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New York, 14<sup>th</sup> March 2008

Dear Simon,

**HSBC Holdings plc**

Thank you for your letter dated 1<sup>st</sup> February 2008.

I have to say that I was concerned by the tone of your letter which left me with the impression that you and perhaps some of the other non-executive members of the Board see shareholders' concerns over HSBC's strategy and corporate governance as little more than a "distraction".

Some commentators believe that the current financial crisis is due to insufficient or inadequate regulation, which may be true in part. However, we (and other informed parties<sup>1</sup>) believe that responsibility for the crisis can also be attributed to the poor structure of executive compensation schemes -- compounded by ineffective supervision of bank management teams by their boards. These issues are at the heart of our concerns about HSBC.

HSBC could have been spared the predicament in which it now finds itself had the Board not brought these problems upon itself by approving the acquisition of Household International (now HSBC Finance, or "HFC") in 2003. HSBC had no real experience in sub-prime lending at the time and it appears that the acquisition was completed notwithstanding the reservations expressed by some of HSBC's most senior executives. Given the huge sub-prime related losses incurred by HSBC in recent months and the even greater losses incurred by its shareholders as a result, we believe it to be entirely appropriate to be thinking constructively about improvements in strategy and governance at this time.

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<sup>1</sup> See, for example the letter "[What banks can learn from this credit crisis](#)" by Francisco González, Chairman of BBVA, published in the Financial Times on 4<sup>th</sup> February, 2008.

The dismissive comments in your letter conveyed a worrying degree of complacency: I hope this is just a matter of tone and not of substance.

### **Independence of the Board**

First, we recognise and welcome the steps that the Board has taken recently to improve its independence. We look forward to meeting the new members of the Board at this year's Annual General Meeting and are forwarding to each of them, as well as to the existing members of the Board, a copy of this letter together with a copy of your letter to us dated 1<sup>st</sup> February, 2008.

Despite the fact that you did not answer the question raised in our previous letter about why there had been two representatives of John Swire & Sons Limited ("Swire") on the Board of HSBC for so long and how they could be considered to be independent in light of the provisions of the Combined Code on this point, the problem has in effect been resolved with the impending departure of Baroness Dunn from the Board<sup>2</sup>.

### **Effectiveness of the Board**

Given that the question of the Board's independence has been resolved, we think it important that the Board turn to the question of its effectiveness.

The supervision of a complex, multi-jurisdictional and multi-product financial services group such as HSBC is never easy, even in the best of times. The task has become even more difficult due to the fact that the financial services industry is going through an unprecedented period of turmoil, in which many previously well-established sources of finance have simply evaporated, financial ratings have ceased to have any meaning, financial models used to value many kinds of securities have proved to be unreliable and the value of securities and their hedges have moved in the same direction at times of greatest market disruption.

One of the Board's main challenges lies in appreciating the true nature of the complex and interrelated risks being taken by an organisation such as HSBC, both on balance sheet and off balance sheet. Much of this is, of course, delegated to specialist risk management teams working under the direction of the executive members of the Board, but an effective Board needs at times to reassess the situation independently, assisted by independent experts

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<sup>2</sup> When looking at the long history of multiple cross-directorships between Swire and HSBC, the strong presumption must be that the directors appointed by Swire to the boards of HSBC and of its subsidiary, the Hongkong and Shanghai Banking Corporation, could not have been independent of each other and that as a result they may at times have been able to exercise a disproportionate degree of influence over the decisions of the HSBC Board. I note, for example, that Mr. Hughes-Hallet, who joined Swire in 1976, sat on the board of the Hongkong and Shanghai Banking Corporation from 1999 to 2004 and replaced Sir Adrian Swire on the board of HSBC on becoming Chairman of Swire, in 2005. Significant cross-directorships also exist at the subsidiary level: Mr. Christopher Pratt, Chairman of Swire Pacific, and Mrs. Marjorie Yang, a director, both sit on the board of the Hongkong and Shanghai Banking Corporation and Mr Eldon, a director of HSBC and Chairman of the Hongkong and Shanghai Banking Corporation, sat on the board of Swire Pacific until he retired in 2004, as did Mr. Vincent Cheng, his successor as Chairman of the Hongkong and Shanghai Banking Corporation, until he was appointed to the Board of HSBC earlier this year. The arrangements between Swire and HSBC have been in place for a very long period of time: for example, Baroness Dunn, HSBC Deputy Chairman, became a director of the Hongkong and Shanghai Banking Corporation in 1981, the year in which she became an executive director of Swire, and became a director of HSBC in 1990.

