

# **HSBC Holdings plc**

## **Issues and recommendations**

**(reflecting feedback from shareholders to date)**

**October 2007**

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# Legal Notice

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This document is dated as of 10th October, 2007.

# Executive Summary

## Issues

- Systematic underperformance against peers over long period (past 14 years)
- Unfocused and incoherent strategy/ poor execution
- Supposed “new” strategy misses all the key issues
- Poor governance/ lack of external discipline (no risk of takeover)

## The outcome are we seeking

- Greater focus/ discipline in capital allocation
- Greater emphasis on synergies and competitive advantage (rather than diversification for its own sake)
- Alignment of management and shareholder interests (LTIP to be corrected)
- A stronger and more independent Board

**We intend to address specific strategic alternatives and valuation in a separate document**

## The story so far ...

- 25 May** Knight Vinke writes to Stephen Green to initiate dialogue regarding strategy and poor performance
- 12 June** Meeting with Douglas Flint, CFO, to discuss areas of concern including US sub-prime, which it would like to see sold/ liquidated – **all options rejected/ “we like the sub-prime business”**
- Knight Vinke and management consultants review responses over next 3 months
- 4 Sept** Knight Vinke letter to the Board asking for independent review of strategy and governance to address long term stock market underperformance; Simon Robertson, senior non-executive, contacted and meeting arranged
- 19 Sept** **4.15 pm** Stephen Green and Simon Robertson send faxes to Knight Vinke offices rejecting request for independent review
- 5.00 pm** Simon Robertson and Rona Fairhead, non-executive directors, meet with Knight Vinke to receive evidence underlying 4th September letter
- 6.00 pm** HSBC reveals rejection of proposals to UK press; front page news the following day together with reports that shareholders supposedly not interested
- 20 Sept** Knight Vinke holds first of 40 meetings with HSBC institutional shareholders
- 21 Sept** HSBC announces closure of sub-prime wholesale business (\$ 880 m provision)

HSBC advertisement – Heathrow Airport September 2007

**Another point of view  
can sometimes open up  
a whole new world**

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**HSBC**

**The world's local bank**

## **SECTION 1**

# **STOCK MARKET PERFORMANCE 1994 – 2007**

# HSBC's selected peer group

	Market Capitalisation USD billion
G Citigroup	227.1
G Bank of America	220.9
G HSBC	211.2
G JP Morgan Chase	149.6
Wells Fargo	119.2
Banco Santander	113.3
G UBS	108.8
G Royal Bank of Scotland	107.0
Mitsubishi UFJ Financial Group	101.7
BNP Paribas	97.0
Wachovia	93.0
G ABN Amro	90.1
Unicredito Italiano	85.9
G Barclays	83.9
BBVA	81.5
G Credit Suisse	80.1
G Societe Generale	75.6
Mizuho Financial	70.6
HBOS	67.7
G Deutsche Bank	66.7
Morgan Stanley	65.8
Royal Bank of Canada	65.3
Lloyds TSB	61.7
Credit Agricole	61.4
US Bancorp	54.9
National Australia Bank	52.9
Bank of New York Mellon	45.8
Standard Chartered	42.1
Westpac	41.2

Source: Bloomberg data, 6<sup>th</sup> September 2007

- The list comprises the 28 banks against which HSBC benchmarks performance for management remuneration purposes (plus HSBC itself)
- Since 2005, HSBC's peer group includes no emerging market banks (except for Standard Chartered)
- HSBC derives approx 50% of income from emerging markets
- We have marked with "G" those banks which are pursuing a diversified global strategy to test the hypothesis that such banks outperform in times of market turmoil.



# Direct competitors in the emerging markets

	Market Capitalisation USD billion
Industrial and Commercial Bank of China	285.8
HSBC	211.2
China Construction Bank –H	197.4
Bank of China – H	189.0
Bank of Communications – H	73.5
China Merchants Bank	69.1
China Citic Bank	52.7
Banco Itau Holdings	50.0
Banco Bradesco	49.2
Industrial Bank Co	37.9
Citic Securities A	37.7
Banco do Brasil	34.3
China Misheng Banking	32.7
Al Rajhi Bank	31.2
Shanghai Pudong Develop Bank A	30.8
Hang Seng Bank	30.4
Kookmin Bank	27.0
Unibanco Units	26.4
BOC Hong Hong Holdings	24.7
ICICI Bank	24.3
Shinhan Financial Group	23.2
Haitong Securities co A	22.5
State Bank of India	21.1
United Overseas Bank	21.0
DBS Group Holdings	20.3

Source: Bloomberg data, 6<sup>th</sup> September 2007

- The list on the left comprises HSBC's largest emerging market competitors
- All these banks would have been included in HSBC's peer group prior to 2005, when the peer group was changed
- It may be helpful to observe how HSBC has performed against these banks to understand more fully its performance in the year to date

# TSR: 2007 year to date

## No evidence of outperformance by global diversified banks

		USD	GBP	Rank
G	ABN Amro	50.0	44.7	1
	WestPac	19.2	15.0	2
	Royal Bank of Canada	8.7	4.9	3
	National Australia Bank	4.2	0.6	4
	Standard Chartered	3.3	-0.3	5
	Lloyds TSB	1.8	-1.8	6
G	HSBC	1.5	-2.0	7
	Wells Fargo	1.4	-2.1	8
	Banco Santander	-2.0	-5.4	9
	Bank of New York Mellon	-3.3	-6.7	10
	BBVA	-3.6	-7.0	11
G	Societe Generale	-4.2	-7.6	12
G	Deutsche Bank	-4.3	-7.7	13
	BNP Paribas	-4.4	-7.8	14
G	Credit Suisse	-4.6	-7.9	15
G	Bank of America	-4.9	-8.3	16
	Unicredito Italiano	-6.4	-9.6	17
	Morgan Stanley	-6.6	-9.8	18
G	JP Morgan Chase	-7.9	-11.2	19
	Credit Agricole	-8.6	-11.8	20
	US Bancorp	-11.0	-14.1	21
G	UBS	-12.1	-15.2	22
G	Royal Bank of Scotland	-12.4	-15.4	23
	Wachovia Group	-12.8	-15.8	24
G	Barclays Bank	-13.0	-16.0	25
	HBOS	-15.5	-18.4	26
	Mizuho Financial	-15.5	-18.5	27
G	Citigroup	-15.8	-18.7	28
	Mitsubishi UFJ Financial	-24.0	-26.6	29

HSBC RANK 7/29      1<sup>ST</sup> QUARTILE

- Although HSBC has performed well, the evidence shows that there has been no systematic outperformance of the global diversified banks compared with local banks in the year to date
- Some of the best performing banks have been those with purely local strategies
- The returns of most banks in this group have been negative ... while most emerging markets banks have been strongly positive (see next slide)
- We believe that HSBC's performance reflects the fact that 50% of its income is derived from emerging markets

# TSR: 2007 year to date

## HSBC benefits from its emerging market exposure ... not from being diversified and global

		USD	GBP	Rank
G	ABN Amro	50.0	44.7	1
	WestPac	19.2	15.0	2
	Royal Bank of Canada	8.7	4.9	3
	National Australia Bank	4.2	0.6	4
	Standard Chartered	3.3	-0.3	5
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G	Citigroup	-15.8	-18.7	28
	Mitsubishi UFJ Financial	-24.0	-26.6	29

		USD	GBP	Rank
	Citic Securities	217.9	206.7	1
	Shanghai Pudong Development Bank	153.2	144.3	2
	China Merchants Bank	128.8	120.8	3
	China Misheng Banking	102.3	95.2	4
	State Bank of India	43.0	38.0	5
	China Construction Bank	42.8	37.8	6
	Banco do Brasil	41.4	37.3	7
	Banco Bradesco	21.9	18.3	8
	Banco Itau	19.4	15.9	9
	Hang Seng Bank	19.0	14.8	10
	Unibanco units	18.1	14.6	11
	Shinhan Financial Group	17.6	13.8	12
	United Overseas Bank	15.8	11.8	13
	Ind & Comm Bank of China	14.1	10.0	14
	ICICI Bank	13.5	9.5	15
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	DBS Group Holdings	-6.9	-10.2	20
	Al Rahji Bank	-10.0	-13.0	21
	BOC Hong Kong Holdings	-11.4	-14.6	22

**Most of HSBC's own peers have negative returns**

**Most of HSBC's emerging market peers have positive returns**

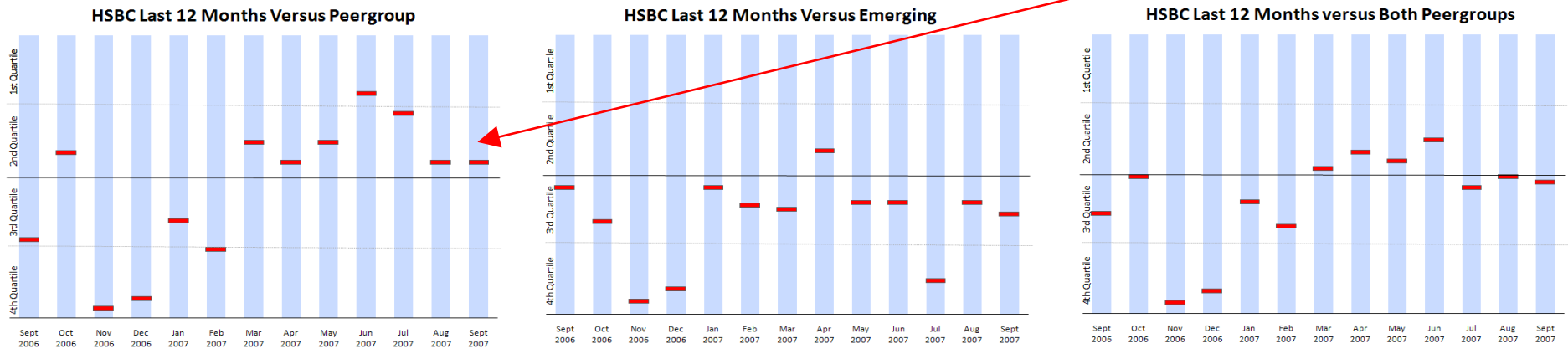
HSBC RANK 7/29 1<sup>ST</sup> QUARTILE

HSBC OVERALL RANK 22/50 2<sup>ND</sup> QUARTILE

# Monthly TSR: HSBC's rank over the past year

HSBC did not outperform when the crisis was most acute

Aug/ Sept 2007: Sub-prime crisis most acute



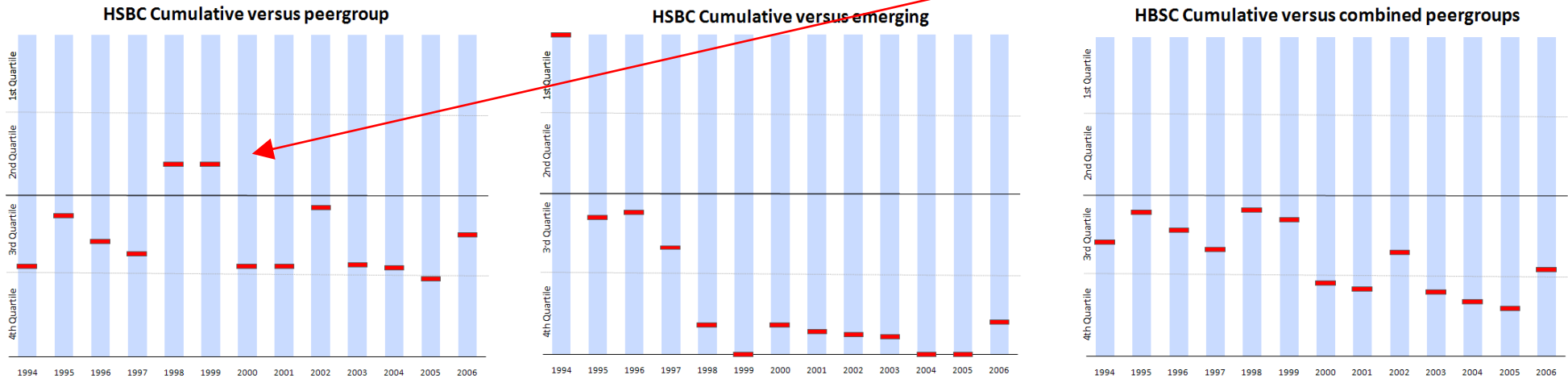
- **HSBC not a first quartile performer in August and September (when the sub-prime crisis was acute)**
- **HSBC first quartile performer only in June (before the sub-prime crisis)**

**The evidence casts strong doubt on HSBC's hypothesis that being globally diversified is an advantage in times of crisis...**

# Systematic underperformance since 1994

TSR rank over periods ranging from past 2 to past 14 years

Bounce back after Argentine/Asian crises



- In the interests of being objective, we have examined HSBC's relative performance over the past 2 years, 3 years, 4 years etc ... going back to when HSBC moved its HQ from Hong Kong to London
- First chart shows that HSBC has generally been a **3rd quartile** performer vs its own 28 peers
- HSBC has generally been a **4th quartile** performer vs emerging market peers (i.e., it has not taken full advantage of its strong position in emerging mkts)

# HSBC share price performance since 1994 - Conclusions

- **Despite claims to the contrary, HSBC has generally underperformed its own peer group over the past 14 years**
- **The bank has outperformed in the year to date, but this is not due to the fact that it is global and diversified**
- **We attribute the underperformance to failures in strategy/ execution and a corporate governance regime that makes it difficult to change strategy or management when there has been failure**

## **SECTION 2**

# **CORPORATE GOVERNANCE ISSUES**

# HSBC's governance

## Inadequate framework for promoting challenge when necessary

In most major UK companies a strategy that fails to produce results can be challenged by the Chairman, by the non-executives or by senior management

- In the case of HSBC the Chairman (who is responsible for strategy and governance and is former CEO) is **not independent**
- When strategy fails, the Chairman has a conflict of interest
- Management compensation arrangements (as embodied in the 2005 Share Plan) **do not create incentives for executives to challenge strategies they think are failing**

**This places HSBC's non-executive directors in an unusually difficult position**



# The HSBC 2005 Share Plan

## Does not properly align interests of shareholders and management

- The HSBC long term incentive plan is split into two independent pots (50% each) subject to separate vesting conditions over three year period
  - 50% starts vesting on achieving median relative TSR target
  - 50% starts vesting on achieving 24% “absolute” EPS target
- Relative TSR element starts vesting when median performance is achieved – which HSBC has achieved on only a few occasions in past 14 years, so EPS element is critically important
- Detailed review of the way in which the EPS element of the scheme works suggests poor alignment of compensation and performance

# Vesting Conditions - EPS Portion

As described in 2005 and 2006 Annual Reports

- EPS element starts to vest when “incremental EPS” over three years reaches at least 24%; it all vests when “incremental EPS” reaches 52%
- Definition of “incremental EPS” is **very unusual**: Sum of A + B + C
  - A = increase in EPS from base year to end of year 1
  - B = increase in EPS from base year to end of year 2 (i.e. over years 1 and 2)
  - C = increase in EPS from base year to end of year 3 (i.e. over years 1, 2 and 3)
- As a result, HSBC effectively **TRIPLE COUNTS** the gains in year 1, **DOUBLE COUNTS** those in year 2 and **SINGLE COUNTS** those in year 3!

NB: This point was not contested by the non-executives when discussed at KV meeting in September 2007

# What this means in practice

“trader’s moral hazard”

IFRS	2004	2005	2006	2007E	
	(Base Year)				
EPS (US\$)	1.184	1.364	1.400	1.400	
% Change					18.2%
A =		15.2%			
B =			18.2%		
C =				18.2%	
“Incremental EPS” A + B + C as per HSBC definition					51.6%

Normal definition of EPS growth over three years gives 18.2% - below the 24% required for any vesting. HSBC definition of incremental EPS growth gives 51.6% almost 100% vesting!!

- In effect 2005 growth is triple counted, 2006 double counted and 2007 growth single counted – creates a moral hazard particularly since there are incentives to pursue one-off gains as EPS definition includes one-off gains!
- No incentive for management to challenge poor strategies under the circumstances

## Was the incentive structure actually approved by shareholders at the May 2005 AGM?

- **No mention of the unusual definition of “incremental” EPS being used by HSBC in the Chairman’s letter of May 2005 (prior to shareholder vote)**
- **This definition was first disclosed to the market in HSBC’s 2005 accounts which were published AFTER the shareholder resolution was passed. HSBC attributes this to a problem of “communication”**
- **HSBC also claims that its EPS calculation is “an accepted method”**
- **Towers Perrin, consultants to HSBC’s remuneration committee recently described the structure as being as “reasonably unusual” and employing “an odd bit of maths” (Daily Telegraph 11 Sept 2007)**

## **Final thought ...**

- **Many senior managers at HSBC appear to have issues with the strategy being pursued**
- **What incentives do they have to challenge this if performance pay is not materially affected? (think of major Wall Street competitors ...)**
- **Does HSBC's culture and practice of appointing only long-standing employees to senior positions permit strategy to be challenged when things go wrong?**

## **SECTION 3**

# **HSBC'S STRATEGY 1998-2007**

# HSBC's "old" strategy 1998 – 2007

Main elements indicated in red

## Managing for Value (1998 – 2003)

### Objectives

- Beat the average TSR of a peer group of financial institutions subject to minimum TSR of 15% p.a.
- Balance earnings between OECD and emerging markets

### Operating Strategy

- Establish HSBC as a global brand.
- Concentrate on delivering 'wealth management' to key markets around the world (Premier product launched in 2000)
- Integrate corporate and investment banking services for HSBC's largest customers
- Grow HSBC's commercial business

## Managing for Growth (2003 – 2007)

### Objectives

- Grow EPS faster than peers to enhance stock market ratings and relative TSR
- Balance earnings between OECD and emerging markets

