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**UNITED STATES SECURITIES AND EXCHANGE COMMISSION**  
**WASHINGTON, D.C. 20549**  
**FORM 10-K**

(Mark One)

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934  
For the fiscal year ended December 31, 2007

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934  
For the transition period from \_\_\_\_\_ to \_\_\_\_\_

**Commission file number 1-7436**

**HSBC USA Inc.**

(Exact name of registrant as specified in its charter)

**Maryland**  
(State of Incorporation)

**13-2764867**  
(I.R.S. Employer Identification No.)

**452 Fifth Avenue, New York, New York**  
(Address of principal executive offices)

**10018**  
(Zip Code)

**(716) 841-2424**

(Registrant's telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Act:

| <u>Title of Each Class</u>   | <u>Name of Each Exchange on Which Registered</u> |
|--|--|
| Depository Shares (each representing a one-fourth share of Adjustable Rate Cumulative Preferred Stock, Series D)     | New York Stock Exchange                          |
| \$2.8575 Cumulative Preferred Stock  | New York Stock Exchange                          |
| Floating Rate Non-Cumulative Preferred Stock, Series F   | New York Stock Exchange                          |
| Depository Shares (each representing a one-fortieth share of Floating Rate Non-Cumulative Preferred Stock, Series G) | New York Stock Exchange                          |
| Depository Shares (each representing a one-fortieth share of Floating Rate Non-Cumulative Preferred Stock, Series H) | New York Stock Exchange                          |

Securities registered pursuant to Section 12(g) of the Act: None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes  No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act.

Yes  No

Indicate by check mark whether the registrant (1) had filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes  No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of the Form 10-K or any amendment to this Form 10-K. [ X ]

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer  Accelerated filer  Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act).

Yes  No

At February 29, 2008, all voting stock (706 shares of Common Stock \$5 par value) is owned by an indirect wholly owned subsidiary of HSBC Holdings plc.

**DOCUMENTS INCORPORATED BY REFERENCE**

None

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**HSBC USA Inc.**  
**Form 10-K**

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## ***PART I***

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### ***Item 1. Business***

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#### ***History***

HSBC USA Inc., incorporated under the laws of Maryland, is a New York State based bank holding company registered under the Bank Holding Company Act of 1956, as amended. HSBC USA Inc. and its subsidiaries are collectively referred to as “HUSI”. HUSI’s origin was in Buffalo, New York in 1850 as The Marine Trust Company, which later became Marine Midland Banks, Inc. (Marine). In 1980, The Hongkong and Shanghai Banking Corporation Limited (now HSBC Holdings plc, hereinafter referred to as “HSBC”) acquired 51% of the common stock of Marine and the remaining 49% of common stock in 1987. In December 1999, HSBC acquired Republic New York Corporation (Republic) and merged it with HUSI. At the merger date, Republic and HUSI had total assets of approximately \$47 billion and \$43 billion, respectively.

Through its affiliation with HSBC, HUSI offers its customers access to global markets and services. In turn, HUSI plays a role in the delivery and processing of other HSBC products. HSBC is one of the largest banking and financial services organizations in the world. Headquartered in London, England, HSBC’s international network comprises over 10,000 offices in 83 countries and territories in Europe, the Asia-Pacific region, Latin America, North America, South America, the Middle East and Africa.

Effective January 1, 2004, HSBC created a North American organizational structure with HSBC North America Holdings Inc. (HNAH) as the top-tier United States (U.S.) bank holding company. At December 31, 2007, HNAH was among the 10 largest U.S. bank holding companies ranked by assets. HUSI routinely conducts transactions with other principal subsidiaries of HNAH, which include:

- HSBC Bank Canada (HBCA), a Canadian banking subsidiary;
- HSBC Finance Corporation, a consumer finance company;
- HSBC Markets (USA) Inc. (HMUS), a holding company for investment banking and markets subsidiaries; and
- HSBC Technology & Services (USA) Inc. (HTSU), a provider of information technology services.

#### ***Description of Operations and Business Segments***

At December 31, 2007, HUSI had total assets of \$188 billion and approximately 12,000 full and part time employees. HUSI is among the 10 largest bank holding companies in the U.S. ranked by assets. Through its principal commercial banking subsidiary, HSBC Bank USA, National Association (HBUS), HUSI offers its four million customers a full range of commercial banking products and services. Its customers include individuals, including high net worth individuals, small businesses, corporations, institutions and governments. HBUS also engages in mortgage banking, and is an international dealer in derivative instruments denominated in U.S. dollars and other currencies, focusing on structuring of transactions to meet clients’ needs as well as for proprietary purposes.

With total assets of \$184 billion at December 31, 2007, HBUS is ranked among the top 10 banks in the U.S. HBUS’s main office is in Delaware, and its domestic operations are primarily located in New York State. It also has banking branch offices and/or representative offices in California, Florida, New Jersey, Delaware, Pennsylvania, Massachusetts, Virginia, Washington, Oregon and Washington, D.C. In addition to its domestic offices, HBUS maintains foreign branch offices, subsidiaries and/or representative offices in the Caribbean, Europe, Asia, Latin America, Australia and Canada.

During 2005, HUSI incorporated a nationally chartered limited purpose bank subsidiary, HSBC Trust Company (Delaware), National Association (HTCD). HTCD's charter includes the following primary activities:

- Custodian of investment securities for other HSBC affiliates;
- Personal trust services; and
- Originator of refund anticipation loans and checks in support of taxpayer financial services business lines.

The operations of HTCD had an immaterial impact on HUSI's consolidated balance sheets and results of operations for the years ended December 31, 2007 and 2006.

During 2006, HUSI also received regulatory approval for a new nationally chartered bank subsidiary, HSBC National Bank USA (HBMD). The charter for this new subsidiary directly supports HUSI's retail branch expansion strategy by allowing for the opening of new branches in Connecticut, Maryland, Virginia and Illinois. These branches offer a full suite of deposit and loan products for its own retail and small business customers, as well as support certain customer service activities on behalf of HBUS. The operations of HBMD had an immaterial impact on HUSI's consolidated balance sheets and results of operations for the years ended December 31, 2007 and 2006.

HUSI has five distinct business segments that it utilizes for management reporting and analysis purposes. The segments are based upon customer groupings, as well as products and services offered. The segments are described in the following paragraphs. Analysis of financial results for HUSI's business segments begins on page 50 of this Form 10-K.

#### *The Personal Financial Services (PFS) Segment*

This segment provides a broad range of financial products and services including installment and revolving term loans, MasterCard<sup>1</sup>/Visa<sup>2</sup> credit card receivables, deposits, branch services, mutual funds, investments and insurance. These products are marketed to individuals primarily through HBUS's branch banking network and increasingly through e-banking channels. Residential mortgage lending provides loan financing through the branch network and wholesale origination channels. Servicing is performed on a contractual basis for residential mortgage loans owned by HBUS or by third parties.

Effective January 1, 2006, activity related to certain commercial banking relationships, which was previously reported in the PFS segment, was transferred to the Commercial Banking (CMB) segment. For comparability purposes, 2005 results for the PFS segment have been revised to reflect these changes.

#### *The Consumer Finance (CF) Segment*

In 2005, HUSI formed the CF segment, which includes balances and activity previously reported as a component of the PFS segment. The CF segment includes point of sale and other lending activities primarily to meet the financial needs of individuals. Specifically, operating activity within the CF segment relates to higher quality nonconforming residential mortgage loans, other consumer loans and private label credit card receivables purchased from HSBC Finance Corporation.

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<sup>1</sup> MasterCard is a registered trademark of MasterCard, Incorporated.

<sup>2</sup> Visa is a registered trademark of Visa USA, Inc.

### *The Commercial Banking (CMB) Segment*

This segment provides loan and deposit products to small businesses and middle-market corporations including specialized products such as real estate financing. Various credit and trade related products such as standby facilities, performance guarantees and acceptances are also offered. These products and services are offered through multiple delivery systems, including the branch banking network.

Effective January 1, 2006, the CMB segment also includes activity related to an equity investment in Wells Fargo HSBC Trade Bank N.A., which was previously reported in the Other segment. This change was made to align financial reporting with the segment that manages this relationship. In addition, also effective January 1, 2006, activity related to certain commercial banking relationships, which was previously reported in the PFS segment, was transferred to the CMB segment. For comparability purposes, 2005 results for these segments have been revised to reflect these changes.

### *The Global Banking and Markets Segment (formerly Corporate, Investment Banking and Markets “CIBM”)*

The Global Banking and Markets segment is an emerging markets-led and financing-focused business that provides tailored financial solutions to major government, corporate and institutional clients worldwide.

Global Banking and Markets clients are served by teams that bring together relationship managers and product specialists to develop financial solutions that meet individual client needs. To ensure that a comprehensive understanding of each client's financial requirements is developed, the Global Banking and Markets teams take a long-term relationship management approach.

Client-focused business lines deliver the following full range of banking capabilities:

- Investment banking and financing solutions for corporate and institutional clients, including corporate banking, investment banking, trade services, payments and cash management, and leveraged acquisition finance;
- One of the largest markets businesses of its kind, with 24-hour coverage and knowledge of local markets and providing services in credit and rates, foreign exchange, money markets and securities services; and
- Global asset management solutions for institutions, financial intermediaries and private investors worldwide.

### *The Private Banking (PB) Segment*

This segment offers a full range of wealth management services for high net worth individuals. Products and services include wealth structuring, investment management, credit and banking, legacy and philanthropy and family advisory services.

### *Other Segment*

This segment includes an equity investment in HSBC Private Bank (Suisse) S.A. Effective January 1, 2006, an equity investment in Wells Fargo HSBC Trade Bank, N.A., which was previously reported in the Other segment, was transferred to the CMB segment. For comparability purposes, 2005 results have been revised to reflect this change.

## 2007 Developments and Trends

### Income Before Income Tax Expense - Significant Trends

Adverse market conditions, particularly in the U.S. mortgage and credit markets, led to substantial declines in trading and other income (refer to the table below). Reduced liquidity, widening credit spreads and higher volatility in the credit and sub-prime lending markets impacted trading in mortgage backed securities and credit derivatives. These adverse market conditions resulted in a significant fall in revenues, due to substantial valuation adjustments in several asset classes, including trading securities, residential mortgage loans held for sale, commercial loans held for sale, and credit derivatives products. In addition, provisions for credit losses have increased significantly, primarily due to increased credit card receivable balances and increased delinquencies in the credit card portfolio.

Income before income tax expense, and various trends and activity affecting operations, are summarized in the following table.

| (in millions)  | 2007           | 2006      | 2005         |
|--|----------------|-----------|--------------|
| Income before income tax expense from prior year .....                   | \$ 1,566       | \$ 1,542  | \$ 1,976     |
| Increase (decrease) in income before income tax expense attributable to: |                |           |              |
| Balance sheet management activities (1) .....                            | (70)           | (325)     | (148)        |
| Trading related activities (2) .....                                     | (606)          | 289       | 46           |
| Private label receivable portfolio (3) .....                             | (32)           | 264       | -            |
| Loans held for sale (4) .....  | (512)          | (120)     | (32)         |
| Residential mortgage banking revenue (5).....                            | (92)           | (85)      | 170          |
| Earnings from equity investments (6) .....                               | (32)           | 67        | (6)          |
| All other activities (7) .....   | (85)           | (66)      | (464)        |
|  | <b>(1,429)</b> | <b>24</b> | <b>(434)</b> |
| Income before income tax expense for current year .....                  | \$ 137         | \$ 1,566  | \$ 1,542     |

- (1) Balance sheet management activities are comprised primarily of net interest income and, to a lesser extent, gains on sales of investments and trading revenues, resulting from management of interest rate risk associated with the repricing characteristics of balance sheet assets and liabilities. Refer to commentary regarding Global Banking and Markets net interest income, trading revenues, and the Global Banking and Markets business segment beginning on page 55 of this Form 10-K, respectively.
- (2) Refer to commentary regarding trading revenues beginning on page 40 of this Form 10-K.
- (3) Refer to commentary regarding the CF business segment beginning on page 52 of this Form 10-K.
- (4) Refer to commentary regarding loans held for sale beginning on page 121 of this Form 10-K.
- (5) Refer to commentary regarding residential mortgage banking revenue beginning on page 43 of this Form 10-K.
- (6) Refer to commentary regarding other income beginning on page 45 of this Form 10-K.
- (7) Represents core banking and other activities that have been affected by challenging market conditions. Refer to business segments commentary beginning on page 50 of this Form 10-K.

### Consolidated Balance Sheet Growth

HUSI's consolidated total assets increased \$24 billion (14%) during 2007. Balance sheet growth was primarily driven by HUSI's deposit strategy during 2007, which improved HUSI's liquidity position. The funds raised were primarily invested in short-term, liquid assets such as trading assets which increased as a result of higher levels of trading activity in precious metals and derivatives businesses. Analysis of balance sheet growth and funding begins on page 30 of this Form 10-K.



### ***Deposit Strategy and Growth***

HUSI has a growth strategy for its core banking network, which includes building deposits across multiple markets and segments, and utilizing multiple delivery systems. This strategy includes various initiatives:

- full deployment of new personal and business checking and savings products, including relationship-based products;
- emphasis on more competitive pricing with the introduction of high yielding products, including on-line savings accounts. Since their introduction in 2005, internet savings balances have grown to \$11 billion, of which \$4 billion was 2007 growth. Substantially all of the 2007 growth was from new customers;
- retail branch expansion in existing and new geographic markets;
- improving delivery systems, including use of internet capabilities;
- refined marketing and customer analytics for the affluent consumer population; and
- strengthening current customer relationships, thereby driving increased utilization of products and customer retention.

Total deposit growth was \$14 billion and \$12 billion during the calendar years 2007 and 2006, respectively. Deposit balances by major depositor categories are summarized on page 32 of this Form 10-K.

### ***Transactions with HSBC Finance Corporation and Other HSBC Affiliates***

Cooperation continued during 2007 between HUSI and HSBC Finance Corporation to identify synergies in products and processes. Synergies have been achieved in loan origination and servicing, card processing, IT contingency rationalization, purchasing, call center cooperation, the shared use of HSBC's service centers, and the consolidation of certain administrative functions. HUSI and HSBC Finance Corporation will continue to work cooperatively on product offerings and support functions.

In 2005, HUSI began acquiring residential mortgage loans from unaffiliated third parties with the intent of selling these loans to an HSBC affiliate, HSBC Markets (USA) Inc. (HMUS). During 2006, HUSI also began acquiring residential mortgage loans from HSBC Finance Corporation under this program. Loans acquired from unaffiliated third parties and HSBC Finance Corporation primarily include sub-prime residential mortgage loans. In addition, a number of prime adjustable rate mortgage loans originated by HUSI were identified for this program and were being held with the intent of selling these loans to HMUS. HUSI now holds its remaining portfolio for sale to a third party.

HUSI has routinely purchased private label credit card receivables from HSBC Finance Corporation since December 2004. In addition, higher quality nonconforming residential mortgage loans were acquired from HSBC Finance Corporation's correspondent network from December 2003 until September 2005. In most cases, HSBC Finance Corporation retained the right to service these portfolios. These purchases of residential mortgage and other loans were discontinued as a result of strategic balance sheet management initiatives intended to enhance HUSI's liquidity position, particularly its loan to deposit ratio, and to address interest rate risk. Fees charged by HSBC Finance Corporation for loan origination and servicing expenses, which are primarily recorded in the CF segment, have increased mostly due to increased private label receivables.

HNAH's technology services in North America are centralized in a separate subsidiary, HTSU. Technology related assets and software developed or purchased are generally owned by HTSU. Pursuant to a master service level agreement, HTSU charges HUSI for technology services and software development. Fees charged by HTSU to HUSI for technology services expenses have increased in 2007, as HUSI continued to upgrade its technology platform.

HUSI obtains certain underwriting, broker-dealer and administrative support services from HSBC and various other affiliates. Fees charged by these affiliates for treasury and traded markets services provided to HUSI's Global Banking and Markets segment have increased in 2007 due primarily to increased trading activity.

Details of these and other transactions with HSBC affiliates are presented in Note 21 of the consolidated financial statements beginning on page 139 of this Form 10-K.

### ***Geographic Distribution of Assets and Earnings***

HUSI's foreign operations represented less than 6% of HUSI's consolidated total assets at December 31, 2007 and 2006, and less than 10% of consolidated income before income tax expense for 2007, 2006 and 2005.

### ***Regulation, Supervision and Capital***

Through June 30, 2004, HUSI and HBUS were supervised and routinely examined by the State of New York Banking Department and the Board of Governors of the Federal Reserve System (the Federal Reserve). Effective July 1, 2004, HBUS became a nationally chartered bank and is primarily supervised by the Office of the Comptroller of the Currency (OCC). HUSI, as a bank holding company, continues to be supervised by the Federal Reserve. HUSI, HBUS, HBMD and HTCD are subject to banking laws and regulations which place various restrictions on and requirements regarding their operations and administration, including the establishment and maintenance of branch offices, capital and reserve requirements, deposits and borrowings, investment and lending activities, payment of dividends and numerous other matters. The Federal Reserve Act restricts certain transactions between banks and their nonbank affiliates. Since the deposits of HBUS, HBMD and HTCD are insured by the Federal Deposit Insurance Corporation (FDIC), HBUS, HBMD and HTCD are subject to relevant FDIC regulations.

HBUS is required to maintain non-interest bearing cash reserves with the Federal Reserve Bank, which averaged \$256 million in 2007 and \$311 million in 2006.

HUSI and HBUS are subject to various regulatory capital requirements administered by federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory actions and possibly additional discretionary actions by regulators. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, specific capital guidelines must be met that involve quantitative measures of assets, liabilities, and certain off-balance sheet items as calculated under regulatory accounting practices. The capital amounts and classifications are also subject to qualitative judgments by the regulators about components, risk weightings and other factors.

HUSI's capital resources are summarized on page 34 of this Form 10-K.

Quantitative measures established by regulation to ensure capital adequacy require the maintenance of minimum amounts and ratios of total and Tier 1 capital (as defined in banking regulations). Capital amounts and ratios for HUSI and HBUS are summarized in Note 19 of the consolidated financial statements on page 137 of this Form 10-K. To be categorized as "well capitalized", a banking institution must have the minimum ratios reflected in the table included in Note 19 and must not be subject to a directive, order or written agreement to meet and maintain specific capital levels.

From time to time, bank regulators propose amendments to or issue interpretations of risk-based capital guidelines. Such proposals or interpretations could, upon implementation, affect reported capital ratios and net risk weighted assets. U.S. regulators have adopted a new capital adequacy framework, which is further described under "Basel Capital Standards".

