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Conference Call Transcript

HBC - Full Year 2008 HSBC Holdings plc Earnings Conference Call

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PRESENTATION

Stephen Green - ***HSBC Holdings plc - Group Chairman***

Well, good morning, ladies and gentlemen. Good morning in London, good evening to our guests in Hong Kong via the satellite. And welcome also to those joining via webcast or conference call.

Introductions first. In Hong Kong we have our Executive Directors, Vincent Cheng, Chairman of the Hong Kong and Shanghai Banking Corporation, Sandy Flockhart, Chief Executive of the Hong Kong and Shanghai Banking Corporation. Also in Hong Kong, Edgar Ancona, the Chief Financial Officer, and Russell Picot, HSBC Group Chief Accounting Officer.

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In London are our other Executive Directors. To my right, Mike Geoghegan, Group Chief Executive, to my left Douglas Flint, Group Finance Director, and on the end there Stuart Gulliver, Chief Executive of Global Banking and Markets and of HSBC Global Asset Management. And I'm very pleased to welcome in the front row here Sir Mark Moody-Stuart, one of our non Executive Directors.

Let me first remind you to take a minute to read the usual forward-looking statements and target audience page that you can see on the screens now.

Let me begin by summarizing the performance of HSBC in 2008. HSBC was of course not immune to this extraordinary financial crisis, but it has fared better than most. Our resilient results show the success of a diverse business model and our trademark financial strength.

The headlines. Profit before tax of $19.9b, excluding the one-off impairment of goodwill in the United States, and $9.3b on a reported basis. Profit attributable, $5.7b, or $16.3b excluding the goodwill impairment. Earnings per share, $1.36 excluding goodwill impairment, $0.47 net of it. And return on equity, 13.3% excluding the goodwill impairment and 4.7% net of it.

We've retained our capital strength. Tier 1 capital, at 8.3%, is within our target range. The uncertain economic outlook has led us to announce today's rights issue to further strengthen our capital base, and more of that later. Dividends paid in respect of 2008 totaled $7.7b, or GBP4.6b, and dividends per share are at $0.64.

Let me now hand over to Mike, to take you through the business highlights.

Michael Geoghegan - ***HSBC Holdings plc - Group Chief Executive***

Thank you, Stephen.

As you all know, 2008 has been an exceptionally challenging year. HSBC's performance has been resilient in difficult times, thanks to our trademark strengths of diversification, financial strength and self-funding. One of our key strengths is our broadly diversified Group business, both by geography and by customer.

The slide in front of you shows that we've been profitable in three out of our four regions - Asia, Latin America and Europe. These three regions produced pre-tax profits of over $24b, a very strong result. The losses in North America and the goodwill impairment charged to North America Personal Financial Services have been a drag on profitability, and I'll talk about that later on as we restructure this business. Looking at our figures another way, you can see that we were profitable in all our customer groups, with the exception of Personal Financial Services, because of the weakness in the USA.

These strong performances mean that HSBC is open for business. We're able to support our customers when other banks can't. We increased lending last year in all regions outside of North America on an underlying basis. We are writing more business and we are growing our margins. We grew customer advances by 9% on an underlying basis. Smaller firms globally are finding it very difficult to obtain credit and we therefore launched a global $5b SME fund, to support this most important sector. And obviously we are focusing on asset quality, as we grow this business.

Being recognized as a strong and solid Group across the world has led to us attracting significantly more deposits. In fact, they're up 17%. And in a period of very low interest rates, that tells a story in itself. As deposit growth exceeded lending growth, we have improved our already strong advances/deposit ratio to 84%. This is one of the best ratios of any major bank in the world.

Now I'm going to ask Douglas to go through the numbers. Douglas.

Douglas Flint - ***HSBC Holdings plc - Group Finance Director***

Thank you, Mike.

This slide shows the results on a reported basis. For the first time, revenues exceeded $80b. And after loan impairment charges and other credit risk provisions, which rose by 45% to $25b, we had net operating income of $57b to absorb our expenses and deliver a return to shareholders.

Operating expenses, excluding goodwill impairment, consumed around $39b, broadly in line with last year. And after contributions from our associates and joint ventures, profit before tax excluding goodwill impairment was just under $20b.

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For reasons we'll discuss shortly, we have now written off fully, in 2008, all of the goodwill held in relation to our North American Personal Financial Services business. And that takes us down to our reported profit before tax of $9.3b.

Turning to the significant factors within our results, the first three items are all non-cash items. The first point is to remind you that last year benefited from $1.1b of dilution gains arising from our inability to take up shares offered by our Mainland Chinese associates.

Secondly, the major factor in 2008 is clearly the full impairment of North American Personal Financial Services' goodwill. And this write-off was necessitated as a result of significant deterioration in the US economy and rising unemployment, which were particularly evident in the fourth quarter. These factors reduced the cash flows foreseeable from this segment. And this, together with a higher applicable discount rate and the impact of structural changes to the business in the United States, which Mike is going to discuss later, led to the conclusion that goodwill held in this segment was fully impaired.

And thirdly, as credit spreads widened generally, we also saw our own credit spread widen, and this led to higher recorded gains on our own debt, held at fair value. Now, clearly, we don't consider these gains as part of managed performance and the benefit of our own credit spread is recorded in Other and is not attributed to any of our customer groups. And as we have said before, these gains will also reverse over time.

If you strip these non-cash items out of both years, reported pre-tax income was lower by 34%.

The other items on this slide are broadly self-explanatory, and I'll deal with Global Banking and Markets write-downs on a later slide, but there are perhaps two other observations.

The equity investment impairments reflect a requirement to write down equity investments as share prices have fallen materially. And on top of private equity and principal investments, the other significant impairments recognized in 2008 were against strategic investments in Vietnam and India, where we remain comfortable with the investments we've made.

On debt securities impairment, I'll deal with asset-backed securities later, but this category also included a number of impairments from assets which were held as part of the deployment of our own liquidity and reflected the failure of a number of financial institutions in the United States and Iceland.

Looking at 2008 against 2007 on an underlying basis, and that's simply constant currency and stripping out of both years the impact of acquisitions and disposals and the dilution gains last year, you can see that the dominant impacts are higher loan impairment charges and other credit risk provisions and the goodwill write-off.

A positive observation would be that on the underlying basis expenses excluding goodwill were flat, and that compares with underlying growth of 10% last year. Clearly, the second half of 2008 was weak, driven primarily by higher impairment charges and lower deposit spreads against all businesses.

But notwithstanding the latter point, we have continued to grow net interest income, benefiting from being positioned in balance sheet management for those lower interest rates. The second half of 2008 also benefited from the credit spread widening on our own debt.

Turning to the balance sheet, considerable attention was paid in 2008 to further enhancing the liquidity of the balance sheet. And this slide shows the underlying deposit growth of close to double that of loans to customers, leading to the advance/deposit ratio that Mike mentioned, of 84% at the end of last year.

I want to spend quite a bit more time on these results looking at our balance sheet, and how we look at risk within it. Reported total assets are broadly in line with last year, at $2.5 trillion. Let's break that down. $228b is Interbank placements and cash; not much I can add to explain that. Over $900b is made up of loans and advances to customers. Mike's going to talk in more detail about the United States position, but let me deal now with credit quality trends, taking the business as a whole.

Clearly, in Personal Financial Services North America dominates, as it has done for a number of years, and Mike will deal with that. Rising loan impairment charges in Latin America reflect growth in unsecured lending in the last couple of years, as well as rising delinquencies as economic conditions have deteriorated. And this has taken loan impairment charge in Latin America to slightly above that of Europe.

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The actions taken in the UK in 2006, to curtail unsecured lending and stand aside from the more exuberant parts of the mortgage markets, are now benefiting our credit performance. Our credit charge in Asia has risen, but remains modest in the context of the Group charge and largely reflects the build-out of credit card and personal lending portfolios in India and the Middle East.

Turning to Commercial Banking, the charge is double that of the prior year and this largely reflects the fact that for the last couple of years we have been noting exceptionally low charges. Our Commercial Banking business continued to grow profitably.

And finally, in Global Banking and Markets, the impairment charge reflects the financial institution impairments within balance sheet management that I mentioned in the significant factors earlier, as well as some $279m of impairment on asset-backed securities arising in the available for sale securities portfolios, as well as a relatively small number of corporate credit failures during the last year.

Turning back to the balance sheet again. On derivatives, although total assets are some 2.5 times the size of last year, this primarily reflects volatility and movement in yield curves and foreign exchange rates and credit spreads, all of which were particularly acute in the last quarter of last year. The underlying notional values increased by only 8%.