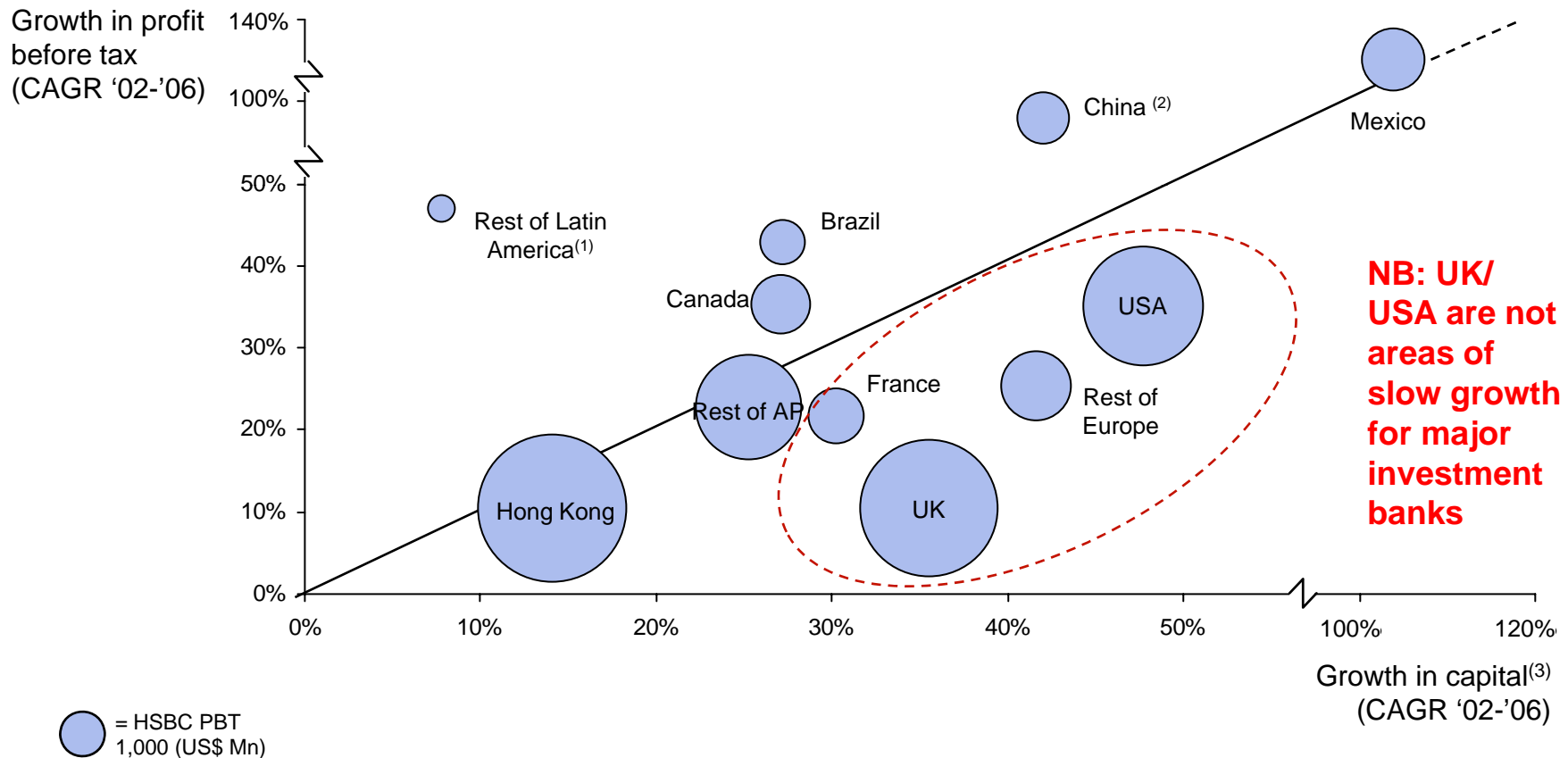
### Operating strategy

- Continue developing the HSBC brand
- Drive growth in key markets to make HSBC strongest global player in PFS
- Roll out Household (consumer finance) model
- Aim for capital markets and M&A leadership across the board including North America
- Commercial banking: make the most of HSBC's international customer base through improved product offering
- Private banking: serve the Group's highest value personal clients around the world

# Allocation of capital under the “old” strategy

Capital allocated to slow growing areas (in the name of diversification)

HSBC profit and capital growth in key markets



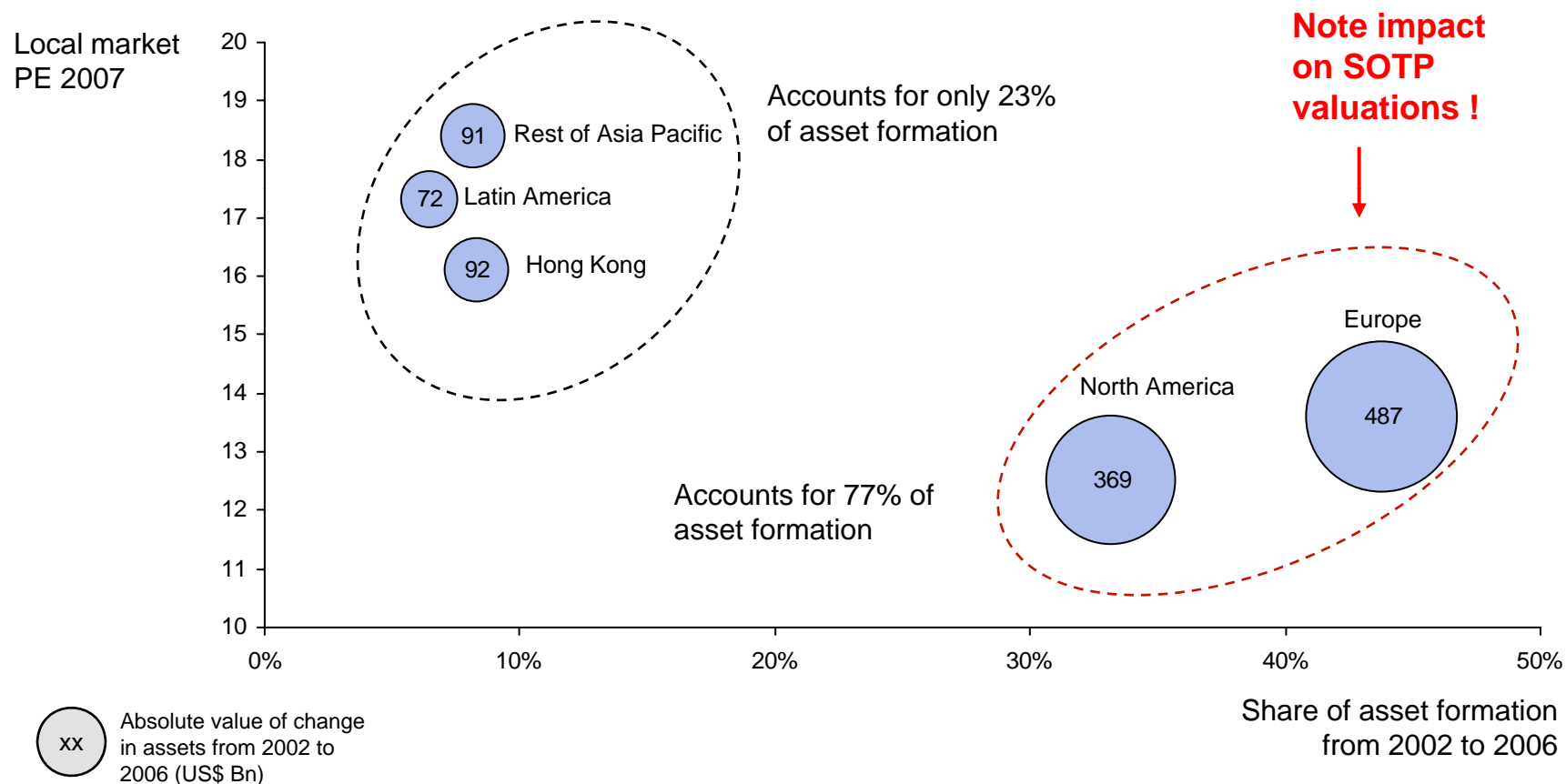
1. PBT CAGR ('03-'06) (2) Includes profit contribution from associates (3) Capital = Total Assets less Total Customer Deposits & Deposit from banks  
Source: HSBC annual report; External analysis



# Allocation of capital under the “old” strategy

## Resulting in capital being allocated to areas with low valuations

### Growth in assets vs. local market PE



Note: P/E multiples of markets are based on P/E multiples of local market peers as of 17 May 2007  
 Source: InFinancials, Bloomberg, Annual report, External analysis

# Poor execution in CIBM and Household Finance

What is left of “Managing for Growth”?

- 1. Objective of achieving capital markets and M&A leadership worldwide has failed.** CIBM is now re-positioned to be “emerging markets led and financing focused”
- 2. Roll out Household’s (consumer finance) model to retail banking network worldwide has failed.** Household damaged by sub-prime problem and loss of key managers; unlikely to be platform for consumer finance globally
- 3. 50/ 50 split between OECD and emerging markets (global diversification).** Objective apparently still intact

This leaves HSBC with two pillars missing and diversification (beyond what is optimal) for its own sake as a strategic objective

# HSBC's "new" strategy announced in 2007

**Fails to address reasons for HSBC's perennial underperformance**

## Key elements

- Reemphasizes emerging markets focus, seeking 50% of income from emerging markets and 50% from OECD
- "Joining up the pieces" – a long standing objective
- Investment banking to be "emerging markets focussed and financing led"
- Aims to exploit growth in world trade and increasing longevity

## Weaknesses

- Does not address the need to concentrate in retail and commercial banking: diversification for its own sake remains a key objective
- Does not address the need for comparative advantage
- No longer aims for global scale in CIBM – objective abandoned

# Diversification as a strategic objective

## Acquisitions/ greenfield projects announced in 2007

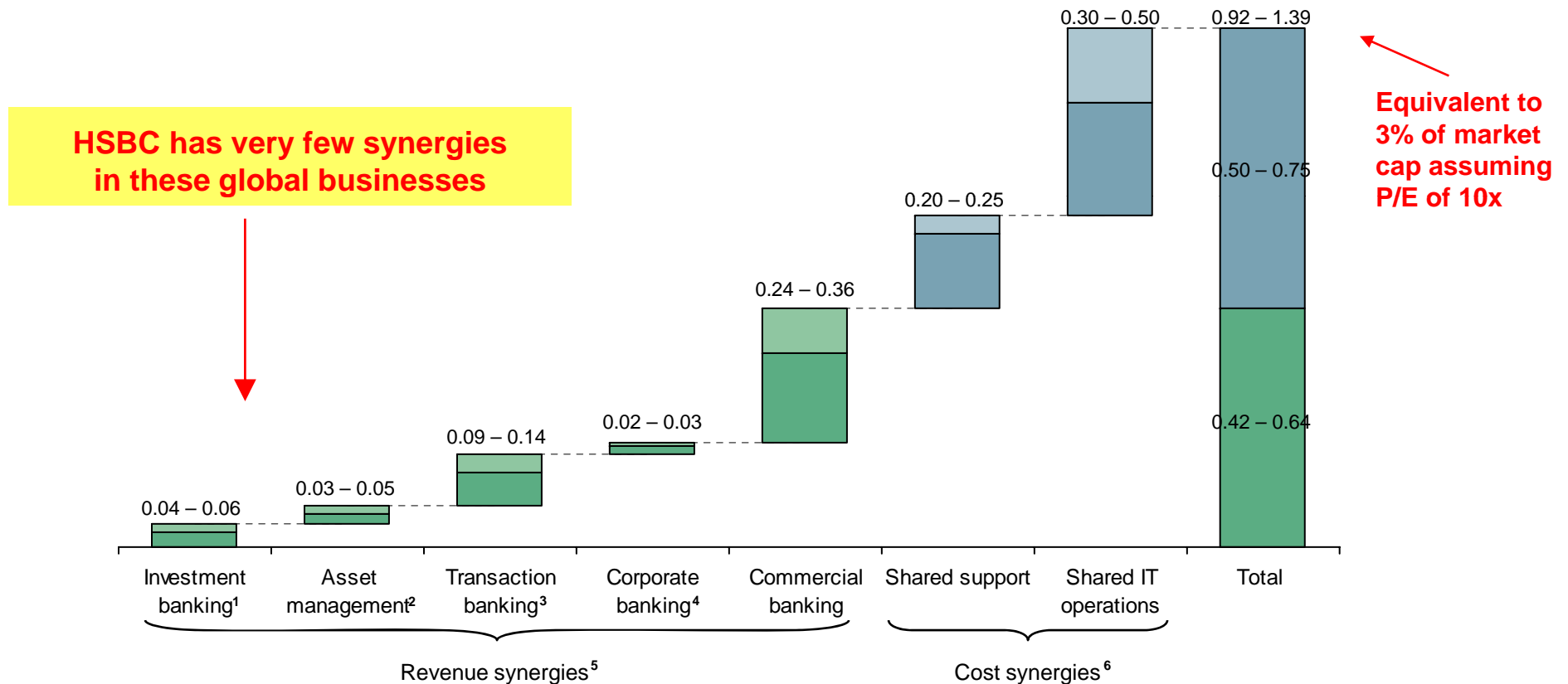
Date		Announcements
08-Oct	Peru	HSBC announces plan to open branch network in Peru
02-Oct	Vietnam	Increases its stake in Vietnamese Techcombank from 10% to 15%
30-Sep	UAE	Gets license to start share broking in the UAE
27-Sep	Taiwan	Launches life insurance in Taiwan
	Czech Republic	Announces the opening of a retail service in Czech Republic
20-Sep	Japan	HSBC announces plan to open 35 branches in Japan
	Georgia	Expects to begin Georgia banking services early in 2008
13-Sep	Vietnam	Agrees to buy a 10% stake in Bao Viet, Vietnam
10-Sep	Italy	Buys 2.7% of Banca Popolare di Milano
03-Sep	Korea	Agrees to buy 51% of Korea Exchange Bank for \$6.3bn
29-May	Algeria	Receives regulatory approval to open a branch in Algeria
24-May	Guatemala	Plans to open an office in Guatemala
02-May	Paraguay	Completes the purchase of Lloyds TSB Bank Paraguay SA
30-Mar	El Salvador	Buys out most of the remaining shares in two units in El Salvador
16-Mar	India	Seeks permission to enter India's pension fund business
15-Feb	Greece	HSBC announces decision to further expand its activities in Greece
12-Feb	Russia	Applies for a license to start retail banking services in Russia

**Where is the comparative advantage from spreading capital so thinly?**

# What value in perfect execution of Joining Up The Pieces?

Our management consultants estimate this at only \$ 0.9 to 1.4 billion pre-tax

**HSBC worth little more than Sum of the Parts unless strategy changes**



1. Investment banking includes CIBM elements (IB, credit and rates, structured derivatives and equities) 2. Asset mgmt includes PB, private equity and group investment  
 3. Transaction banking includes CIBM elements (FX, payments and cash mgmt and other transaction services) 4. Corporate banking includes CIBM lending 5. Value synergies of 1 – 8% from PBT varies with different business units based on External experience 6. Based on scale curve, Regional and local scale effects on IT/Operations costs per product are differentiated for Europe, North America, Latin America and Asia  
 Source: HSBC 2006 group and country annual report; External IT benchmarking and experience; External experience and analysis

# The strategy is incoherent

HSBC is unique in pursuing global strategy with respect to mass market retail banking and limited/ regional strategy with respect to CIBM

- **Global strategy where local strategies do best** (mass market retail banking)
- **Local (or limited) strategy where global strategies do best** (CIBM to be “emerging markets led and financing focused”)
- **Global brand/ Premier account only relevant to 2 million out of 125 million customers today**

## ROE compared with peers

- HSBC is the only bank to be pursuing global strategy in retail banking ...
- **If this strategy generated significant synergies one would expect HSBC's ROE to rise relative to its 28 peers**
- In fact, HSBC's ranking in terms of ROE measured against its own peer group fell from
  - **2nd out of 13 in 1993**
  - **21st out of 29 in 2006**

**NB: We do not believe that HSBC has excess capital (Basel II considerations and international scope)**

# The existing strategy is worst of all possible choices ...

The Board may need to consider radical alternatives to secure value

Considerable synergies could be released by adopting a more coherent strategy, including, for example:

- Going for global scale in investment banking, asset management, transaction banking ... but this **may require a major acquisition** which shareholders may not approve with this management team; or
- Going for scale in selected local markets in retail and commercial banking

**We see 50 – 75% upside for shareholders** (compared to only 3% from “joining up the pieces” with the current diversification-led strategy)



## **SECTION 4**

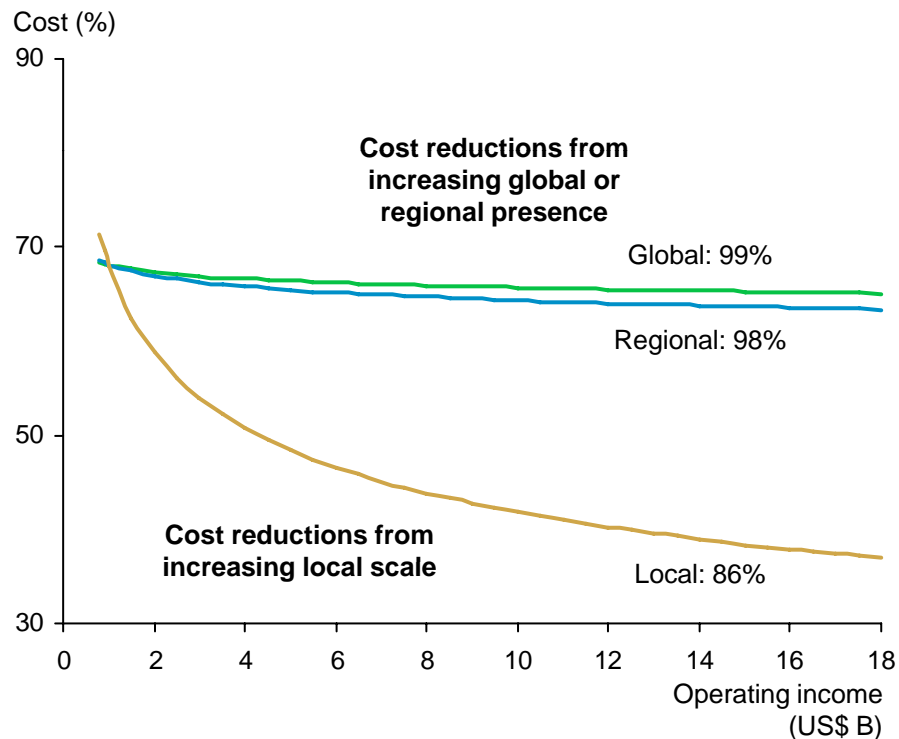
# **STRATEGY IN RETAIL AND COMMERCIAL BANKING**

# Strategy in Retail and Commercial Banking

- **Far more synergies and value can be released by achieving scale in **local** markets rather than at a regional level or globally**
  - Cost reductions through rationalisation of property portfolio, reduction in unit processing costs, overhead etc
  - Revenue synergies from using market position to distribute value added products and services e.g. insurance
- **Compare HSBC's superior performance of Hong Kong, where HSBC has scale, versus poor performance in France where it does not**
- **Strategy in retail and commercial banking should be to use capital to achieve scale in local markets rather than to spread capital thinly to achieve global diversification**
- **It is easy (but wrong) to dismiss local banks, which may have both scale and political connections**

# Cost reductions from increases in scale in retail banking

## Banking Scale Curve



Based on our consultants' experience, **global scale effect generates only 1% cost reduction when business volume doubles**