HBUS, HBMD and HTCD are subject to risk-based assessments from the FDIC, the U.S. Government agency that insures deposits generally to a maximum of \$100,000 per domestic depositor. During November 2006, the FDIC adopted final regulations that implement a new risk-based assessment system. Depository institutions subject to assessment are categorized based on supervisory ratings, financial ratios and long-term debt issuer ratings, with those in the highest rated categories paying lower assessments. The new assessment rates, which took effect at the

beginning of 2007, will vary between five and seven cents for every \$100 of domestic deposits for nearly all banks. Banks that paid premiums in the past will have assessment credits to offset some or all of the premiums in 2007.

The Deposit Insurance Funds Act (DIFA) of 1996 authorized the Financing Corporation (FICO), a U.S. Government corporation, to collect funds from FDIC insured institutions to pay interest on FICO bonds. The FICO assessment rate in effect at December 31, 2007 was 1.14 percent of assessable deposits. The FICO assessment rate is adjusted quarterly. HBUS, HBMD and HTCD are subject to a quarterly FICO premium.

The USA Patriot Act (the Patriot Act), effective October 26, 2001, imposed significant record keeping and customer identity requirements, expanded the government's powers to freeze or confiscate assets and increased the available penalties that may be assessed against financial institutions for violation of the requirements of the Patriot Act intended to detect and deter money laundering. The Patriot Act required the U.S. Treasury Secretary to develop and adopt final regulations with regard to the anti-money laundering compliance obligations of financial institutions (a term which includes insured U.S. depository institutions, U.S. branches and agencies of foreign banks, U.S. broker-dealers and numerous other entities). The U.S. Treasury Secretary delegated certain authority to a bureau of the U.S. Treasury Department known as the Financial Crimes Enforcement Network (FinCEN).

Many of the anti-money laundering compliance requirements of the Patriot Act, as implemented by FinCEN, are generally consistent with the anti-money laundering compliance obligations that applied to HBUS under the Bank Secrecy Act and applicable Federal Reserve Board regulations before the Patriot Act was adopted. These include requirements to adopt and implement an anti-money laundering program, report suspicious transactions and implement due diligence procedures for certain correspondent and private banking accounts. Certain other specific requirements under the Patriot Act involve compliance obligations. The Patriot Act and other recent events have resulted in heightened scrutiny of the Bank Secrecy Act and anti-money laundering compliance programs by the federal and state bank regulators.

#### ***Basel Capital Standards (Basel II)***

HUSI is currently working toward compliance with final U.S. Basel II capital rule, published in December 2007. In addition, HUSI supports HSBC's implementation of the Financial Services Authority's (FSA) Basel II capital rule.

HUSI's approach toward implementing the Basel framework is summarized beginning on page 76 of this Form 10-K.

#### ***Sarbanes-Oxley Act of 2002, Section 404 Compliance***

As an SEC registrant of public debt and preferred shares, HUSI is required to comply with the Sarbanes-Oxley Act of 2002. Section 404 of the Sarbanes-Oxley Act of 2002 (Section 404) requires registrants and their auditors to assess and report on internal controls over financial reporting on an annual basis. Under the SEC's current rules for non-accelerated filers, HUSI was required to complete a management assessment of internal controls over financial reporting for the fiscal year ending December 31, 2007. An audit of HUSI's internal controls over financial reporting, along with management's assessment of these controls, is required beginning in the fiscal year ending December 31, 2009.

As a foreign registrant, HSBC was required to comply with Section 404 beginning in the fiscal year ending December 31, 2006. As a subsidiary of a foreign registrant, HUSI has supported HSBC with its Section 404 compliance.

HUSI has adopted the internal control framework established by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) to complete its management assessment of the effectiveness of internal controls over financial reporting in compliance with Section 404. Certain other financial reporting risk assessment factors have also been included to ensure adequate coverage of safeguarding of assets and anti-fraud risks.

## ***Competition***

The Gramm-Leach-Bliley Act of 1999 (GLB Act), effective March 11, 2000, eliminated many of the regulatory restrictions on providing financial services. The GLB Act allows for financial institutions and other providers of financial products to enter into combinations that permit a single organization to offer a complete line of financial products and services. Therefore, HUSI and its subsidiaries face intense competition in all of the markets they serve, competing with both other financial institutions and non-banking institutions such as insurance companies, major retailers, brokerage firms and investment companies.

Following the enactment of the GLB Act, HUSI elected to be treated as a financial holding company (FHC). As an FHC, HUSI's activities in the U.S. have been expanded enabling it to offer a more complete line of products and services. HUSI's ability to engage in expanded financial activities as an FHC depends upon its meeting certain criteria, including requirements that its U.S. depository institution subsidiary, HBUS, its forty percent owned subsidiary, Wells Fargo HSBC Trade Bank N.A., HBMD and HTCD be well capitalized and well managed, and that they have achieved at least a satisfactory record of meeting community credit needs during their most recent examination pursuant to the Community Reinvestment Act. In general, an FHC would be required, upon notice by the Federal Reserve Board, to enter into an agreement to correct any deficiency in the requirements necessary to maintain its FHC election. Until such deficiencies are corrected, the Federal Reserve Board may impose limitations on the conduct or activities of an FHC or any of its affiliates as it deems appropriate. If such deficiencies are not corrected in a timely manner, the Federal Reserve Board may require an FHC to divest its control of any subsidiary depository institution or to cease to engage in certain financial activities. As of December 31, 2007, no known deficiencies exist, and HUSI is not subject to limitations or penalties relative to its status as an FHC.

## ***Cautionary Statement on Forward-Looking Statements***

Certain matters discussed throughout this Form 10-K constitute forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. In addition, HUSI may make or approve certain statements in future filings with the SEC, in press releases, or oral or written presentations by representatives of HUSI that are not statements of historical fact and may also constitute forward-looking statements. Words such as "may", "should", "would", "could", "believes", "intends", "expects", "estimates", "targeted", "plans", "anticipates", "goal" and similar expressions are intended to identify forward-looking statements but should not be considered as the only means through which these statements may be made. These matters or statements will relate to future financial condition, results of operations, plans, objectives, performance or business developments and will involve known and unknown risks, uncertainties and other factors that may cause HUSI's actual results, performance or achievements to be materially different from that which was expressed or implied by such forward-looking statements. Forward-looking statements are based on current views and assumptions and speak only as of the date they are made. HUSI undertakes no obligation to update any forward-looking statement to reflect subsequent circumstances or events.

## ***Item 1A. Risk Factors***

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### ***General Business, Economic, Political and Market Conditions***

HUSI's business and earnings are affected by general business, economic, market and political conditions in the United States and abroad. Given its concentration of business activities in the United States, HUSI is particularly exposed to downturns in the United States economy. For example, in a poor economic environment there is greater likelihood that more of HUSI's customers or counterparties could become delinquent or default on their loans or other obligations. This could result in higher levels of charge offs and provisions for credit losses, which would adversely affect HUSI's earnings. General business, economic and market conditions that could affect HUSI include, but are not limited to:

- short-term and long-term interest rates;
- inflation;
- recession;
- unemployment levels;
- monetary supply and market liquidity;
- fluctuations in both debt and equity capital markets in which HUSI funds its operations;
- market value of consumer owned and commercial real estate throughout the United States;
- consumer perception as to the availability of credit; and
- the ease of filing for bankruptcy.

Certain changes to these conditions could diminish demand for HUSI's products and services, or increase the cost to provide such products or services. Recent trends in world-wide financial markets related to, among other things, the growth of derivatives and hedge funds, could add instability and could change the way those markets work. Political conditions may also impact HUSI's earnings. The economic health of geographic areas where HUSI has greater concentrations of business may decline relative to other geographic regions, with related impacts on HUSI's earnings. Acts or threats of war or terrorism, as well as actions taken by the United States or other governments in response to such acts or threats, could affect business and economic conditions in the United States.

### ***Competition***

HUSI operates in a highly competitive environment. Competitive conditions are expected to continue to intensify as continued merger activity in the financial services industry produces larger, better-capitalized and more geographically diverse companies. New products, customers and channels of distribution are constantly emerging. Such competition may impact the terms, rates, costs and/or profits historically included in the financial products HUSI offers or purchases. The traditional segregation of commercial and investment banks has all but eroded. There is no assurance that the significant and increasing competition within the financial services industry will not materially and adversely affect HUSI's future results of operations.

### ***Federal and State Regulation***

HUSI operates in a highly regulated environment. Changes in federal, state and local laws and regulations affecting banking, consumer credit, bankruptcy, privacy, consumer protection or other matters could materially impact HUSI's performance. For example, anti-money laundering requirements under the Patriot Act are frequently revisited by the U.S. Congress and Executive Agencies. Broad or targeted legislative or regulatory initiatives may be aimed at lenders operating in consumer lending markets. These initiatives could affect HUSI in substantial and unpredictable ways, including limiting the types of consumer loan products it can offer. In addition, there may be amendments to, and new interpretations of, risk-based capital guidelines. HUSI cannot determine whether such legislative or regulatory amendments will be instituted or predict the impact that such amendments would have on results.

### ***Changes in Accounting Standards***

HUSI's accounting policies and methods are fundamental to how HUSI records and reports its financial condition and the results of its operations. From time to time, the Financial Accounting Standards Board (FASB), the SEC and bank regulators, including the Office of Comptroller of the Currency and the Board of Governors of the Federal Reserve System, change the financial accounting and reporting standards that govern the preparation of external financial statements. These changes are beyond HUSI's control, can be hard to predict and could materially impact how HUSI reports its financial condition and the results of its operations.

### ***Management Financial Projections and Judgments***

HUSI's management is required to use certain estimates in preparing financial statements, including accounting estimates to determine loan loss reserves, reserves related to litigation, and the fair market value of certain assets and liabilities, among other items. In particular, loan loss reserve estimates are judgmental and are influenced by factors outside of HUSI's control. Actual results could differ from those estimates.

### ***Lawsuits and Regulatory Investigations and Proceedings***

HUSI or one of its subsidiaries may be named as a defendant in various legal actions, including class actions and other litigation or disputes with third parties, as well as investigations or proceedings brought by regulatory agencies. These actions may result in judgments, settlements, fines, penalties or other results, including additional compliance requirements, adverse to HUSI which could have a material adverse effect on HUSI's business, financial condition or results of operations, or cause serious reputational harm.

### ***Operational Risks***

HUSI's businesses are dependent upon its ability to process a large number of increasingly complex transactions. If any of HUSI's accounting, data processing and other record keeping systems and management controls fail or have other significant shortcomings, HUSI could be materially and adversely affected. HUSI is similarly dependent on its employees. HUSI could be materially and adversely affected if an employee causes a significant operational break-down or failure, either as a result of human error or where an individual intentionally sabotages or fraudulently manipulates HUSI's operations or systems. Third parties with which HUSI does business could also be sources of operational risk, including risks associated with break-downs or failures of such parties' own systems or employees. Any of these occurrences could result in diminished ability of HUSI to operate one or more of its businesses, potential liability to clients, reputational damage and regulatory intervention, all of which could have a material adverse effect on HUSI.

HUSI may also be subject to disruptions of its operating systems and businesses arising from events that are wholly or partially beyond its control. These may include:

- computer viruses or electrical or telecommunications outages;
- natural disasters, such as hurricanes and earthquakes;
- events arising from local or regional politics, including terrorist acts;
- unforeseen problems encountered while implementing major new computer systems; or
- global pandemics, which could have a significant effect on HUSI's business operations as well as on HSBC affiliates world-wide.

Such disruptions may give rise to losses in service to customers, an inability to collect receivables in affected areas and other loss or liability to HUSI.

In recent years, instances of identity theft and fraudulent attempts to obtain personal and financial information from individuals and from companies that maintain such information pertaining to their customers have become more prevalent. Use of the internet for these purposes has also increased. Such acts can have the following possible impacts:

- threaten the assets of customers and of HUSI;
- negatively impact customer credit ratings;
- impact customers' ability to repay loan balances;
- increase costs for HUSI to respond to such threats and to enhance its processes and systems to ensure maximum security of data; or
- damage HUSI's reputation from public knowledge of intrusion into its systems and databases.

There is the risk that HUSI's controls and procedures, business continuity planning, and data security systems could prove to be inadequate. Any such failure could affect HUSI's operations and could have a material adverse effect on HUSI's results of operations by requiring HUSI to expend significant resources to correct the defect, as well as by exposing HUSI to litigation or losses not covered by insurance.

Changes to operational practices from time to time could materially impact HUSI's performance and results. Such changes may include:

- raising the minimum payment on credit card accounts;
- determinations to acquire or sell private label credit card receivables, residential mortgage loans and other loans;
- changes to customer account management, risk management and collection policies and practices;
- increasing investment in technology, business infrastructure and specialized personnel; or
- outsourcing of various operations.

### ***Liquidity***

Adequate liquidity is critical to HUSI's ability to operate its businesses, grow and be profitable. A compromise to liquidity caused by market disruptions and other events could therefore have a negative effect on HUSI. Potential conditions that could negatively affect HUSI's liquidity include:

- diminished access to capital markets;
- unforeseen cash or capital requirements;
- an inability to sell assets; and
- an inability to obtain expected funding from HSBC affiliates and clients.

HUSI's credit ratings are an important part of maintaining liquidity. Any downgrade in credit ratings could potentially increase borrowing costs, limit access to capital markets, require cash payments or collateral posting, and permit termination of certain contracts material to HUSI.

### ***Acquisition Integration***

HUSI has in the past, and may again in the future, seek to grow its business by acquiring other businesses or loan portfolios. There can be no assurance that acquisitions will have the anticipated positive results, including results relating to:

- the total cost of integration;
- the time required to complete the integration;
- the amount of longer-term cost savings; or
- the overall performance of the combined entity.

Integration of an acquired business can be complex and costly, and may sometimes include combining relevant accounting, data processing and other record keeping systems and management controls, as well as managing relevant relationships with clients, suppliers and other business partners, as well as with employees.

There is no assurance that any businesses or portfolios acquired in the future will be successfully integrated and will result in all of the positive benefits anticipated. If HUSI is not able to successfully integrate acquisitions, there is the risk that its results of operations could be materially and adversely affected.

### ***Risk Management***

HUSI seeks to monitor and manage its risk exposure through a variety of separate but complementary financial, credit, market, operational, compliance and legal reporting systems, including models and programs that predict loan delinquency and loss. While HUSI employs a broad and diversified set of risk monitoring and risk mitigation techniques, those techniques and the judgments that accompany their application cannot anticipate every unfavorable event or the specifics and timing of every outcome. Accordingly, HUSI's ability to successfully identify and balance risks and rewards, and to manage all significant risks, is an important factor that can significantly impact results of operations.

### ***Employee Attraction and Retention***

HUSI's employees are its most important resource and, in many areas of the financial services industry, competition for qualified personnel is intense. If HUSI were unable to continue to attract and retain qualified employees to support the various functions of its business, HUSI's performance, including its competitive position, could be materially and adversely affected.

### ***Reputational Risk***

HUSI's ability to attract and retain customers and conduct business transactions with its counterparties could be adversely affected to the extent that its reputation, or the reputation of affiliates operating under the HSBC brand, are damaged. Failure to address, or appearing to fail to address, various issues that could give rise to reputational risk could cause harm to HUSI and its business prospects. Reputational issues include, but are not limited to:

- appropriately addressing potential conflicts of interest, legal and regulatory requirements;
- ethical issues;
- adequacy of anti-money laundering processes;
- privacy issues;
- record-keeping;
- sales and trading practices;
- proper identification of the legal, reputational, credit, liquidity and market risks inherent in products offered; and
- general company performance.

The failure to address these issues appropriately could make customers unwilling to do business with HUSI, which could adversely affect its results of operations.



### ***Item 1B. Unresolved Staff Comments***

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None.

### ***Item 2. Properties***

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The principal executive offices of HUSI are located at 452 Fifth Avenue, New York, New York 10018, which is owned by HBUS. The main office of HBUS is located at 1105 N. Market Street, Wilmington, Delaware 19801. The principal executive offices of HBUS are located at One HSBC Center, Buffalo, New York 14203, in a building under a long-term lease. HBUS has more than 385 other banking offices in New York State located in 44 counties, twenty-three branches in California, seventeen branches each in Florida and New Jersey, two branches in Pennsylvania and one branch each in Oregon, Washington State, Delaware and Washington D.C. Approximately 29% of these offices are located in buildings owned by HBUS and the remaining are located in leased quarters. In addition, there are branch offices and locations for other activities occupied under various types of ownership and leaseholds in states other than New York, none of which are materially important to the respective activities. HBUS also owns properties in Montevideo, Uruguay and Punta del Este, Uruguay.

### ***Item 3. Legal Proceedings***

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HUSI's legal proceedings are summarized in Note 25 of the consolidated financial statements beginning on page 152 of this Form 10-K.

### ***Item 4. Submission of Matters to a Vote of Security Holders***

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Not applicable.

## ***P A R T II***

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### ***Item 5. Market for the Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities***

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All 706 shares of HUSI's outstanding stock are owned by HSBC North America Inc. (HNAI), an indirect subsidiary of HSBC. Consequently, there is no public market in HUSI's common stock.