Now, as you're aware, we're required under IFRS to show the gross fair value of derivative assets, taking very little benefit for netting our credit support arrangements. Taking into account the benefits of netting and collateral, the $495b of assets comes down to $112b against $66b in the prior year. And importantly, less than 2% of our derivatives are valued on a model basis, where the inputs are unobservable.

If we turn now to trading assets of $427b, more than 65% is represented by government, or government agency bonds, settlement accounts and secured lending against collateral. Approximately $80b is represented by corporate bonds, of which financial institutions comprise a significant element. Most of the $22b of equities are held linked to offsetting derivatives. All of these assets are marked-to-market. And again, less than 2% of our trading assets are valued on the so-called Level 3 basis, i.e. marked-to-model without observable input.

Within trading performance, this slide shows the progression of write-downs on legacy credit trading and securitization activity assets, as well as updating our exposure to monoline insurers.

You can see that in relation to sub-prime assets our residual exposure has significantly declined during the year, while in relation to our exposure to monolines, while we've taken on no fresh exposure, the widening of credit spreads has increased the fair value of the protection contractually committed. The notional value of the assets referenced to this monoline exposure is $12.4b, which is $3b lower than last year.

The table illustrates the significant write-downs we've made in 2008, particularly against non-investment grade counterparties, where the increased exposure there reflects downgrading during 2008 of previously investment grade monolines.

The slide also tracks the performance of assets reclassified in the second half of 2008, predominantly to loans and advances following revisions to IAS 39. Subsequent impairment was $26m. Had the transfers not been made, mark-to-market losses which by definition would not reflect impairment would have been some $3.5b higher.

And then, finally, financial investments of $300b. Government exposure is approximately $90b. Product guaranteed by government is another $40b. $100b is predominantly to banks and other financial institutions, which leaves $56b of asset-backed securities. And this is where the majority of risk in this portfolio lies, so let's turn to that.

You can see from this slide that asset-backed securities within the available for sale category account for virtually all of the AFS reserve at December 2008. $20b of the portfolio is high quality government agency bonds, against which there is very little reserve.

The structured investment conduits, which we took on board during 2008 to protect the income note holders from a forced liquidation of the underlying assets, have substantially declined in carrying value. And although they represent $7.2b of the AFS reserve, HSBC's position is protected by first loss protection from the equity notes within these vehicles. These amount to in excess of $2b, which comfortably exceeds our estimate of the likely losses which will arise as these portfolios mature.

That leaves some $21b of securities to which are attached a bit under $12b of AFS reserve. The slide illustrates the various asset categories for them, but the most at risk assets are Alt-A securities within retail mortgage backed securities and home equity line of credit. These are valued with reference to independently sourced, cumulative default and loss severity statistics, as well as our own analysis of the excess spread and cash flow prioritization on each and every bond.

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Turning to the next slide, and to respond in part to the very wide range of estimates that exist in the marketplace, we're providing in our accounts and on the slide our own sensitivity assessment of this risk. We continually stress this portfolio to assess likely capital consumption from possible impairment. We do this by stressing the loss expectation variables I mentioned a moment ago, by way of example in respect of Alt-A, by between 33% and 50%, and we close to double the variables for sub-prime.

These stress tests indicate a possible risk in the range of $2b to $2.5b over the next two to three years, with a likely ultimate expected loss of around a third of that figure over the next three to four years.

Let me hand you over to Mike for a review of business performance.

Michael Geoghegan *- HSBC Holdings plc - Group Chief Executive*

Thanks, Douglas.

This slide shows how we've performed against our financial measures. We are showing the figures with and without goodwill and the impairment charge. Excluding the goodwill impairment, our return on equity in 2008 was 13.3%, close to the target range. And whilst the target range is challenging, we do believe, over the cycle, that we can operate within it. Our cost efficiency ratio was better than the target, ex goodwill. We have maintained our capital strength and more on that later. And our shareholders' return has been above the peer group average.

In our Asian business, in our Asian heartland, we've generated profits of $11.9b, which excluding dilution gains was slightly down on 2007. This principally reflects the significantly reduced turnover in equity markets in Hong Kong during the year, and which impacted revenues in Global Banking and Markets, Personal Financial Services and Private Banking. There was also an increase in loan impairment charges in Commercial Banking, although from a very low level, as the economy slowed. Overall, the credit quality of the book remains sound.

Outside of Hong Kong, our Asian business continued to perform strongly. They contributed to a 30% growth in profits, to a record $4.7b. There was notable growth in Korea, Mainland China and India.

In the Middle East, we grew profits before tax to a record $1.7b, up 34%. This growth was broadly based across all major markets and customer groups, with particular strength in Global Banking and Markets. Since early 2007, we have been tightening credit origination, but we are beginning to see some credit deterioration in Personal Financial Services.

Strong growth in Europe came from Personal Financial Services and Private Banking, and was further assisted by disposals and fair value gains. Excluding this growth, and with lower profits in Global Banking and Markets arising from write-downs, European profits were down. In the UK our financial brand and strength helped us build market share, as we were able to remain open for business when others couldn't.

There has been a lot of comment in the UK and in Hong Kong about whether banks are open for business. HSBC certainly is. This slide shows the growth in both lending and deposits among our personal and commercial customers in these two very important markets. In Hong Kong, we grew lending to Personal Financial Services and commercial customers by 11% in 2008.

In the UK, lending increased by 12%, partially on the back of a rate match mortgage campaign, which we launched last spring to attract customers facing interest rate resets with other banks. This brought in about GBP5.4b of new business. With an average LTV of 59%, these are high quality assets. For 2009, to build on this success, we have also established a GBP15b mortgage fund and the quality of the mortgage book overall remains remarkably strong.

Our commercial lending in the UK grew by 9%, but it would be fair to say that we are now beginning to see some increases in provisioning, but off a low base, and with low individual nominal amounts. In both the UK and Hong Kong, we attracted higher deposits from customers who sought refuge from the market turmoil. Our core businesses are thriving, and our financial strength and our funding base gives us the opportunity to take market share from more constrained competitors.

We increased revenues in Latin America in 2008, but loan impairment charges in Mexico and Brazil are increasing, and increasing operating costs across the region led to a decline in profit before tax of 6%. Global Banking and Markets posted pre-tax profits of $3.5b, after write-downs of $6.1b arising from market turmoil and higher loan impairment charges of $1.5b.

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These results underpin the success of our strategy to be emerging markets-led and financing focused. Emerging markets now contribute two-thirds of the profit before tax, up from a half in 2006. Core businesses, including foreign exchange, rates, balance sheet management and financing and equity capital markets all achieved record revenues.

HSBC Private Bank held up well in difficult market conditions, in which clients adopted a more conservative stance. Net new fund flows were strong, although total client assets decreased, mainly because of falling markets. Pre-tax profit was up 4% -- sorry, pre-tax profit was down 4% from 2007's record profit. We are pleased to move up a place in Euromoney's annual ranking, and to be named the world's second best private bank. And I see Chris Meares is in the audience. I'm surprised we're not first, Chris.

Anyway, as we turn to insurance, premium growth remained resilient in all regions. Both Latin America and North America achieved higher profits. Overall, weak equity markets, particularly in Asia, caused profits to fall by 19% to $2.6b.

Before I start talking about North America, let me summarize the core businesses outside the USA. They are solid and profitable and we are taking market share in assets and liabilities. Although credit quality is weakening, it is doing so very slightly and remains remarkably robust at this stage of the economic cycle. So, while we do not underestimate the scale of the economic challenges in 2009, we think there's a lot to go for, with HSBC now recognized as the number one brand in financial services.

Now, turning to the USA, where all our businesses have struggled. And this is not surprising considering the rapid decline in asset values and the rapid rise in unemployment. In 2008, we made a loss in North America of $15.5b, spread across the bank and the finance company. The dominant factors were the losses of $6.8b in Personal Financial Services, in both the bank and the finance company. This resulted in our decision to write off the entire goodwill value of $10.6b relating to Personal Financial Services.

Losses in the bank were primarily due to mark-down in non-core assets in Global Banking and Markets, which are reflected in their results. As we've announced, we're going to write no new business in Consumer Lending, and it, along with Mortgage Services and Vehicle Finance, will now be run off.

This slide shows that we now have $147b of consumer lending assets, down 12% in 12 months. We have now announced we are going to split this portfolio between core and non-core businesses and run off the non-core portfolio. In this room, in March 2007, I said that it would take us three years to fix Mortgage Services. And so far, after two years, the book is down from $47b to $28b.