with specialist knowledge and experience. In this context, the Board cannot simply rely on the management team as its sole source of advice and input (and this is no reflection on the quality of the team). I would add that impartial advice from professionals with experience and judgement are vital to this process and cannot be replaced by internally generated statistical models, no matter how sophisticated. It is salutary to remember that “state of the art” risk management systems at leading banks such as UBS, Credit Suisse and Société Générale were unable to prevent the occurrence of substantial unexpected losses, much to the embarrassment of their Boards.

As you know, Knight Vinke has been calling for the Board to undertake a fundamental review of the Group’s strategy and as part of this has consistently recommended that HSBC take steps to sell, spin off or otherwise “ring fence” HFC. HSBC faces some very difficult choices with respect to this business and we believe that it would be entirely appropriate for the Board to seek independent financial advice in weighing up the risks and rewards associated with each of the potential solutions.

The Board has the power to appoint independent financial advisers to assist it with respect to strategy but has apparently chosen not to do so, despite our suggestions. We cannot see how that can be a wise decision.

### **HSBC Finance (“HFC”)**

Of all the issues which the Board of HSBC needs to consider, we believe that the most urgent is HFC. Had HSBC not acquired Household International in 2003, we believe that HSBC’s share price would be 200p to 300p higher than where it stands today. The potential cost to HSBC’s shareholders of procrastination in fundamentally addressing HFC’s problems is escalating by the day.

As we will discuss below, we believe that HFC has an unsustainable business model and is structurally unable to support its \$ 150 billion of debt. Its problems are not simply related to the state of the U.S. property market. Furthermore, in order to keep HFC afloat, we believe that HSBC has injected tens of billions of dollars into HFC by buying assets, thereby placing other parts of the Group at risk. Appreciating the increasing risk of sub-prime (and related) contagion throughout the Group is central to evaluating the alternatives for HFC.

HFC relies almost entirely on debt raised in the wholesale markets to lend to sub-prime creditors. Its debt to tangible managed assets amounts to approximately 94% and yet it lends to customers with a very high level of credit risk. In effect it adds very high credit risk to very high business risk. Such businesses do not survive for long and HFC would have collapsed in 2003 had HSBC not acquired it and supported it financially. Taking into account the acquisition price of \$14.8 billion, HSBC has disbursed almost \$60 billion on HFC since 2003, much of it by buying “contaminated” receivables from HFC in order to keep it afloat.

Last week we suggested four methods of “ring fencing” this business so as to prevent it from affecting HSBC’s thriving emerging markets business. HSBC’s Board responded to this immediately, apparently with very little due diligence (if any), by saying that it would be “irresponsible” and “unthinkable” for HSBC to walk away from HFC.

In our mind, this raises a question as to where the HSBC Board's primary responsibilities and allegiance truly lie. Is it to HSBC's shareholders or is it to HFC's bondholders? HFC's debt is not guaranteed by HSBC, it mostly pre-dates the acquisition of Household, is now trading at more than 300 basis points over the cost of HSBC's debt (i.e., as "junk" debt) and we believe is increasingly held by specialist distressed debt investors who have hedged themselves by buying CDS's. These, mostly U.S. based, professional investors are well versed in the mechanics of Chapter 11 proceedings and appear to have already priced into the bonds the high probability of this occurring.

With absolutely no access to customer deposits and only limited access to the debt markets (by its own admission HFC is facing "*a reduction in the number of financial institutions willing to provide direct financing*"<sup>3</sup>) HFC is increasingly dependent on asset sales and support from its parent for funding. With delinquencies rising (and ARM loans being restructured in the borrowers' favour), we believe that net interest and loan repayments received may not cover the operating cash flow needs of the business. We have observed that net new lending has virtually come to a standstill and is projected to go into negative territory next year. Even more worrying, however, is the fact that debt repayments due over the next three years amount to **over \$ 80 billion**. Selling assets is not a solution: in its 10-K, HFC discloses that the fair value of its consumer lending portfolio is **\$ 26.7 billion lower than the value at which the loans are carried in the 2007 accounts**<sup>4</sup> and a forced sale of these assets might result in even greater losses.