## Item 6. Selected Financial Data

| Year Ended December 31   | 2007          | 2006            | 2005          | 2004            | 2003          |
|--|---------------|-----------------|---------------|-----------------|---------------|
| (\$ in millions)   |               |                 |               |                 |               |
| <b>Income statement:</b>   |               |                 |               |                 |               |
| Net interest income .....  | \$ 3,398      | \$ 3,081        | \$ 3,063      | \$ 2,741        | \$ 2,510      |
| (Provision) credit for credit losses .....                           | (1,522)       | (823)           | (674)         | 17              | (113)         |
| Total other revenues .....   | 1,847         | 2,563           | 1,911         | 1,319           | 1,154         |
| Total operating expenses .....                                       | (3,586)       | (3,255)         | (2,758)       | (2,101)         | (2,040)       |
| Income tax benefit (expense) .....                                   | 1             | (530)           | (566)         | (718)           | (570)         |
| Net income .....   | \$ <u>138</u> | \$ <u>1,036</u> | \$ <u>976</u> | \$ <u>1,258</u> | \$ <u>941</u> |
| <b>Balances at year end:</b>   |               |                 |               |                 |               |
| Loans, net of allowance .....  | \$ 93,535     | \$ 89,340       | \$ 89,496     | \$ 84,159       | \$ 48,075     |
| Total assets .....   | 188,373       | 164,817         | 151,584       | 141,050         | 95,562        |
| Total tangible assets .....  | 185,633       | 162,054         | 148,845       | 138,310         | 92,736        |
| Total deposits .....   | 116,228       | 102,146         | 90,292        | 79,981          | 63,955        |
| Common shareholder's equity .....                                    | 9,672         | 10,571          | 10,278        | 10,366          | 6,962         |
| Tangible common shareholder's equity .....                           | 7,297         | 8,034           | 7,562         | 7,611           | 4,022         |
| Total shareholders' equity .....                                     | 11,237        | 12,261          | 11,594        | 10,866          | 7,462         |
| <b>Selected financial ratios:</b>                                    |               |                 |               |                 |               |
| Total shareholders' equity to total assets .....                     | 5.97 %        | 7.44 %          | 7.65 %        | 7.70 %          | 7.81 %        |
| Tangible common shareholder's equity to total tangible assets .....  | 3.93          | 4.96            | 5.08          | 5.50            | 4.34          |
| Rate of return on average (1):                                       |               |                 |               |                 |               |
| Total assets .....   | .08           | .64             | .66           | 1.12            | 1.02          |
| Total common shareholder's equity .....                              | .37           | 9.03            | 8.78          | 16.35           | 13.06         |
| Net interest margin to average (1):                                  |               |                 |               |                 |               |
| Earning assets .....   | 2.36          | 2.26            | 2.49          | 3.00            | 3.39          |
| Total assets .....   | 1.99          | 1.91            | 2.09          | 2.46            | 2.76          |
| Average total shareholders' equity to average total assets (1) ..... |               |                 |               |                 |               |
|  | 7.02          | 7.39            | 7.85          | 7.18            | 8.20          |
| Efficiency ratio (2) .....   | 68.34         | 57.66           | 55.44         | 51.73           | 55.65         |

(1) Selected financial ratios are defined in the Glossary of Terms beginning on page 91 of this Form 10-K.

(2) Represents the ratio of total operating expenses, reduced by minority interest, to the sum of net interest income and other revenues.

Significant trends and transactions that impacted net income for 2007 and 2006 are summarized on pages 35-49 of this Form 10-K.

## ***Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations***

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### ***Executive Overview***

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Adverse conditions, particularly in the U.S. mortgage and credit markets, led to substantial declines in trading and other income and to increases in provisions for consumer assets during the second half of 2007. This resulted in income before income tax expense of \$137 million for the year ended December 31, 2007, a decrease of 91% from 2006. Net income decreased 87% to \$138 million in 2007 from 2006.

Revenues decreased significantly led by declines in trading revenues and negative valuation adjustments on assets held for sale as market disruptions resulted in significantly wider credit spreads and severely diminished liquidity. These market conditions translated into substantial write-downs in the carrying value of several asset classes, including sub-prime residential mortgage and leveraged commercial loans held for sale, credit derivative products, including derivative contracts with monoline insurance companies, and other derivative trading activities. Trading revenues also reflect the decrease in value of derivative trading instruments used to hedge an investment in Class B shares issued by MasterCard, Incorporated, the fair value of which has increased significantly but which cannot be recognized until the investment is sold. The decrease was partially offset by gains on sale of a portion of HUSI's investment in certain Class B shares, increased fees from credit card receivable portfolios, payments and cash management revenues and increased trading revenue from the foreign exchange desk.

The provision for credit losses increased significantly in 2007, primarily due to growing delinquencies within the credit card portfolio, a refinement to credit card loss reserve methodology and higher average credit card receivable balances. Provisions related to home equity lines of credit have also increased due to a higher rate of delinquencies in the portfolio during 2007 as conditions in the housing markets deteriorated. In addition, provisions for credit losses on consumer assets were unusually low in 2006, due to the impact of bankruptcy legislation enacted in 2005, which resulted in accelerated consumer charge offs and higher provision expense during 2005.

Net interest income was \$3,398 million for 2007, an increase of 10% over 2006. This increase primarily resulted from growth in the private label credit card portfolio, reduced amortization of the initial premium paid for the portfolio and a more refined income recognition methodology on promotional balances. In addition, retail and commercial business expansion initiatives, including continued focus on the Online Savings product, new branches, expansion of services and products to small business customers and increased payments and cash management activities led to growth in deposits and commercial loans. Income from short term investments also increased as excess liquidity was invested. These increases were partially offset by narrowing of interest rate spreads on core banking products primarily due to competitive pressures as customers migrated to higher yielding deposit products and lower interest income from residential mortgage loans due to the impact of balance sheet initiatives to reduce the portfolio.

Operating expenses were negatively impacted for 2007 by a \$70 million litigation charge related to Visa (Refer to Note 25 of the consolidated financial statements beginning on page 152 of this Form 10-K for commentary regarding Visa litigation) but also reflect higher salaries, marketing and other direct expenses related to business expansion initiatives in the retail and commercial businesses, as well as higher technology and other costs to support the build-out of enhanced product and service platforms.

During the first quarter of 2007, after a thorough review of its deferred income taxes, HUSI increased the carrying value of its deferred tax asset, with a corresponding decrease in income tax expense. The remaining decrease in income tax expense was mainly due to a concentration of normal tax credits, an adjustment of the tax provision to reflect the actual tax return liabilities and a lowering of the effective rate due to a change in the sourcing of income.

## ***Basis of Reporting***

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HUSI's consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States (U.S. GAAP).

### ***International Financial Reporting Standards (IFRS)***

Effective January 1, 2007, corporate goals of HUSI are based upon results reported under IFRS (a non-U.S. GAAP measure). Operating results for HUSI are now monitored and reviewed, trends are being evaluated, and decisions are being made about allocating certain resources on an IFRS basis. In addition, HSBC reports its results in accordance with IFRS and IFRS results are used by HSBC in measuring and rewarding performance of employees. The following table reconciles HUSI's net income on a U.S. GAAP basis to net income on an IFRS basis.

| <b>Year Ended December 31</b>            | <b>2007</b> | <b>2006</b> | <b>2005</b> |
|--|-------------|-------------|-------------|
| <b>(in millions)</b>                     |             |             |             |
| Net income – U.S. GAAP basis .....       | \$ 138      | \$ 1,036    | \$ 976      |
| Adjustments, net of tax:                 |             |             |             |
| Unquoted equity securities .....         | 58          | 26          | -           |
| Fair value option .....                  | 124         | (49)        | 18          |
| Loan origination .....                   | 15          | -           | (7)         |
| Loan impairment .....                    | 3           | (2)         | (11)        |
| Purchase accounting/deferred taxes ..... | -           | (21)        | -           |
| Stock based compensation .....           | -           | (5)         | (17)        |
| Property .....                           | 13          | (1)         | (46)        |
| Pension costs .....                      | 16          | 6           | 5           |
| Other .....                              | 19          | (8)         | 15          |
| Total adjustments, net of tax .....      | 248         | (54)        | (43)        |
| Net income – IFRS basis .....            | \$ 386      | \$ 982      | \$ 933      |

Differences between U.S. GAAP and IFRS are as follows:

#### ***Unquoted equity securities***

HUSI holds certain equity securities whose market price is not quoted on a recognized exchange, but for which the fair value can be reliably measured either through an active market, comparison to similar equity securities which are quoted, or by using discounted cash flow calculations.

#### **IFRS**

- Under IAS 39, equity securities which are not quoted on a recognized exchange, but for which fair value can be reliably measured, are required to be measured at fair value. Accordingly, such securities are measured at fair value and classified as either available-for-sale securities, with changes in fair value recognized in other comprehensive income, or as trading securities, with changes in fair value recognized in income.

#### **U.S. GAAP**

- Under SFAS 115, equity securities that are not quoted on a recognized exchange are not considered to have a readily determinable fair value and are required to be measured at cost, less any provisions for impairment. Unquoted equity securities are reported within "Other assets".

#### **Impact**

- Changes in fair values of equity securities for which IFRS requires recognition of the change and U.S. GAAP requires the securities to be held at cost, impact net income when the security is classified as trading under IFRS and impact shareholders' equity when the security is classified as available-for-sale under IFRS.

## *Fair value option*

### IFRS

- Under IAS 39, a financial instrument, other than one held for trading, is classified in this category if it meets the criteria set out below, and is so designated by management. An entity may designate financial instruments at fair value where the designation:
  - eliminates or significantly reduces a measurement or recognition inconsistency that would otherwise arise from measuring financial assets or financial liabilities or recognizing the gains and losses on them on different bases; or
  - applies to a group of financial assets, financial liabilities or both that is managed and its performance evaluated on a fair value basis, in accordance with a documented risk management or investment strategy, and where information about that group of financial instruments is provided internally on that basis to management; or
  - relates to financial instruments containing one or more embedded derivatives that significantly modify the cash flows resulting from those financial instruments.
- Financial assets and financial liabilities so designated are recognized initially at fair value, with transaction costs taken directly to the income statement, and are subsequently remeasured at fair value. This designation, once made, is irrevocable in respect of the financial instruments to which it is made. Financial assets and financial liabilities are recognized using trade date accounting.
- Gains and losses from changes in the fair value of such assets and liabilities are recognized in the income statement as they arise, together with related interest income and expense and dividends.

### U.S. GAAP

- Generally, for financial assets to be measured at fair value with gains and losses recognized immediately in the income statement, they must meet the definition of trading securities in SFAS 115, Accounting for Certain Investments in Debt and Equity Securities. Financial liabilities are generally reported at amortized cost under U.S. GAAP.
- Since January 1, 2006, HUSI has accounted for hybrid financial instruments under the provisions of SFAS 155, Accounting for Certain Hybrid Financial Instruments. Hybrid financial instruments that contain an embedded derivative that would otherwise require bifurcation are, where designated through an irrevocable election, initially and subsequently measured at fair value, with changes in fair value recognized through net income.

### Impact

- HUSI has principally used the fair value designation for certain fixed rate long-term debt issues whose interest rate characteristic has been changed to floating through interest rate swaps as part of a documented interest rate management strategy. Approximately \$2 billion of HUSI's debt issues have been accounted for using the option. The movement in fair value of these debt issues includes the effect of changes in the credit spread and any ineffectiveness in the economic relationship between the related swaps and this debt. Such ineffectiveness arises from the different credit characteristics of the swap and the debt coupled with the sensitivity of the floating leg of the swap to changes in short-term interest rates. In addition, the economic relationship between the swap and the debt can be affected by relative movements in market factors, such as bond and swap rates, and the relative bond and swap rates at inception. The size and direction of the accounting consequences of changes in credit spread and ineffectiveness can be volatile from period to period, but do not alter the cash flows anticipated as part of the documented interest rate management strategy.
- Under U.S. GAAP, debt issues are generally reported at amortized cost. There are circumstances, by virtue of different technical requirements and the transition arrangements to IFRS, where derivatives providing an economic hedge for an asset or liability, and so designated under IFRS, are not so treated under U.S. GAAP, thereby creating a reconciliation difference and asymmetrical accounting between the asset and liability and the offsetting derivative.

### ***Loan origination***

#### IFRS

- Certain loan fee income and incremental directly attributable loan origination costs are amortized to the income statement over the life of the loan as part of the effective interest calculation under IAS 39.

#### U.S. GAAP

- Certain loan fee income and direct loan origination costs, including an apportionment of overheads, are amortized to the income statement over the life of the loan as an adjustment to interest income (SFAS No. 91, “Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases”).

#### Impact

- During the year ended 2007, the net costs amortized against earnings under U.S. GAAP exceeded net costs amortized under IFRS.

### ***Loan impairment***

#### IFRS

- When statistical models, using historic loss rates adjusted for economic conditions, provide evidence of impairment in portfolios of loans, their values are written down to their net recoverable amount. The net recoverable amount is the present value of the estimated future recoveries discounted at the portfolio’s original effective interest rate. The calculations include a reasonable estimate of recoveries on loans individually identified for write-off pursuant to HUSI’s credit guidelines.

#### U.S. GAAP

- When the delinquency status of loans in a portfolio is such that there is no realistic prospect of recovery, the loans are written off in full, or to recoverable value where collateral exists. Delinquency depends on the number of days payment is overdue. The delinquency status is applied consistently across similar loan products in accordance with HUSI’s credit guidelines. When local regulators mandate the delinquency status at which write-off must occur for different retail loan products and these regulations reasonably reflect estimated recoveries on individual loans, this basis of measuring loan impairment is reflected in U.S. GAAP accounting. Cash recoveries relating to pools of such written-off loans, if any, are reported as loan recoveries upon collection.

#### Impact

- Under both IFRS and U.S. GAAP, HUSI’s policy and regulatory instructions mandate that individual loans evidencing adverse credit characteristics which indicate no reasonable likelihood of recovery are written off. When, on a portfolio basis, cash flows can reasonably be estimated in aggregate from these written-off loans, an asset equal to the present value of the future cash flows is recognized under IFRS.
- No asset for future recoveries arising from written-off assets was recognized in the balance sheet under IFRS prior to January 1, 2005.
- The establishment of the recovery asset under IFRS associated with the private label credit card portfolio purchased from HSBC Finance Corporation results in higher earnings under IFRS than under U.S. GAAP in the initial period and higher earnings under U.S. GAAP when subsequent recoveries are made.
- Net interest income is higher under IFRS than under U.S. GAAP due to the imputed interest on the recovery asset.

### ***Purchase accounting/deferred taxes***

#### IFRS

- Deferred tax amounts are recorded in the consolidated balance sheets to recognize differences between the tax bases and the cost of assets and liabilities recorded pursuant to an acquisition. Subsequent changes to the estimates of the tax bases are recorded as an adjustment of current period earnings.

#### U.S. GAAP

- Changes in tax estimates of the basis in assets and liabilities or other tax estimates recorded at the date of acquisition are adjusted against goodwill.

#### Impact

- In 2006, a deferred tax asset related to a previous acquisition was adjusted against the related goodwill account for U.S. GAAP reporting. Under IFRS, this adjustment was charged to earnings.

### ***Stock-based compensation***

#### IFRS

- IFRS 2, Share-Based Payment, requires that when annual bonuses are paid in restricted shares and the employee must remain with HSBC for a fixed period in order to receive the shares, the award is expensed over that period.

#### U.S. GAAP

- For awards made before July 1, 2005, SFAS 123, Accounting for Stock Based Compensation requires that compensation cost be recognized over the period(s) in which the related employee services are rendered. HUSI has interpreted this service period as the period to which the bonus relates.
- For 2005 bonuses, awarded in early 2006, HSBC followed SFAS 123 (revised 2004), Share-Based Payment (SFAS 123R). SFAS 123R is consistent with IFRS 2 in requiring that restricted bonuses are expensed over the period the employee must remain with HSBC. However, SFAS 123R only applies to awards made after the date of adoption, which for HUSI is July 1, 2005.

#### Impact

- Some of the bonuses awarded in respect of 2002, 2003 and 2004 were recognized over the relevant vesting period and were, therefore, expensed in net income under IFRS during 2005. Under U.S. GAAP, these awards were expensed in the years for which they were granted. 2005 bonuses will be expensed over the vesting period under both IFRS and U.S. GAAP. Net income was, therefore, higher under U.S. GAAP in 2005.
- IFRS and U.S. GAAP are now largely aligned and this transition difference has now been eliminated.

## ***Property***

### IFRS

- Under the transition rules of IFRS 1, HSBC has elected to freeze the value of its properties at their January 1, 2004 valuations. These are the “deemed cost” of properties under IFRS. They will not be revalued in the future. Assets held at historical or deemed cost are depreciated except for freehold land.
- Investment properties are recognized at current market values with gains or losses recognized in net income for the period. Investment properties are not depreciated.

### U.S. GAAP

- U.S. GAAP does not permit revaluations of property, including investment property, although it requires recognition of asset impairment. Any realized surplus or deficit is, therefore, reflected in net income on disposal of the property. Depreciation is charged on all properties based on cost.

### Impact

- Under IFRS, the value of property held for own use reflects revaluation surpluses recorded prior to January 1, 2004. Consequently, the values of tangible fixed assets and shareholders’ equity are lower under U.S. GAAP than under IFRS.
- There is a correspondingly lower depreciation charge and higher net income as well as higher gains (or smaller losses) on the disposal of fixed assets under U.S. GAAP.
- For investment properties, net income under U.S. GAAP does not reflect the unrealized gain or loss recorded under IFRS for the period.

## ***Pension costs***

### IFRS

- In accordance with IAS 19 (revised 2006), HSBC has elected to record all actuarial gains and losses on the pension surplus or deficit in the year in which they occur within the ‘Consolidated statement of recognized income and expense’.

### U.S. GAAP

- SFAS 87 does not permit recognition of all actuarial gains and losses in a statement other than the primary income statement. As permitted by U.S. GAAP, HSBC uses the 'corridor method', whereby actuarial gains and losses outside a certain range are recognized in the income statement in equal amounts over the remaining service lives of current employees. That range is 10 per cent of the greater of plan assets and plan liabilities. The remaining additional minimum pension liability and the transition to SFAS 158 are recognized directly in Other comprehensive income (OCI).

### Impact

- Net income under US GAAP is lower than under IFRS as a result of the amortization of the amount by which actuarial losses exceed gains beyond the 10 per cent 'corridor'.

## ***Other***

In 2007, other includes the net impact of certain adjustments which represent a temporary difference between U.S. GAAP and IFRS. These adjustments were not individually material for the years ended 2007, 2006 and 2005.



## ***Critical Accounting Policies***

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HUSI's consolidated financial statements are prepared in accordance with U.S. GAAP. The significant accounting policies used in the preparation of HUSI's consolidated financial statements are more fully described in Note 2 to the accompanying consolidated financial statements beginning on page 103 of this Form 10-K.

Many of HUSI's significant accounting policies require complex judgments to estimate values of assets and liabilities. In making these judgments, management must make certain estimates and assumptions that affect the reported amounts of assets, liabilities, revenues, and expenses. Because changes in such estimates and assumptions could significantly affect HUSI's reported financial position or results of operations, detailed policies and control procedures have been established to ensure that valuation methods, including judgments made as part of such methods, are well controlled, independently reviewed, and applied consistently from period to period.

Of the significant accounting policies used in the preparation of HUSI's consolidated financial statements, the items discussed below require critical accounting estimates involving a high degree of judgment and complexity.

### ***Allowance for Credit Losses***

HUSI lends money to others, resulting in risk that borrowers may not repay amounts owed when they become contractually due. Consequently, an allowance for credit losses is maintained at a level that is considered appropriate to cover estimates of probable losses of principal, interest and fees in the existing portfolio. Allowance estimates are reviewed periodically, and adjustments are reflected through the provision for credit losses in the period when they become known. The accounting estimate relating to the allowance for credit losses is a "critical accounting estimate" for the following reasons:

- changes in such estimates could significantly impact HUSI's credit loss reserves and provision for credit losses;
- estimates related to the reserve for credit losses require consideration of future delinquency and charge off trends, which are uncertain and require a high degree of judgment; and
- the allowance for credit losses is influenced by factors outside of HUSI's control. Customer payment patterns, economic conditions, bankruptcy trends and changes in laws and regulations all have an impact on the estimates.