In summary, we saw the problem before others and have had the benefit of first mover advantage. During 2008, credit quality has deteriorated slightly, but this mature book is now relatively stable. However, it could be impacted by further rises in unemployment. The speed of the run-off has slowed, due to difficulties of customers finding alternative finance as the industry has rapidly contracted, and we wait to see what future initiatives the US administration will announce to stimulate the housing market.

Turning to Vehicle Finance, this is running off to plan. Although credit quality has deteriorated, it's within our expectations and we still expect this book to run off over the next five years. The message from this slide is that HSBC, when it focuses on run-offs, is very successful.

Now, let's turn to Consumer Lending. Because basically there isn't any home equity to support the demand for debt consolidation finance, there is no longer a viable consumer lending product. Therefore, HSBC Finance has announced today that it will cease to write new consumer finance business through the HFC and Beneficial brands in the USA. It will close most of its HFC and Beneficial branches, and will focus on running off or selling its portfolio of real estate secured loans of $46b and its unsecured portfolio of $16b.

We are hopeful that HSBC Finance will be as successful running off the Consumer Lending as it has been with Mortgage Services and Vehicle Finance. But again, we do believe that over the next two years provisioning will remain elevated, particularly if unemployment continues to rise.

In addition to HSBC's US retail bank network, the other remaining sizeable Personal Financial Services business in the USA is the card business, the majority of which is prime and which is now within the bank. We have kept receivables relatively flat and have tightened credit quality quite significantly in the past two years. And whilst there will most likely be losses in the short term as unemployment rises, we do believe that these 36m active customers do have a significant long-term role to play within our global card base of over 100m cards.

As you know, we tell it as it is and today will be no exception. Therefore, I say that with the benefit of hindsight the Group wishes that it hadn't made this investment. And that is recognized by the write-off in full of the goodwill arising on this deal. But we are where we are and we believe that the majority of our shareholders wish us to collect these assets which are now non-core and then move on.

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To add some perspective to the obvious debate on this investment, from the time of the acquisition in 2003 to the end of last year, HSBC Finance has been profitable, if only modestly, and the card business, which we are continuing with, contributed close to $10b. In cash terms, taking into account dividend paid to the Group and capital injected into HSBC Finance, the net position to date has been an injection of approximately $500m.

As the revenues fall from a lower base of assets and impairments remain elevated, the next two years will be challenging and further capital will need to be injected. But we are committed to supporting HSBC Finance, to allow it to run off its exit portfolios in a measured way and meet all its commitments. And we project we can do this from the current Group's financial resources.

Turning now to Joining up the Company. We continue to make progress in this important initiative. We are now offering our customers a consistently high quality service all over the world, by the connectivity of our global systems and services under the One HSBC banner.

Everybody now knows that we have an advantage that others do not. And hence we have the right to win from scale and automation, and you can see that we are winning. We have accelerated implementation of common systems across the Group. And HSBC Premier, our service for international mobile clients, attracted nearly 0.5m new customers, taking our total customer base to 2.6m customers.

Our Global Links referral service for commercial clients doubled intra-Group introductions and resulted in transactions with an aggregate value of $11b. We continue to migrate work to global service centers, which are becoming centers of excellence.

We purposely launched Joining up the Company to better manage our costs and improve our earnings. And whilst the reported cost efficiency ratio increased, it did so because of the one-off charge for goodwill. If we excluded this, our costs remained virtually flat and our cost efficiency ratio improved to 47.2%, which is already better than the minimum target of 48% that we set ourselves.

We cannot provide real quality service from the world's number one brand in financial services without having a motivated team, and we've really been focusing on this in the last two years. Even in these difficult market conditions, staff engagement within HSBC rose to a new high in 2008 and now exceeds both global and sector norms.

At this point, I would like to thank all our 312,000 colleagues across the world in 86 countries and territories who have done and continue to do a tremendous job in extremely difficult circumstances.

Before I hand back to Stephen, let me leave you with some final thoughts. 2008 was an incredibly challenging year. However, we generated capital while others destroyed it. Senior management who have been through a crisis or two in their lives focused on protecting the businesses across the world while supporting our clients. And in our core businesses, the growth and the quality of the business stands out.

Our financial strength and stable funding base has allowed us to write new business when others couldn't. We saw a flight to quality, with customers choosing to place their deposits with us, improving our already strong advance/deposit ratio to 84%. Our resilient global performance reflects the merits of the diversified nature of our business, by geography and by customer group. Our plans to restructure the USA are in place. It will obviously be a challenge in itself, but it's something that we have already proved we can do.

And finally, let me state the obvious. 2009 will be another challenging year, but we have the spread of core businesses to benefit from it. And I'm pleased to report that our business performance in January 2009 has been strong and ahead of our expectations.

Thank you very much. Now, back to Stephen.

Stephen Green - ***HSBC Holdings plc - Group Chairman***

Mike, thank you.

I'd like now to turn to the rights issue proposals. I'm going to talk about the background to them and the reasons for them. Douglas will take you through the dividend and capital impact. And then Stuart will talk you through the structure of the deal and its timetable.

It's hardly necessary to remind you, I think, of the changes in the economic and financial environment over the last 18 months or so. There has been unprecedented turmoil and there are major uncertainties still ahead. The current global economic slowdown, combined with extreme volatility in the financial markets, means that the financial system remains under stress.

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Over the past year, many competitors have increased their capital, either through significant government capital injections or by raising capital from shareholders or other investors. Added to this, higher regulatory capital requirements and changing market sentiment have raised expectations concerning capital levels.

While HSBC has always maintained strong capital ratios, we're now raising the top of our target range for the Tier 1 ratio, so that it will going forward be from 7.5% to 10%. We're determined, in other words, that HSBC should maintain its signature financial strength.

We're continuing to manage capital allocation within HSBC, to concentrate on our core emerging markets and other fast-growing businesses. We're managing our business with the intent of limiting capital consumption by non-core or volatile businesses. We remain confident that HSBC is well placed in today's environment and that our strength leads to opportunity. Our strategy has served us well. We continue to combine our position as the world's leading emerging markets bank, with an extensive international network across both developed and faster-growing markets.

At the same time as the financial system exhibits stress, our competitive position is improving, as capacity and capabilities are reduced of financial institutions constrained by lack of capital and funding, many of whom are focusing more on their domestic markets going forward.

Our planned internal capital generation remains strong. This capital raising will enhance our ability to deal with the impact of an uncertain economic environment and to respond to unforeseen events. Importantly, it also gives us options with regard to opportunities which will undoubtedly present themselves to those with superior financial strength in the next couple of years or so.

These may involve organic investment and the continued taking of market share from more capital constrained competitors. There may also be opportunities to grow through targeted acquisitions, by taking advantage of attractive valuations where the opportunities align with HSBC's strategy and where we understand the risks clearly.

Let me now hand over to Douglas, to take you through the dividend and capital proposals. Douglas.

Douglas Flint *- HSBC Holdings plc - Group Finance Director*

Stephen, thank you.

For 2008, the directors have declared a fourth interim dividend of $0.10 per ordinary share, in lieu of a final dividend. Together with the first three interim dividends for 2008 of $0.18 already paid, this makes a total distribution for the year of $0.64. The payments in total represent a decrease of 29% in US dollar terms and 15% in sterling terms. The total dividend paid in respect of 2008 will be $7.7b, or GBP4.6b.

For 2009, we are rebasing the envisaged dividend per share for the first three dividends, to reflect the impact of the enlarged ordinary share capital resulting from the rights issue, prevailing business conditions and capital requirements. Until the end of 2007, HSBC has grown its dividend per share by 10% or more every year for over 15 years, reflecting strong growth in shareholder returns which we've delivered.

For 2009, we've carefully considered our dividend payments in view of our desire to retain an absolute and relative position of capital strength. We intend to continue paying quarterly interim dividends, still with a pattern of three equal interim dividends with a variable fourth interim dividend, and it is envisaged that the first three interim dividends for 2009 will be $0.08 per ordinary share. The dividend payments envisaged remain substantial and reflect management's long-term confidence in the business. And we will continue to aim to pay progressive dividends, in line with the long-term growth of the business.

HSBC has long maintained strong capital ratios, but we're now raising the top of our target range for Tier 1 capital to 10%, as Stephen has already said. As a result of the rights issue, HSBC's pro forma Tier 1 capital would have been 9.8% and core equity Tier 1 ratio would have increased also by 150 basis points to 8.5%, again on a pro forma basis, so at December 2008.

Now let me hand you over to Stuart, who will talk you through the transaction.