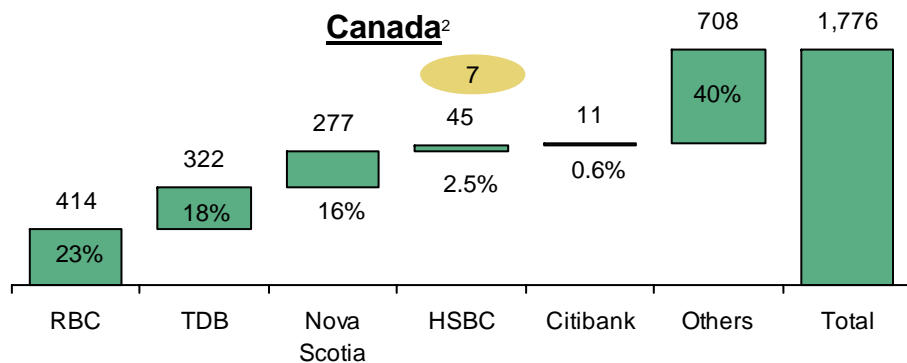
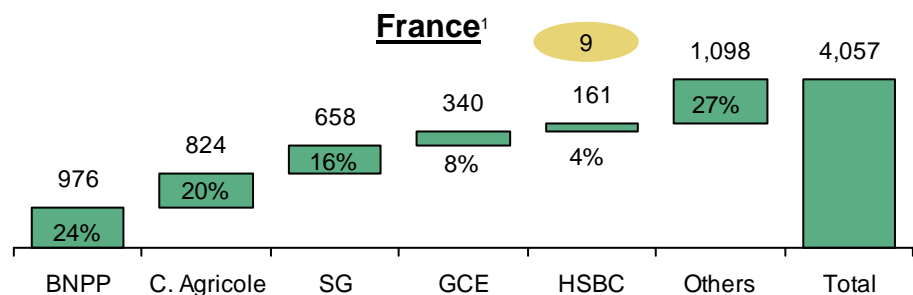
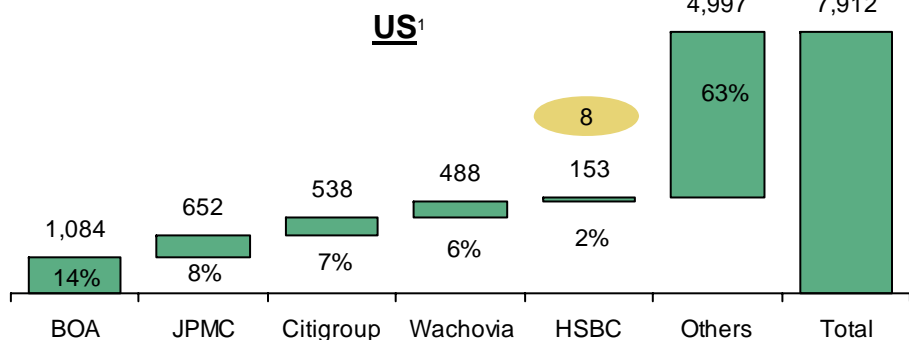
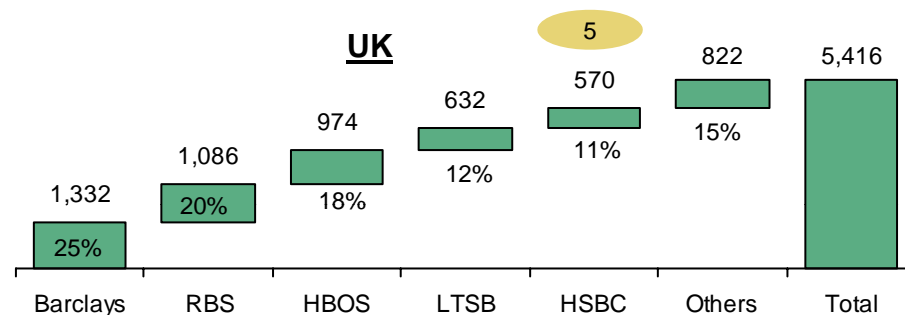
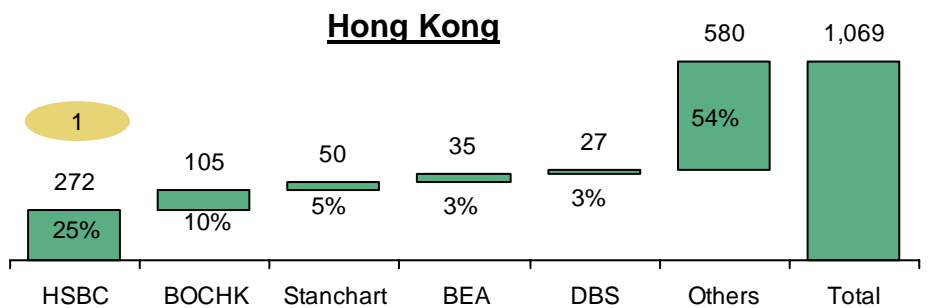
### Different geographical scale effects

- Global scale effects hindered by complexity of systems and processes, different information capture, regulations and legacy infrastructure
- Regional scale effects involve sharing of systems and processes, regional processing centers and distribution practices
- Local scale effects provide domestic advantages of similar systems, data capture, streamlining of processing, procurement and distribution channels

# HSBC not a leading player in its key retail markets

Not number 1, 2 or 3 (except in Hong Kong)

HSBC's assets in key markets against its selected key competitors, 2006 (US\$ Bn)

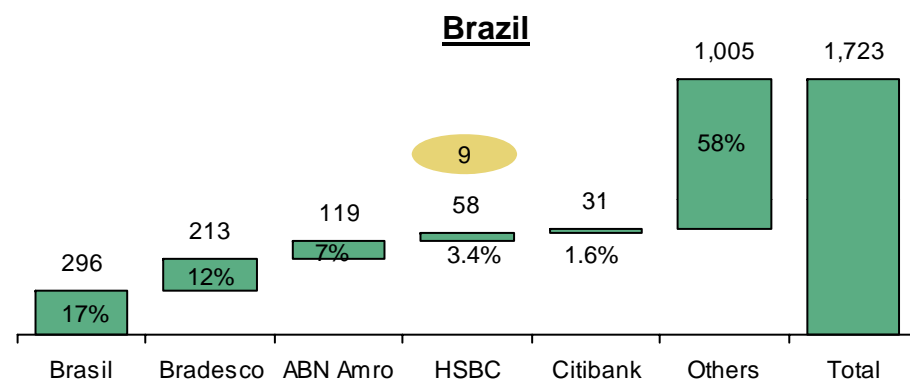
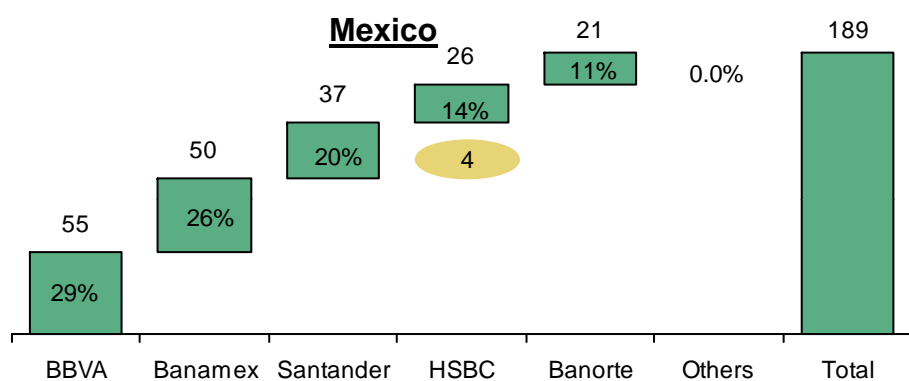


xx HSBC rank

1. US assets and market share as of Sept'06; Assets for HSBC Bank USA, Inc only;

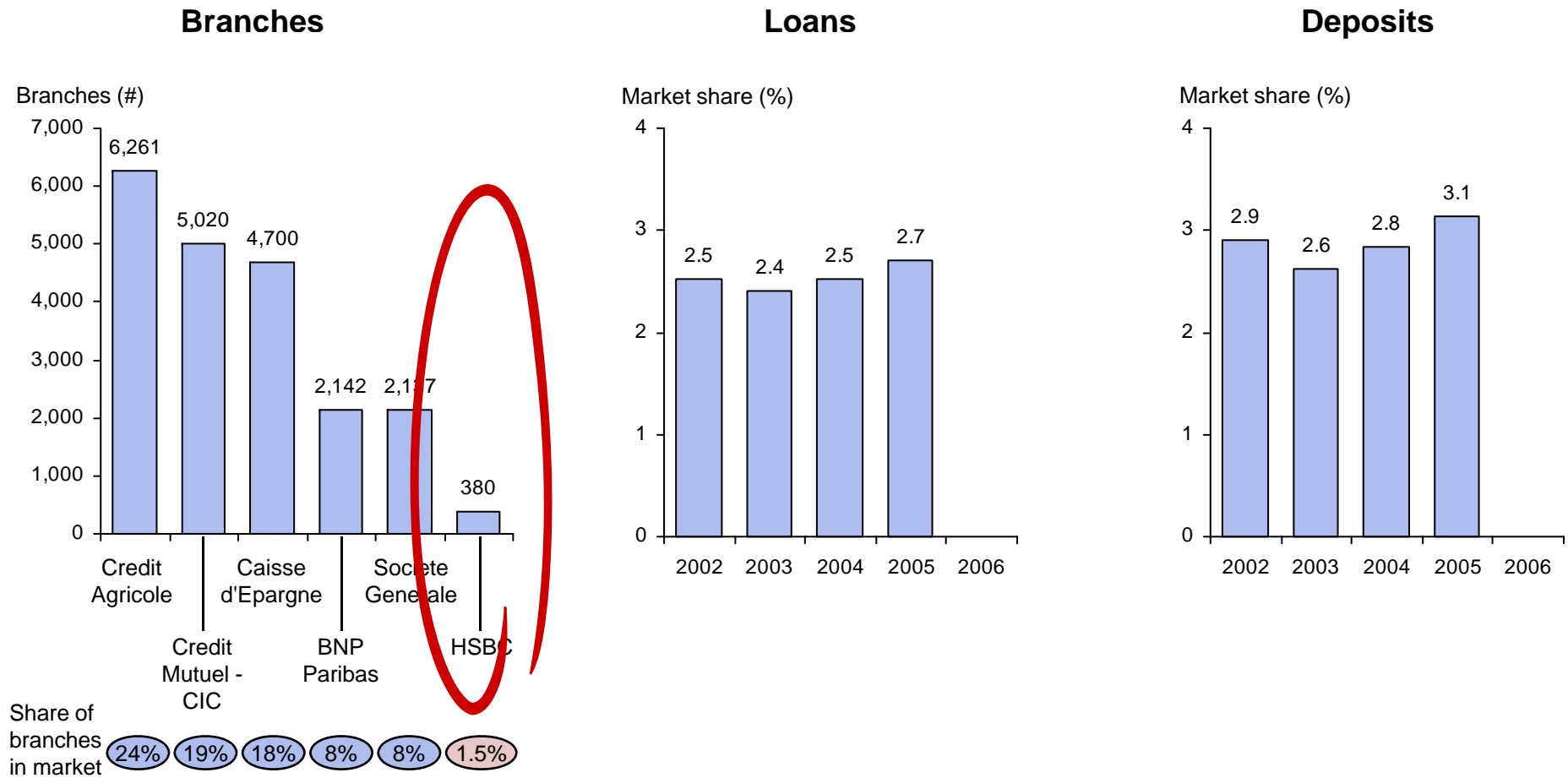
# HSBC not a leading player in its key retail markets

Not number 1, 2 or 3 (except in Hong Kong)



xx HSBC rank

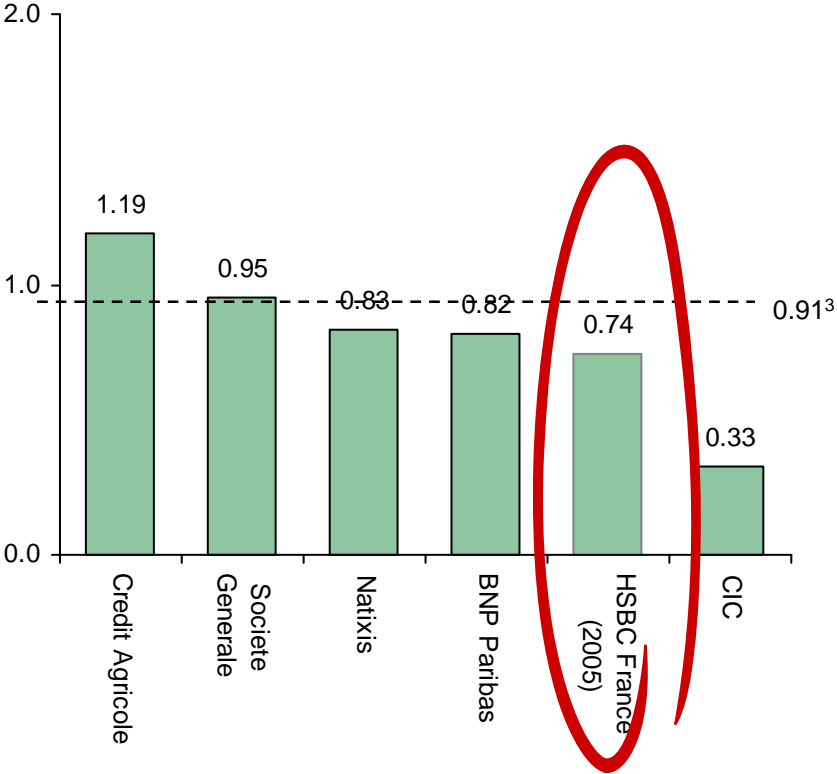
# France: small footprint with low share of loans and deposits



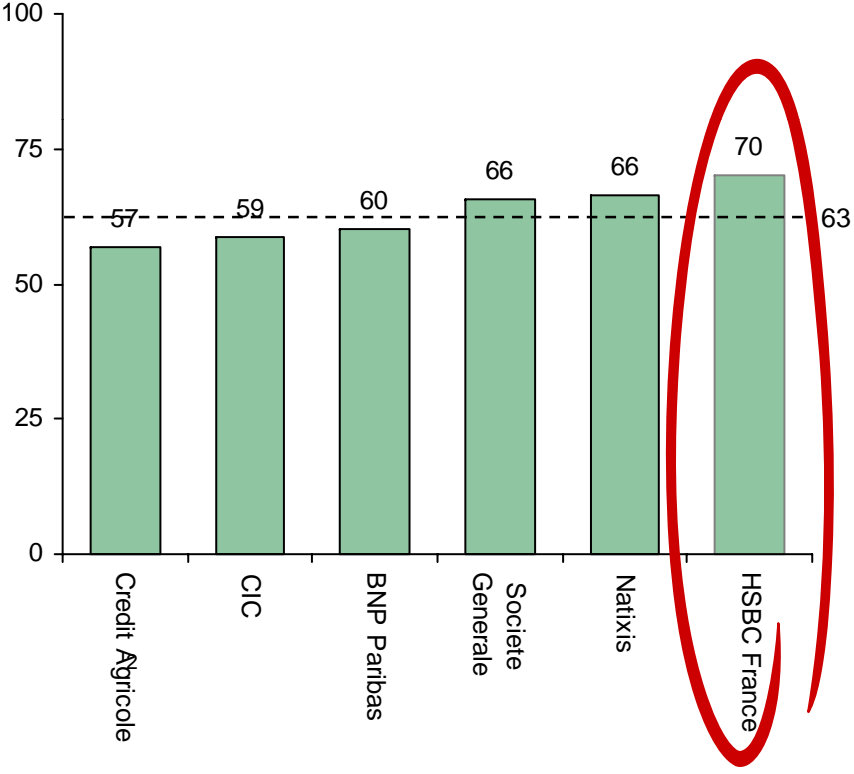
Source: External Global FS Landscape; Banque de France; HSBC France annual reports; External analysis

# .... operating performance lags peers with lower margin and higher cost

Net Interest Margin<sup>1</sup> (%)



Cost-to-income ratio<sup>2</sup> (%)

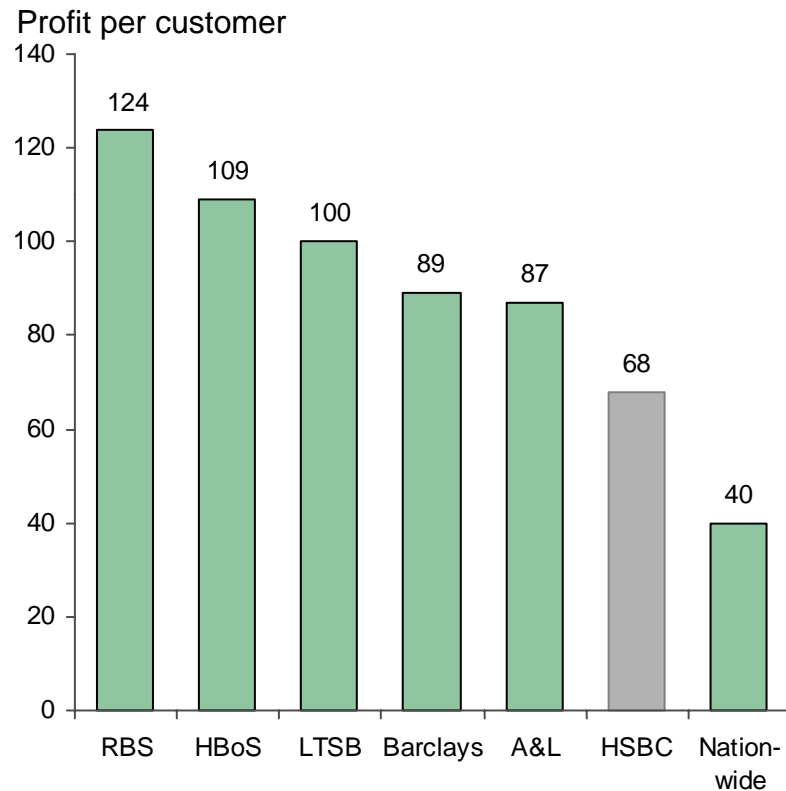


1. Net Interest Income / Average Interest Earning Assets (including trading assets) 2. Opex / Total Operating Income  
 Source: inFinancials; Orbis; HBOS Annual Report; HSBC Bank plc Annual Report; External Analysis

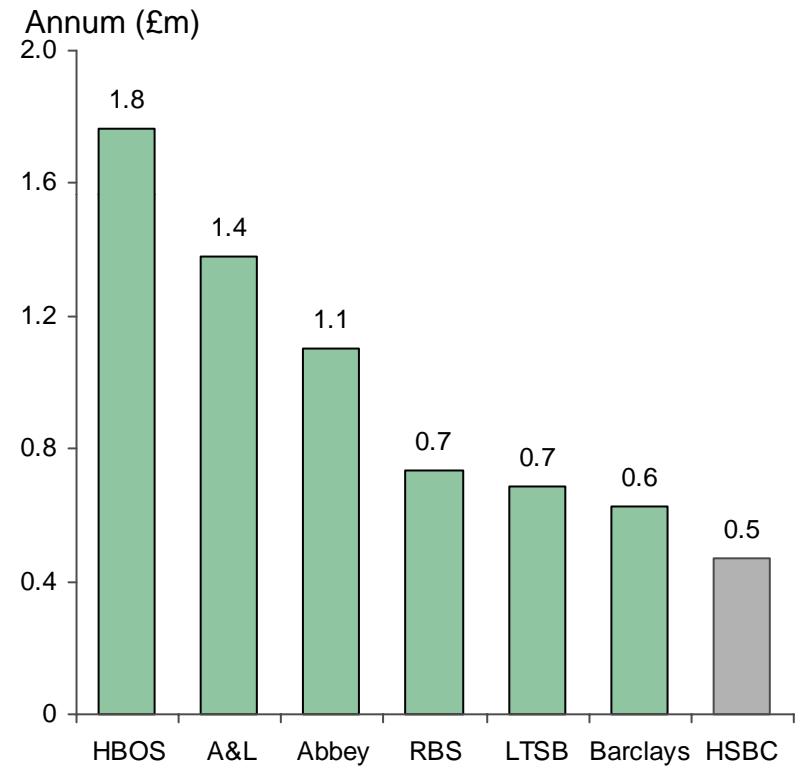
# UK: HSBC less profitable than its peers