HUSI's allowance for credit losses is regularly assessed for adequacy through a detailed review of the loan portfolio. The allowance is comprised of two balance sheet components:

- the allowance for credit losses, which is carried as a reduction to loans on the balance sheet, includes reserves for anticipated losses associated with all loans and leases outstanding; and
- the reserve for off-balance sheet risk, which is recorded in other liabilities, includes probable and reasonably estimable losses arising from off-balance sheet arrangements such as letters of credit and undrawn commitments to lend.

Both types of reserves include amounts calculated for specific individual loan balances and for collective loan portfolios depending on the nature of the exposure and the manner in which risks inherent in that exposure are managed.

- All commercial loans that exceed five hundred thousand dollars are evaluated individually for impairment. When a loan is found to be "impaired", a specific reserve is calculated. Reserves against impaired loans are determined primarily by an analysis of discounted expected cash flows expected by HUSI with reference to independent valuations of underlying loan collateral and also considering secondary market prices for distressed debt where appropriate.
- Loans which are not individually evaluated for impairment are pooled into homogeneous categories of loans and evaluated to determine if it is deemed probable, based on historical data, that a loss has been realized even though it has not yet been manifested in a specific loan.

For consumer receivables and certain small business revolving loans, HUSI uses a roll rate methodology (statistical analysis of historical trends used to estimate the probability of continued delinquency, ultimate charge off, and amount of consequential loss assessed at each time period for which payments are overdue) to support the estimation of inherent losses. The results of these models are reviewed by management in conjunction with changes in risk selection, changes in underwriting policies, national and local economic trends, trends in bankruptcy, loss severity and recoveries, and months of loss coverage. The resulting loss coverage ratio varies by portfolio based on inherent risk and, where applicable, regulatory guidance. Roll rates are regularly updated and benchmarked against actual outcomes to ensure that they remain appropriate.

An advanced credit risk methodology is utilized to support the estimation of losses inherent in pools of homogeneous commercial loans, leases and off-balance sheet risk. This methodology uses the probability of default from the customer rating assigned to each counterparty, the "Loss Given Default" rating assigned to each transaction or facility based on the collateral securing the transaction, and the measure of exposure based on the transaction. A suite of models, tools and templates is maintained using quantitative and statistical techniques, which are combined with expert judgment to support the assessment of each transaction. These were developed using internal data and supplemented with data from external sources which was judged to be consistent with HUSI's internal credit standards. These advanced measures are applied to the homogeneous credit pools to estimate the reserves required.

The results from the advanced commercial analysis, consumer roll rate analysis and the specific/impairment reserving process are reviewed each quarter by a Credit Reserve Committee co-chaired by the Chief Financial Officer and Chief Credit Officer. This committee also considers other observable factors, both internal to HUSI and external in the general economy, to ensure that the estimates provided by the various models adequately include all known information at each reporting period. The Credit Reserve Committee may add to or reduce a general unallocated allowance to account for any observable factor not considered in the various models, for small portfolios or period ending manual entries not considered in a model and to recognize modeling imperfections. The credit reserves and the results of the Credit Reserve Committee are reviewed with HUSI's Credit Risk Management Committee and the Board of Directors' Audit Committee each quarter.

HUSI recognizes however, that there is a high degree of subjectivity and imprecision inherent in the process of estimating losses utilizing historical data. Accordingly, a discretionary component of the allowance for credit losses for unspecified potential losses inherent in the loan portfolios is provided based upon an evaluation of certain portfolio risk factors which, for consumer loans, may not be reflected in the statistical roll rate analysis. Critical factors include the impact of the national economic cycle, migration of loans within non-criticized loan portfolios, and loan portfolio concentration.

Additional credit quality related analysis begins on page 59 of this Form 10-K. HUSI's approach toward credit risk management begins on page 77 of this Form 10-K.

## ***Goodwill Impairment***

Goodwill is not subject to amortization but is tested for possible impairment at least annually or more frequently if events or changes in circumstances indicate that the asset might be impaired. Impairment testing requires that the fair value of each reporting unit be compared to its carrying amount, including the goodwill. Significant and long-term changes in industry and economic conditions are considered to be primary indicators of potential impairment.

Impairment testing of goodwill is a “critical accounting estimate” due to the significant judgment required in the use of discounted cash flow models to determine fair value. Discounted cash flow models include such variables as revenue growth rates, expense trends, interest rates and terminal values. Based on an evaluation of key data and market factors, management’s judgment is required to select the specific variables to be incorporated into the models. Additionally, the estimated fair value can be significantly impacted by the cost of capital used to discount future cash flows. The cost of capital percentage is generally derived from an appropriate capital asset pricing model, which itself depends on a number of financial and economic variables which are established on the basis of management’s judgment. When management’s judgment is that the anticipated cash flows have decreased and/or the cost of capital has increased, the effect will be a lower estimate of fair value. If the fair value is determined to be lower than the carrying value, an impairment charge will be recorded and net income will be negatively impacted.

Reporting units were identified based upon an analysis of each of HUSI’s individual operating segments. A reporting unit is defined as any distinct, separately identifiable component of an operating segment for which complete, discrete financial information is available that management regularly reviews. Goodwill was allocated to the carrying value of each reporting unit based on its relative fair value. Refer to Note 24 beginning on page 147 of this Form 10-K for an allocation of recorded book value of goodwill by segment.

HUSI has established July 1 of each year as the date for conducting its annual goodwill impairment assessment. At July 1, 2007, there were no individual reporting units with a fair value less than carrying value, including goodwill. The fair value calculations were also tested for sensitivity to reflect reasonable variations, including stress testing of certain attributes such as cost saves, terminal values and the discount rate. Results of these tests were taken into consideration by management during the review of the annual goodwill impairment test.

As a result of a difficult business climate and the market volatility which occurred during the second half of 2007, HUSI performed an interim goodwill test in the Global Banking and Markets business segment, formerly Corporate, Investment Banking and Markets (CIBM), as of December 31, 2007. The results of this test showed the fair value of this business unit exceeded the carrying value including goodwill that was assigned. Based on these results, HUSI determined goodwill was not impaired in this business segment at December 31, 2007.

## ***Fair Value of Financial Instruments and MSRs***

A substantial portion of HUSI’s assets and liabilities are carried at fair value. These include trading assets and liabilities, including derivatives and commodities held for trading, derivatives used for hedging, securities available for sale, and mortgage servicing rights (MSRs). Loans held for sale, which are carried at the lower of amortized cost or fair value, are also reported at fair value when their amortized cost exceeds their current fair value.

Fair value is defined as the amount at which an asset or liability could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale. The fair value of a significant majority of HUSI’s assets and liabilities that are reported at fair value is based on quoted market prices or on internally developed valuation models that utilize observable market parameters, including interest rate yield curves, volatilities, option adjusted spreads, and currency rates.

For certain assets and liabilities, however, quoted market prices and observable market parameters are not available. For these items, fair value is estimated using internally-developed valuation models that require the use of significant management judgment to estimate certain required valuation parameters. The following is a description of the significant estimates used in the valuation of assets and liabilities for which quoted market prices and observable market parameters are not available.

**Derivatives** — Fair value estimates for the majority of HUSI's derivative instruments are based on quoted market prices or on internally developed models that utilize independently sourced market parameters, including interest rate yield curves, option volatilities, and currency rates. Where such market data is not available, derivative instruments are valued using discounted cash flow modeling techniques that require the company to estimate the amount and timing of future cash flows. These estimates are susceptible to significant change in future periods as market conditions change.

The company may adjust certain values derived using the methods described above in order to ensure that those values represent appropriate estimates of fair value. These adjustments, which are applied consistently over time, are generally required to reflect factors, such as liquidity and concentration concerns and counterparty credit risk, that can affect prices in arms-length transactions with unrelated third parties. Finally, other factors such as model assumptions, market dislocations and unexpected correlations can affect estimates of fair value. Imprecision in estimating these factors can impact the amount of revenue or loss recorded for a particular position.

Derivatives designated as qualified hedges are tested for effectiveness. For these transactions, assessments are made at the inception of the hedge and on a recurring basis, whether the derivative used in the hedging transaction has been and is expected to continue to be highly effective in offsetting changes in fair values or cash flows of the hedged item. This assessment is conducted using statistical regression analysis.

If it is determined as a result of this assessment that a derivative is not expected to be a highly effective hedge or that it has ceased to be a highly effective hedge, hedge accounting is discontinued as of the quarter in which such determination was made. The assessment of the effectiveness of the derivatives used in hedging transactions is considered to be a "critical accounting estimate" due to the use of statistical regression analysis in making this determination. Similar to discounted cash flow modeling techniques, statistical regression analysis also requires the use of estimates regarding the amount and timing of future cash flows, which are susceptible to significant changes in future periods based on changes in market rates. Statistical regression analysis also involves the use of additional assumptions including the determination of the period over which the analysis should occur as well as selecting a convention for the treatment of credit spreads in the analysis.

The outcome of the statistical regression analysis serves as the foundation for determining whether or not the derivative is highly effective as a hedging instrument. This can result in earnings volatility as the mark to market on derivatives which do not qualify as effective hedges and the ineffectiveness associated with qualifying hedges are recorded in current period earnings.

**Loans held for sale** — Loans held for sale are carried at the lower of amortized cost or fair value. Accordingly, fair value for such loans must be estimated to determine any required write down to fair value when the amortized cost of the loans exceeds their current fair value. Loans held for sale include residential mortgage loans and commercial loans that have been originated by HUSI or purchased from third parties. Where quoted market prices and observable market parameters are not available, the fair value of loans held for sale is based on contractual cash flows adjusted for management's estimates of prepayments, defaults, and recoveries, discounted at management's estimate of the rate that would be required by investors in the current market given the specific loan characteristics and inherent credit risk.

Loans held for sale include certain mortgage loans, primarily subprime residential mortgage loans purchased from third parties, held for sale to an HSBC affiliate that subsequently securitizes them. Historically, the fair value of these loans has been estimated using parameters derived from the current pricing of securities backed by loans with similar characteristics. During 2007, however, the markets for securities backed by residential mortgages, and sub-prime residential mortgages in particular, became very illiquid. As a result, management judgment has been required to estimate a number of parameters that are no longer observable in the marketplace, including rates for prepayments, defaults, recoveries and discount rates that would be required by investors under current market conditions given the specific loan characteristics and perceived credit risk. The valuation of these loans reflects significant write downs from their amortized cost as a result of management's views regarding these valuation parameters.

Loans held for sale also includes certain leveraged lending loans. Where available, quoted market prices are used to estimate the fair value of these loans. Where market quotes are not available, fair value is estimated using observable market prices of similar instruments, including bonds, credit derivatives, and loans with similar characteristics. During 2007, the commercial credit markets experienced a contraction that resulted in a significant decrease in the availability of observable market data for leveraged loans and similar instruments. As a result, the level of management judgment required to estimate fair value for these loans has increased. The lack of liquidity in the commercial credit markets has resulted in significant decreases in the valuation of these loans from their funded amounts, which reflects the impact of the view management takes with regard to various valuation assumptions in light of current market conditions.

***Mortgage servicing rights*** — HUSI recognizes the right to service mortgage loans as a separate and distinct asset at the time the loans are sold. Upon adoption of Statement of Financial Accounting Standards No. 156, Accounting for Servicing of Financial Assets, (SFAS 156) on January 1, 2006, HUSI elected to measure its existing MSRs at fair value. As a result, MSRs are initially measured at fair value at the time that the related loans are sold and periodically re-measured using the fair value measurement method. This method requires that MSRs be measured at fair value at each reporting date with changes in fair value reflected in income in the period that the changes occur.

MSRs are subject to interest rate risk, in that their fair value will fluctuate as a result of changes in the interest rate environment. Fair value is determined based upon the application of valuation models and other inputs. The valuation models incorporate assumptions market participants would use in estimating future cash flows. These assumptions include expected prepayments, default rates and market based option adjusted spreads. The estimate of fair value is considered to be a "critical accounting estimate" because the assumptions used in the valuation models involve a high degree of subjectivity that is dependent upon future interest rate movements. The reasonableness of these pricing models is periodically validated by reference to external independent broker valuations and industry surveys.

Because the fair value of certain assets and liabilities are significantly impacted by the use of estimates, the use of different estimates can result in changes in the estimated fair value of those assets and liabilities, which can result in equity and earnings volatility as follows:

- changes in the fair value of trading assets and liabilities are recorded in current period earnings;
- changes in the fair value of securities available for sale are recorded in other comprehensive income;
- changes in the fair value of loans held for sale below their amortized cost are recorded in current period earnings;
- changes in the fair value of a derivative that has been designated and qualifies as a fair value hedge, along with the changes in the fair value of the hedged asset or liability (including losses or gains on firm commitments), are recorded in current period earnings;
- changes in the fair value of a derivative that has been designated and qualifies as a cash flow hedge are recorded in other comprehensive income to the extent of its effectiveness, until earnings are impacted by the variability of cash flows from the hedged item; and
- changes in the fair value of MSRs are reported in current period earnings.

## Balance Sheet Review

### Overview

HUSI utilizes deposits and borrowings from various sources to provide additional liquidity, to fund balance sheet growth, to meet cash and capital needs, and to fund investments in subsidiaries. During 2007, balance sheet growth was driven by HUSI's deposit growth strategy. Funds generated from new deposits were generally invested in short-term liquid assets. Balance sheet growth and funding sources are summarized in the following table.

|                                  | December 31,<br>2007 | Increase (Decrease) from |           |                   |           |
|----------------------------------|----------------------|--------------------------|-----------|-------------------|-----------|
|                                  |                      | December 31, 2006        |           | December 31, 2005 |           |
|                                  |                      | Amount                   | %         | Amount            | %         |
| <b>(\$ in millions)</b>          |                      |                          |           |                   |           |
| Period end assets:               |                      |                          |           |                   |           |
| Short-term investments (1) ..... | \$ 22,862            | \$ 3,807                 | 20        | \$ 11,602         | 103       |
| Loans, net .....                 | 93,535               | 4,195                    | 5         | 4,039             | 5         |
| Trading assets .....             | 37,036               | 13,406                   | 57        | 17,340            | 88        |
| Securities.....                  | 22,853               | 98                       | -         | 1,918             | 9         |
| Other assets .....               | 12,087               | 2,050                    | 20        | 1,890             | 19        |
|                                  | <u>\$ 188,373</u>    | <u>\$ 23,556</u>         | <u>14</u> | <u>\$ 36,789</u>  | <u>24</u> |
| Funding sources:                 |                      |                          |           |                   |           |
| Total deposits .....             | \$ 116,228           | \$ 14,082                | 14        | \$ 25,936         | 29        |
| Trading liabilities .....        | 16,253               | 3,939                    | 32        | 6,294             | 63        |
| Short-term borrowings .....      | 11,832               | 6,759                    | 133       | 5,465             | 86        |
| All other liabilities .....      | 4,555                | 784                      | 21        | 778               | 21        |
| Long-term debt .....             | 28,268               | (984)                    | (3)       | (1,327)           | (4)       |
| Shareholders' equity .....       | 11,237               | (1,024)                  | (8)       | (357)             | (3)       |
|                                  | <u>\$ 188,373</u>    | <u>\$ 23,556</u>         | <u>14</u> | <u>\$ 36,789</u>  | <u>24</u> |

(1) Includes cash and due from banks, interest bearing deposits with banks and Federal funds sold and securities purchased under resale agreements.

### Short-Term Investments

Short-term investments include cash and due from banks, interest bearing deposits with banks, Federal funds sold and securities purchased under resale agreements. The funds raised from HUSI's deposit growth strategy during 2007 and 2006 were primarily invested in short-term liquid assets (refer to page 9 of this Form 10-K).

## Loans, Net

Loan balances, which include loans held for sale, at December 31, 2007 and movements in comparison with prior years are summarized in the following table.

|                                   | December 31,<br>2007 | Increase (Decrease) from |           |                   |           |
|-----------------------------------|----------------------|--------------------------|-----------|-------------------|-----------|
|                                   |                      | December 31, 2006        |           | December 31, 2005 |           |
|                                   |                      | Amount                   | %         | Amount            | %         |
| <b>(\$ in millions)</b>           |                      |                          |           |                   |           |
| Total commercial loans .....      | \$ <u>37,923</u>     | \$ <u>8,441</u>          | <u>29</u> | \$ <u>10,205</u>  | <u>37</u> |
| Consumer loans:                   |                      |                          |           |                   |           |
| Residential mortgages .....       | <u>35,380</u>        | (4,428)                  | (11)      | (8,606)           | (20)      |
| Credit card receivables:          |                      |                          |           |                   |           |
| Private label .....               | <u>17,427</u>        | 454                      | 3         | 3,072             | 21        |
| MasterCard/Visa .....             | <u>1,988</u>         | 701                      | 54        | 829               | 72        |
| Other consumer .....              | <u>2,231</u>         | (456)                    | (17)      | (893)             | (29)      |
| Total consumer loans .....        | <u>57,026</u>        | (3,729)                  | (6)       | (5,598)           | (9)       |
| Total loans .....                 | <u>94,949</u>        | 4,712                    | 5         | 4,607             | 5         |
| Allowance for credit losses ..... | <u>1,414</u>         | 517                      | 58        | 568               | 67        |
| Loans, net .....                  | \$ <u>93,535</u>     | \$ <u>4,195</u>          | <u>5</u>  | \$ <u>4,039</u>   | <u>5</u>  |

Increased commercial loan balances in 2007 and 2006 were partly due to expansion of middle market activities and, in 2007, were also due to an increase in the draw-downs of previously unfunded commitments. Additionally, HUSI originates commercial loans in connection with its participation in a number of leveraged acquisition finance syndicates. A majority of these loans are originated with the intent of selling them to third parties.

Beginning in 2005, as a result of balance sheet initiatives to reduce prepayment risk and improve HBUS's structural liquidity, HUSI decided to sell a majority of its residential loan originations through the secondary markets and allow the existing loan portfolio to run off, resulting in reductions in loan balances throughout 2007 and 2006.

The addition of new merchant and customer relationships to the private label and MasterCard/Visa credit card portfolios, higher average receivable balances, and decreased balance requirements of off-balance sheet securitized receivable trusts (refer to page 124 of this Form 10-K) have resulted in higher on-balance sheet credit card receivable balances for 2007 and 2006.