Stuart Gulliver *- HSBC Holdings plc - Chief Executive, Global Banking & Markets and HSBC Global Asset Management*

Thanks, Douglas.

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The rights issue aims to raise approximately GBP12.5b, or $17.7b, and it is already fully underwritten. And it is a classic rights, meaning it will be made on a fully preemptive basis to existing shareholders at a discounted price. So we're proposing to offer five new ordinary shares for every 12 existing ordinary shares to qualifying shareholders. This will result in the issue of just over 5b new ordinary shares, at GBP2.54, a discount of 47.5% to the closing price on Friday and 39% to the theoretical ex-rights price. The issue price for Hong Kong shareholders is HKD28 per new ordinary share, a discount of 50.2% to the closing price on the Hong Kong register on February 27.

The rights issue is conditional upon, among other things, shareholders' approval of an increase in HSBC's authorized share capital to create sufficient ordinary shares for the rights issue, and the shareholders granting authority to the directors to allot and issue the new ordinary shares at the General Meeting to be held on Thursday, March 19.

This slide sets out the timetable of the transaction. We'll be sending the circular to shareholders tomorrow. A General Meeting will be held on March 19, at the Excel Center here in London. And if successful, the new shares will start trading on April 6 in London and on April 9 in Hong Kong. The results of the rights issue will then be announced by April 8.

Stephen.

Stephen Green - ***HSBC Holdings plc - Group Chairman***

Stuart, thank you. And thank you for your patience with a longer than usual presentation.

A few brief words to conclude. 2008, a resilient performance in a very difficult environment. It shows the success of a diverse business model and our trademark financial strength. We've taken decisive action to restructure our US business in a deteriorating environment.

The 2009 outlook is a difficult one, in our view, but we're maintaining our financial strength, our signature financial strength, through strong internal capital generation and through the proposed rights issue. It's the long-term confidence that we have in the Group's proposition which gives us the confidence to aim for and to pursue a progressive dividend policy.

Thank you very much. We'd be very happy to take your questions now. What I'd like to do is to ask you to raise a hand for questions and we'll get a microphone to you. In Hong Kong, Vincent, I'll ask you to invite the next question and I'll do the same in London. We'd be grateful if you could tell us your name and organization before you ask the question. And if I could ask to -- if you could take it one question at a time, per person. To try and avoid any confusion between the two locations, I'll indicate who's going to answer the question and who -- and any follow-ups.

Let me now hand over to Vincent for the first question from Hong Kong. Vincent.

QUESTION AND ANSWER

Vincent Cheng - ***HSBC Holdings plc - Chairman, Hong Kong & Shanghai Banking Corporation***

Thank you, Stephen. That gentleman.

Cameron Odgers - ***CICC - Analyst***

Hi. Cameron Odgers from CICC. You mentioned about the stress test on your ABSs [that have] losses were a third to a half worse, depending on vintage. Can you give us an idea of what the basic inputs to your expected losses are in terms of when do you expect the US economy to start to recover, how long do you expect the recession in the UK to last and what would you expect the peak unemployment rates to be in those two geographies under your expected loss scenario?

Stephen Green - ***HSBC Holdings plc - Group Chairman***

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Let me suggest Mike to talk about the economic prospects in the UK and the US. And Douglas, any comments you want to add on how we stress tested the portfolio.

Michael Geoghegan - ***HSBC Holdings plc - Group Chief Executive***

Well, clearly the economies of the US and the UK are certainly weakening. We see unemployment rising in the US and there are various figures being given about by economists. Our own in-house view is things are deteriorating. In the UK, certainly for HSBC, we are not seeing that coming through into our impairment lines at the current time. And that goes back to what I think I said in my presentation, is that we saw things in the US in late 2006 and took steps here in the UK to cut back our unsecured lending and be more conservative on our secured lending, and that's clearly helped us.

But the economy slowing, unemployment is rising and will rise further, and your guess is as good as mine as to where this is going to end. I would say it's the speed of where we're all seeing growth, both in the US and the UK, dropping which is quite concerning.

Stephen Green - ***HSBC Holdings plc - Group Chairman***

Douglas, can you talk about the way we stress tested the ABS portfolio (multiple speakers)?

Douglas Flint - ***HSBC Holdings plc - Group Finance Director***

Yes, it's incredibly granular. It has to be on the basis of a bond by bond, taking into account where we sit in the capital structure and, more importantly, where we originally sat in the capital structure, which was to the very, very vast majority almost exclusively at the AAA level. It then looks at levels of default, loss given default, prepayment speeds, all of which derive from triangulated with external fixed income research, the assumptions that are published by the major rating agencies in terms of how they do stressing or they do their loss given default, their loss severity tests on individual securitization tranches by vintage.

We look at the extent to which we've got insurance cover. We look at the excess spread within each of the bonds that we hold. We look at cash prioritization in terms of the waterfall of cash flow, and on each and every bond basis. And then we take all of that into a loss severity and tend to stress it by 30%, 40%, 50%. And that gave us the number of $2b to $2.5b on that stress basis, taking current market expectations or triangulated expectations of loss severity. And that gave that number, which would ultimately flow to an actual loss, i.e. that the $2b to $2.5b would be the reversal from the AFS of what's in it at the moment in relation to those bonds. And we expect about a third of that would actually be cash loss from that stress test. That's what we do.

Stephen Green - ***HSBC Holdings plc - Group Chairman***

Douglas, thank you. A question from London. Aaistair.

Alastair Ryan - ***UBS - Analyst***

Thanks. It's Alastair Ryan at UBS. Just one point -- sorry, one question and one simple thing. When you say you expect to be internally capital generative, according to your plan this year, one assumes that's driven by earnings rather than reducing risk assets, because it ought to be relatively difficult to cut your risk assets if you're lending and there's pro-cyclicality. Is that a fair assumption?

Stephen Green - ***HSBC Holdings plc - Group Chairman***

Correct, yes.

Alastair Ryan - ***UBS - Analyst***

Thank you. So the question is slide 69, as I'm sure you've anticipated you'll get this. The rate of deterioration in the Consumer Lending book in the third and fourth quarters, we obviously had Q3 before Q4 was fairly spectacular. Now you say you gave everybody a month off foreclosures

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in December, so there's an element of that in there. But what's driving that? And is part of your conclusion to put that business into run-off just that things have moved so far ahead you really don't feel confident in underwriting at all even what limited amount there is to be [dealt there]?

Stephen Green - ***HSBC Holdings plc - Group Chairman***

Alastair, essentially the answer is yes. I'll let my colleagues elaborate. But the world has changed a great deal. It is worth noting that even as late as the beginning of last year, 2008, forecasts for '09 for the US were showing over 2% GNP growth. The condition of the US economy has radically deteriorated rather rapidly in the last few months of last year. It has led us to the conclusion that this business model is no longer viable. Mike.

Michael Geoghegan - ***HSBC Holdings plc - Group Chief Executive***

The main product is a debt consolidation product in the US, secured by equity in your home. The reality is in the last few months we're probably doing a tenth of that business that we'd normally do and that's because people haven't got equity in their homes. And our scoring of that risk has made them ineligible for finance, so we've stopped doing it. And obviously, there is a deterioration. We try to keep as many people in their homes as possible. We've modified 100,000 loans, but at the end of the day there is not a product out there.

Alastair Ryan - ***UBS - Analyst***

But just to be specific, though, is the deterioration driven by economic conditions or -- so if you'd run these economic conditions through your score cards, would you have got this number? Or have you come to a conclusion that the underwriting just doesn't work, so you may as well pack it in?

Michael Geoghegan - HSBC Holdings plc - ***Group Chief Executive***

Well, there's two things. One is the cost of running those loans, i.e. that the network cost wasn't giving a return, and two, the stress testing of the assets. Although, actually, the asset stress test was better for these newer products, there wasn't enough volume in it.

Douglas Flint - ***HSBC Holdings plc - Group Finance Director***

But I think, just adding a little bit, I think that it was the rapid rise in unemployment in the fourth quarter that led to higher expectation of loss. And if you look at the build-up of reserves, the build-up of reserves in Consumer Lending is well above charge-offs in the third and fourth quarter, which was a reaction to the rising unemployment. In fact, the finance company's more -- it is very correlated to unemployment. The question is do we get to a level of unemployment where that relationship breaks down. I don't know. But it was largely employment driven in the fourth quarter. Jump in unemployment led to a larger expectation of loss than was a contributing factor.

Stephen Green - ***HSBC Holdings plc - Group Chairman***

Another question. Yes, please.