Declining market position (from no. 3 to no. 5) as others consolidate

### Customer profitability<sup>1</sup>



### Profit per UK branch (2005)<sup>1</sup>

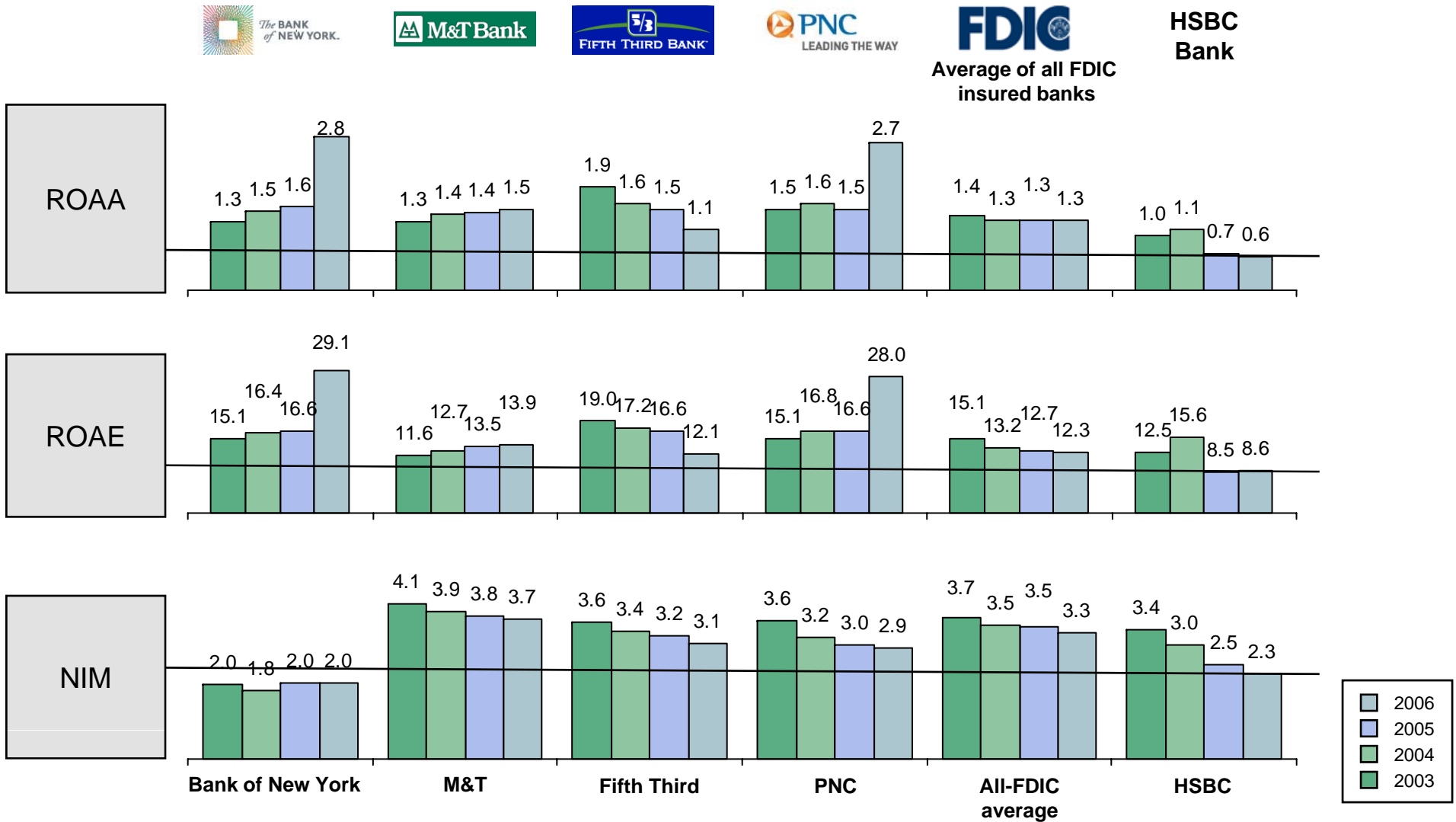


1. Profit is retail profitability calculated on a like for like basis  
Source: Consultants' analysis, company reports



# USA: HSBC Bank profitability mostly below peers

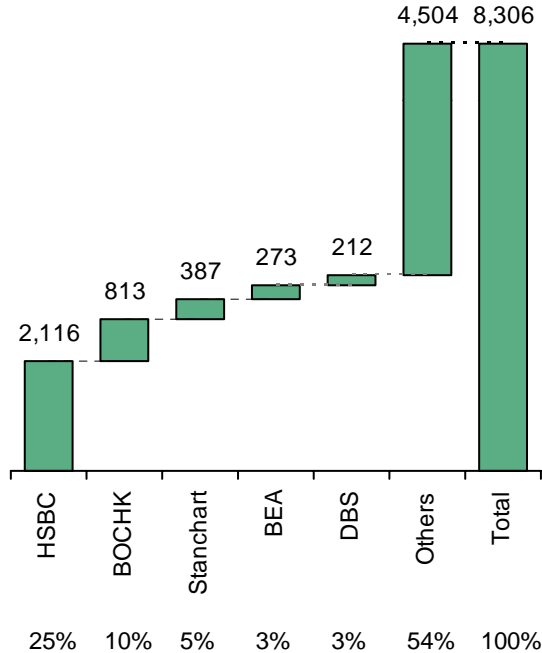
**NB: This does not include Household credit card business, which is strong**



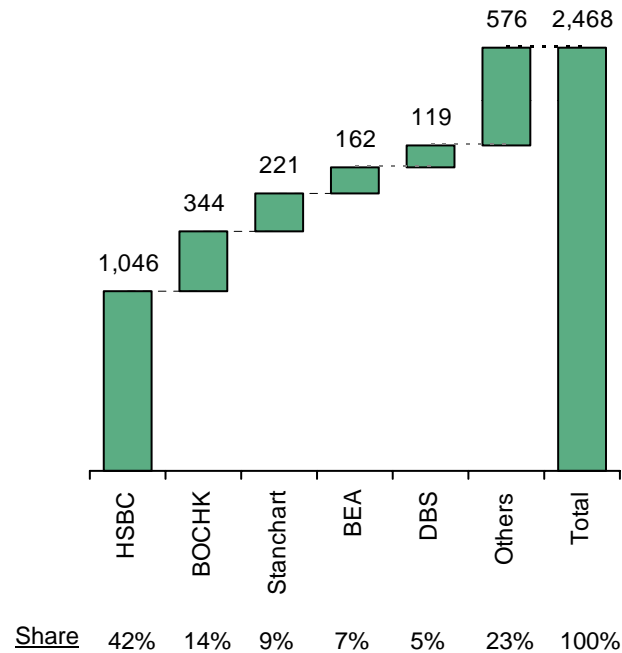
Source: SNL Financials, Company reports, FDIC Q1 07 Quarterly Banking Profile

# Hong Kong: key market and an area of comparative advantage

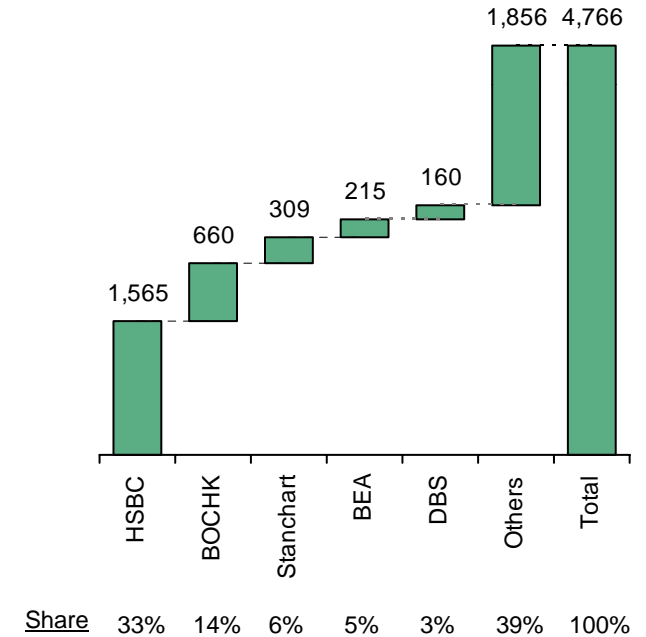
Total bank assets 2006 (HK\$ Bn)



Total loans 2006 (HK\$ Bn)



Total deposits 2006 (HK\$ Bn)

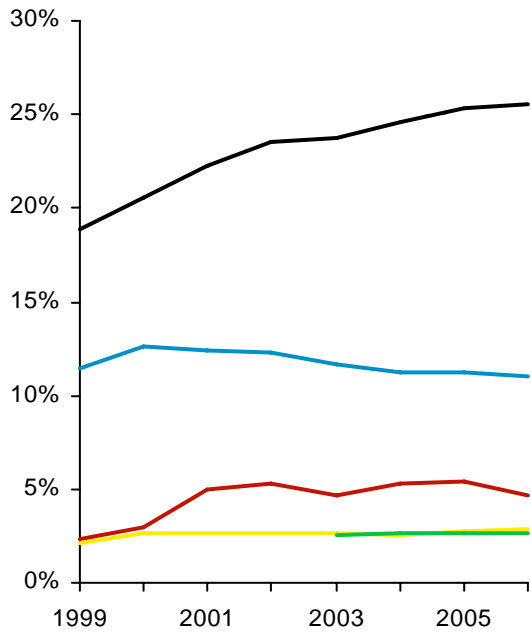


Source: HKMA; Analyst reports; Company reports; External analysis

# ... but HSBC losing market share in recent years

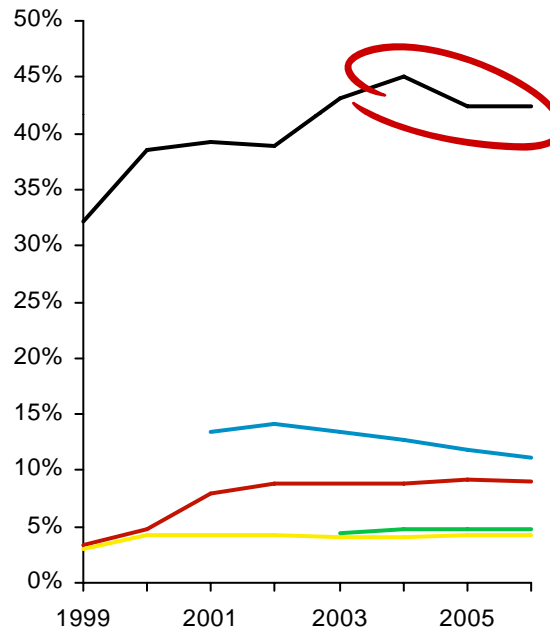
## Assets, 1999 - 2006

Market share



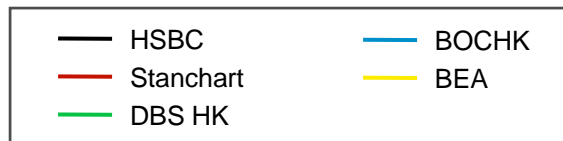
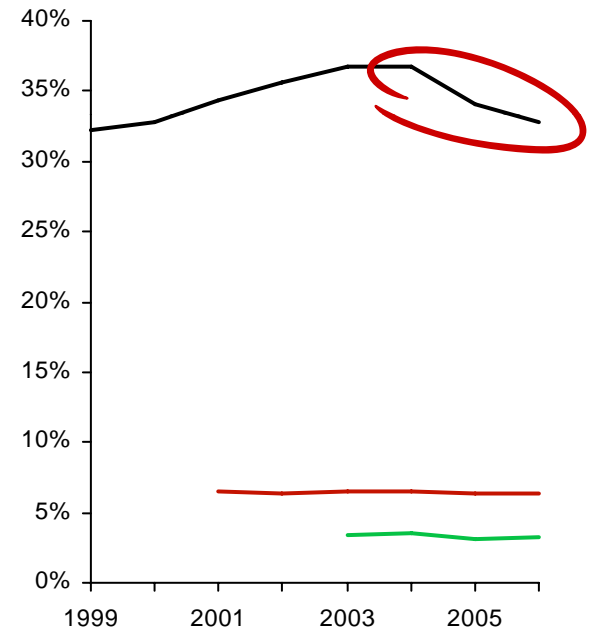
## Loans, 1999 - 2006

Market share



## Deposits, 1999 - 2006

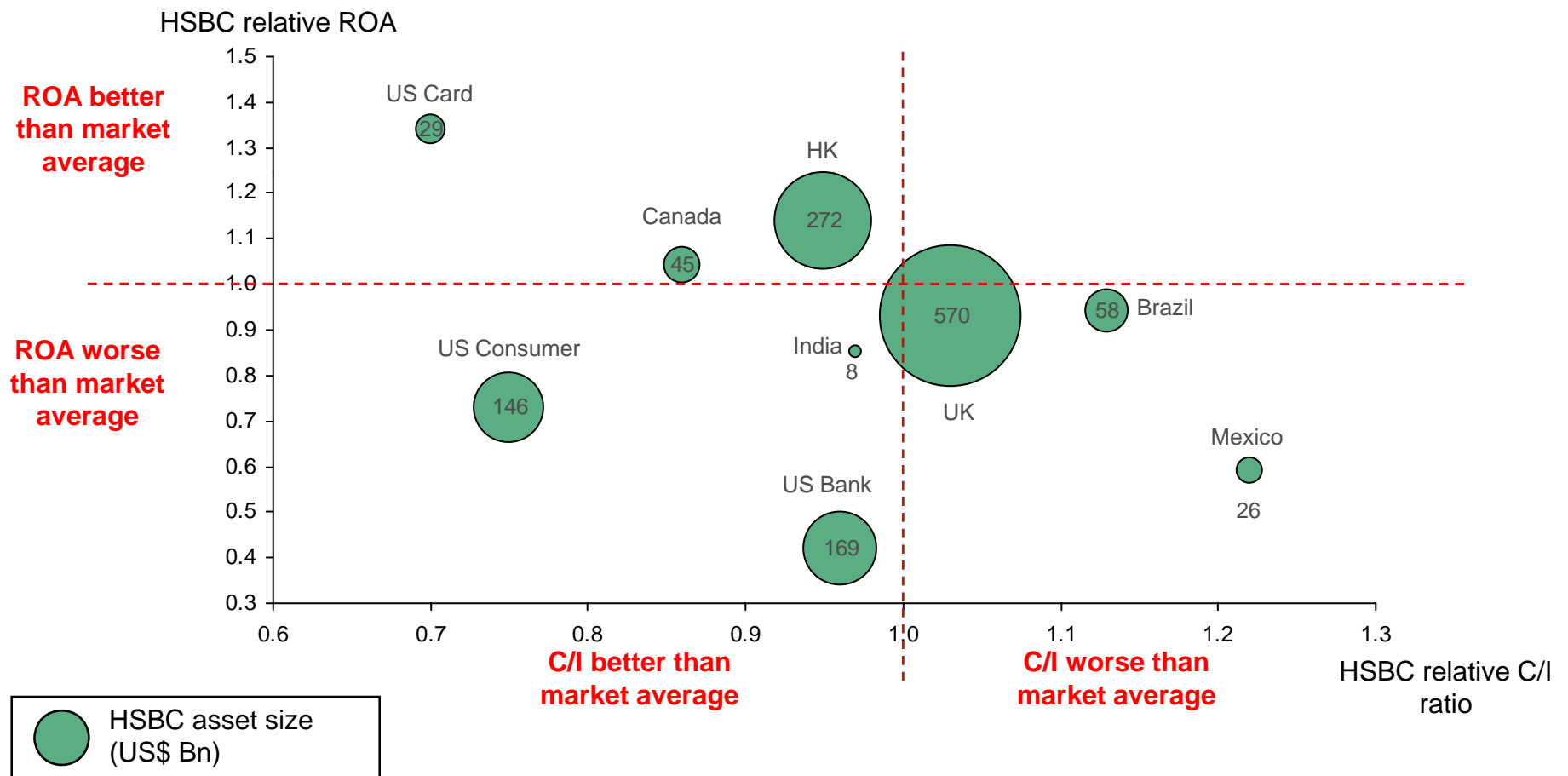
Market share



Source: Company annual reports; HKMA; External analysis

# HSBC ROA in retail financial services – no evidence of comparative advantage

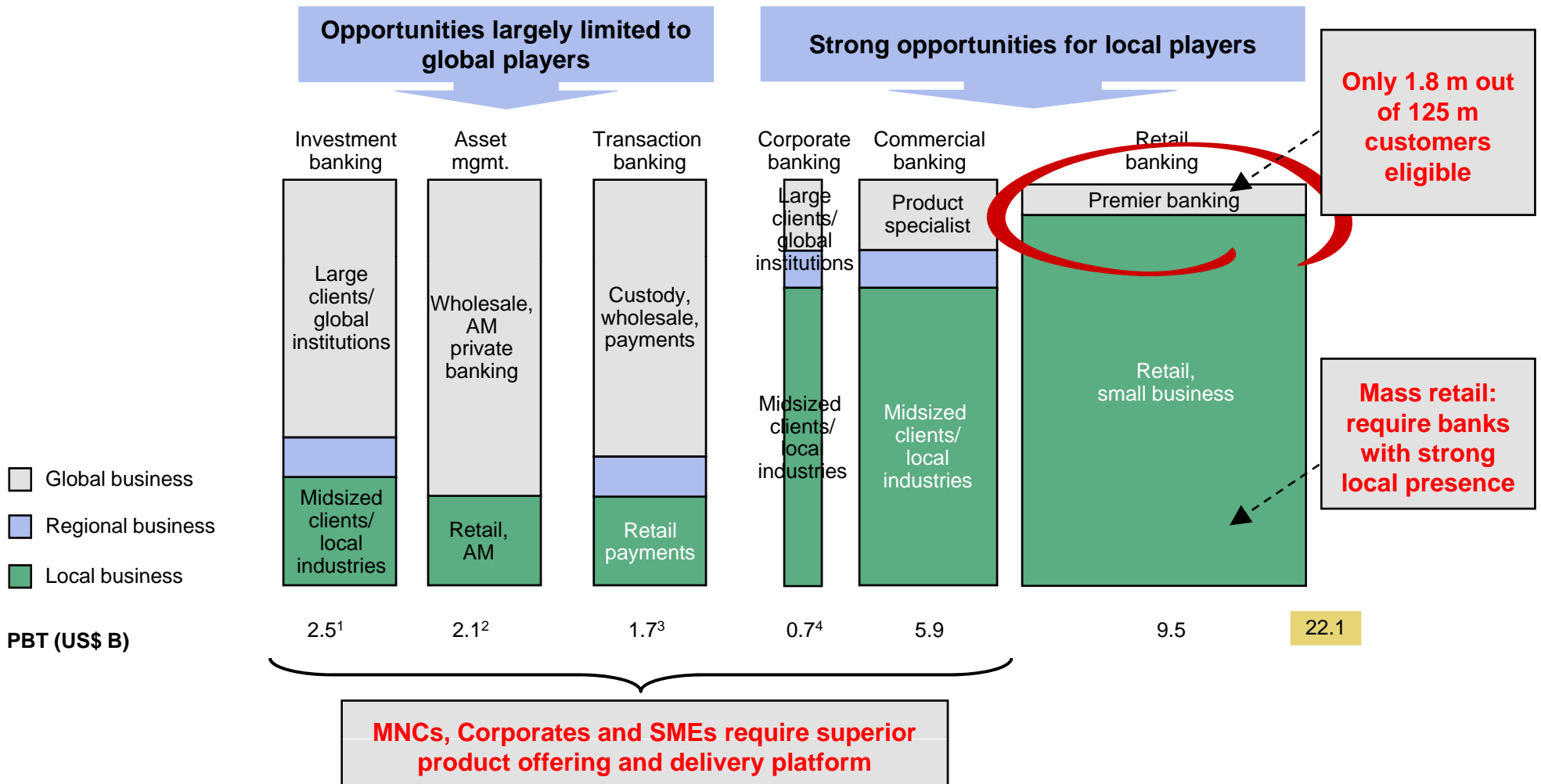
Lower returns than local peers (despite good cost to income ratios)



Source: Company reports; analyst reports; central banks; External analysis

# Retail banking is about strong local presence

Premier banking product applies to small number only



# Conclusions – Retail and Commercial Banking

- Evidence suggests that, in most of its major markets, HSBC lacks scale
- This is evident in low ROAs when compared with peers, even though costs are under control
- **By exiting from some markets (where it may be more difficult to achieve scale) and focusing on others (where it can more credibly achieve scale), HSBC could materially improve its return on assets and its performance more generally**
- Instead HSBC seems to be focused on further diversifying its retail banking presence with new greenfield ventures (all announced in the past 4 weeks) in Japan, Korea, Rural China, Vietnam, Georgia, Peru, Czech Republic...
- Further diversification as a strategy has limited benefits for a Group such as HSBC (which is already well diversified) -- what is needed is more focus and concentration
- “Premier” account as a unifying idea is worthy but the value can be overestimated – just 1.8 million out of 125 million customers worldwide qualify!