### *Commercial Loan Maturities and Sensitivity to Changes in Interest Rates*

The contractual maturity and interest sensitivity of total commercial loans at December 31, 2007 is summarized in the following table.

| December 31, 2007<br>(in millions)         | One<br>Year<br>or Less | Over One<br>Through<br>Five Years | Over<br>Five<br>Years | Total<br>Loans   |
|--|------------------------|-----------------------------------|-----------------------|------------------|
| Commercial:                                |                        |                                   |                       |                  |
| Construction and other real estate .....   | \$ <u>4,002</u>        | \$ <u>3,533</u>                   | \$ <u>919</u>         | \$ <u>8,454</u>  |
| Other commercial.....                      | <u>17,412</u>          | <u>8,474</u>                      | <u>3,583</u>          | <u>29,469</u>    |
| Total .....                                | \$ <u>21,414</u>       | \$ <u>12,007</u>                  | \$ <u>4,502</u>       | \$ <u>37,923</u> |
| Loans with fixed interest rates.....       | \$ <u>7,787</u>        | \$ <u>2,037</u>                   | \$ <u>791</u>         | \$ <u>10,615</u> |
| Loans having variable interest rates ..... | <u>13,627</u>          | <u>9,970</u>                      | <u>3,711</u>          | <u>27,308</u>    |
| Total .....                                | \$ <u>21,414</u>       | \$ <u>12,007</u>                  | \$ <u>4,502</u>       | \$ <u>37,923</u> |

## Trading Assets and Liabilities

Trading assets and liabilities balances at December 31, 2007, and movements in comparison with prior years, are summarized in the following table.

|  | December 31,<br>2007 | Increase (Decrease) from |           |                   |           |
|--|----------------------|--------------------------|-----------|-------------------|-----------|
|  |                      | December 31, 2006        |           | December 31, 2005 |           |
|  |                      | Amount                   | %         | Amount            | %         |
| <b>(\$ in millions)</b>                  |                      |                          |           |                   |           |
| Trading assets:                          |                      |                          |           |                   |           |
| Securities (1) .....                     | \$ 13,537            | \$ 1,613                 | 14        | \$ 2,758          | 26        |
| Precious metals .....                    | 8,788                | 6,072                    | 224       | 6,502             | 284       |
| Derivatives .....                        | 14,711               | 5,721                    | 64        | 8,080             | 122       |
|  | <u>\$ 37,036</u>     | <u>\$ 13,406</u>         | <u>57</u> | <u>\$ 17,340</u>  | <u>88</u> |
| Trading liabilities:                     |                      |                          |           |                   |           |
| Securities sold, not yet purchased ..... | \$ 1,444             | \$ (470)                 | (25)      | \$ (364)          | (20)      |
| Payables for precious metals .....       | 1,523                | 187                      | 14        | 362               | 31        |
| Derivatives .....                        | 13,286               | 4,222                    | 47        | 6,296             | 90        |
|  | <u>\$ 16,253</u>     | <u>\$ 3,939</u>          | <u>32</u> | <u>\$ 6,294</u>   | <u>63</u> |

(1) Includes U.S. Treasury, U.S. Government agency, U.S. Government sponsored enterprises, asset-backed, corporate bonds and other securities.

Increase in securities balances in 2007 and 2006 was attributable to higher volumes of activity in the Global Banking and Markets business segment. Also contributing to the increase in 2007 were purchases of emerging market securities as part of the continued development of our emerging-market franchise.

Higher precious metals balances were due to higher levels of trading activity, and to generally higher market prices for various metals, specifically gold and platinum.

Higher derivative balances resulted from increased fair values on various derivative products including credit default swaps, foreign currency forward contracts and equity swaps as a result of increasing credit spreads, increased trading volumes and volatility of foreign exchange rates and equity prices during 2007.

## Deposits

The following table summarizes balances for major depositor categories.

| December 31   | 2007              | 2006              | 2005             | 2004             | 2003             |
|---|-------------------|-------------------|------------------|------------------|------------------|
| <b>(in millions)</b>  |                   |                   |                  |                  |                  |
| Individuals .....   | \$ 47,751         | \$ 43,266         | \$ 33,394        | \$ 30,882        | \$ 30,691        |
| Partnerships and corporations .....                         | 43,718            | 39,538            | 42,503           | 34,430           | 23,268           |
| Domestic and foreign banks .....                            | 19,748            | 16,243            | 11,889           | 12,759           | 7,580            |
| U.S. Government and states and political subdivisions ..... | 2,461             | 1,927             | 1,566            | 1,493            | 1,464            |
| Foreign governments and official institutions .....         | 2,550             | 1,172             | 940              | 417              | 952              |
| Total deposits .....  | <u>\$ 116,228</u> | <u>\$ 102,146</u> | <u>\$ 90,292</u> | <u>\$ 79,981</u> | <u>\$ 63,955</u> |
| Total core deposits (1) .....                               | <u>\$ 65,079</u>  | <u>\$ 57,518</u>  | <u>\$ 44,882</u> | <u>\$ 39,291</u> | <u>\$ 37,840</u> |

(1) HUSI monitors "core deposits" as a key measure for assessing results of its core banking network. Core deposits generally include all domestic demand, money market and other savings accounts, as well as time deposits with balances not exceeding \$100,000.

Deposits were the primary source of funding for balance sheet growth during 2007 and 2006. Total deposits increased 14% and 13% in 2007 and 2006, respectively. For additional commentary regarding deposit growth and strategy, refer to page 9 of this Form 10-K.



### ***Short-Term Borrowings***

Higher short-term borrowings for 2007 was a result of an increase in federal funds purchased and an increase in precious metals borrowings in response to favorable precious metals market conditions in comparison with the years ended 2006 and 2005.

### ***Long-Term Debt***

Incremental borrowings from the \$40 billion Global Bank Note Program were \$1.4 billion and \$1.6 billion for 2007 and 2006, respectively. Total borrowings outstanding under this program were \$10 billion at December 31, 2007. Additional information regarding this program and other long-term debt is presented in Note 15 of the consolidated financial statements, beginning on page 128 of this Form 10-K.

HUSI had borrowings from the Federal Home Loan Bank (FHLB) of \$5.5 billion and \$5.0 billion at December 31, 2007 and 2006, respectively, and had access to a potential secured borrowing facility as a member of the FHLB.

Beginning in 2005, HUSI entered into a series of transactions with Variable Interest Entities (VIEs) organized by HSBC affiliates and unrelated third parties. HUSI has determined that it is the primary beneficiary of these VIEs under the applicable accounting literature and, accordingly, consolidated the assets and debt of the VIEs. Debt obligations of the VIEs totaling \$2.5 billion were recorded in long-term debt at December 31, 2007 and 2006. Refer to Note 27 of the consolidated financial statements, beginning on page 155 of this Form 10-K, for additional information regarding HUSI's VIE arrangements.

### ***Preferred Stock***

In November 2007, HUSI redeemed all issued shares of Dutch Auction Rate Transferable Securities™ Preferred Stock (DARTS), Series A and B at their stated value of \$100,000 per share, resulting in a total cash payment of \$125 million.

In May 2006, HUSI issued 14,950,000 depository shares, each representing one-fortieth of a share of 6.50% Non-Cumulative Preferred Stock, Series H (\$1,000 stated value). Total issue proceeds, net of \$9 million of underwriting fees and other expenses, were \$365 million. When and if declared by HUSI's Board of Directors, dividends of 6.50% per annum on the stated value per share will be payable quarterly on the first calendar day of January, April, July and October of each year.

Refer to Note 18 of the consolidated financial statements, beginning on page 135 of this Form 10-K, for information regarding all outstanding preferred share issues.

## Capital Resources

A summary of changes in common shareholder's equity is presented in the following table.

|  | 2007            | 2006             | 2005             |
|--|-----------------|------------------|------------------|
| <b>(in millions)</b>                           |                 |                  |                  |
| Balance, January 1 .....                       | \$ 10,571       | \$ 10,278        | \$ 10,366        |
| Increase (decrease) due to:                    |                 |                  |                  |
| Net income .....                               | 138             | 1,036            | 976              |
| Dividends paid to common shareholder .....     | (800)           | (455)            | (675)            |
| Dividends paid to preferred shareholders ..... | (98)            | (88)             | (46)             |
| Change in other comprehensive income .....     | (138)           | (202)            | (43)             |
| Capital contributions from parent (1) .....    | 4               | 15               | 3                |
| Reductions of capital surplus .....            | (5)             | (9)              | (303)            |
| Other .....                                    | -               | (4)              | -                |
| Total net increase (decrease) .....            | <u>(899)</u>    | <u>293</u>       | <u>(88)</u>      |
| Balance, December 31 .....                     | <u>\$ 9,672</u> | <u>\$ 10,571</u> | <u>\$ 10,278</u> |

- (1) Capital contributions from parent include amounts related to an HSBC stock option plan in which almost all of HUSI's employees are eligible to participate.

HUSI maintains rolling 12 month capital forecasts on a consolidated basis, and for its banking subsidiaries. Target capital ratios approved by the board of directors are set above levels established by regulators as "well capitalized", and are partly based on a review of peer banks. Dividends are generally paid by HUSI to its parent company, HSBC North America, Inc. (HNAI), when available capital exceeds target levels.

Effective January 1, 2005, the separate U.S. defined benefit pension plans were merged into a single defined benefit pension plan which facilitates the development of a unified employee benefit policy and unified employee benefit plan administration for HSBC affiliates operating in the U.S. As a result, HUSI's prepaid pension asset of \$482 million and a related deferred tax liability of \$203 million were transferred to HNAH. The net transfer amount of \$279 million was recorded as a reduction of capital surplus.

HUSI and HBUS are required to meet minimum capital requirements by their principal regulators. Risk-based capital amounts and ratios are presented in Note 19 of the consolidated financial statements, beginning on page 137 of this Form 10-K.

## Results of Operations

### Net Interest Income

Net interest income is the total interest income on earning assets less the total interest expense on deposits and borrowed funds. In the discussion that follows, interest income and rates are presented and analyzed on a taxable equivalent basis to permit comparisons of yields on tax-exempt and taxable assets. An analysis of consolidated average balances and interest rates on a taxable equivalent basis is presented on pages 94-95 of this Form 10-K.

The following table presents changes in the components of net interest income according to “volume” and “rate”.

| Year Ended December 31<br>(in millions)                                      | 2007 Compared to 2006<br>Increase (Decrease) |        |        | 2006 Compared to 2005<br>Increase (Decrease) |        |          | 2005     |
|--|--|--------|--------|--|--------|----------|----------|
|  | 2007   | Volume | Rate   | 2006   | Volume | Rate     |          |
| Interest income:   |  |        |        |  |        |          |          |
| Interest bearing deposits with banks .....                                   | \$ 309                                       | \$ 91  | \$ (7) | \$ 225                                       | \$ 13  | \$ 92    | \$ 120   |
| Federal funds sold and securities<br>purchased under resale agreements ..... | 610  | 70     | 14     | 526  | 220    | 116      | 190      |
| Trading assets .....   | 633  | 20     | 195    | 418  | 140    | 3        | 275      |
| Securities .....   | 1,221  | 51     | 25     | 1,145  | 158    | 88       | 899      |
| Loans:   |  |        |        |  |        |          |          |
| Commercial .....   | 2,017  | 213    | 40     | 1,764  | 217    | 314      | 1,233    |
| Consumer:  |  |        |        |  |        |          |          |
| Residential mortgages .....  | 2,042  | (223)  | 54     | 2,211  | (271)  | 161      | 2,321    |
| Credit cards .....   | 1,764  | 170    | 265    | 1,329  | 172    | 345      | 812      |
| Other consumer .....   | 249  | (47)   | 28     | 268  | (17)   | 21       | 264      |
| Total consumer .....   | 4,055  | (100)  | 347    | 3,808  | (116)  | 527      | 3,397    |
| Other interest .....   | 221  | 134    | (4)    | 91   | 53     | 6        | 32       |
| Total interest income .....  | 9,066  | 479    | 610    | 7,977  | 685    | 1,146    | 6,146    |
| Interest expense:  |  |        |        |  |        |          |          |
| Deposits in domestic offices:  |  |        |        |  |        |          |          |
| Savings deposits .....   | 1,376  | 253    | 142    | 981  | 150    | 513      | 318      |
| Other time deposits .....  | 1,267  | (74)   | 189    | 1,152  | (57)   | 387      | 822      |
| Deposits in foreign offices:   |  |        |        |  |        |          |          |
| Foreign banks deposits .....   | 454  | 86     | (24)   | 392  | (13)   | 150      | 255      |
| Other time and savings .....   | 743  | 60     | 95     | 588  | (1)    | 213      | 376      |
| Short-term borrowings .....  | 357  | (9)    | 66     | 300  | (19)   | 49       | 270      |
| Long-term debt .....   | 1,443  | (43)   | 29     | 1,457  | 187    | 245      | 1,025    |
| Total interest expense .....   | 5,640  | 273    | 497    | 4,870  | 247    | 1,557    | 3,066    |
| Net interest income -<br>taxable equivalent basis .....                      | 3,426  | \$ 206 | \$ 113 | 3,107  | \$ 438 | \$ (411) | 3,080    |
| Tax equivalent adjustment .....  | 28   |        |        | 26   |        |          | 17       |
| Net interest income -<br>non taxable equivalent basis .....                  | \$ 3,398                                     |        |        | \$ 3,081                                     |        |          | \$ 3,063 |

Significant components of HUSI's net interest margin are summarized in the following table.

| Year Ended December 31                                  | 2007   | 2006   | 2005   |
|---|--------|--------|--------|
| Yield on total earning assets .....                     | 6.24 % | 5.79 % | 4.96 % |
| Rate paid on interest bearing liabilities .....         | 4.35   | 4.03   | 2.78   |
| Interest rate spread .....                              | 1.89   | 1.76   | 2.18   |
| Benefit from net non-interest or paying funds .....     | .47    | .50    | .31    |
| Net interest margin on average earning assets (1) ..... | 2.36 % | 2.26 % | 2.49 % |

(1) Selected financial ratios are defined in the Glossary of Terms beginning on page 91 of this Form 10-K.

Significant trends affecting net interest income and interest rate spreads are summarized in the following table. Net interest income in the table is presented on a taxable equivalent basis (refer to pages 94-95 of this Form 10-K).

| Year Ended December 31  | 2007            |                      | 2006            |                      | 2005            |                      |
|---|-----------------|----------------------|-----------------|----------------------|-----------------|----------------------|
|   | Amount          | Interest Rate Spread | Amount          | Interest Rate Spread | Amount          | Interest Rate Spread |
| <b>(\$ in millions)</b>   |                 |                      |                 |                      |                 |                      |
| Net interest income/interest rate spread from prior year .....  | \$ 3,107        | <u>1.76</u> %        | \$ 3,080        | <u>2.18</u> %        | \$ 2,758        | <u>2.81</u> %        |
| Increase (decrease) in net interest income associated with:     |                 |                      |                 |                      |                 |                      |
| Trading related activities (1) .....                            | 20              |                      | (71)            |                      | (61)            |                      |
| Balance sheet management activities (2) .....                   | (21)            |                      | (269)           |                      | (156)           |                      |
| Private label receivable portfolio (3) .....                    | 298             |                      | 210             |                      | 435             |                      |
| Other activity .....  | <u>22</u>       |                      | <u>157</u>      |                      | <u>104</u>      |                      |
| Net interest income/interest rate spread for current year ..... | \$ <u>3,426</u> | <u>1.89</u> %        | \$ <u>3,107</u> | <u>1.76</u> %        | \$ <u>3,080</u> | <u>2.18</u> %        |

- (1) Refer to commentary regarding trading revenues, beginning on page 40 of this Form 10-K.
- (2) Represents HUSI's activities to manage interest rate risk associated with the repricing characteristics of balance sheet assets and liabilities. Interest rate risk, and HUSI's approach to manage such risk, are described beginning on page 81 of this Form 10-K.
- (3) Refer to commentary regarding the private label receivable portfolio, beginning on page 52 of this Form 10-K.

### ***Trading Related Activities***

Net interest income for trading related activities increased primarily due to increased trading assets balances.

### ***Balance Sheet Management Activities***

Lower net interest income from balance sheet management activities continued to impact results for 2007. A relatively flat yield curve and elevated short term interest rates have continued to limit opportunities to generate additional net funds income.

### ***Private Label Receivable Portfolio (PLRP)***

Higher net interest income for the PLRP for 2007 resulted from:

- increased credit card receivable balances, due to the addition of new PLRP merchant relationships during 2007 and 2006;
- higher accrued income as a result of a more refined income recognition methodology on private label credit card promotional transactions; and
- lower amortization of premiums paid for purchases of receivables included within the PLRP. Although premiums associated with daily purchases of receivables from HSBC Finance Corporation continue to be recorded and amortized, premium amortization associated with the initial portfolio acquisition in 2004 was \$70 million lower for 2007, as compared to 2006.

### ***Residential Mortgages***

Lower net interest income from residential mortgage activities, included in other activity in the above table, primarily resulted from continued narrowing of interest rate spreads and from contraction of the residential mortgage loan portfolio. As a result of a continuing strategy to reduce prepayment risk and improve HBUS's structural liquidity, HUSI continues to sell a majority of its residential mortgage loan originations and allow the residential mortgage loan portfolio to run off.

### ***Other Core Banking Activity***

Higher net interest income from other core banking activity mostly resulted from business expansion initiatives, which have led to increased deposits and loans.

Personal deposits continued to grow in 2007 as a result of continued success of the Online Savings product and expansion of the branch network. However, customers continued to migrate to higher yielding deposit products such as the Online Savings product, leading to a change in product mix and narrowing of deposit spreads, which partly offset the benefit of higher deposit balances. Refer to page 9 of this Form 10-K for commentary regarding HUSI's deposit strategy and growth.

Significant resources have been dedicated to expansion of various commercial lending businesses and regional offices, which has resulted in increased loan and deposit balances. The average yield earned on commercial loans was also higher in 2007.