We are of the view that HFC is carrying far too much debt, that it will require significant additional capital from its parent just to survive and that, even after the U.S. property market finally recovers, this business will probably not be worth anything to HSBC's shareholders. We note that Goldman Sachs, HSBC's house broker, recently issued a report indicating that HSBC may have to inject a further \$ 12 billion into HFC in order to keep it afloat and that, even after the capital injection, they value HFC at nil.

Acquiring Household International was a catastrophic strategic mistake. Holding onto the business without considering the value destruction and opportunity cost to HSBC shareholders of doing so, is worse. Unless the Board feels that its primary responsibilities and allegiance are to HFC's bondholders, this would truly be "irresponsible".

We now ask ourselves the following questions. If there is no reasonable prospect that injecting additional capital and providing liquidity support to HFC will ever create shareholder value, should HSBC nevertheless continue to do so in order to protect HFC's bondholders? How can the suggestion that HSBC support HFC's bondholders be squared with the fiduciary duty that the HSBC Board owes to its shareholders? Would it be consistent with the stated strategy of focusing on emerging markets if the Board authorised the investment of very significant and as yet unquantifiable amounts of capital in a failing business in the developed markets? Should there be a limit to the amount of equity and liquidity support that HSBC will give to HFC or is this support without any limit?

These are surely questions which the Board would be negligent to ignore or attempt to answer without independent external financial advice at the very least. It continues to be of

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<sup>3</sup> See page 14 of HFC's recently published 2007 10-K.

<sup>4</sup> See page 188 of HFC 2007 10-K.

great concern to us that the Board has apparently not thought it wise to take independent advice to date.

Our consistent position has been that HSBC should seek to separate itself from HFC. In our meeting with Douglas Flint on 12<sup>th</sup> June 2007, before the sub-prime crisis became acute, we suggested that the business should be sold and were told that this was a good business that HSBC preferred to keep. As of today, selling the business may no longer be possible on acceptable terms but it may still be possible to spin it off or otherwise “ring fence” it. If all else fails, then the best course of action may well be for HFC to file for protection from its creditors under Chapter 11.

Some commentators have suggested, rather simplistically, that HSBC has the capital to support HFC until the U.S. property market finally recovers. HFC’s main problem comes from the fact that it has never been sufficiently capitalised for the sort of risks that it takes. Recovery in the U.S. property market will not solve HFC’s problems – what is required is a massive capital injection, but this will not give HSBC’s shareholders anything like a sufficient return on capital. A Chapter 11 restructuring, on the other hand, would allow HFC to negotiate a restructuring with its creditors under which it exchanges some of its \$ 150 billion in debt for equity.

Please see the attached note by Knight Vinke on HSBC Finance which provides further analysis.

#### **Governance issues/ Management incentive scheme**

Turning now to the question of the way the 2005 Share Plan was approved, you say in your letter that we have misunderstood the consultation process that is normally used in the UK. I can categorically assure you that we have not misunderstood the practice and in principle have no problem with the practice. As you may know, we have also received advice from leading counsel on the matter.

Our concern is that the description of the 2005 Share Plan that was given in advance to some large investors was different from that which HSBC gave to the vast majority of its investors and that, as a result, the information that it gave to the majority of its investors was misleading and insufficient. I cannot see how you or any of the other Board members can regard that as satisfactory.

We are aware that HSBC is now proposing to introduce a new scheme for senior management but, having recently seen the consultation document, we have serious reservations as to its content, which fails to address the fundamental weaknesses of the existing Share Plan.

We also have concerns about the way in which the consultation process is being conducted. We and the other institutions who signed the letter to you dated 25<sup>th</sup> January made it very clear that we wished to participate in the consultation process, which we understand is now effectively over. Because of this, I would ask that you please publish the consultation paper within the next two weeks, failing which we will do so ourselves in order to ensure that all shareholders can make their views known before the Annual General Meeting.