Tom Rayner - ***Citi - Analyst***

Yes. Thank you very much. It's Tom Rayner from Citi. Is it possible I could have two as well? (Multiple speakers).

Stephen Green - ***HSBC Holdings plc - Group Chairman***

Yes, go on.

Tom Rayner - ***Citi - Analyst***

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Thanks very much. The first one maybe for Douglas. End of Q3, I think the Tier 1 ratio was 8.9%. I just wondered, could you help us reconcile the move from the end of Q3 to the full year position, in terms of the broad drivers of what -- I think it came down 60 basis points in the final quarter.

Stephen Green *- HSBC Holdings plc - Group Chairman*

Do you want to table the other question, so that whoever it is can be thinking about it?

Tom Rayner *- Citi - Analyst*

Yes. Well, the second one was to push you a bit more on your dividend guidance because if I just take the -- if I take the $0.08 per share for the first three quarters and assume the same sort of relationship in the fourth quarter as you saw in 2007, you're looking at another fairly hefty dividend cut, '09 on '08. But I guess if you'd wanted to you could have paid a zero dividend in Q4 '08 and brought the base down that way. So I'm just trying to understand what we really should be expecting in terms of full year '09. So that's the second question.

Stephen Green *- HSBC Holdings plc - Group Chairman*

The first question is about the move from 8 (multiple speakers).

Douglas Flint *- HSBC Holdings plc - Group Finance Director*

Yes. Two major factors. Fourth quarter, we didn't generate capital, is one part. And the second point, because -- and the second point is that there's a foreign exchange element in it where there is some sensitivity in the Tier 1 ratio to the dollar against euro and sterling. And the significant strengthening of dollar, we have a slight mismatch between dollar risk-weighted assets and sterling and that was a few tens of basis points. And the rest was simply the performance in the fourth quarter, where we were hit with Madoff write-downs in Global Banking and Markets and higher credit reserves.

Stephen Green *- HSBC Holdings plc - Group Chairman*

And on dividend guidance?

Douglas Flint *- HSBC Holdings plc - Group Finance Director*

We've given you a guidance of $0.08.

Stephen Green *- HSBC Holdings plc - Group Chairman*

We don't make forecasts. You know what the answer's going to be, Tom.

Douglas Flint *- HSBC Holdings plc - Group Finance Director*

It says something like -- I think you have to -- it's pretty good guidance, actually. I think you have to draw a line and look at our rebasing. And I wouldn't try and compare 2009 to 2008. I'd just start with 2009 and say we're giving you the guidance. We're paying or aiming to pay three $0.08s and then a variable dividend.

Tom Rayner *- Citi - Analyst*

Okay. Thank you.

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Stephen Green - ***HSBC Holdings plc - Group Chairman***

Any question from Hong Kong before -- well, if not, yes, over there, please.

Vincent Cheng - ***HSBC Holdings plc - Chairman, Hong Kong & Shanghai Banking Corporation***

Thank you, Stephen. Roy.

Stephen Green - ***HSBC Holdings plc - Group Chairman***

Sorry, Vincent. Let me come back to you, please.

Jon Kirk - ***Redburn Partners - Analyst***

Thanks. It's Jon Kirk of Redburn Partners. I've got a question on the cram-down legislation that may or may not occur in the US, and particularly how vulnerable your books, i.e. across the ABS portfolios but also the mortgage lending within household, might be to that, whether that was included in your stress testing and also the extent to which that could bring the AFS losses of $21b or so, which are currently taken out of capital, could bring them back into capital.

Douglas Flint - ***HSBC Holdings plc - Group Finance Director***

We haven't seen any [decent] proposals in the cram-down. You could take two views on cram-down. You can certainly paint a bad picture in terms of if the courts force lenders to take losses on lending that they would otherwise think they would be able to recover in part. Of course, if it's successful in rebooting the securitization market, net/net it might be positive for us. But it's very difficult to comment on legislation for which there is no details. And clearly, in the securitization market, giving effect to the proposals is one of the reasons I think, very clearly, why the legislation hasn't been formulated yet, because it's incredibly difficult to do.

As I said, our stress test to market expectations are, if you like, fixed income research and rating agency expectations of loss severity, from the factors that they can see and then stress them. Now, whether that stress includes -- it was just taken -- it was done in a number of ways but it ended up with a 30%, 40%, 50% severity increase.

Jon Kirk - ***Redburn Partners - Analyst***

Just -- sorry to dwell on it, but is there any way that you -- as I understand it, there are certain mortgages and certain securitization structures that have specific protection against cram-down and there are some that don't. Are you able to quantify what proportion of your books are and aren't protected?

Douglas Flint - ***HSBC Holdings plc - Group Finance Director***

Not off the top of my head, no.

Stephen Green - ***HSBC Holdings plc - Group Chairman***

Vincent, question from Hong Kong.

Vincent Cheng - ***HSBC Holdings plc - Chairman, Hong Kong & Shanghai Banking Corporation***

Thank you. Roy Ramos.

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Roy Ramos - ***Goldman Sachs - Analyst***

Yes. Roy Ramos with Goldman Sachs. Two questions, if I may, the first on household. If you could give us a little more color or detail in terms of how you will run it down in terms of modalities, timeframe, accounting implications. Are you going to show this as discontinued operations? And also, maybe, are you also talking about ring-fencing? I'm sure you're not going to comment on this, but if you have any color on the ultimate loss as you wind it down.

The second question I have is on the Group ex-household. Mike, I think you were the one -- or Stephen, you mentioned about the opportunities. You've got the liquidity, you've got the capital raising, you've got the foreign banks or competitors, global banks pulling back. But at the same time, assuming my numbers are correct, your credit cost now, ex-household, is actually quite a bit higher already than the peak in 1998, during the Asian banking crisis. My question is should we expect a continued net shrinkage in your loan books? Where would you explicitly be looking to de-risk, versus where do you see the opportunity to take market share, to take advantage of the foreign banks and peer competitors that are pulling back? Thank you.

Stephen Green - ***HSBC Holdings plc - Group Chairman***

Roy, thank you for that. On the first question, I'm going to get Mike to talk about how we'll run it down. Just let me quickly say, from a Group perspective, we are not ring-fencing these assets in the sense of not supporting the funding. You've heard us on this before. These are bonds, which carry the Group's trust. We've -- you heard Mike say it earlier. We are clearly committed to supporting it. So we are not in that sense ring-fencing it. We are, however, running it down. We are closing it to new business. And Mike (multiple speakers).

Michael Geoghegan - ***HSBC Holdings plc - Group Chief Executive***

Yes. Basically, if you look at the Mortgage Services portfolio, which started off at around $49b, what happens is when you close it down for new business there is some increase in impairments. And then the business matures and basically people pay for their homes and stay in them. And we expect that to happen the same with Mortgage Services -- sorry, in Consumer Lending. And clearly, the vast majority of customers are and will continue to pay their mortgages and it does come down. People do change their style of living. They move, they die, they get divorced, they marry, all the different things that go on in life, and that does have that impact.

How many years it will take, a lot depends on what happens in the securitization market. The reality is all of us have been through these downturns before. They will come back. There will then be a surge in property. And so it'll be pay offs, sell offs, all the different things that you expect in any portfolio. But it'll be over a period of years.

Stephen Green - ***HSBC Holdings plc - Group Chairman***

Roy, thank you. And on your second question, on opportunities and what we see in the emerging markets world, there are some emerging markets that are clearly facing difficulty - the East Europeans, a number of East European countries. They're not actually countries where we're very exposed. We look at our business in Latin America and consumer finance business in Mexico. We've seen that take a strain as the book grew very fast. We've restrained that somewhat. But overall, we're very comfortable with our business in Latin America.

In the Middle East, clearly there are some areas of activity where credit impairment is on the rise and we have to watch that. But again, overall, the business is of good quality. In Asia more generally, the countries where we've got a good base in I think are in a good position to continue to show some growth, albeit at a lower level than in '08 -- '07/'08. But nonetheless, our forecast for China, for example, is of a growth rate of 7% to 8%. We still think that that's good business.

And we want to be able to make sure that we can grow our risk-weighted assets where there is good business to be done, and that is one of the key reasons for the capital raising. It will enable us not to be constrained about growing our business where we want to do so. I've talked both about organic and inorganic. I don't want to major a great deal on the inorganic. But we want to be in a position where, for example, there may be some foreign banks looking to dispose of what part of their non-core assets as they begin to shrink back into their domestic markets. We ought to be able to be interested in those propositions, where they make sense and where there's a good value. And in order to do that, we want to be extremely well capital -- positioned in capital terms.

