the whole industry is working through this at the present time, there are people leading the industry, there are other people as I've indicated want to get into the industry. Price is a force of market, we're not seeing a squeezed on pricing at the current time, quite the reverse, we will go for quality rather than quantity and that it the sort of major change that you're seeing in the strategy that I've outlined to you today.

Mamoun Tazi:

Ok, one final point if I may, you mentioned when you acquired Household that you'd be moving some sub-prime to near-prime and changing the mix and that everything was looking rosy at the time you announced that, but now you've had this problem and again it leads me back to the third question, I mean, what would make you sell this business?

Michael Geoghegan:

Well as I said, it's not for sale, so the questions not worth going to comment on, but what I will say, that's to answer your first question, yes, we are focussing this business at the prime or the sub, near-prime market both in the cards business, the auto finance business and the other areas. And I'd like to say, management made some mistakes and they made the mistakes in this brokerage business where it went for volume and it went for a second lien business, it won't happen again.

Mamoun Tazi:

Ok, thank you very much.

Operator:

Thank you. The next question we have comes through from the line again of Sunil Garg of JP Morgan. Mr Garg, please go ahead.

Sunil Garg:

One quick factual question, what's the exposure to Option ARMS.

Douglas Flint:

We have no direct exposure to Option ARMs and we never underwrote them in the finance company, so our only exposure is to the secondary impact, so customers who may have an Option ARM somewhere else, who really have an unsecured loan to them, but we did not underwrite Option ARMs.

Operator:

Thank you. There are currently no further questions in queue, so a final reminder, if you would like to ask a question, please press 7 on your telephone keypad now.

Douglas Flint:

OK, if there are no further questions, can I just ask Michael Geoghehan to wrap up from this end. Thank you.

Michael Geoghehan:

Well firstly thank you to everybody on the line. I know that some people are staying up late and others have got early and the weather here in the UK hasn't been very favourable to us, but thank you for participating. I mean I think as you've probably seen from this presentation today we have updated you as well as we can in regard to what we are allowed to say at the present time and no doubt we will update you further in regard to the specifics with granularity that some of you have asked when we present at the 5th of March. I mean there is no doubt – and I am sure you have felt it – this is a problem that we have taken very seriously on board. HSBC doesn't like losing money; it prides itself on its credit quality and it has been let down in one subsidiary. We are focusing on it, we are going to get it right, but I think you know, you all need to remember, this is a business that has given the shareholder $9 billion to date since we acquired it. So we are all working through it; we are going to definitely get to the other end and we will certainly have it joined up with the HSBC Group and I think, you know, we will talk in the future about this business as a major part of the ongoing success of HSBC.

Thank you very much indeed.