## **SECTION 5**

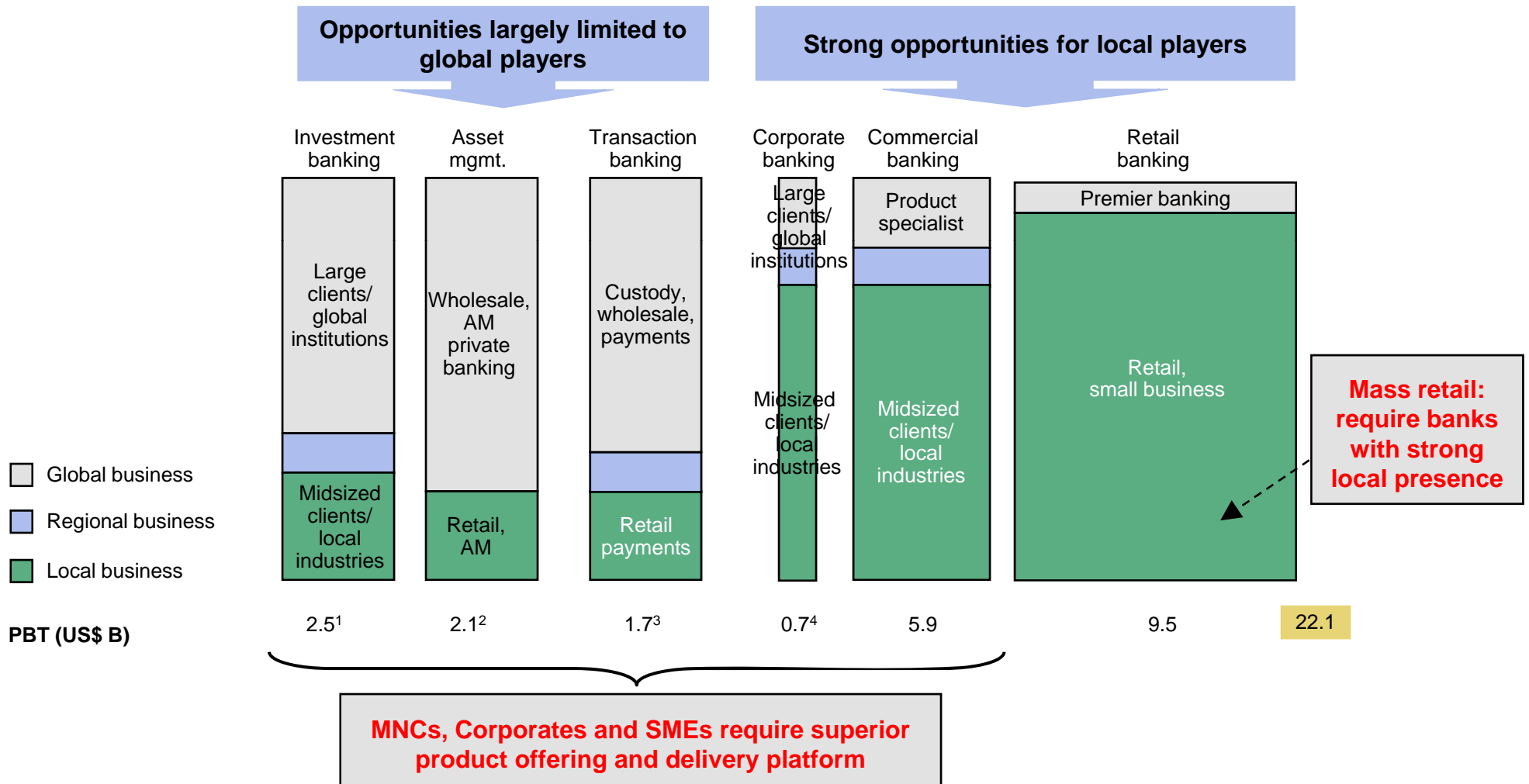
# **STRATEGY IN INVESTMENT BANKING AND CAPITAL MARKETS**

# Strategy in Investment Banking and Capital Markets

- Growth in securities issuance, even in the emerging markets, is unlikely to abate
- Large companies want their securities (debt or equity) distributed to those investors who value them most and are willing to pay the highest price wherever they may be globally. This is also true of emerging market companies
- Securities houses with global distribution will always have an advantage over those which do not. The only exceptions are politically connected local businesses which are important in some markets despite lacking global distribution capability
- The cost structure of a global distribution platform is essentially fixed and the marginal cost of securing extra revenues is low
- This is why leading securities businesses **all pursue a global strategy** in sourcing capital markets revenues. Failure to do so exposes them to greater risk in terms of hiring staff and in a downturn
- **HSBC's "emerging markets-led and financing focused" investment banking strategy is very risky....**  
**.....and runs the risk of repeating the failures of the past 20 years**



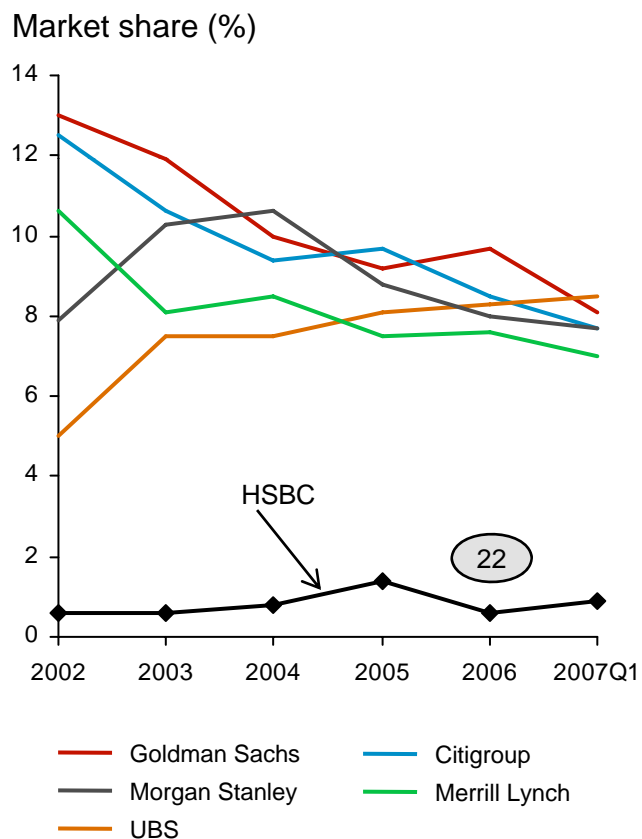
# The opportunities in investment banking are largely limited to global players



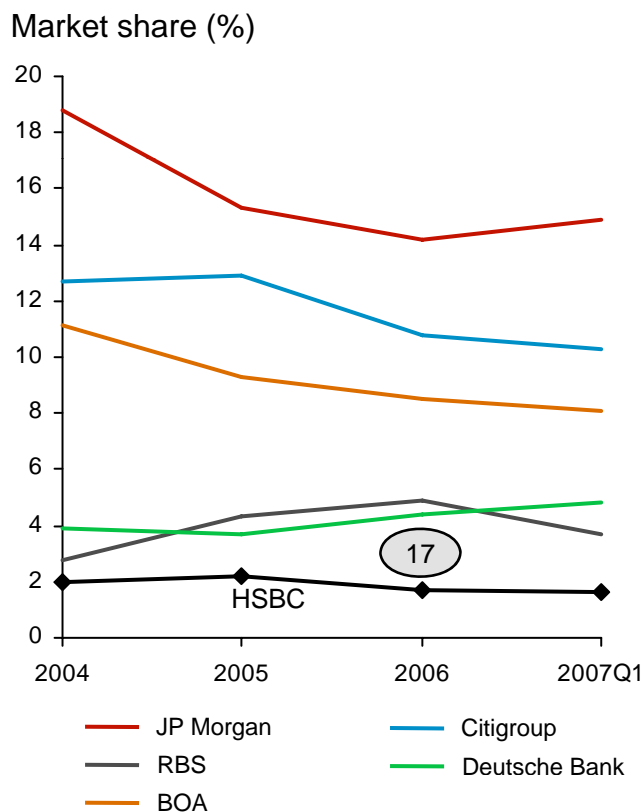
# HSBC has a weak position in global capital markets and M&A

## Outside of top 15 across different segments

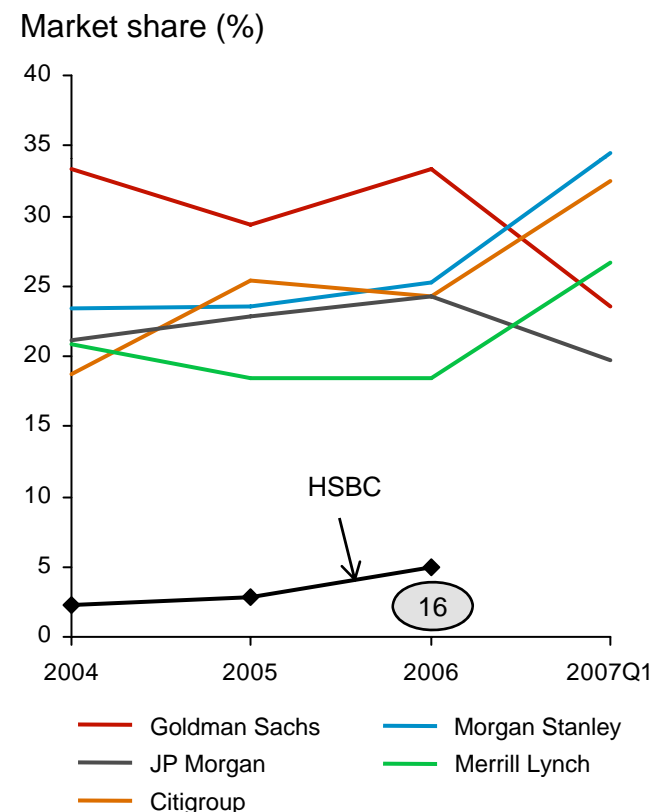
### Global equity and equity-related



### Global syndicated loans



### Global mergers & acquisitions



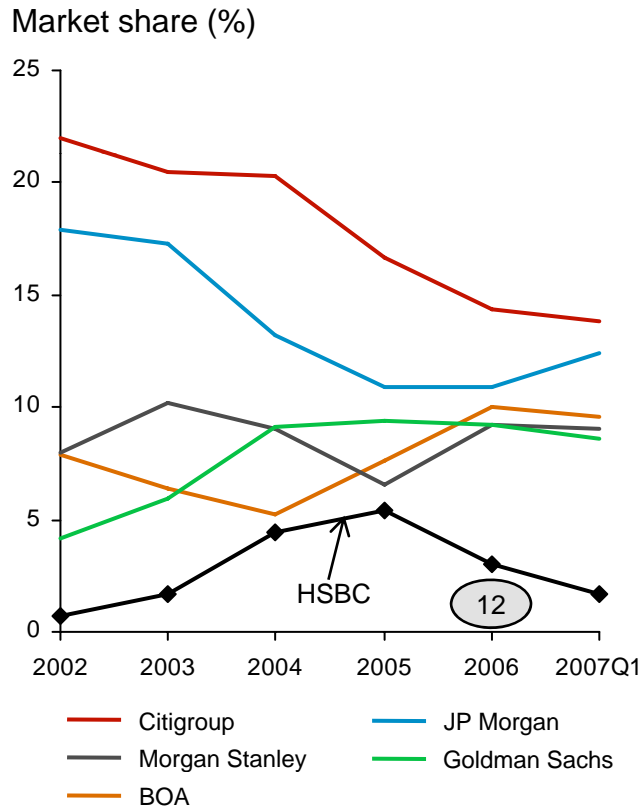
1. Excluding Japan and Australia  
Source: Thomson Financials; External analysis

xx HSBC rank in 2006

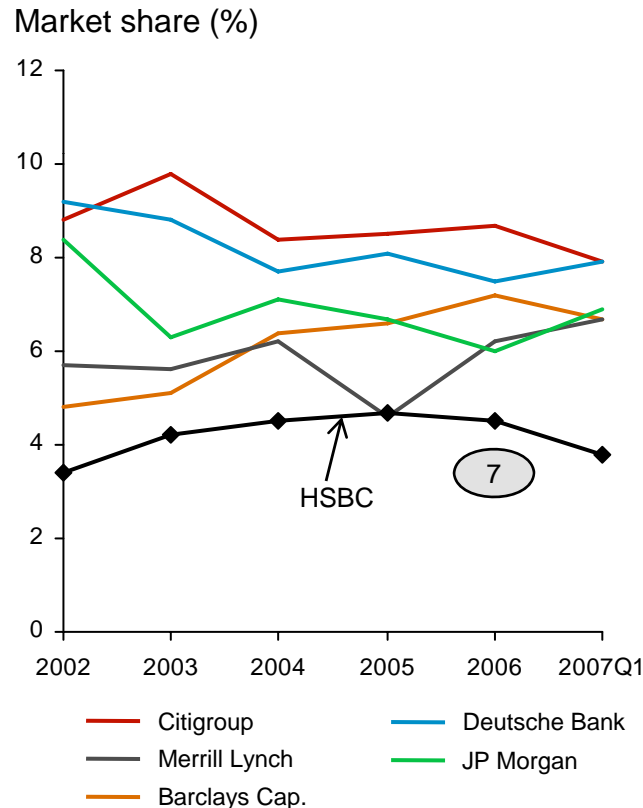
# Weak position in debt capital markets globally

## Declining market share positions

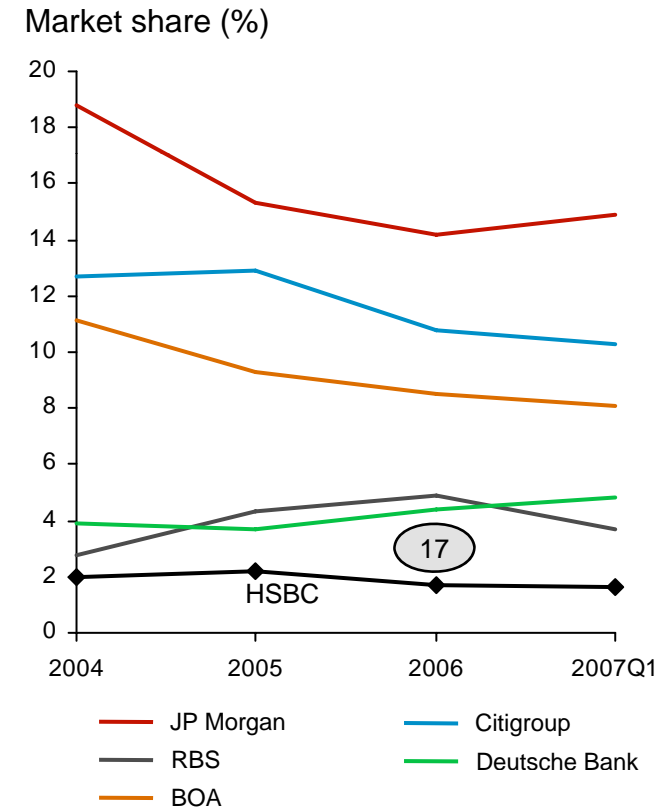
### US investment grade corporate debt



### All international bonds



### Global syndicated loans



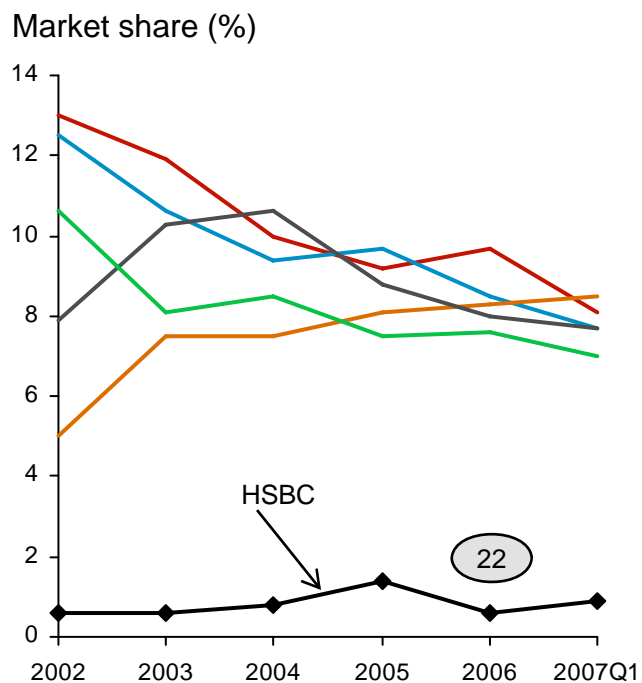
Source: Thomson Financials; External analysis

xx HSBC rank in 2006

# Weak position in equity capital market

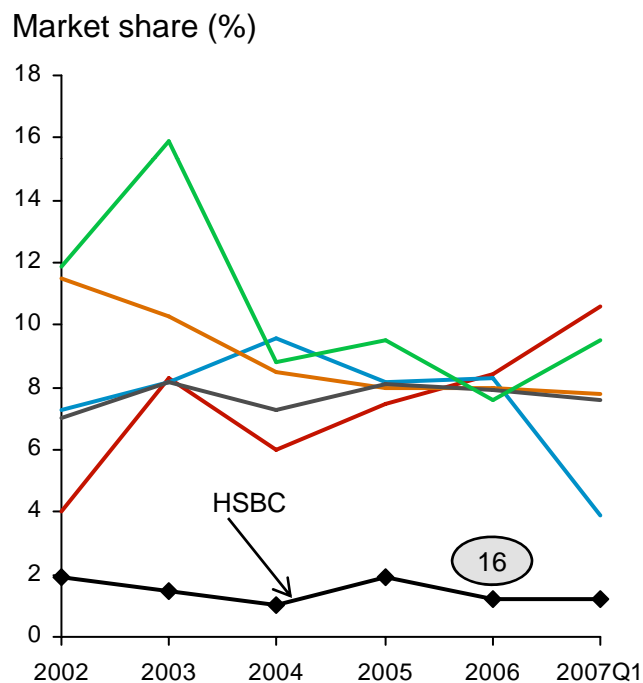
## Outside of top 15 across different segments