### ***Provision for Credit Losses***

The provision for credit losses associated with various loan portfolios is summarized in the following table.

| Year Ended December 31                  | 2007     | 2006   | 2005    | 2007 Compared to 2006 |    | 2006 Compared to 2005 |      |
|---|----------|--------|---------|-----------------------|----|-----------------------|------|
|   |          |        |         | Increase (Decrease)   |    | Increase (Decrease)   |      |
|   | Amount   | Amount | Amount  | Amount                | %  | Amount                | %    |
| <b>(\$ in millions)</b>                 |          |        |         |                       |    |                       |      |
| Commercial .....                        | \$ 205   | \$ 136 | \$ (15) | \$ 69                 | 51 | \$ 151                | *    |
| Consumer:                               |          |        |         |                       |    |                       |      |
| Residential mortgages .....             | 126      | 32     | 37      | 94                    | *  | (5)                   | (14) |
| Credit card receivables .....           | 1,108    | 592    | 560     | 516                   | 87 | 32                    | 6    |
| Other consumer .....                    | 83       | 63     | 92      | 20                    | 32 | (29)                  | (32) |
| Total consumer .....                    | 1,317    | 687    | 689     | 630                   | 92 | (2)                   | *    |
| Total provision for credit losses ..... | \$ 1,522 | \$ 823 | \$ 674  | \$ 699                | 85 | \$ 149                | 22   |

\* Not meaningful.

### ***Overview***

HUSI's methodology and accounting policies related to its allowance for credit losses are presented in Critical Accounting Policies beginning on page 25 and in Note 2 of the consolidated financial statements beginning on page 103 of this Form 10-K.

Additional commentary regarding credit quality begins on page 59 of this Form 10-K.

HUSI's approach toward credit risk management is summarized on pages 77-78 of this Form 10-K.

### ***2007 Compared to 2006***

Increased provision expense reflects a refinement in the methodology used to estimate inherent losses on private label loans less than 30 days delinquent, which increased credit loss reserves by \$107 million in the fourth quarter. In addition, provision expense for 2006 was unusually low due to the impact of bankruptcy legislation enacted in 2005, which resulted in accelerated credit card receivable and other consumer loan charge offs during the fourth quarter of 2005. During the first quarter of 2007, HUSI refined its allowance methodology associated with MasterCard/Visa credit card receivables, resulting in a reduction in the allowance balance and provision expense, which partially offset overall increases in credit card allowances. Refer to additional commentary regarding credit card receivables credit quality on page 65 of this Form 10-K.

Provisions on residential mortgages have increased in 2007, as compared with 2006, due primarily to increased delinquencies and charge offs in the portfolio of higher quality nonconforming residential mortgage loans which HUSI purchased from HSBC Finance Corporation in order to hold in the residential mortgage loan portfolio. Also contributing to this increase are delinquencies within the Home Equity Line of Credit (HELOC) portfolio, which is primarily due to continued deterioration in the housing markets. Other prime mortgage loans are also experiencing minimal deterioration. Refer to additional commentary regarding residential mortgage credit quality beginning on page 65 of this Form 10-K.

Commercial loan provision expense increased \$69 million for 2007, as compared with 2006, primarily due to higher criticized asset balances. Additionally, there was a refinement of the loan loss provision methodology related to the small business line of credit portfolio, which resulted in an increase to provision expense in 2007. During the second quarter of 2006, provision expense of \$29 million was recorded due to a combination of charge offs and increased allowances related to a specific commercial real estate investment loan for which no specific allowance for credit losses was previously recorded. Refer to additional commentary regarding commercial loan credit quality beginning on page 64 of this Form 10-K.

### ***2006 Compared to 2005***

Higher commercial loan provision expense for 2006 resulted from:

- higher allowance requirements associated with higher small business and real estate commercial loan portfolio balances in 2006 and 2005;
- higher charge offs associated with the growing small business portfolio;
- more normalized commercial loan charge off and recovery activity, in comparison with 2005; and
- a combination of charge offs and increased allowance for credit losses related to a specific commercial loan relationship within the PB business segment, which resulted in a \$29 million provision.

Increased provision expense associated with credit card receivables was consistent with growth in private label credit card receivables during 2006.

Lower residential mortgage and other consumer loan balances were the primary driver for lower allowance requirements and lower provisions associated with these portfolios. Credit quality associated with HUSI's residential mortgage loan portfolio remained strong in 2006.

## Other Revenues

Decreased revenue for the year ended December 31, 2007, was mostly driven by reduced liquidity, higher volatility and widening spreads in the credit and sub-prime markets which led to substantial valuation losses being recorded. This was partially offset by increased credit card fees, other fees and commissions, and increased securities gains.

The components of other revenues are summarized in the following table.

| Year Ended December 31<br>(\$ in millions)  | 2007     | 2006     | 2005     | 2007 Compared to<br>2006      |       | 2006 Compared to<br>2005      |      |
|---|----------|----------|----------|-------------------------------|-------|-------------------------------|------|
|   |          |          |          | Increase (Decrease)<br>Amount | %     | Increase (Decrease)<br>Amount | %    |
| Credit card fees .....  | \$ 843   | \$ 580   | \$ 323   | \$ 263                        | 45    | \$ 257                        | 80   |
| Trust income .....  | 101      | 88       | 87       | 13                            | 15    | 1                             | 1    |
| Service charges .....   | 216      | 204      | 195      | 12                            | 6     | 9                             | 5    |
| Other fees and commissions:   |          |          |          |                               |       |                               |      |
| Letter of credit fees .....   | 75       | 74       | 70       | 1                             | 1     | 4                             | 6    |
| Wealth and tax advisory services ....   | 104      | 94       | 60       | 10                            | 11    | 34                            | 57   |
| Other fee-based income, net of<br>referral fees .....                             | 311      | 233      | 174      | 78                            | 33    | 59                            | 34   |
|   | 490      | 401      | 304      | 89                            | 22    | 97                            | 32   |
| Trading revenues .....  | 129      | 755      | 395      | (626)                         | (83)  | 360                           | 91   |
| Securities gains, net .....   | 112      | 29       | 106      | 83                            | *     | (77)                          | (73) |
| HSBC affiliate income:  |          |          |          |                               |       |                               |      |
| Service charges .....   | 11       | 15       | 15       | (4)                           | (27)  | -                             | -    |
| Other fees and commissions .....  | 105      | 51       | 71       | 54                            | 106   | (20)                          | (28) |
| Gain on sale of residential<br>mortgage loans to HMUS .....                       | 18       | 106      | 18       | (88)                          | (83)  | 88                            | *    |
| Gain on sale of refund anticipation<br>loans to HSBC Finance<br>Corporation ..... | 23       | 22       | 19       | 1                             | 5     | 3                             | 16   |
| Other affiliate income .....  | 15       | 14       | 7        | 1                             | 7     | 7                             | 100  |
|   | 172      | 208      | 130      | (36)                          | (17)  | 78                            | 60   |
| Residential mortgage banking<br>revenue .....                                     | 74       | 96       | 64       | (22)                          | (23)  | 32                            | 50   |
| Other (loss) income:  |          |          |          |                               |       |                               |      |
| Valuation of loans held for sale .....  | (512)    | (120)    | (32)     | (392)                         | *     | (88)                          | *    |
| Insurance .....   | 47       | 47       | 48       | -                             | -     | (1)                           | (2)  |
| Gains (loss) on sale of property and<br>other financial assets .....              | 34       | 52       | 67       | (18)                          | (35)  | (15)                          | (22) |
| Earnings from equity investments ...  | 78       | 110      | 43       | (32)                          | (29)  | 67                            | 156  |
| Securitization revenue .....  | -        | 18       | 114      | (18)                          | (100) | (96)                          | (84) |
| Miscellaneous income .....  | 63       | 95       | 67       | (32)                          | (34)  | 28                            | 42   |
|   | (290)    | 202      | 307      | (492)                         | *     | (105)                         | (34) |
| Total other revenues .....  | \$ 1,847 | \$ 2,563 | \$ 1,911 | \$ (716)                      | (28)  | \$ 652                        | 34   |

\* Not meaningful.

### *Credit Card Fees*

Higher credit card fees in 2007 from private label and co-brand credit card portfolio activity were primarily due to the following factors:

- the number of accounts, volume of customer transaction activity and average receivable balances included within the private label portfolio all were higher for 2007, due to the addition of merchant and customer relationships and to expansion of credit card products offered. Product repricing also resulted in higher fees; and
- higher late fees due to increased delinquencies within the private label portfolio.

### *Other Fees and Commissions*

Increased wealth and tax advisory services revenue in 2007 and 2006 primarily resulted from expansion of such services within the PB business segment (refer to page 57 of this Form 10-K).

Higher other fee-based income is partially due to various growth initiatives undertaken in 2007 and 2006, which resulted in general increases in fee income recorded within the PFS, CMB and Global Banking and Markets business segments.

### *Trading Revenues*

Trading revenues are generated by HUSI's participation in the foreign exchange, credit derivative and precious metal markets; from trading derivative contracts, including interest rate swaps and options; from trading securities; and as a result of certain residential mortgage banking activities.

The following table presents trading related revenues by business. The data in the table includes net interest income earned on trading instruments, as well as an allocation of the funding benefit or cost associated with the trading positions. The trading related net interest income component is included in net interest income on the consolidated income statement. Trading revenues related to the mortgage banking business are included in residential mortgage banking revenue.

| Year Ended December 31                | 2007     | 2006   | 2005   | 2007 Compared to 2006 |       | 2006 Compared to 2005 |      |
|---------------------------------------|----------|--------|--------|-----------------------|-------|-----------------------|------|
|                                       |          |        |        | Increase (Decrease)   |       | Increase (Decrease)   |      |
|                                       |          |        |        | Amount                | %     | Amount                | %    |
| <b>(\$ in millions)</b>               |          |        |        |                       |       |                       |      |
| Trading revenues .....                | \$ 129   | \$ 755 | \$ 395 | \$ (626)              | (83)  | \$ 360                | 91   |
| Net interest (loss) income .....      | (36)     | (56)   | 15     | 20                    | (36)  | (71)                  | *    |
| Trading related revenues .....        | \$ 93    | \$ 699 | \$ 410 | \$ (606)              | (87)  | \$ 289                | 70   |
| <b>Business:</b>                      |          |        |        |                       |       |                       |      |
| Derivatives .....                     | \$ (179) | \$ 415 | \$ 202 | \$ (594)              | (143) | \$ 213                | 105  |
| Treasury (primarily securities) ..... | (82)     | 8      | 24     | (90)                  | *     | (16)                  | (67) |
| Foreign exchange and banknotes .....  | 245      | 182    | 133    | 63                    | 35    | 49                    | 37   |
| Precious metals .....                 | 77       | 87     | 42     | (10)                  | (11)  | 45                    | 107  |
| Other trading .....                   | 32       | 7      | 9      | 25                    | *     | (2)                   | (22) |
| Trading related revenues .....        | \$ 93    | \$ 699 | \$ 410 | \$ (606)              | (87)  | \$ 289                | 70   |

\* Not meaningful.



### ***2007 Compared to 2006***

Trading revenue for 2007 was significantly affected by reduced liquidity, widening spreads and higher volatility in the credit and sub-prime lending markets. The market turmoil has caused a significant fall in revenues for 2007, as compared with 2006.

Trading revenues related to derivatives were substantially reduced primarily due to write downs and trading activity on credit derivatives. Most notably, recent downgrades in credit ratings of monoline insurance companies have resulted in fair value adjustments on derivative contracts with these entities due to counterparty credit risk exposures. As of December 31, 2007, this exposure totaled \$1,083 million. HUSI recorded write-downs on contracts with monoline insurance companies of approximately \$287 million in 2007, which reflects the decreased credit quality of these entities and concerns over their ability to perform at December 31, 2007. The exposure relating to monoline insurance companies rated CCC+ and lower was fully reserved for as of December 31, 2007.

Effective during the third quarter of 2006, HUSI maintains a portfolio of MasterCard Class B shares as part of structured product transactions for customers. In addition, HUSI uses derivative instruments to offset changes in the fair value of the MasterCard Class B shares. In 2007, the decrease in value of the derivative instruments totaling \$91 million is reflected in trading revenue.

Trading related revenue also includes the increase or decrease in the value of derivatives used as an economic hedge on the interest rate risk of residential mortgages held for sale, as well as the net interest income associated with these loans. During 2007, HUSI realized total trading related revenues of \$41 million, as compared to \$132 million in 2006. Lower revenues from this program reflect the overall lack of liquidity in the market. Also refer to HSBC affiliate income beginning on page 42 of this Form 10-K for additional commentary on gains related to the sale of sub-prime residential mortgage loans.

HUSI recognizes gains or losses at the inception of derivative transactions only when the fair value of the transaction can be verified to market transactions or if all significant pricing model assumptions can be verified to observable market data. Gain or loss not recognized at inception is recorded in trading assets and recognized over the term of the derivative contract, or when market data becomes observable. The availability of observable market data resulted in recognition of \$7 million and \$53 million in trading revenues for 2007 and 2006, respectively.

Trading revenues related to securities were significantly reduced, primarily due to credit spread widening and write downs on asset backed securities held for trading purposes.

Precious metals revenue also experienced a decline in 2007, as compared to prior year, as a result of lower price volatility.

Partially offsetting the above noted declines in trading revenues, the foreign exchange business has continued to contribute solid revenues as a result of ongoing market volatility.

The increase in net interest income reflects higher trading assets and increased balances of loans held for sale resulting from loan syndication activity.

### ***2006 Compared to 2005***

During 2006, a wider range of product offerings and enhanced sales capabilities drove significant trading gains across all major client-related activities, primarily during the first half of the year. Derivatives trading revenue was higher due to the success of new product launches, to increased sales of structured products that are tailored to specific customer needs, and to the recognition of income during 2006 that was deferred in the previous year, as market inputs to valuation models became observable. Gains in the precious metals business reflected volume growth driven by a surge in demand arising from strong commodities markets. Income streams in the foreign exchange business remained robust against the backdrop of a weakening U.S. dollar.

Effective since the third quarter of 2005, HUSI maintains a portfolio of derivative instruments that are utilized as economic hedges to offset changes in market values of sub-prime residential mortgage loans held for sale. During 2006, HUSI realized \$68 million of net trading revenues and \$64 million of net interest income related to this program, as compared to \$25 million and \$11 million, respectively, in 2005.

Decreased net interest income was primarily due to steadily rising short-term interest rates during 2005 and 2006, which had an adverse impact on interest rate spreads related to funding of various trading activities.

### *Securities Gains, Net*

HUSI maintains various securities portfolios as part of its balance sheet diversification and risk management strategy. The following table summarizes the net securities gains resulting from various strategies.

| <b>Year Ended December 31</b>                               | <b>2007</b>   | <b>2006</b>  | <b>2005</b>   |
|---|---------------|--------------|---------------|
| <b>(in millions)</b>  |               |              |               |
| Sale of MasterCard Class B Shares .....                     | \$ 55         | \$ -         | \$ -          |
| Balance sheet diversification and reduction of risk .....   | 22            | 5            | 33            |
| Reduction of Latin and South American exposure .....        | 26            | 22           | 22            |
| Sale of an equity investment to an HSBC affiliate (1) ..... | 9             | -            | 48            |
| Other .....   | -             | 2            | 3             |
| Total securities gains, net .....                           | \$ <u>112</u> | \$ <u>29</u> | \$ <u>106</u> |

(1) In June 2005, HUSI sold shares in a foreign equity fund to an HSBC affiliate for a gain of \$48 million, which is recorded within the PB segment.

Gross realized gains and losses from sales of securities are summarized in Note 6 of the consolidated financial statements, which begins on page 116 of this Form 10-K.

### *HSBC Affiliate Income*

In 2007, higher fees and commissions from HSBC affiliates was primarily due to increased customer referral fees and other fees received related to the payments and cash management business. There was also an increase in fees received for various financial, operational and asset management functions performed by HUSI.

In June 2005, HUSI began acquiring residential mortgage loans from unaffiliated third parties and subsequently selling these loans to HMUS. During 2006, HUSI also began acquiring residential mortgage loans from HSBC Finance Corporation under this program. Lower gains on sales of loans to HMUS in 2007 resulted from decreased activity under the programs driven by illiquidity in the credit and sub-prime markets causing a decrease in loans sold. Refer to other income beginning on page 45 of this Form 10-K for commentary regarding the valuation allowance related to loans held for resale under this program.

## Residential Mortgage Banking Revenue

The following table presents the components of residential mortgage banking revenue. The net interest income component of the table is included in net interest income in the consolidated statements of income and reflects actual interest earned, net of interest expense and corporate transfer pricing.

| Year Ended December 31<br>(\$ in millions)  | 2007          | 2006          | 2005          | 2007 Compared to<br>2006      |             | 2006 Compared to<br>2005      |             |
|---|---------------|---------------|---------------|-------------------------------|-------------|-------------------------------|-------------|
|   |               |               |               | Increase (Decrease)<br>Amount | %           | Increase (Decrease)<br>Amount | %           |
| Net interest income .....   | \$ 260        | \$ 330        | \$ 447        | \$ (70)                       | (21)        | \$ (117)                      | (26)        |
| Servicing related income:   |               |               |               |                               |             |                               |             |
| Servicing fee income .....  | 116           | 100           | 76            | 16                            | 16          | 24                            | 32          |
| Changes in fair value of MSR due<br>to (1):   |               |               |               |                               |             |                               |             |
| Changes in valuation inputs or<br>assumptions used in valuation<br>model .....      | (18)          | 44            | -             | (62)                          | (141)       | 44                            | *           |
| Realization of cash flows .....   | (85)          | (87)          | -             | 2                             | 2           | (87)                          | *           |
| MSRs amortization (2) .....   | -             | -             | (73)          | -                             | -           | 73                            | *           |
| MSRs temporary impairment<br>recovery (2) .....                                     | -             | -             | 47            | -                             | -           | (47)                          | *           |
| Trading – Derivative instruments<br>used to offset changes in value<br>of MSR ..... | 10            | (17)          | 2             | 27                            | 159         | (19)                          | *           |
| Losses on sales of available for sale<br>securities .....                           | -             | -             | (11)          | -                             | -           | 11                            | *           |
|   | <u>23</u>     | <u>40</u>     | <u>41</u>     | <u>(17)</u>                   | <u>(43)</u> | <u>(1)</u>                    | <u>(2)</u>  |
| Originations and sales related income:  |               |               |               |                               |             |                               |             |
| Gains on sales of residential<br>mortgages .....                                    | 26            | 33            | 17            | (7)                           | (21)        | 16                            | 94          |
| Trading and hedging activity .....  | -             | 1             | (13)          | (1)                           | (100)       | 14                            | 108         |
|   | <u>26</u>     | <u>34</u>     | <u>4</u>      | <u>(8)</u>                    | <u>(24)</u> | <u>30</u>                     | <u>*</u>    |
| Other mortgage income .....   | <u>25</u>     | <u>22</u>     | <u>19</u>     | <u>3</u>                      | <u>14</u>   | <u>3</u>                      | <u>16</u>   |
| Total residential mortgage banking<br>revenue included in other revenues .....      | <u>74</u>     | <u>96</u>     | <u>64</u>     | <u>(22)</u>                   | <u>(23)</u> | <u>32</u>                     | <u>50</u>   |
| Total residential mortgage banking<br>related revenue .....                         | \$ <u>334</u> | \$ <u>426</u> | \$ <u>511</u> | \$ <u>(92)</u>                | <u>(22)</u> | \$ <u>(85)</u>                | <u>(17)</u> |

(1) Based upon adoption of SFAS 156 effective January 1, 2006. Refer to Note 2 of the consolidated financial statements, beginning on page 103 of this Form 10-K for further discussion.