In the meantime, we have set out below our thoughts on the document that we have seen:

#### EPS growth formula

Under the 2005 Share Plan it was possible, because of the unusual way in which the three year earnings per share growth was calculated, for management to benefit from a full payment of the earnings per share element of the scheme even if there was no earnings per share growth over the three year period.

It seems that the Board is proposing to retain this system of calculating earnings per share growth notwithstanding the widespread criticism and ridicule to which it has been subject with respect to this element of the 2005 Scheme. This is utterly absurd and it simply will not pass the test of credibility and reasonableness in the eyes of your shareholders or of public opinion.

#### TSR peer group

Although the Board has now acknowledged that it is unsatisfactory that the peer group of a bank which focuses on the emerging markets should only include one emerging markets bank, the proposal on which the Remuneration Committee is seeking shareholders' views makes no sense. It gives a weighting to each member of the peer group in line with the free float, which means that, according to your own worked example<sup>5</sup>, all of the Chinese banks have a combined weighting of just £16.4 billion (i.e. 1.7% of the peer group based on the share prices today) while Bank of America on its own has a weighted market capitalisation of £93 billion (or 9.8%). As such, the updated comparator group remains heavily weighted towards the developed markets. This makes no sense to us since the banks against which HSBC competes (and against which it must therefore compare itself) do not depend on the size of their free float. We also note with disappointment that your updated comparator group only includes five emerging market banks, the combined weighting of which, under your new methodology, remains relatively minor. This new methodology is inconsistent with your stated commitment to focus on emerging markets. How can HSBC define itself as "*The world's leading international emerging markets bank*"<sup>6</sup> and at the same time keep on comparing itself mainly to its developed markets peers for compensation purposes?

#### Economic Profit

The third element of the new remuneration structure is the introduction of a performance measure based on economic profit. We are not in favour of this. In the case of Barclays Bank, for example, which has such a measure, the goal over the period 2004-2007 was to generate economic profit of £6.5bn-7.0bn with a compound average growth rate of 10-13%. The actual outcome was £8.3bn with a 16% CAGR. When Barclays set this target they believed that the economic performance they were hoping to achieve would give them first quartile TSR relative performance against a basket of international banks (Santander, BNP, BBVA, Deutsche, Lloyds TSB, UBS, JP Morgan, HBOS, HSBC, RBS, and Citigroup). Against this not

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<sup>5</sup> Worked example 1 – TSR, provided by HSBC in its "*Consultation on Proposed Remuneration Arrangements*". Simulations as of 20-Dec-07.

<sup>6</sup> HSBC Holding plc, Annual Results 2007 Presentation to Investors and Analysts, page 6.

exactly challenging and self selected peer group it delivered third quartile performance, despite exceeding all its targets.

In the case of Barclays, the system of economic profit/economic capital appears to favour allocation of capital to Barclays Capital. Whilst this has been successful in driving the bank's earnings it has coincided with those same earnings being de-rated. This dichotomy is seen in the divergence between achieving the economic profit goal and this translating into relative share price performance. The reason for this is that Barclays Capital succeeds by being leveraged, and although investors like earnings upgrades and reasonable return on equity levels they are wary of the need for leverage and an ever growing balance sheet to create this.

Economic profit and economic capital are a theoretical construct. They had merit when banks were regulated under Basel I, a rigid rules based system which was not aligned to underlying economic risks. However, Basel II is much more closely aligned to economic risk so the decision to stick with economic profit/capital appears to be flawed; the more so as it appears to ignore what shareholders are actually concerned about.

I would like to conclude by reminding you that if HSBC had followed our advice to sell or dispose or spin off Household in June last year, HSBC would now have virtually no remaining exposure to sub-prime and I have very little doubt that the share price would not be where it is today. The collapse of Bear Stearns reinforces our view that there is a need for the Board to draw a line under the HFC disaster once and for all. Holding onto the business in the vague hope that matters will resolve themselves is a very high risk strategy.

As mentioned above, we are copying this letter and the attachments to the other members of the Board and wish to offer the Board an opportunity to meet with us to discuss these issues further.

Yours sincerely



Eric Knight  
Chief Executive

cc : ABI  
Council of Institutional Investors  
Financial Services Authority  
HSBC Board members  
Institutional shareholders  
ISS Institutional Shareholder Services