### Global equity and equity-related



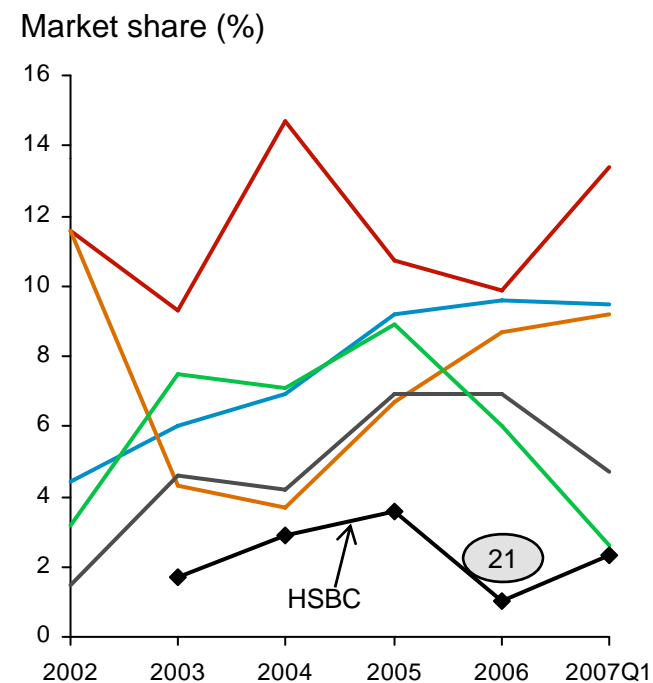
- Goldman Sachs
- Citigroup
- Morgan Stanley
- Merrill Lynch
- UBS

### EMEA equity and equity-related



- JP Morgan
- Morgan Stanley
- UBS
- Deutsche Bank
- Goldman Sachs

### APAC<sup>1</sup> common stocks



- Goldman Sachs
- UBS
- Credit Suisse
- Merrill Lynch
- China Intl. Capital

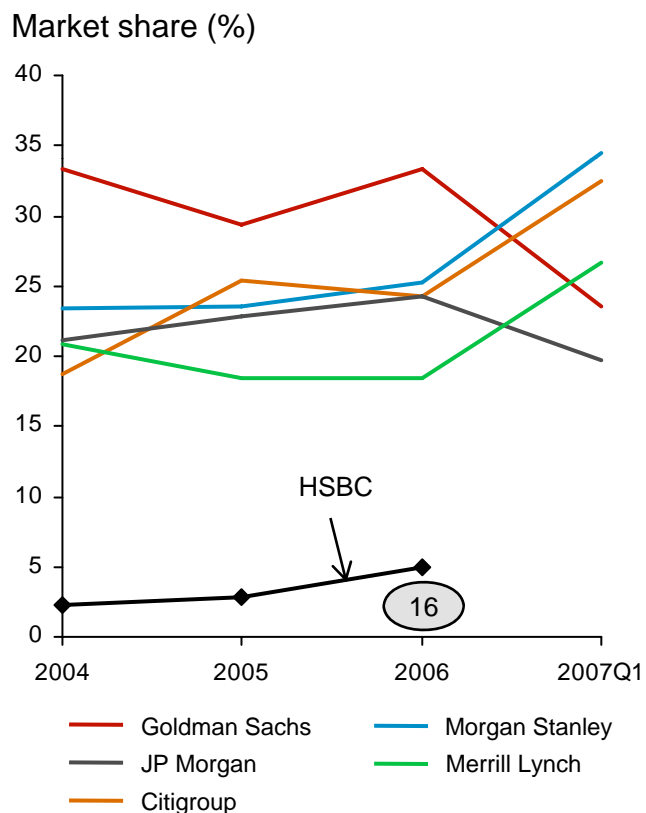
1. Excluding Japan and Australia  
Source: Thomson Financials; External analysis

xx HSBC rank in 2006

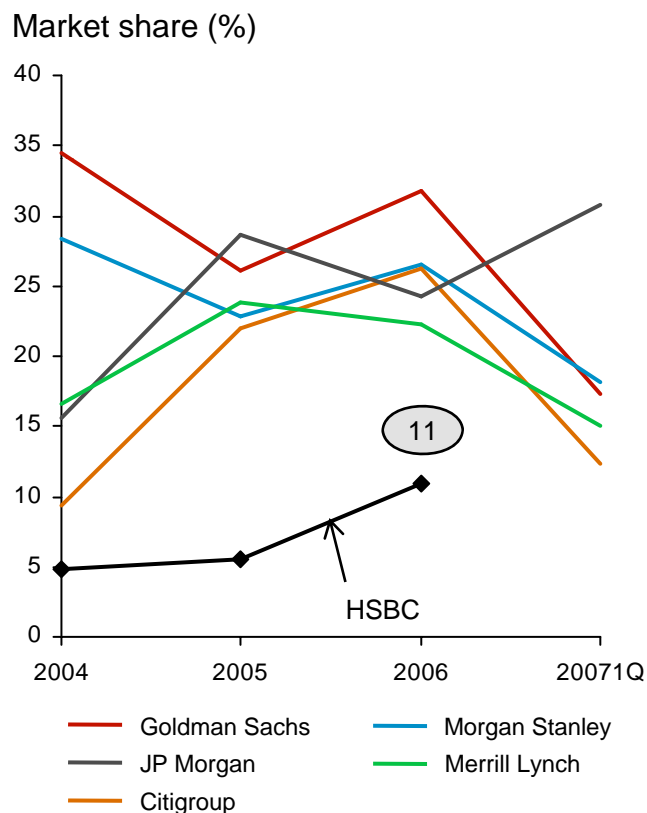
# Weak position in M&A advisory

## Especially in Asia

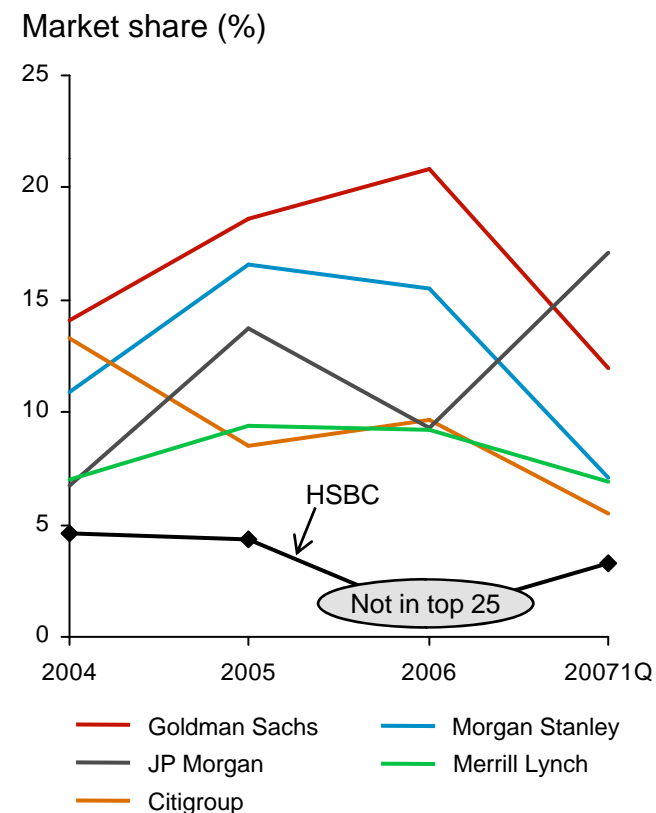
### Global mergers & acquisitions



### European mergers & acquisitions



### Asia ex-Japan mergers & acquisitions



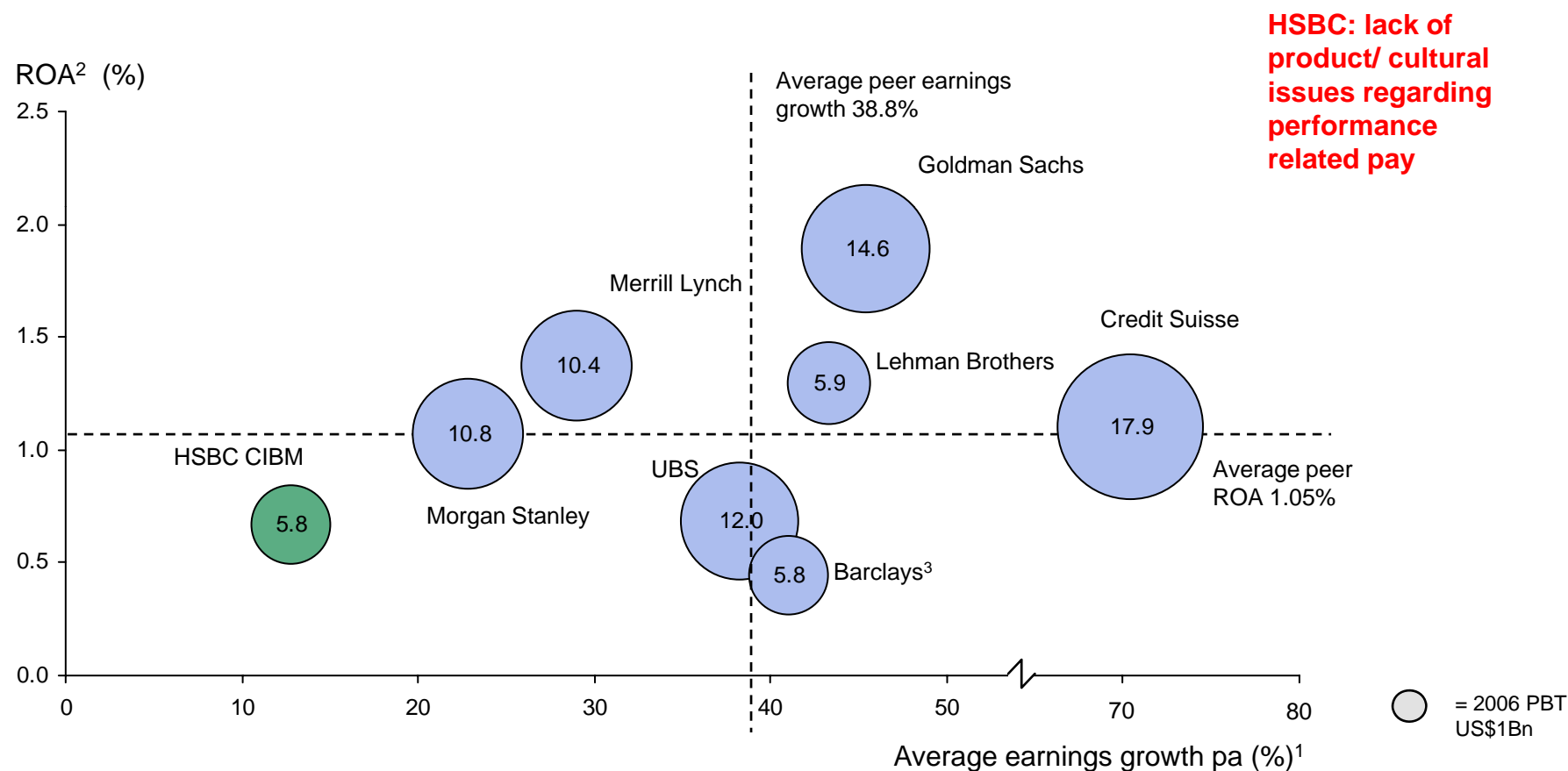
Note: European and Asia ex-Japan M&A league tables are for any involvement completed (Table AF3 and AF32)  
Source: Thomson Financials; External analysis

xx HSBC rank in 2006

# CIBM earnings growth and asset returns have lagged peers

**Lack of ambition? Cultural issues?**

Financial performance of selected investment banks

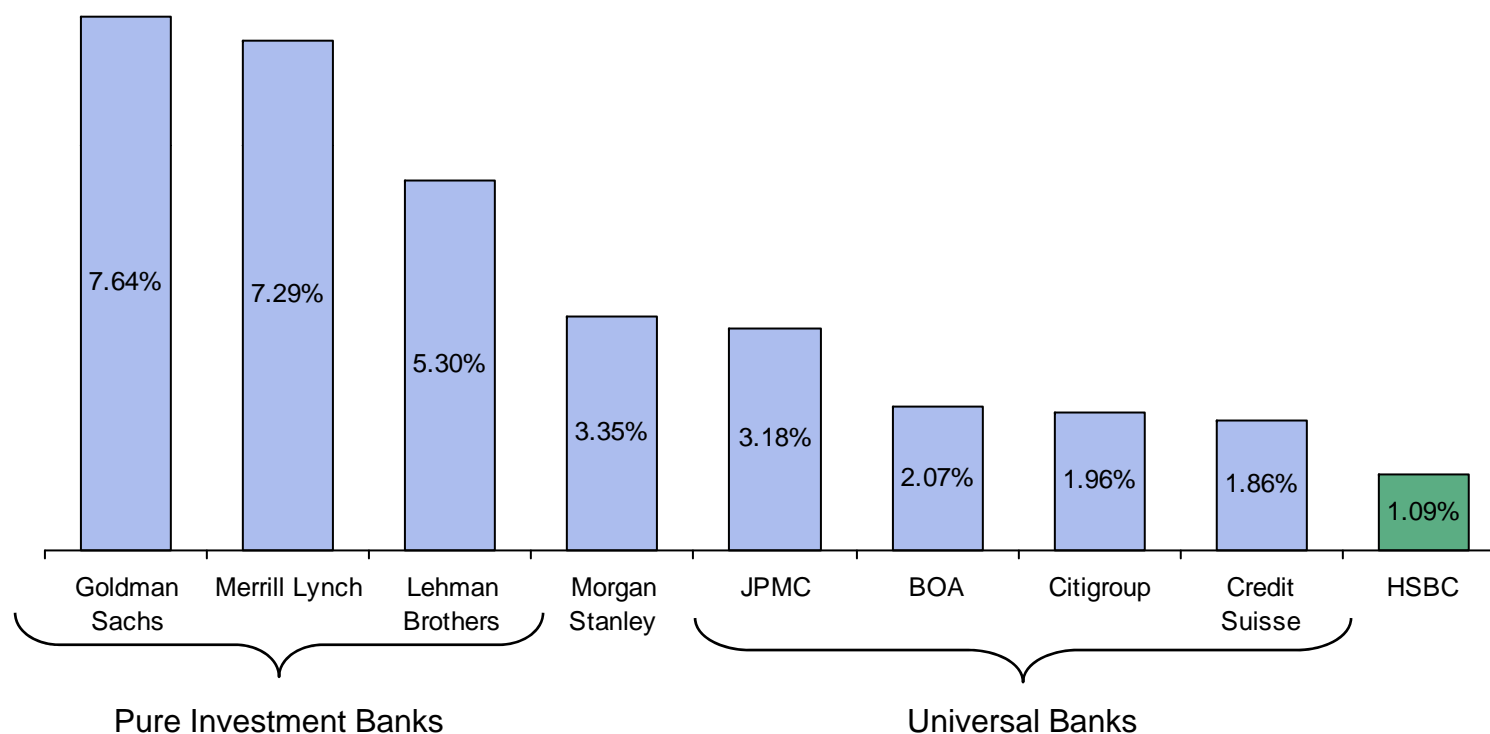


1. Based on 2002-2006 data; Earnings Before Tax reporting under US GAAP; Net Profit Before Tax for companies reporting under IFRS  
 2. 2006 based on earnings / average total assets  
 3. Including Barclays Capital, Barclays Global Investors, and Barclays Wealth; earning growth is for 2004 - 2006  
 Source: inFinancials; External analysis

# Trading: CIBM seems to under-perform most of its peers

Too much capital allocated to CIBM; too much lending vs fee revenue

HSBC corporate & investment bank trading income / Bank wide total trading assets, 2006



Note: GS: Trading and principal investment revenue over financial instruments owned; ML: Revenue from FICC and equity markets principal transactions and net interest profit due to trading, commissions over total trading assets; LB: Capital Markets revenue from institutional client-flow activities, prime brokerage, research, mortgage, origination and securitization and secondary-trading and financing activities in fixed income and equity products over financial instruments owned; MS: Trading revenue from principal transactions over financial instruments owned; JPMC: Fixed income and equity markets revenue from client and portfolio management revenue related to both market-making and proprietary risk-taking over trading assets; BOA: Trading account profits over trading assets; CS: trading revenue over trading assets; HSBC: net trading revenue over trading assets; Citigroup: total principal transactions revenue over trading assets  
Source: Company annual reports; External analysis

# Conclusions – Investment banking and capital markets

- **HSBC's strategy in investment banking of being "emerging markets led and financing focused" is risky as it combines a global cost base with a regional revenue sourcing strategy**
- **The strategy has limited appeal ... We have discussed it with a major Asian customer and others in Asia seem to agree (as evidenced in the league tables)**
- **HSBC must decide whether it wishes to be in investment banking or not...**
- **If it does then it must reconsider its plans to build up a global investment banking business – possibly by acquisition – or it should exit the area entirely and use the capital which is released to add value in other parts of its business**
- **In view of past failures, the quality of execution will be key if HSBC decides to grow its investment banking activities**
- **IF HSBC decides to exit investment banking altogether there may be consequences for its businesses in many emerging markets (and especially India and China)**
- **HSBC has some tough choices to make but cannot afford to sit on the fence (as it is doing)**



## **SECTION 6**

### **ASIAN EMERGING MARKETS**

**Viable strategies or just “options”?**

# Asian Emerging Markets

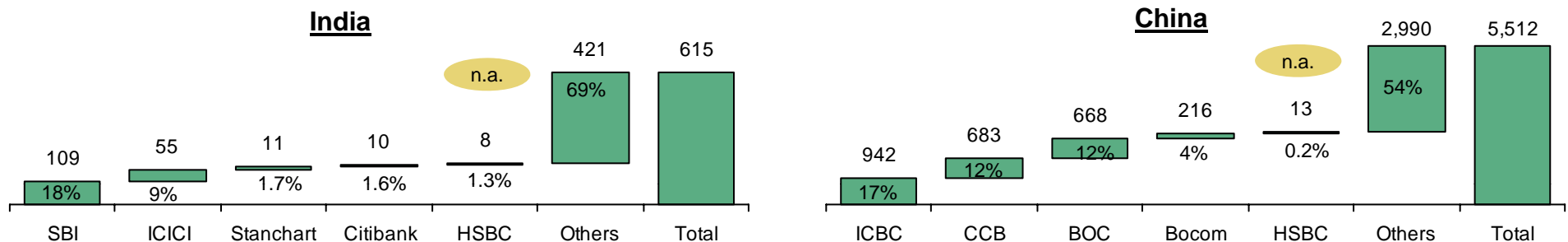
- The growth of financial services markets in Asia is not questioned
- As in other markets, in retail financial services **local scale** confers an advantage both in terms of cost as well as revenue synergies; in wholesale capital markets a **global** distribution platform and a **global** revenue sourcing strategy remain key advantages

It is a mistake to think that being a local is a disadvantage or that being a global financial business confers an advantage

- We recognise the restrictions on expansion that HSBC faces in key growth markets such as India and China in retail banking ... but if these restrictions were lifted we question whether there is anything that HSBC could do to achieve scale that its local peers already have (other than by massively diluting shareholders through expensive acquisitions)
- **The real opportunity for global firms in India, China and many other emerging markets lies in securities distribution (rather than retail banking) - where HSBC is weak.**
- Is HSBC's strategy in the Asian emerging markets sustainable? Can it achieve scale in all the markets where it is currently present at the same time? Or are these just "options"?