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So, it's an overall position of very strong capital strength -- a strong capital position. Clearly, there are some countries where you don't want to push the boat out at the moment. I think some of the Eastern European countries are good examples of that. And there are some lines of business where you need to be careful. Credit cards or credit -- direct personal lending is a good example of that. But overall I think there are lots of opportunities we can pursue in the emerging markets, given that they as a group will show relatively sound growth compared with the mature markets.

Yes, please. Over there.

Robert Law - ***Nomura - Analyst***

Robert Law of Nomura. I'd like to ask some questions on the exit cost implications of HSBC Finance, please. So, as it's one area, could I have a number of questions on it?

Stephen Green - ***HSBC Holdings plc - Group Chairman***

Try us.

Robert Law - ***Nomura - Analyst***

First of all, you commented in your presentation that you'd be able to meet the capital requirements for that out of your existing resources. Could I ask you to clarify what that means, please? Will you be within your range? Or is your planning assumption on the exit costs that you'll be within your capital range, say, two or three years out from here without a further capital strengthening?

Secondly, I haven't got to where the mark-to-market on the loan book is. I think you have given that before. Can you tell us what it is and how we might think about that versus the credit loss expectations that we might build in for the exit? What I'm thinking about here is the fact that you are now closing that to new business might well affect the credit characteristics of the book, because you've got customers who effectively need finance to keep servicing their debt. And once that's shut off, it might well have an impact on -- could you comment on that and how we might think about credit losses at HSBC Finance, going forward?

Stephen Green - ***HSBC Holdings plc - Group Chairman***

Robert, thank you. I'm going to get Douglas to comment primarily. On that very last point, I think there is a reason to expect that impairment will be higher when it's a closed book than when there's an ongoing book. We've factored in some assumptions on that. And of course you get the trade-off of the fact that you save on the costs of the operating network, which is some $700m.

Douglas, do you want to comment on the other questions?

Douglas Flint - ***HSBC Holdings plc - Group Finance Director***

Yes. The fair value of the US consumer finance assets is a minus mid 40s billion. What that number means, we can debate for a very, very long time. I think it's fair, as Stephen says, that there -- and indeed was factored into our thinking that there will be some impact in relation to collectability in unsecured credit potential in relation to no longer underwriting. But at the same time, the fair value, so-called, represents what you can sell these loans for in a marketplace that doesn't exist.

So our assessment is that it's a hypothetical figure because our intention is to run them off to maturity or prepayment or sale. And that will be a considerably higher value than the price we could sell them for today. That fair value is that exit price. And I don't think it's a particularly meaningful one because we have the ability to fund the book to any of the exit dates and we'll do so.

Stephen Green - ***HSBC Holdings plc - Group Chairman***

Mike, do you want to comment on experience on the Mortgage Services book?

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Michael Geoghegan - ***HSBC Holdings plc - Group Chief Executive***

Well, the Mortgage Services book, as I said before, came down from $49b to $28b. And clearly we were surprised how many people continued to pay us, even though we weren't going through brokers to them. I think you get down to a realization - I'm in my home, I need to pay for it, I'm going to pay whoever holds the mortgage. And that's what we're doing with our customers at this time.

Clearly we have, as Douglas said, put a projection in for an increase in delinquencies, if there are not people around to -- the actual outlets themselves are not open. We're not absolutely certain we're going to close every single outlet. We're going to test this and see whether we need people out in those communities collecting as well. It's a work in progress.

Stephen Green - ***HSBC Holdings plc - Group Chairman***

There's a question, I believe, from one of the webcast listeners. Danielle, do you want to read it out?

Danielle Neben - ***HSBC Holdings plc - Manager, IR***

We have an Internet question from Takahiro Omura at Western Asset Management Company. Will the decision to close HSBC Finance affect the legal status of senior bonds issued by HSBC Finance? Will they remain as the obligation of HSBC Finance or will they be changed as the obligation of HSBC Holdings plc? Thank you.

Stephen Green - ***HSBC Holdings plc - Group Chairman***

Their legal status is not affected. And indeed, you have heard Mike or Douglas - I can't remember which it is - say that we are committed to making sure there are resources there, to continue to honor those obligations.

Hong Kong, Vincent, any questions?

Vincent Cheng - ***HSBC Holdings plc - Chairman, Hong Kong & Shanghai Banking Corporation***

Thank you, Stephen. Gentleman.

John Wadley - ***UBS - Analyst***

Hi. It's John Wadley from UBS. I just wanted to follow up on the capital. You're raising $17.7b. And on two -- page 279 of your release, in your report, you show that there's a deduction from your Tier 1 capital of about $14b, which changed from a surplus of $8b last year under Basel I, which reflects exchange differences and it must be the available for sale losses. So it's a difference of $22b. What can you do, if anything, to try to unwind the deduction of $22b from that Tier 1 capital?

And the second question is your risk-weighted assets were flat last year, which looks like a big achievement given that you were growing in some of the businesses. Do you anticipate that local regulators will require more capital in some of your subsidiaries, or that regulators will require the calculation of risk-weighted assets to increase going forward, given that Basel II has proven to be -- too much leverage was artificially built into Basel II requirements? Thank you very much.

Stephen Green - ***HSBC Holdings plc - Group Chairman***

John, thank you. Douglas, on the first question.

Douglas Flint - ***HSBC Holdings plc - Group Finance Director***

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A big piece of the number you referred to is exchange. And you'll see in the movement in risk-weighted assets that foreign exchange translation impacts are assessed to have reduced risk-weighted assets by around $80b. So, while the capital has been reduced on a translation impact for our sterling and euro net assets, the risk-weighted assets have also come down. As I said, the risk-weighted assets come down proportionately less than the capital did because there are some mismatched, which is why there was an impact on the ratio. So, broadly speaking, they move in sync, so to the extent that it's translation it's on both sides of the calculation and I wouldn't worry too much about it.

The second part of your question?

Stephen Green *- HSBC Holdings plc - Group Chairman*

Was about the regulatory treatment of capital in subsidiaries in relation to risk-weighted assets.

Douglas Flint *- HSBC Holdings plc - Group Finance Director*

What a great question. There's a lot of focus on this now and the regulators, [both too]. On the one side, clearly too much -- too little capital was allocated to some of the trading operations and there are moves afoot to change that, to increase the amount of capital allocated to trading.

There is also a growing recognition that in relation to some of the balance sheet allocations, particularly those that are based on structured products, securitization and are influenced by ratings, and it's one of the reasons why assets held subject to -- where the capital is measured against a ratings grade are even more illiquid is that the change in rating methodology is leading to enormous volatility and expected downgrade in ratings, and leading to capital allocations that are well beyond economic risk.

So I think, on the one hand, you're definitely going to see, I think, more capital coming through on the trading book. I think there is now some regulatory recognition that there are aspects of the framework in relation to balance sheet risk that need to be looked at. But whether those can be addressed in a relatively short period of time, we don't know. But there is, I think, a meeting of minds now, that it's something that deserves a bit more attention, otherwise it constrains use of capital for the purposes that the stimulus programs are designed to address.

Stephen Green *- HSBC Holdings plc - Group Chairman*

Question from here. Yes, please.

Michael Helsby *- Morgan Stanley - Analyst*

Thank you. It's Michael Helsby from Morgan Stanley. I've got two questions, if that's okay. Firstly, if I look at slide nine, which is the profits, the significant items that impacted your profits, on my numbers I think you've made about $5b before significant items in the second half of the year, compared to about $13.9b in the first half. Within that, it looks like UK and Hong Kong have stepped down a hell of a lot. Hong Kong we know about. UK, just looking, it looks like profits have come down across the board in all of the divisions quite sharply. So I was wondering if you could give a comment on that.

But also clearly, given, as you've said, the deterioration in the macro was much more Q4 loaded, whether you could give us an idea about the profit split of that in the second half, 3Q versus Q4, and if you could just give us some idea of how we've started in the first quarter of 2009. So that's the first question.

And second question. I think, Mike, you talked about the resilience of the results and you're generating capital. I think one of the big reasons why you stand out relative to peers is the accounting that you are required to follow in regard to the fair value in your AFS reserve. So you would have had a $23b hit to the P&L if those AFS unrealized losses had gone through the P&L, like a lot of your peers have had. So that's more of a statement.

I guess what I'm trying to get to grips with is how comfortable you are, carrying that $21b of unrealized losses in the balance sheet. I guess one way you'd answer that is by looking at the stress test that you come through. But I just want to understand, if you're really -- well, if there's really only $500m to -- sorry, $600m to $800m of losses throughout that portfolio, given your liquidity, why aren't you in the bond market buying a lot of these assets?