(2) Based upon methodology existing prior to adoption of SFAS 156.

\* Not meaningful.

## Overview

As a result of balance sheet management initiatives to enhance liquidity and to address interest rate risk, the following strategic decisions were undertaken affecting residential mortgage banking results:

- HUSI opted to decrease the loan volumes generated through HSBC Finance Corporation's network of residential mortgage loan correspondents for the purpose of holding loans in the portfolio. Purchases from correspondents were discontinued in September 2005; and
- HUSI sold a higher proportion of its own adjustable rate mortgage loan originations in 2007 and 2006, which previously would have been held on the balance sheet.

## ***2007 Compared to 2006***

### ***Net Interest Income***

Decreased net interest income for 2007 resulted from lower average residential mortgage loans outstanding as well as a slight narrowing of interest rate spreads. During 2007, HUSI continued to sell the majority of new loan originations to government sponsored enterprises and private investors and to allow existing loans to runoff.

### ***Servicing Related Income***

Higher servicing fee income for 2007 resulted from a higher volume of loans included within the average serviced loans portfolio. The average serviced portfolio increased approximately 13% in 2007 as HUSI commenced servicing a portfolio of loans previously serviced by a third party. The increased serviced loans portfolio, and its positive impact on service fee income, was more than offset by changes in the value of the net hedged MSR position.

### ***Origination and Sales Related Income***

HUSI routinely sells residential mortgage loans to government sponsored entities and other private investors. The decrease in origination and sales related income for 2007 was attributable to a lower basis point gain on each individual loan sale as well as lower volumes as compared with 2006.

## ***2006 Compared to 2005***

### ***Net Interest Income***

As a result of the strategies previously noted, average residential mortgage loans recorded on the consolidated balance sheets decreased 11% during 2006, which resulted in a corresponding decrease in net interest income. Decreased net interest income in 2006 was also partially attributable to a narrowing of interest rate spreads on the core mortgage portfolio. Overall yields earned on residential mortgage loans in 2006 were consistent with 2005 levels.

### ***Servicing Related Income***

Higher servicing fee income in 2006 resulted primarily from the growth in the portfolio of loans serviced for others, which increased approximately 24% in 2006 due to the following factors:

- HUSI sold substantially all adjustable rate loans in 2006 and 2005, which previously would have been held on the balance sheet;
- in the fourth quarter of 2005, HUSI commenced servicing a portfolio of loans previously serviced by a third party; and
- also in the fourth quarter of 2005, HUSI completed a sale of loans, which were previously held in portfolio, to a government agency for which it continues to provide servicing.

Overall, servicing related income in 2006 was flat in comparison with 2005 levels. Higher servicing fee income was offset by reductions in the value of MSRs, primarily resulting from higher cash flow realization (classified as a component of MSR amortization in prior years). The monthly fluctuation of rates was generally less volatile in 2006 compared to 2005.

Under accounting rules in place prior to 2006, there was no direct relationship between the lower of cost or market value (LOCOM) accounting model for valuing MSR's and the fair value model for valuing related derivative instruments used to offset changes in the economic value of MSR's. Under the guidance outlined in SFAS 156, which became effective January 1, 2006, the accounting model for MSR's now more closely matches the model for related hedging activity as both are fair value models, which has reduced income statement volatility related to the valuation of MSR's.

Additional analysis of MSR's activity is provided in Note 11 of the consolidated financial statements beginning on page 125 of this Form 10-K.

Additional commentary regarding risk management associated with the MSR's hedging program is provided beginning on page 86 of this Form 10-K.

### ***Origination and Sales Related Income***

HUSI routinely sells residential mortgage loans to government sponsored entities and other private investors. The increase in originations and sales related income for 2006 was attributable to a higher basis point gain on each individual loan sale as compared with 2005, partially offset by lower volumes sold in 2006.

### ***Other (Loss) Income***

The significant decrease in other (loss) income is primarily due to write downs on loans held for sale which totaled \$512 million in 2007. Refer to Note 7 beginning on page 121 of this Form 10-K for additional commentary on loans held for sale and the related valuation allowance.

### ***Valuation on Loans Held for Sale***

In 2005, HUSI began acquiring residential mortgage loans from unaffiliated third parties with the intent of selling these loans to an HSBC affiliate, HSBC Markets (USA) Inc. (HMUS). During 2006, HUSI also began acquiring residential mortgage loans from HSBC Finance Corporation under this program. Loans acquired from unaffiliated third parties and HSBC Finance Corporation primarily include sub-prime residential mortgage loans. In addition, a number of prime adjustable rate mortgage loans originated by HUSI were identified for this program and were being held with the intent of selling these loans to HMUS. HUSI now holds its remaining portfolio for sale to a third party. Loans held for sale are recorded by HUSI at the lower of their aggregate cost or market value, with adjustments to market value being recorded as a valuation allowance. Lower results and activity for this program for 2007 generally resulted from the overall weakness and illiquidity in the U.S. residential mortgage market, and specifically from significantly reduced fair values of sub-prime loans, resulting in a significant increase in the valuation allowance for residential mortgage loans held for sale.

HUSI originates commercial loans in connection with its participation in a number of leveraged acquisition finance syndicates. A majority of these loans were originated with the intent of selling them to unaffiliated third parties, however, due to current market dislocations, a significant amount of these loans continue to be held for sale at December 31, 2007. Adverse conditions in the corporate credit markets have resulted in a substantial increase in the valuation allowance for commercial loans held for sale.

### ***Gain (Loss) on Sale of Property and Other Financial Assets***

In 2007, gains on sale of property and other financial assets included a gain of \$27 million, of which \$15 million was related to the sale of the Wealth and Tax Advisory Services (WTAS) business (refer to Note 3 beginning on page 114 of this Form 10-K). In 2006 and 2005, gains of \$43 million were recorded in each of these years related primarily to the sale of property.

### ***Earnings from Equity Investments***

The PB business segment includes an equity investment in a non-consolidated foreign HSBC affiliate (the foreign equity investment). During the third quarter of 2006, the foreign equity investment sold a portion of its investment in a foreign equity fund to another HSBC affiliate. During the second quarter of 2007, the foreign equity investment sold its remaining investment in the foreign equity fund, resulting in a decrease in equity investment holdings and lower equity earnings in 2007.

### ***Securitization Revenue***

In the third quarter of 2006, the last remaining securitization trust agreement related to the private label credit card receivable portfolio was amended. As a result, the trust no longer qualified for sale treatment and all assets and liabilities of the trust were returned to HUSI's consolidated balance sheet. The loss of securitization revenue for 2007 was offset by higher net interest income and higher fee revenue (refer to previous credit card fees commentary) from the receivables and liabilities that were returned to the consolidated balance sheet.

### ***Miscellaneous Income***

Lower miscellaneous income during 2007 is a result of loss on redemption of Junior Subordinated Debt Securities in the third quarter of 2007 (refer to Note 15, beginning on page 128 of this Form 10-K). This was partially offset by increased income from credit card enhancement products and services such as credit insurance.

## Operating Expenses

The components of operating expenses are summarized in the following table.

| Year Ended December 31  | 2007            | 2006            | 2005            | 2007 Compared to<br>2006      |           | 2006 Compared to<br>2005      |           |
|---|-----------------|-----------------|-----------------|-------------------------------|-----------|-------------------------------|-----------|
|   |                 |                 |                 | Increase (Decrease)<br>Amount | %         | Increase (Decrease)<br>Amount | %         |
| <b>(\$ in millions)</b>   |                 |                 |                 |                               |           |                               |           |
| Salaries and employee benefits:   |                 |                 |                 |                               |           |                               |           |
| Salaries .....  | \$ 971          | \$ 916          | \$ 776          | \$ 55                         | 6         | \$ 140                        | 18        |
| Employee benefits .....   | 381             | 384             | 276             | (3)                           | (1)       | 108                           | 39        |
| Total salaries and employee benefits....  | <u>1,352</u>    | <u>1,300</u>    | <u>1,052</u>    | <u>52</u>                     | <u>4</u>  | <u>248</u>                    | <u>24</u> |
| Occupancy expense, net .....  | <u>243</u>      | <u>221</u>      | <u>182</u>      | <u>22</u>                     | <u>10</u> | <u>39</u>                     | <u>21</u> |
| Support services from HSBC affiliates:  |                 |                 |                 |                               |           |                               |           |
| Fees paid to HSBC Finance Corporation for loan servicing and other administrative support ..... | 468             | 452             | 415             | 16                            | 4         | 37                            | 9         |
| Fees paid to HMUS .....   | 238             | 227             | 162             | 11                            | 5         | 65                            | 40        |
| Fees paid to HTSU for technology services .....   | 260             | 235             | 216             | 25                            | 11        | 19                            | 9         |
| Fees paid to other HSBC affiliates .....  | <u>196</u>      | <u>162</u>      | <u>126</u>      | <u>34</u>                     | <u>21</u> | <u>36</u>                     | <u>29</u> |
| Total support services from HSBC affiliates .....   | <u>1,162</u>    | <u>1,076</u>    | <u>919</u>      | <u>86</u>                     | <u>8</u>  | <u>157</u>                    | <u>17</u> |
| Other expenses:   |                 |                 |                 |                               |           |                               |           |
| Equipment and software .....  | 54              | 72              | 91              | (18)                          | (25)      | (19)                          | (21)      |
| Marketing .....   | 125             | 98              | 79              | 27                            | 28        | 19                            | 24        |
| Outside services .....  | 137             | 125             | 116             | 12                            | 10        | 9                             | 8         |
| Professional fees .....   | 79              | 78              | 67              | 1                             | 1         | 11                            | 16        |
| Telecommunications .....  | 20              | 21              | 19              | (1)                           | (5)       | 2                             | 11        |
| Postage, printing and office supplies ...   | 39              | 34              | 26              | 5                             | 15        | 8                             | 31        |
| Insurance business .....  | 24              | 19              | 19              | 5                             | 26        | -                             | -         |
| Miscellaneous .....   | 351             | 211             | 188             | 140                           | 66        | 23                            | 12        |
| Total other expenses .....  | <u>829</u>      | <u>658</u>      | <u>605</u>      | <u>171</u>                    | <u>26</u> | <u>53</u>                     | <u>9</u>  |
| Total operating expenses .....  | \$ <u>3,586</u> | \$ <u>3,255</u> | \$ <u>2,758</u> | \$ <u>331</u>                 | <u>10</u> | \$ <u>497</u>                 | <u>18</u> |
| Personnel - average number .....  | <u>12,336</u>   | <u>12,326</u>   | <u>11,275</u>   | <u>10</u>                     | -         | <u>1,051</u>                  | <u>9</u>  |
| Efficiency ratio .....  | <u>68.34</u> %  | <u>57.66</u> %  | <u>55.44</u> %  |                               |           |                               |           |

### Overview

Increased operating expenses in 2007 was largely driven by higher personnel, marketing, technology and other expense growth associated with continued rollout of various retail and commercial business growth initiatives. Additionally, miscellaneous expenses increased as a result of a \$70 million litigation expense related to our ownership interest in Visa.

### Salaries and Employee Benefits

#### 2007 Compared to 2006

Higher salaries expenses for 2007 are mainly due to:

- changing mix of staffing to support various business growth initiatives, primarily within the PFS and CMB segments;
- higher average salaries and pay rates, due to normal annual pay increases; and
- higher personnel costs within the Global Banking and Markets segment associated with repositioning certain businesses in order to focus on building a financing and emerging markets led wholesale banking business.

During the second quarter of 2006, the HSBC Remuneration Committee exercised its discretion to waive the Total Shareholder Return performance condition related to 2003 share option awards under the HSBC Group Share Option Plan (refer to page 143 of HUSI's 2007 Form 10-K for a description of this plan). This modification resulted in an additional charge to employee benefits expense of \$9 million for the second quarter of 2006. No similar charge was recorded during 2007. Excluding this 2006 charge, higher employee benefit costs directly associated with increased salaries expenses were offset by lower pension costs.

### *2006 Compared to 2005*

Higher salaries and benefits expenses for 2006 were primarily due to:

- higher staff counts and a changing mix of staffing to support various business growth initiatives within the PFS, CMB, Global Banking and Markets and PB business segments (refer to commentary regarding Business Segments, beginning on page 50 of this Form 10-K);
- higher incentive compensation expenses, largely due to growth in the Global Banking and Markets and PB segments;
- lower deferrals of costs within the residential mortgage banking business, included within the PFS business segment, resulting from lower loan originations during 2006;
- higher pension expense, resulting from changes in plan assumptions, particularly a lower discount rate, for 2006; and
- higher employee welfare costs and payroll related taxes, which relate directly to higher salary costs.

In addition, during 2006, HUSI recorded \$12 million of increased compensation expenses related to retirement and other transition of certain HUSI senior executives.

### *Occupancy Expense, Net*

Expansion of the core banking and commercial lending networks within the PFS and CMB business segments has been a key component of recent business expansion initiatives. New branches have been opened and lending operations have been expanded, which have resulted in higher rental expenses, depreciation of leasehold improvements, utilities and other occupancy expenses during 2007.

### *Support Services from HSBC Affiliates*

HUSI has routinely purchased private label credit card receivables from HSBC Finance Corporation since December 2004. In addition, higher quality nonconforming residential mortgage loans were acquired from HSBC Finance Corporation's correspondent network from December 2003 until September 2005. In most cases, HSBC Finance Corporation retained the right to service these portfolios. Fees charged by HSBC Finance Corporation for loan origination and servicing expenses, which are primarily recorded in the CF segment, have increased moderately for 2007 due to an increased number of private label credit card receivables serviced.

Fees charged by HMUS pursuant to service level agreements for broker dealer, loan syndication, treasury and traded markets related services are included in support services from HSBC affiliates. Higher fees charged by HMUS in 2007 primarily relate to increased loan syndication services.

HSBC's technology services in North America are centralized within HSBC Technology & Services (USA) Inc. (HTSU). Technology related assets and software acquired for HUSI are generally purchased and owned by HTSU. Pursuant to a master service level agreement, HTSU charges HUSI for equipment related costs and technology services. Fees charged by HTSU to HUSI for technology services are higher in 2007, as HUSI continues to upgrade its technology environment within all business segments.



HUSI also utilizes other HSBC affiliates in support of global outsourcing initiatives and, to a lesser extent, for treasury and traded markets services. Higher expense for 2007 primarily resulted from expanded data processing and other global outsourcing services.

### ***Other Expenses***

Higher marketing and promotional expenses resulted from continuing investment in HSBC brand activities, promotion of the internet savings account and marketing support for branch expansion initiatives, primarily within the PFS business segment.

As a result of a decision to discontinue operations of HBUS's real estate settlement services company, certain deferred start-up costs and other contractual costs totaling \$7 million were included in outside services in 2007. Market data services and collection agency fees, also included in outside services, increased \$11 million in comparison to 2006. This was slightly offset by a decrease in employment agency and staff recruitment fees.

The increase in Insurance business expense in 2007 primarily relates to the costs incurred to terminate a portion of the annuity reinsurance business. Additionally, there was a nominal increase in claims during the third quarter of 2007.

Higher miscellaneous expenses for 2007 were primarily due to \$70 million of litigation expense related to Visa (refer to Note 25 of the consolidated financial statements beginning on page 152 of this Form 10-K for commentary on the Visa litigation), increased insurance costs and higher expenses associated with business expansion in the PFS and CMB segments. In addition, miscellaneous expenses in 2006 were unusually low, mainly due to reversal of a charge for the accrued interest related to settlement of certain income tax liabilities during the second quarter of 2006.

### ***Efficiency Ratio***

Increase in efficiency ratio resulted primarily from a decrease in other revenues and increased operating expenses, partially offset by higher net interest income, for the year ended 2007, in comparison to 2006.

### ***Income Taxes***

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Income tax expense decreased \$531 million (100%) in 2007, as compared with 2006. The decrease in income tax expense and the related decrease in the effective tax rate is primarily due to the effect of a significantly reduced level of earnings and the effect of concentrating tax credits (primarily low income housing credits) over a significantly reduced level of pre-tax income.

Income tax expense decreased \$36 million (6%) in 2006, primarily resulting from a lower effective rate compared with 2005. The lower effective tax rate for 2006 reflects higher revenues from operations in states with lower tax rates and an increase in low income housing tax credits.

Refer to Note 17 of the consolidated financial statements beginning on page 133 of this Form 10-K for additional information regarding income taxes.

## ***Business Segment Results***

HUSI has five distinct segments that are utilized for management reporting and analysis purposes. The segments, which are based upon customer groupings as well as products and services offered, are described on pages 6 and 7 of this Form 10-K.

Effective January 1, 2007, corporate goals of HUSI are based upon results reported under International Financial Reporting Standards (IFRS), which are utilized by HSBC to prepare its consolidated financial statements. Operating results for HUSI are now being monitored and reviewed, trends are being evaluated, and decisions are being made about allocating certain resources on an IFRS basis. As a result, business segment results are reported on an IFRS basis to align with the revised internal reporting mechanism for monitoring performance. Results for 2007, 2006 and 2005 in the tables that follow are reflected on an IFRS basis. Refer to Note 24 of this Form 10-K for additional information on business segments, including a reconciliation between IFRS and U.S. GAAP for reported results and certain other key balances.

Effective January 1, 2006, activity related to certain commercial banking relationships, which was previously reported in the PFS segment, was transferred to the CMB segment. In addition, also effective January 1, 2006, the CMB segment also includes activity related to an equity investment in Wells Fargo HSBC Trade Bank N.A., which was previously reported in the Other segment. For comparability purposes, prior period disclosures previously reported for 2006 and 2005 have been conformed herein to the presentation of current segments.

Results for each business segment on an IFRS basis are summarized in the following tables.

### ***Personal Financial Services (PFS)***

During 2007, resources continued to be directed towards expansion of the core retail banking business, including investment in the HSBC brand, expansion of the branch network in existing and new geographic areas, and continued rollout of HSBC Direct, the internet banking channel. As a result, balance sheet growth for core retail banking in 2007 was highlighted by a 22% increase in average deposits, as compared with 2006.