# Being local does not make you uncompetitive

HSBC's assets in key markets against its selected key competitors, 2006 (US\$ Bn)



- **HSBC tends to compare its performance in India and China with other foreign banks ...but the real competition in retail banking is with local banks which have both scale and political connections**
- **In many cases, local banks are just as competitive as global banks in terms of costs and products**
- **However, execution may also be a problem since HSBC appears also to be underperforming against its international peers in terms of some critical metrics**

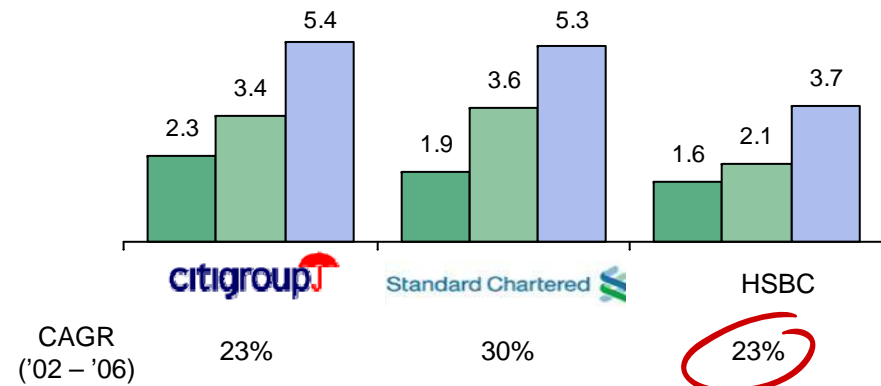
xx HSBC rank

# India: HSBC's growth lagging Standard Chartered

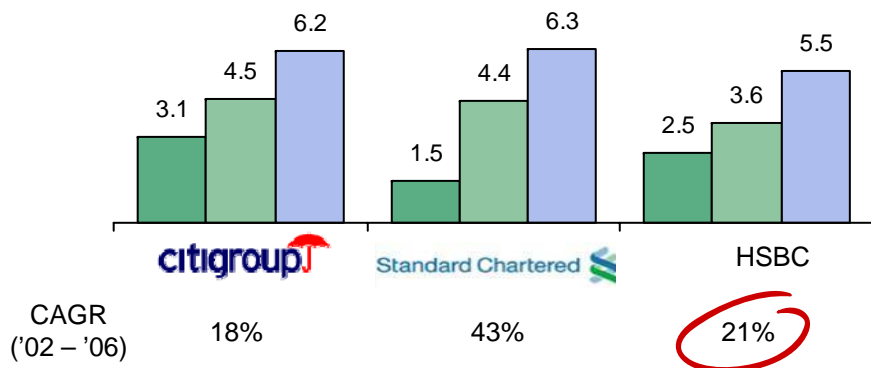
Assets (US\$ Bn)



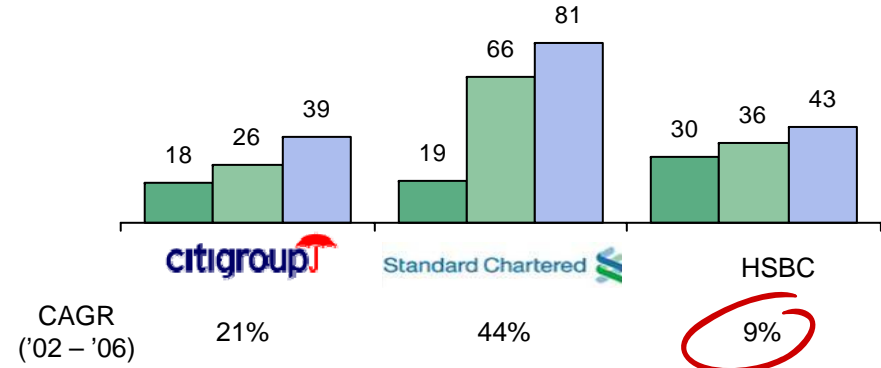
Loans (US\$ Bn)



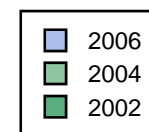
Deposits (US\$ Bn)



Branches (US\$ Bn)

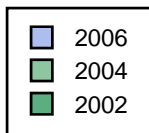
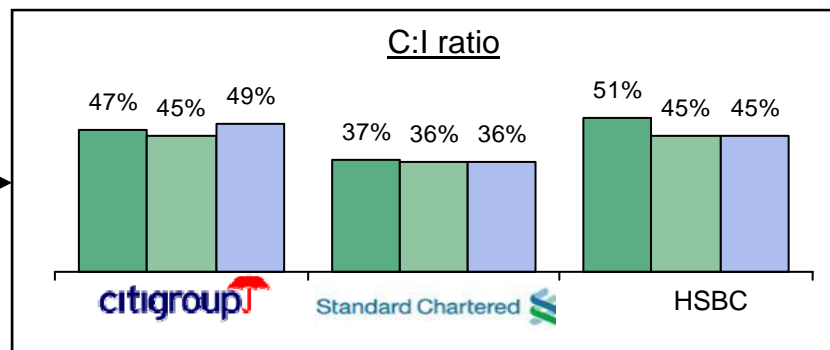
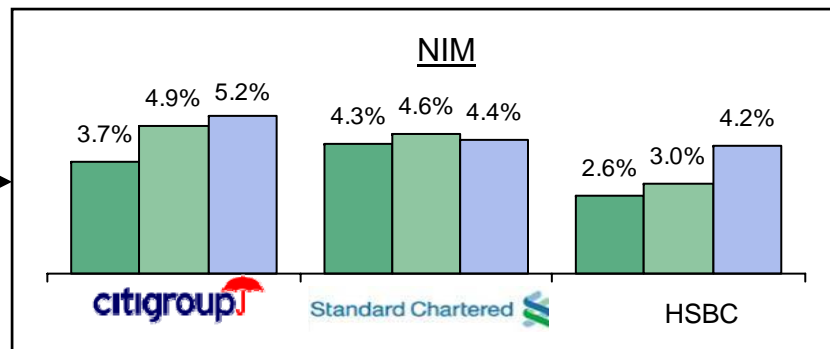
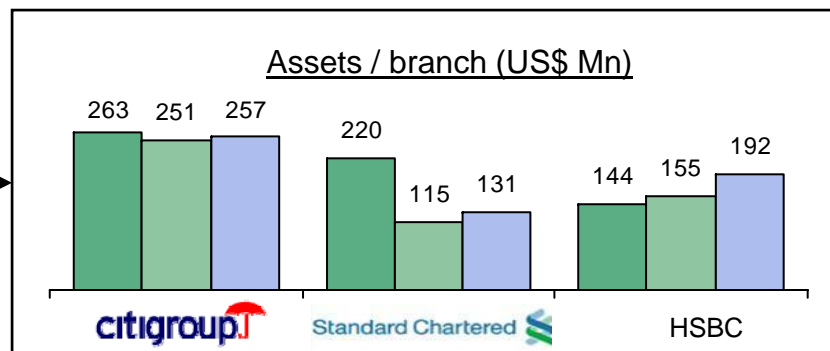
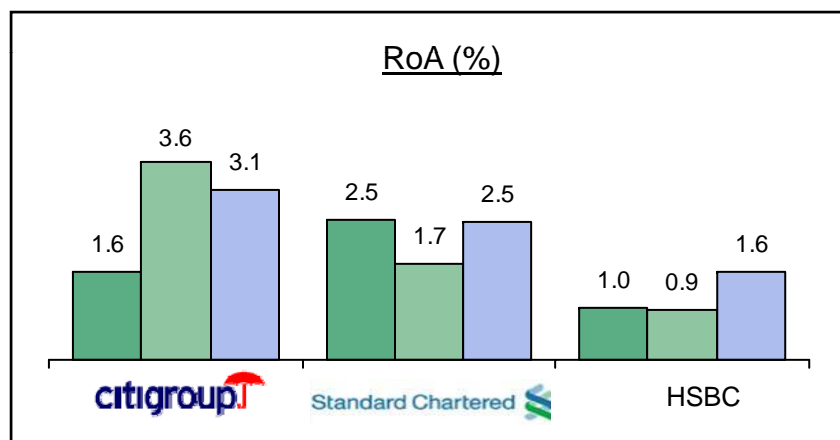


Note: the data are as reported on 31 March of each year  
Source: IBA; RBI; External analysis



# Lowest returns amongst the top three foreign banks in India

Lower productivity and NIM but higher cost



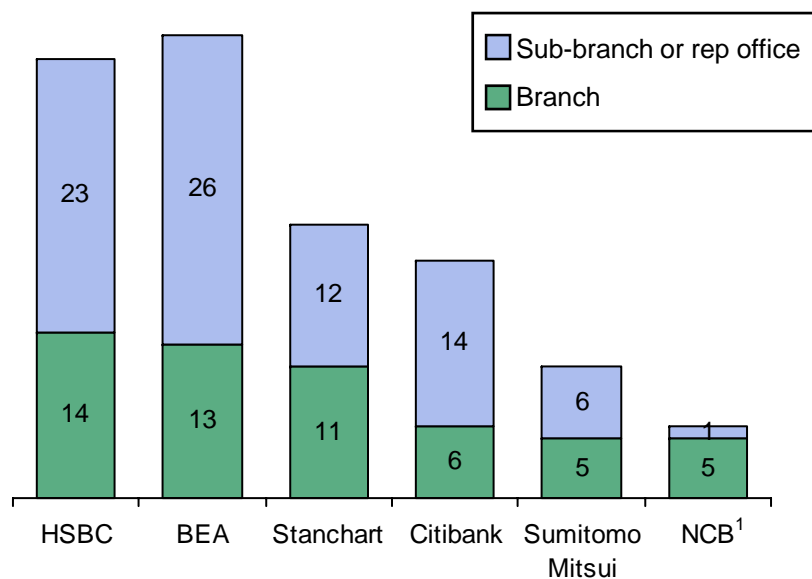
Note: the data are as reported on 31 March  
 Source: IBA; RBI; External analysis

# China: HSBC has the largest branch network of the “foreign” banks

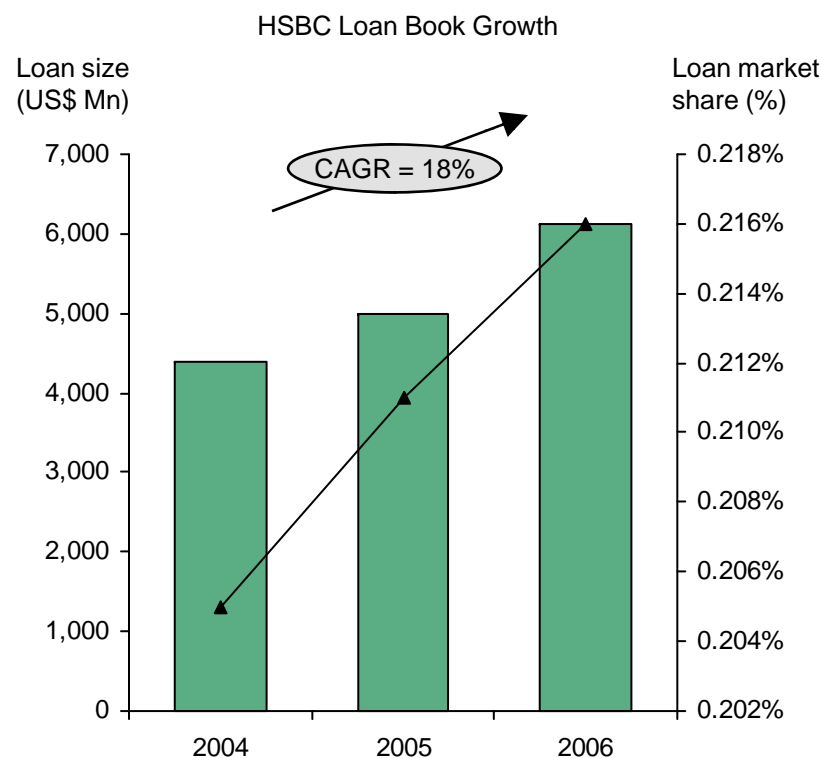
But moderate loan growth ...

## Among the largest branch networks

Foreign banks by branch network in China  
(as stated on company website in June '07)



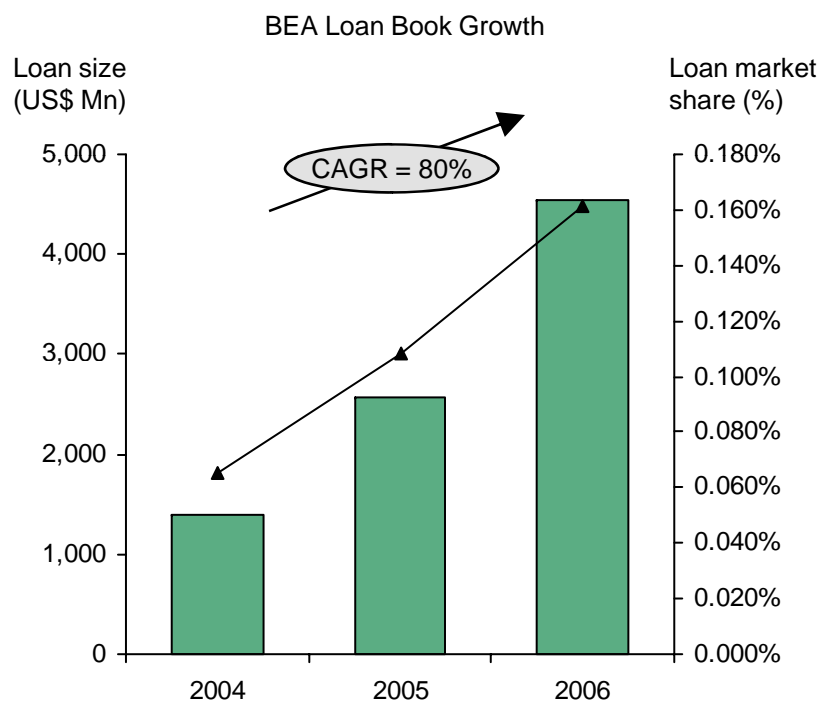
## HSBC loan book grows by \$ 1.5 Bn



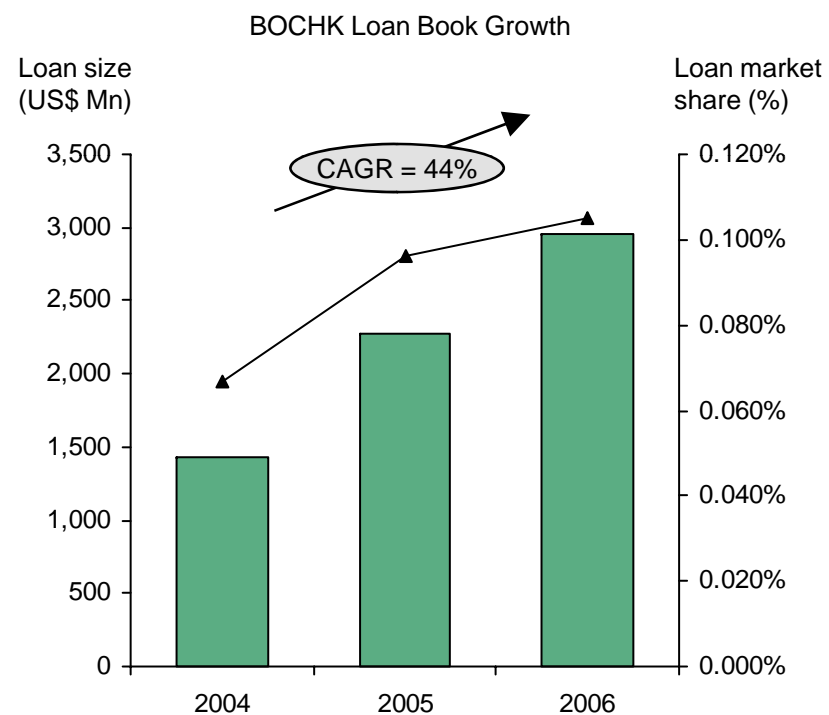
1. Fully owned subsidiary of BOCHK  
Source: CBRC; EIU; HSBC annual reports; External analysis

# China: Other Hong Kong based banks growing as fast (or faster)

## Bank of East Asia grows loans by \$ 3 Bn



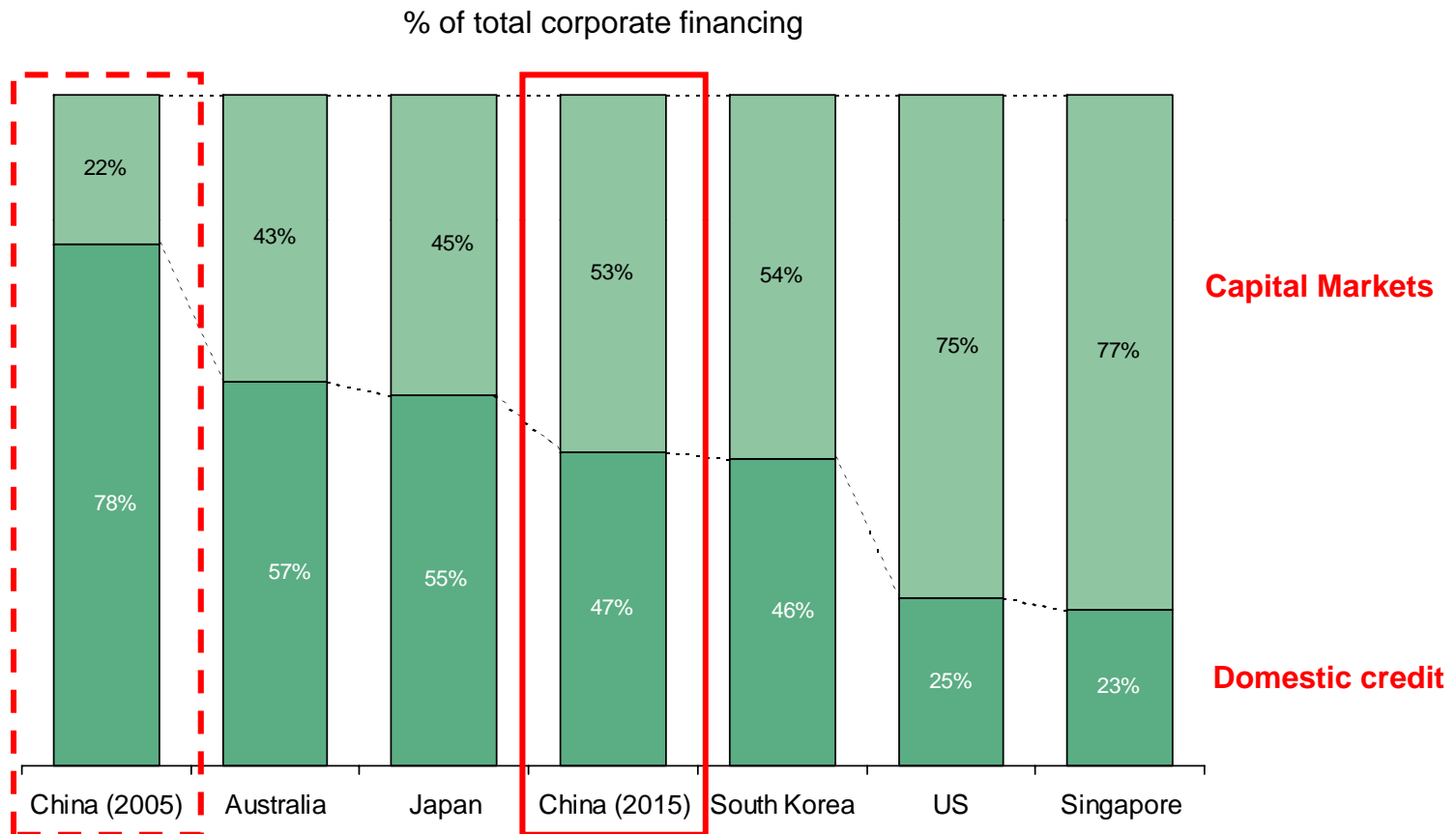
## BOCHK<sup>1</sup> grows loans by \$ 1.6 Bn