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Stephen Green - *HSBC Holdings plc - Group Chairman*

Michael, thank you. On the first set of questions on performance in the second half, clearly the second half was weaker than the first half, in common with the entire industry. And indeed - and I'll get Douglas to elaborate on this - the fourth quarter was weaker than the third quarter. The fourth quarter's been a very difficult quarter for the industry. On the start of this year, as I think it was Douglas who mentioned, we've started off with January being actually quite a strong month, better than our expectations. Again, actually consistent with the signals one's getting from the industry generally.

I guess that's -- just saying all of that is a testament to how volatile the banking market -- the financial markets have been over the last few months, really since September, October of last year.

Douglas, do you want to add anything to add to that, in terms of second half?

Douglas Flint - *HSBC Holdings plc - Group Finance Director*

Yes, okay. Can I do AFS as well?

Stephen Green - *HSBC Holdings plc - Group Chairman*

Yes.

Douglas Flint - *HSBC Holdings plc - Group Finance Director*

I think you raise a really good question, but I guess that there's two or three ways of responding to it. You're absolutely right. If the assets were marked-to-market, you'd come to a different answer, if that went through the P&L account. On the other hand, if they were held as loans and advances, you'd virtually take no impairment at all and you wouldn't mark them to market through equity either. You would note that there was a fair value amount which was entirely driven by liquidity. And these are audited numbers. The calculation is subject to audit too.

The other thing you could say is if they were held in trading books and you thought that the losses were only 2% or 3% of nominal and your marks were giving you 30% or 40%, I'd submit that many people would put that into a model basis and call it Level 3, because clearly the market would be -- I don't know how much is in other people's unobservable model 3 valuations. All I know is that we've got only 2% of our trading assets in Level 3 and most of that's in leveraged loans and the like. It's not stuff where we can get a price. So we're being very transparent.

Are we comfortable? We're clearly not comfortable with a deficit of $21b, but we understand it. And we've now set out our own assessment of the stresses within it. And they're meaningful but manageable and certainly, on an expected loss basis, over a three or four-year period, a $600m to $800m number is very manageable.

So you can paint all sorts of pictures. We account the way we account, which is very transparent. It goes into the capital calculation in the way it goes into the capital calculation. And we monitor, in terms of the risk, to there being a call on capital requirement in the way that I described and we've set out our sensitivity.

The second half in Europe is actually still reasonably resilient. In PFS, they were only slightly down in Europe. Second half was a bit weaker because you've got July, August and December. And you're beginning to see the impact of lower deposit spreads and falling interest rates that also hit commercial banking and the transactional banking businesses within Global Banking and Markets. And we began to see an increase, albeit not very much in dollar terms but in percentage terms higher, of loan impairments coming through commercial banking and to some extent Global Banking and Markets.

The second half had an element of write-downs because of the widening of credit spreads in the fourth quarter and we had the Madoff loss in the fourth quarter. And those are the major elements that would contrast first half/second half. And I'm looking on an underlying basis. Clearly, there's a currency impact between first and second half in Europe which is quite marked.

Stephen Green - *HSBC Holdings plc - Group Chairman*

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Any questions from Hong Kong, Vincent?

Vincent Cheng *- HSBC Holdings plc - Chairman, Hong Kong & Shanghai Banking Corporation*

Thank you. The gentleman in front.

Sunil Garg *- JP Morgan - Analyst*

Hi. This is Sunil Garg from JP Morgan. I have just one question. You mentioned you're benefiting from a flight to quality and also deposit spreads are coming down. So, could you tell us about how you're managing your net interest margins and how you see the outlook for that? Thank you.

Stuart Gulliver *- HSBC Holdings plc - Chief Executive, Global Banking & Markets and HSBC Global Asset Management*

The balance sheet management area has been positioned for lower interest rates. So, to some extent, in 2009 we'll continue to see a strong revenue line in the BSM line, which we also saw in 2008. However, as you know, that book's quite short term. So, if low interest rates persist for 2010, most of those positions will then run off. At that point in time, a low flat yield curve will be very difficult for balance sheet management to make money out of, and it will also be very difficult for the PFS business to make money out of a very low and flat yield curve.

So, for '09, BSM actually should, with the positions we've already taken in anticipation of rates going down, continue to produce good revenue. But the PFS business already in '09 will suffer some challenges in terms of spread compression with very low rates, particularly in Hong Kong. Maybe Sandy might want to add.

Stephen Green *- HSBC Holdings plc - Group Chairman*

Yes, good point, Stuart. Sandy, would you like to add anything to that?

Sandy Flockhart *- HSBC Holdings plc - Chief Executive, Hong Kong & Shanghai Banking Corporation*

Well, margins on lending, in terms of our business in commercial banking and also retail lending, have increased over this period. But undoubtedly, as HIBOR rates have reduced to the levels they are today, the profitability of deposits for the commercial banking and the personal banking businesses are diminished quite greatly. At the moment, we're well positioned for that, as Stuart says, but a long period will undoubtedly mean that profitability of deposits over that period will be far less. But we have the ability to re-price up on loans.

Stephen Green *- HSBC Holdings plc - Group Chairman*

Sandy, thank you. Questions from London.

Ian Smillie *- RBS - Analyst*

Thank you. It's Ian Smillie from RBS. Two questions, please. Firstly, if I read correctly, there's $5b of deferred tax assets belonging to the US. Could you color in for us how that squares with the losses that you're anticipating to come through there in future years from HSBC Finance, and perhaps quantify how much new capital injection that supposes that you put into the US, please?

And the second question is on the reinvestment of the surplus deposits. Could you give us some sense as to how we should think about the revenue generation coming from those deposits? Is there an appetite or an aspiration to perhaps start to move along the yield curve again, to pick up some of those high yields which are available in secondary market assets?

Stephen Green *- HSBC Holdings plc - Group Chairman*

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Thank you. Douglas first, on the deferred tax assets, and then Stuart, I think, on the investment of surplus deposits.

Douglas Flint - ***HSBC Holdings plc - Group Finance Director***

There's an extraordinarily full description of the deferred tax assets and its recoverability in the US filings, which I won't go through in painstaking detail, but it's there. Essentially, a good -- the smaller portion of it comes back from carrying back losses, from 2009 to years that are open. If -- and if there is a legislation change, which was proposed and then put away, as to further carry backs that would help that situation. The portion that's not going to be carried back from 2009 is going to be recovered through future profitability, from -- predominantly from the bank, not from the finance company. We have a tax group in the United States.

Stuart Gulliver - ***HSBC Holdings plc - Chief Executive, Global Banking & Markets and HSBC Global Asset Management***

On the balance sheet management number, Ian, the BSM activity is meant to keep itself clean, as far as possible, of credit risk, although that's not been the case with Icelandic banks failing and while moving cram-down. But it tends to take exposure to governments and to the Interbank market.

What you've just described, of going out down the yield curve into the secondary market, actually means taking credit risk. You're talking about basically buying the secondary assets that have fallen. And that's not what the balance sheet management book's about. That's about the liquidity of the Group. It's about that powerful AD ratio and being incredibly liquid and never having funding problems.

So, that isn't the activity in which you would see that. You would probably see it coming through on a mark-to-market basis from some of the trading desks that may indeed choose to invest in assets that we believe are mis-priced. But they would be held in mark-to-market and not come through the BSM line, but come through probably either rates or credit line.

Ian Smillie - ***RBS - Analyst***

Thanks, Stuart. And can you give us any sense as to how their appetite is being conditioned as we speak?

Stuart Gulliver - ***HSBC Holdings plc - Chief Executive, Global Banking & Markets and HSBC Global Asset Management***

We have started, I guess in November last year, to start building a couple of portfolios up where we think there are mis-priced assets. But this is very early days. I don't think we're, sadly, looking at a kind of V-shaped recovery in anything, so I don't think you need to rush to do this.

Ian Smillie - ***RBS - Analyst***

Thanks.

Stephen Green - ***HSBC Holdings plc - Group Chairman***

Question from Hong Kong, Vincent? No? Okay. From London.

Vincent Cheng - ***HSBC Holdings plc - Chairman, Hong Kong & Shanghai Banking Corporation***

(Inaudible).

Stephen Green - ***HSBC Holdings plc - Group Chairman***

Oh sorry. Yes, please.

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Cameron Odgers *- CICC - Analyst*

Cameron Odgers, CICC again. Can you give us an idea how much of your Alt-A RMBS and sub-prime had ratings downgrades? And at what point, if you get credit rating downgrades on these securities, do you take impairment losses on them? And has there been -- how is the trends going in the first two months of the year, in terms of the sub-prime Alt-A? Are they pretty flat line or continuing to experience mark-to-market losses? Thanks.