1. Including both Nanyang Commercial Bank (NCB) and BOCHK branches in China  
Source: Company annual reports; External analysis

# The major opportunity for foreign banks in China is in the capital markets

These are less restricted than retail banking and growing faster



Source: Bank annual reports and audited financial statements; External analysis and estimates



# Weak position in capital markets in China

Both in equity and in debt

	2002			2004			2006		
Debt issuance	Rank	Bank	m/s (%)	Bank	m/s (%)	Bank	m/s (%)		
	1	China Int'l Trust Investment	33.2	China Int'l Capital	23.6	China Int'l Trust Investment	20.5		
	2	China Development Bank	22.7	China Galaxy Securities	11.5	China Int'l Capital	17.5		
	3	China Power Finance	14.0	"Advisor undisclosed"	10.5	Bank of China	15.0		
	4	Merrill Lynch	7.2	Deutsche Bank	6.3	Galaxy Securities	9.8		
	5	Credit Suisse	7.2	HSBC	6.3	Guotai Junan Securities	3.6		
		HSBC (Not in Top 15)				HSBC (20 <sup>th</sup> )	0.9		
		Industry total = US\$ 3,452 Mn		Industry total = US\$ 9,483 Mn		Industry total = US\$ 22,545 Mn			

	2002			2004			2006		
IPO	Rank	Bank	m/s (%)	Bank	m/s (%)	Bank	m/s (%)		
	1	China Int'l Capital	38.1	Morgan Stanley	12.3	China Int'l Capital	14.1		
	2	Merrill Lynch	8.0	"Advisor undisclosed"	10.8	Bank of China	9.7		
	3	Morgan Stanley	6.0	China Int'l Capital	10.5	UBS	9.3		
	4	Guangfa Securities	4.5	Credit Suisse	8.2	Goldman Sachs	9.3		
	5	Guotai Junan Securities	2.8	Deutsche Bank	6.9	Merrill Lynch	7.6		
		HSBC (19 <sup>th</sup> )	1.2	HSBC (9 <sup>th</sup> )	3.7	HSBC (24 <sup>th</sup> )	0.5		
		Industry total = US\$ 8,436 Mn		Industry total = US\$ 24,782 Mn		Industry total = US\$ 59,440 Mn			

Source: Thomson Financials; Consultant's analysis

## **SECTION 7**

### **PRIVATE BANKING: A MISSED OPPORTUNITY?**

**Clearly, an area of comparative advantage  
-- but needs attention, particularly in Asia**

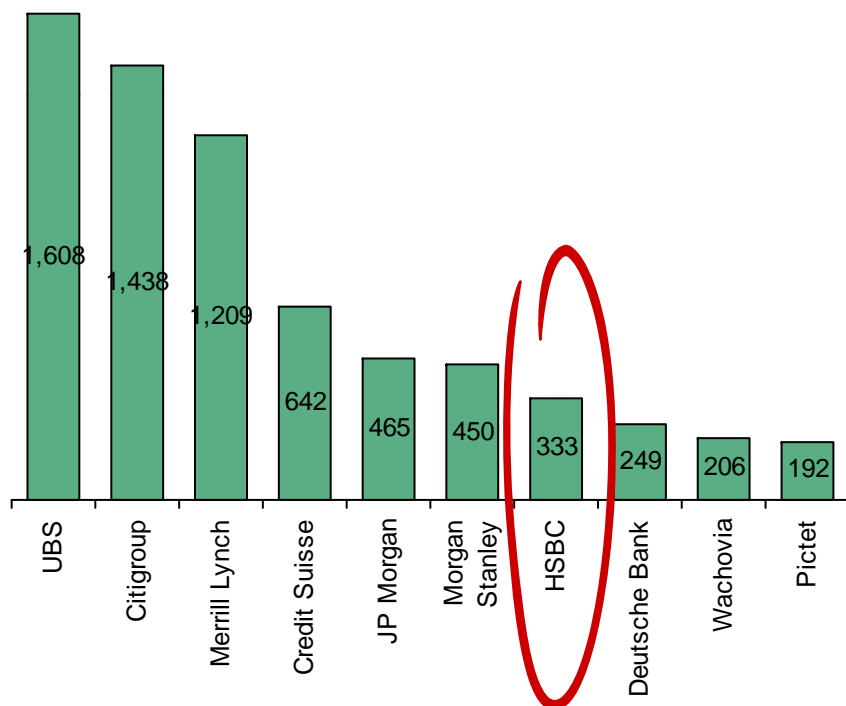
## HSBC has a good position in private banking

- **We believe that HSBC may well have comparative advantage in private banking:** it is the third largest provider of private banking services after UBS and CS in the non-US market
- Its revenues are growing faster than the market in all global regions and assets under management exceed the growth in the market in all regions except Asia
- There is some evidence that the brand is not as strong as it might be in Asia: there may be some issues about serving both mass market retail and high net worth clients using the same brand
- Segmentation of the market using Hang Seng and HSBC may be one solution, but would require taking over Hang Seng's minorities
- We feel that private banking may be one of the areas of real opportunity for HSBC

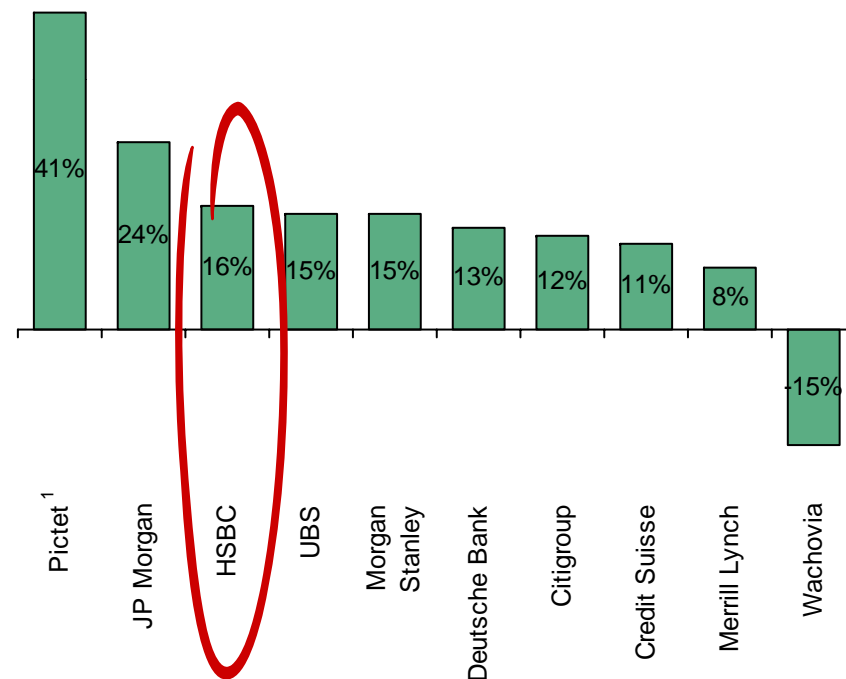
# Private banking: HSBC amongst top 10 global players

Third largest non-U.S. based private bank and growing well

Top 10 largest wealth managers by AuM (US\$ Bn), 2006



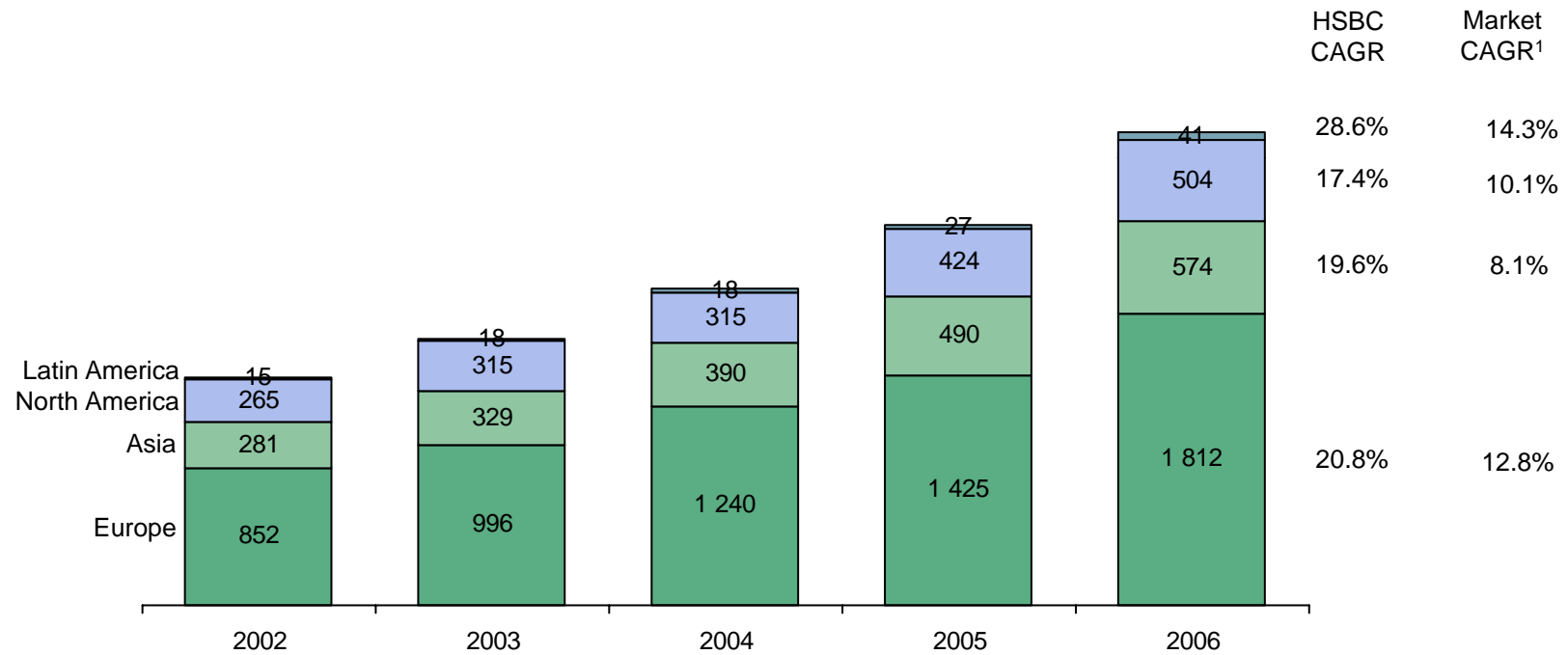
AuM growth rate of top 10 largest wealth managers, 2004-06 CAGR



1. Pictet growth data for 2006 vs. 2005 only  
Source: Scorpio Partnership; Company annual reports; External analysis

# HSBC Private Bank growing faster than the market across all regions in terms of revenue




HSBC private banking total operating revenue growth by region (US\$ Mn)



1. Market CAGR is from 2002 – 2005, derived from External Global Wealth Management Database  
Source: HSBC annual report; External Global Wealth Management Database; External analysis

# HSBC Private Bank: tier 1 player in Asia-Pacific

Almost All Players Are Growing Fast

	Players	Size <sup>1</sup> in Asia	State of business
<p><b>Leading banks</b></p> <p>(TIER 1)</p>		<p>~USD50-100B in AuM</p> <p>~200-300 RMs</p>	<ul style="list-style-type: none"> <li>• Dominant positions across all markets</li> <li>• All players growing at 20-30% p.a.</li> <li>• Growing RMs organically (prefer hiring new RMs and train-up in own culture)</li> <li>• Exploring new offerings (e.g., HSBC family office)</li> </ul>
<p><b>Medium-sized banks</b></p> <p>(TIER 2)</p>		<p>~USD10-20B in AuM</p> <p>~60-80 RMs</p>	<ul style="list-style-type: none"> <li>• Much smaller than Tier-1 leading banks</li> <li>• Players growing at different rates</li> <li>• Hiring experienced RMs to grow the business</li> <li>• Focus on a core capability to become a niche player                             <ul style="list-style-type: none"> <li>- BNP has strong relations with wealthy HK families</li> <li>- DB links private bank with its trading desks</li> <li>- SG is well-known for alternative products</li> </ul> </li> </ul>
<p><b>Small players</b></p> <p>(TIER 3)</p>		<p>&lt; USD10B in AuM</p> <p>&lt; 60 RMs</p>	<ul style="list-style-type: none"> <li>• Some growing rapidly in the large Asian market</li> <li>• Hiring experienced RMs aggressively to drive growth</li> <li>• More limited product offerings than Tier 1 and 2</li> <li>• Attract clients by excellent services / relationships</li> <li>• Acquiring AuM through RM hiring</li> </ul>

1. All information estimated as at end 2005  
Source: External database

# But ... HSBC's brand still has room for improvement in Asia!

The world's local bank – the right logo for aspirational customers?

Best global private banks in Asia, 2007

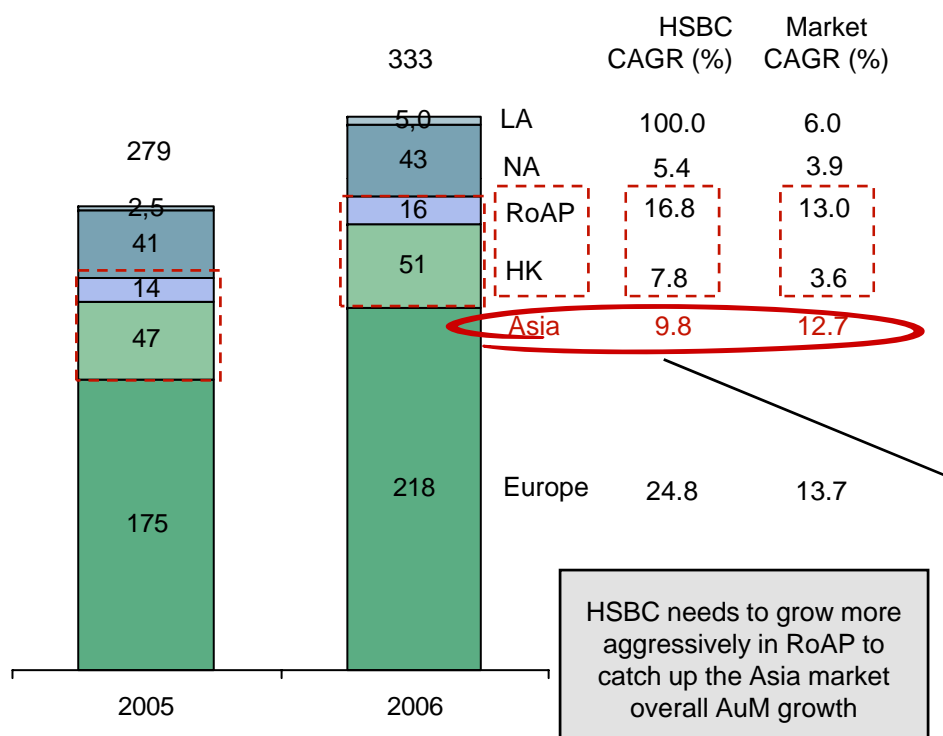
Rank	HNWI's with US\$ 1 – 5 Mn		HNWI's with US\$ 5.01 - 25 Mn		HNWI's with > US\$ 25 Mn	
	Bank	Voting (%)	Bank	Voting (%)	Bank	Voting (%)
1	BNP Paribas Private Bank	16.7	UBS Wealth Management	19.7	Citi Private Bank	14.2
2	UBS Wealth Management	14.3	BNP Paribas Private Bank	16.8	UBS Wealth Management	13.7
3	Deutsche Bank PWM	13.4	Citi Private Bank	15.6	BNP Paribas Private Bank	11.8
4	Citi Private Bank	11.6	HSBC Private Bank	13.3	HSBC Private Bank	11.3
5	HSBC Private Bank	11.3	Coutts Bank	5.9	Credit Suisse Private Banking	9.4
6	Merrill Lynch	7.3	Deutsche Bank PWM	5.9	Coutts Bank	9.0
7	Coutts Bank	5.8	ING Asia Private Banking	5.1	ING Asia Private Banking	8.0
8	ING Asia Private Banking	5.0	Credit Suisse Private Banking	3.7	Golman Sachs PWM	4.3
9	ABN Amro Private Banking	3.7	ABN Amro Private Banking	2.0	Deutsche Bank PWM	3.8
10	Credit Suisse Private Banking	3.2	Merrill Lynch	1.8	JPMorgan Private Bank	3.3

Note: Ranking based on voting results by a sample size of 389 respondents located in Hong Kong, India, Korea, Singapore, Taiwan and other countries in Asia  
Source: AsiaMoney

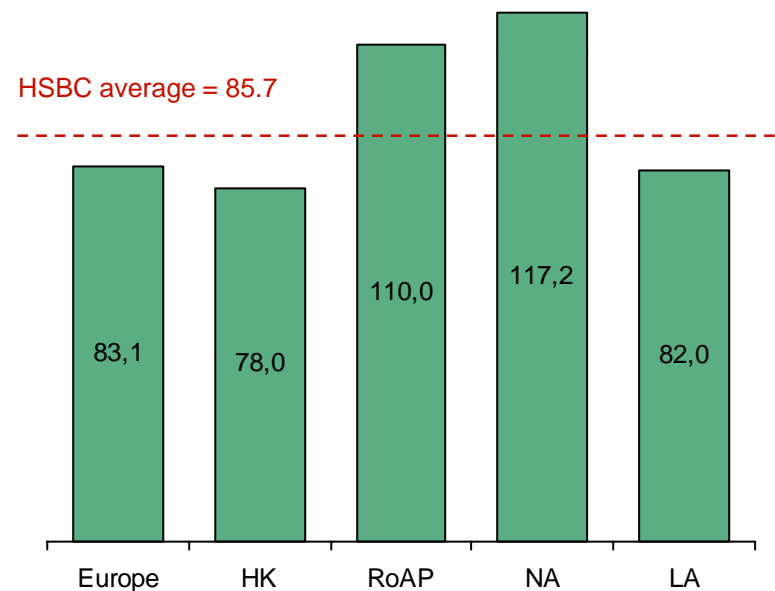
# HSBC losing market share in Asia in terms of AuM

HSBC's AuM growing at 9.8% vs market at 12.7%

HSBC AuM (US\$ Bn), '05 & '06



HSBC Private Banking regional revenue margin (bps), 2006



Source: HSBC annual reports; External Global Wealth Management Database; External analysis



**SECTION 8**  
**OTHER ISSUES**

## **HSBC's capital base**

**HSBC may not have as much leverage capacity or surplus capital as is thought**

- **HSBC's strong capital position, which has been fungible in the past, may no longer be such an advantage in the future, particularly in light of the requirement to incorporate and capitalize its regional businesses separately for local regulatory purposes**
- **HSBC's Hong Kong business is already incorporated and the decision to incorporate its Chinese business has already been taken. The Indian businesses will also be incorporated before the end of 2009**
- **That means that HSBC may well have no surplus capital at all – this is of course something that Douglas Flint, CFO, has frequently said**

**SECTION 9**  
**FINAL WORD TO HSBC**

# Final word to HSBC

## Questioning HSBC's synergies

“Despite much talk of the synergies and efficiencies that a larger organisation can achieve ... we have to concede that there is a **distinct lack of empirical evidence** that size equals efficiency...”

## Questioning HSBC's competitive advantage

“...The decision to build a global banking platform needs to be a hard-headed one; it needs to be based on a **realistic analysis of competitive advantage**”

“**Being a domestic player does not make a bank uncompetitive**”

## Questioning the global banking model

“In seeking a global base, many banks have come severely unstuck. ... **while global banking can be a successful model, it is not the only one**”

*David Hodgkinson, HSBC Chief Operating Officer, 17 May 2007*