Douglas Flint *- HSBC Holdings plc - Group Finance Director*

A substantial proportion of the Alt-A market, including the bonds we hold in that category, were subject to downgrade. But there is not a correlation between credit -- and indeed we've set this out in the accounts as well. There's not a direct correlation between ratings downgrade and expected loss. It depends where we are in the capital structure. So it could be well be that a tranche dips into a lower rating or the rating methodology changes, but our portion of that tranche at the higher levels is still unimpaired because of the prioritization of cash flows that we have.

So while it would be a factor that would cause us to look with considerable more attention at those assets, i.e. the downgrade, it wouldn't necessarily correlate directly to the recognition of impairment. But it would mean that we'd look much more carefully at the cash flows that were coming from that asset.

Stephen Green *- HSBC Holdings plc - Group Chairman*

Douglas, thank you. Yes, please.

Bill Stacey *- Aviate Global - Analyst*

Bill Stacey from Aviate. My simple question is how would you prioritize the acquisition opportunities that might emerge over the next two years? And to elaborate a little bit on that, you've said in the past that insurance was an area you wanted to be a much bigger proportion of your business. Is that something that you would still prioritize in the same way? And given that and the look that you might have had at AIG assets, how would that fit with your strategy?

And I suppose, relating to that, given that insurance as well as household were diversifications probably from your core strategy and strengths, would you have changed your thinking about diversification in terms of acquisition and priorities?

Stephen Green *- HSBC Holdings plc - Group Chairman*

Bill, thank you. To be very clear, any acquisition that we do has got to fit within the strategy that we've articulated over the last couple or three years. So that is emerging markets or emerging markets related, fast-growing markets, not necessarily geographically in them but related to that positioning.

We have nothing on the drawing board at the moment. If we had something to talk about, we would. But we do see potential opportunities over the next couple of years, as I've said before, organically as well as inorganically. And you probably -- I'm sure you would appreciate that in so many cases you're better off investing organically rather than inorganically. But nonetheless, we see opportunities that may arise.

I would say they will be primarily in banking business. We have committed ourselves to a target for a role for insurance, and indeed you'll see that we've made good progress in building our insurance business. I think that should be a proposition that depends very much on the fact that we have the client base, so it's a Bancassurance model. I can't tell you whether we will be likely to invest in insurance. I certainly wouldn't want to rule that out. You never know. But I would say that the priority, and I think broadly speaking, you should expect us to be focusing to a large extent on core banking business.

And in terms of geography, well, I think it's self-evident from what I'm saying where you might expect us to do activity. And indeed, if you look at what we did in '08, the bank in Taiwan, the bank in Indonesia, the increase of our position in Vietnam, the retail broker in India, these are all propositions that I think are straight down the line of our articulated strategy.

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We've probably got time for one more question each from London and Hong Kong. Let me go to Hong Kong first and then perhaps -- Vincent?

Vincent Cheng *- HSBC Holdings plc - Chairman, Hong Kong & Shanghai Banking Corporation*

Thank you, Stephen. That gentlemen please.

Alistair Scarff *- Merrill Lynch Hong Kong - Analyst*

Thank you. It's Alistair Scarff from Merrill. I was wondering if you could perhaps share with us your views on the potential contagion from Central and Eastern Europe on your operations, particularly in Europe, and potential knock-on for other EM businesses. Thank you.

Stephen Green *- HSBC Holdings plc - Group Chairman*

Well, as far as we're concerned, our exposure to East Europe is pretty small. And of course, as you'll be aware, different European countries are in different positions. The ones that are particularly distressed at the moment, we have little or no exposure in. Second order effects, if some other bank got itself into distress, that's something -- we monitor our bank exposures very carefully and we continue to do so. And we focus on making sure we understand where banks have got themselves particularly exposed to areas that we think are going to come into stress. East Europe would be one. But we -- but in terms of direct impact on us, it's pretty modest.

John-Paul.

John-Paul Crutchley *- UBS - Analyst*

Stephen. John-Paul Crutchley from UBS. It was just a broader strategic question, particularly about the US market because you are the world's local bank as you lay claim to be. Clearly, the strategy there hasn't worked and you've pretty much torn that up, to be left with essentially a regional bank and a credit card operation. And clearly, the US landscape has been completely reshaped over the course of the last six months or so.

So I'm just wondering is that it now for HSBC in the US? Is it too hard to deal with camp and retrench back to now licking the wounds, back to the areas of your traditional strength? Or is it still something that is a market that is sensible for you to be in, in some size and scale, longer term? And how do you think that process through?

Stephen Green *- HSBC Holdings plc - Group Chairman*

John-Paul, I think that's a very well taken question. I want to be very clear about it. We're not turning our backs on the US. What we do want to make sure we've got, and I think you could say we've never really had it in the past but I think there's a good opportunity, is to ensure that we have a business in the US that makes a reasonable contribution to overall Group profits - I don't want to put a percentage on that - and is properly connected with what the Group proposition is.

That means focusing on the kinds of customer base that have a clear international connectivity, particularly to areas where we're strong. Just (inaudible) on this, business banking. We should be focusing on business banking customers who have a clear -- let's say an interest in China, one way or another, for example. And in the personal sector, we should be looking at those sectors of the personal market that have connectivity. Hispanics is an obvious example in our case, given our preeminence in Mexico, Central America, South America.

So if you look at A, where we're at now, B, where I think it would be reasonable to evolve our business, it's clear from what I've said that we've got some work in hand to do this. But I think the prize is there. It should also tell you things we will not do. We will not go out and buy a bank for Middle America because it's looking cheap. We need to be sure that the way we build up, and we'll do this organically or inorganically, but I think a strong emphasis on organic plus incremental rather than some big ticket thing. I don't think there's a big ticket thing that gets in one leap from what where we are now to what I've described. But that's the sort of growth path we're looking at for the US.

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But to be very clear, it is important to recognize that doing business in America has its own dynamic, its own cultural dynamic. I think sometimes Europeans, including Brits in that, have been -- have underestimated the difference between doing business in America and doing it in Europe, and Europeans have underestimated that to their cost. We need to be very alert to that. But I do think there are opportunities there. And no, we're not turning back on -- turning our back on the US.

Sandy. Douglas was telling me you wanted to ask a question.

Douglas Flint *- HSBC Holdings plc - Group Finance Director*

He's been trying hard.

Sandy Chen *- Panmure Gordon - Analyst*

Yes, thanks very much.

Stephen Green *- HSBC Holdings plc - Group Chairman*

And this is the last one, I'm afraid.

Sandy Chen *- Panmure Gordon - Analyst*

Oh thanks. Well, for that I won't ask the AFS question again. I just wanted to see if you could -- sorry, Sandy Chen, Panmure Gordon. If you could talk us through the net derivatives movement. You mentioned that it moved from $66b to $112b. How did that show up in the P&L, in terms of gains and/or losses that might have been mitigated by the monoline wraps, etc.? And how sustainable would they be?

Stuart Gulliver *- HSBC Holdings plc - Chief Executive, Global Banking & Markets and HSBC Global Asset Management*

Sure. Let me take it in two parts. The increase from $66b to $112b occurs in part for us because we don't net as much as other institutions, and the reason we don't net as much is actually because of two things. One is a lot of our derivatives are in emerging markets, where CSAs are not enforceable. So, if they're not enforceable, we don't put in CSAs and then pretend they might be. Some others might do that.

The second thing is most of our derivatives are with corporate and commercial customers. So, therefore, when they hedge with us, they're not trading with us, meaning that they'll only have one side. Their trades will be directional. Therefore, if you have very big moves in foreign exchange markets, rates markets and credit spread, that will create enormous VAR. If my counterparties were mostly hedge funds, they'd be on both sides. I'd have a netting agreement. I'd therefore be able to drop the number down. So, actually, the underlying notional only went up nominally, only moved by about 8%. So, there's an amplify factor because of the nature and scope of our business.

On the monoline question, we have separately - and I can take you through this after - provided -- done the analysis on our monoline book that you did on RBSs. And we think the stress number is about $1.2b on equivalent analysis that you did on the RBS book. And I'm happy to share that with you.

Stephen Green *- HSBC Holdings plc - Group Chairman*

Sandy, thank you. I think we probably ought to draw to a close at that point. Ladies and gentlemen, thank you here in London and, Vincent, to your guests in Hong Kong. Thank you for being with us. Thanks very much.

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