During 2007, HUSI continued to sell the majority of new residential mortgage loan originations to government sponsored enterprises and private investors and to allow the existing balance sheet to runoff. As a result, average residential mortgage loans decreased 11% in 2007, as compared with 2006.

The following table summarizes results for the PFS segment.

| <b>Year Ended December 31</b>          | <b>2007</b>     | <b>2006</b> | <b>2005</b> | <b>2007 Compared to 2006</b> |                            | <b>2006 Compared to 2005</b> |          |
|--|-----------------|-------------|-------------|------------------------------|----------------------------|------------------------------|----------|
|  |                 |             |             | <b>Increase (Decrease)</b>   | <b>Increase (Decrease)</b> |                              |          |
|  |                 |             |             | <b>Amount</b>                | <b>%</b>                   | <b>Amount</b>                | <b>%</b> |
| <b>(\$ in millions)</b>                |                 |             |             |                              |                            |                              |          |
| Net interest income .....              | \$ <b>1,102</b> | \$ 1,155    | \$ 948      | \$ <b>(53)</b>               | <b>(5)</b>                 | \$ 207                       | 22       |
| Other revenues .....                   | <b>559</b>      | 496         | 704         | <b>63</b>                    | <b>13</b>                  | (208)                        | (30)     |
| Total revenues .....                   | <b>1,661</b>    | 1,651       | 1,652       | <b>10</b>                    | <b>1</b>                   | (1)                          | -        |
| Provision for credit losses .....      | <b>139</b>      | 52          | 100         | <b>87</b>                    | <b>167</b>                 | (48)                         | (48)     |
|  | <b>1,522</b>    | 1,599       | 1,552       | <b>(77)</b>                  | <b>(5)</b>                 | 47                           | 3        |
| Operating expenses .....               | <b>1,302</b>    | 1,173       | 1,023       | <b>129</b>                   | <b>11</b>                  | 150                          | 15       |
| Income before income tax expense ..... | <b>220</b>      | 426         | 529         | <b>(206)</b>                 | <b>(48)</b>                | (103)                        | (19)     |
| Income tax expense .....               | <b>52</b>       | 154         | 218         | <b>(102)</b>                 | <b>(66)</b>                | (64)                         | (29)     |
| Net income .....                       | \$ <b>168</b>   | \$ 272      | \$ 311      | \$ <b>(104)</b>              | <b>(38)</b>                | \$ (39)                      | (13)     |

### ***2007 Compared to 2006***

Lower overall results for the PFS segment in 2007 were primarily driven by higher operating expenses from expansion initiatives and higher provision for loan losses in the mortgage business, primarily related to increased delinquencies on home equity lines of credit.

Net interest income from continuing core banking activities has decreased in 2007 due to narrowing of interest rate spreads as customers migrated to higher yielding deposit products such as Online Savings and CDs. Net interest income for 2007 was also impacted by lower interest income and loan portfolio runoff on the residential mortgage portfolio.

Other revenues for 2007 were higher as compared to 2006 due to \$45 million of gains realized on the sale of MasterCard Class B Shares and \$21 million of gains realized on sales of branch premises to unaffiliated third parties.

Higher provision for credit losses was driven by an increase in delinquencies and charge offs within the Home Equity Line of Credit (HELOC) portfolio, which is primarily due to conditions in the housing markets deteriorating. Prime mortgage loans experienced minimal deterioration. In addition, provision expense for the first half of 2006 was unusually low due to the impact of bankruptcy legislation enacted in 2005, which resulted in accelerated consumer charge offs in the fourth quarter of 2005. This was partially offset by a reduction resulting from refinement of the allowance methodology associated with MasterCard/Visa receivables.

Higher expenses in 2007 are primarily due to \$70 million of litigation expense related to Visa. Refer to Note 25 of this Form 10-K, beginning on page 152, for additional information regarding the Visa litigation. Also contributing to increased operating expenses was investment in branch expansion and HSBC Direct, which includes higher staff, occupancy, and marketing expenses.

### ***2006 Compared to 2005***

Net interest income associated with the core banking operations grew 22% for 2006 as a result of favorable interest rate spreads on a growing deposit base. As expected during the expansion build-out phase, expense growth associated with expansion initiatives has outpaced related core banking revenue growth.

Lower residential mortgage related results in 2006 were driven by strategic balance sheet initiatives to decrease the residential mortgage loan portfolio, and by tightening interest rate spreads.

The provision for credit losses decreased \$48 million in 2006, as compared to 2005, mainly due to changes in bankruptcy legislation in 2005, which accelerated charge offs and impairment activity related to the legacy MasterCard/Visa credit card and automotive finance portfolios in that year.

Higher operating expenses for 2006, as compared to 2005, were primarily due to:

- staff costs from additional headcount recruited to support branch expansion and the internet banking channel. Greater emphasis was also placed on recruiting staff dedicated to sales and customer relationship activities, which changed the staff mix, and contributed to higher expenses;
- marketing and other direct costs associated with expansion of the core banking network and growth of the internet savings banking channel;
- higher expenses within the residential mortgage banking business throughout 2006, partly due to reduced cost deferrals related to a reduced volume of loan originations; and
- increased fees paid to HTSU, as HUSI continued to upgrade its branch sales platform.

### *Consumer Finance (CF)*

The CF segment includes the private label receivable portfolio (the PLRP) and other loans acquired from HSBC Finance Corporation and its correspondents. Private label credit card receivable balances have continued to grow and are 5% higher at December 31, 2007 compared with 2006.

The following table summarizes results for the CF segment.

| Year Ended December 31                        | 2007   | 2006   | 2005    | 2007 Compared to 2006 |      | 2006 Compared to 2005 |      |
|---|--------|--------|---------|-----------------------|------|-----------------------|------|
|   |        |        |         | Increase (Decrease)   |      | Increase (Decrease)   |      |
|   |        |        |         | Amount                | %    | Amount                | %    |
| <b>(\$ in millions)</b>                       |        |        |         |                       |      |                       |      |
| Net interest income .....                     | \$ 951 | \$ 721 | \$ 641  | \$ 230                | 32   | \$ 80                 | 12   |
| Other revenues (1) .....                      | 294    | 105    | (41)    | 189                   | 180  | 146                   | *    |
| Total revenues .....                          | 1,245  | 826    | 600     | 419                   | 51   | 226                   | 38   |
| Provision for credit losses .....             | 1,187  | 654    | 662     | 533                   | 81   | (8)                   | (1)  |
|   | 58     | 172    | (62)    | (114)                 | (66) | 234                   | *    |
| Operating expenses .....                      | 33     | 31     | 39      | 2                     | 6    | (8)                   | (21) |
| Income (loss) before income tax expense ..... | 25     | 141    | (101)   | (116)                 | (82) | 242                   | *    |
| Income tax expense (benefit) .....            | 7      | 50     | (38)    | (43)                  | (86) | 88                    | *    |
| Net income (loss) .....                       | \$ 18  | \$ 91  | \$ (63) | \$ (73)               | (80) | \$ 154                | *    |

(1) For IFRS reporting purposes, fees charged by HSBC Finance Corporation for servicing various loan and receivable portfolios are netted against other revenues. These fees totaled \$420 million and \$410 million for the year ended December 31, 2007 and 2006, respectively.

\* Not meaningful.

### *2007 Compared to 2006*

Higher net interest income in 2007 primarily resulted from increased credit card receivable balances, due to the addition of new private label merchant relationships during 2007 and 2006, and to lower amortization of premiums paid for purchases of receivables included within the PLRP. Although premiums associated with daily purchases of receivables from HSBC Finance Corporation continue to be recorded and amortized, the premium amortization associated with the initial portfolio acquisition in 2004 was lower in 2007 as compared to 2006. Additionally, in 2007, HUSI adopted a more refined income recognition methodology on private label credit card promotional transactions which resulted in an increase to net interest income during 2007.

Higher other revenues are directly related to increased credit card fees (refer to page 40 of this Form 10-K).

Higher provision expense for credit card receivables in 2007 primarily reflects higher levels of charge offs and delinquencies within the private label credit card portfolio as market conditions continue to deteriorate. Higher delinquencies and charge offs in the portfolio of higher quality non-conforming residential mortgage loans which HUSI purchased from HSBC Finance Corporation in order to hold in the residential mortgage loan portfolio also contributed to this increase. Additionally, increased provision expense reflects a refinement in the methodology used to estimate inherent losses on private label loans less than 30 days delinquent, which increased credit loss reserves by \$107 million in the fourth quarter.

HUSI is considering the purchase of a portfolio of General Motors MasterCard and Visa receivables (the “GM Portfolio”) from HSBC Finance Corporation in the future in order to maximize the efficient use of capital and liquidity at each entity. Any such purchase will be subject to obtaining the necessary regulatory and other approvals, including the approval of HSBC Finance Corporation’s partner. HSBC Finance Corporation would, however, maintain the customer account relationships and, subsequent to the initial receivable purchase, HUSI would purchase additional volume on a daily basis. At December 31, 2007, the GM Portfolio had an outstanding principal balance of approximately \$7 billion. If this bulk purchase occurs, it is expected to result in payment of a significant premium upon completion. In future periods, HUSI’s net interest income, fee income and provision for credit losses would be increased, while net interest income would decrease due to payment of premium from continuing purchases of credit card receivables, and servicing fees paid to HSBC Finance Corporation would increase. It is not anticipated that the net effect of these potential purchases would have a material impact on HUSI’s future results of operations.

### *2006 Compared to 2005*

Net interest income and other revenue grew in 2006, compared with 2005, due to significant growth in the number of accounts included within the PLRP, increased late fees and lower fees paid to merchant partners.

Lower provision for credit losses for the PLRP portfolio is primarily due to the impact of bankruptcy legislation enacted in 2005, which resulted in accelerated consumer charge offs and higher provision expense during 2005.

### *Commercial Banking (CMB)*

Expansion of middle market lending activities in Chicago, Washington D.C. and the West Coast, contributed to growth in small business deposits and average commercial loans. However a slowdown in commercial real estate activity and deterioration in the credit environment coupled with business expansion, restructuring costs and lower gains on asset disposals have depressed results.

The following table summarizes results for the CMB segment.

| Year Ended December 31                 | 2007   | 2006   | 2005   | 2007 Compared to 2006      |      | 2006 Compared to 2005      |     |
|--|--------|--------|--------|----------------------------|------|----------------------------|-----|
|  |        |        |        | Increase (Decrease) Amount | %    | Increase (Decrease) Amount | %   |
| <b>(\$ in millions)</b>                |        |        |        |                            |      |                            |     |
| Net interest income .....              | \$ 814 | \$ 746 | \$ 666 | \$ 68                      | 9    | \$ 80                      | 12  |
| Other revenues .....                   | 259    | 273    | 183    | (14)                       | (5)  | 90                         | 49  |
| Total revenues .....                   | 1,073  | 1,019  | 849    | 54                         | 5    | 170                        | 20  |
| Provision for credit losses .....      | 126    | 70     | 27     | 56                         | 80   | 43                         | 159 |
|  | 947    | 949    | 822    | (2)                        | -    | 127                        | 15  |
| Operating expenses .....               | 558    | 503    | 378    | 55                         | 11   | 125                        | 33  |
| Income before income tax expense ..... | 389    | 446    | 444    | (57)                       | (13) | 2                          | -   |
| Income tax expense .....               | 92     | 155    | 170    | (63)                       | (41) | (15)                       | (9) |
| Net income .....                       | \$ 297 | \$ 291 | \$ 274 | \$ 6                       | 2    | \$ 17                      | 6   |

### *2007 Compared to 2006*

Net interest income grew by 9% to \$814 million for 2007, as compared to 2006, mostly driven by average balance growth of 20% in middle market loans and 21% in small business deposits. Offsetting this, net interest income was constrained by lower commercial real estate activity and narrowing spreads, particularly on deposits, as customers migrated to higher yielding products.

Other revenues decreased in 2007, mainly due to lower gains on asset disposals.

Provisions for credit losses have increased by 80% in 2007, as compared to 2006. This is due to a change in loan loss reserve methodology for HUSI's small business revolving line of credit product, as well as higher commercial real estate provisions, mainly as a result of customer downgrades.

Higher operating expenses for 2007 over 2006, reflect organic growth in legacy markets and business expansion in Chicago, Washington D.C. and the West Coast. In addition, higher incentive compensation costs, business restructuring and increased community investment activities have also contributed to cost growth.

Deposit volumes continue to be a key driver of growth in 2007, driven by expansion initiatives and targeted marketing campaigns. For the CMB segment, average customer deposit balances are 20% higher in 2007 compared with 2006.

Loan growth resulted primarily from strong activity in middle market lending, with growth distributed between legacy and expansion markets. However, overall loan growth has been adversely impacted by a slowdown in commercial real estate activity. For the CMB segment, average loans are 4% higher for 2007, compared with 2006.

### *2006 Compared to 2005*

Higher other revenues primarily resulted from:

- sales of Venezuelan Brady Bonds and related instruments during 2006;
- increased syndication fees resulting from a strategic decision by the Commercial Real Estate business to mitigate risk by reducing the balance sheet; and
- higher other fees resulting from business expansion.

Higher operating expenses primarily resulted from:

- higher personnel costs from additional staff to support expansion initiatives. Recruitment of additional relationship managers also changed the mix of staff and drove costs higher;
- higher marketing and other direct costs associated with branch expansion initiatives and new lending offices; and
- to a lesser extent, allocation to CMB of various increased corporate expenses, including increased compensation costs.

Increased provision for credit losses for 2006 resulted from higher criticized commercial assets, and higher charge offs associated with the growing small business loan portfolio. In addition, net commercial loan charge offs for 2006 reflect a more normalized credit environment in comparison to lower net charge offs recorded in the prior year.

## Global Banking and Markets

During the second half of 2007, the Global Banking and Markets segment was significantly affected by reduced market liquidity, widening spreads and higher volatility in the credit and sub-prime lending markets, which has led to a considerable fall in revenues for 2007, as compared with 2006. This impacted trading in mortgage backed securities and credit derivatives and led to substantial reserves in several asset classes. Partially offsetting this, the payments and cash management business and the foreign exchange business have contributed solid revenues.

The following table summarizes results for the Global Banking and Markets segment.

| Year Ended December 31                        | 2007     | 2006   | 2005   | 2007 Compared to 2006      |       | 2006 Compared to 2005      |      |
|---|----------|--------|--------|----------------------------|-------|----------------------------|------|
|   |          |        |        | Increase (Decrease) Amount | %     | Increase (Decrease) Amount | %    |
| <b>(\$ in millions)</b>                       |          |        |        |                            |       |                            |      |
| Net interest income .....                     | \$ 321   | \$ 235 | \$ 348 | \$ 86                      | 37    | \$ (113)                   | (32) |
| Other revenues .....                          | 46       | 957    | 738    | (911)                      | (95)  | 219                        | 30   |
| Total revenues .....                          | 367      | 1,192  | 1,086  | (825)                      | (69)  | 106                        | 10   |
| Provision (credit) for credit losses .....    | 35       | 3      | (52)   | 32                         | *     | 55                         | 106  |
|   | 332      | 1,189  | 1,138  | (857)                      | (72)  | 51                         | 4    |
| Operating expenses .....                      | 803      | 791    | 644    | 12                         | 2     | 147                        | 23   |
| (Loss) income before income tax expense ..... | (471)    | 398    | 494    | (869)                      | *     | (96)                       | (19) |
| Income tax (benefit) expense ....             | (129)    | 148    | 184    | (277)                      | (187) | (36)                       | (20) |
| Net (loss) income .....                       | \$ (342) | \$ 250 | \$ 310 | \$ (592)                   | *     | \$ (60)                    | (19) |

\* Not meaningful.

### 2007 Compared to 2006

Increased net interest income was primarily due to an increase in trading assets and also reflects higher lending balances and increased balances of loans held for sale resulting from loan syndication activity. Refer to page 32 of this Form 10-K for additional commentary on trading assets.

Other revenues were significantly affected by adverse market conditions. Specifically, substantial valuation losses were recorded on sub-prime residential mortgage and leveraged commercial loans held for sale. Additionally, reserves were recorded for trading securities, credit derivatives and structured derivative products.

Adverse market conditions have led to downgrades in internal credit ratings of monoline insurance companies. Fair value adjustments of approximately \$287 million have been recorded due to counterparty credit risk exposures on derivative contracts with these entities, which reflects the decreased credit quality of these entities and concerns over their ability to perform at December 31, 2007. The exposure relating to monoline insurance companies, which are rated CCC+ and below has been fully reserved as of December 31, 2007.

Partially offsetting the above mentioned declines, revenues from the recently expanded payments and cash management business were significantly higher for 2007, as compared with 2006, reflecting higher deposit balances and higher associated transaction fee revenues. The foreign exchange business also contributed increased revenue as a result of ongoing market volatility and a weakening dollar. Additionally, revenue increased from emerging market and from interest rate trading activities.

Higher operating expenses for 2007, as compared with 2006, primarily resulted from incremental costs associated with repositioning certain non-strategic businesses in order to focus on building a financing and emerging markets led wholesale banking business.

### *2006 Compared to 2005*

During 2006, successful launches of new products and increased sales of structured products that are tailored to specific customer needs led to strong derivatives trading revenues. Gains in the precious metals business reflected volume growth driven by a surge in demand arising from strong commodities markets. Income streams in the foreign exchange business were robust against the backdrop of a weak U.S. dollar.

Strong trading results more than offset lower balance sheet management revenues, which were adversely affected by rising short-term interest rates and a flattening yield curve that reduced net interest income and limited opportunities to profit from placing funds generated from operations.

Higher trading revenues, included in other revenues, were attributable to expanded operations and favorable market conditions related to precious metals, foreign exchange and structured products desks, especially during the first six months of 2006. Refer to page 40 of this Form 10-K for additional analysis and commentary regarding trading revenues.

Excluding the trading revenues impact noted above, higher other revenues for 2006, as compared to 2005, mainly resulted from higher fee-based income, primarily within the transaction banking business, resulting from expanded product offerings, and from one additional quarter in 2006 of service fees generated by a subsidiary transferred to HUSI from HSBC in March 2005, which provides accounting and valuation services for hedge fund clients.

Higher operating expenses were mainly due to the first full year impact of the business expansion initiatives begun in 2005, as well as additional investments in early 2006 to support the growing complexity of the Global Banking and Markets business. Specifically, cost growth in Global Markets was primarily driven by expansion within the mortgage backed securities, structured derivative and equity businesses. Similarly, operating expenses grew in Transaction Banking, primarily the payments and cash management and the securities services businesses, as business volumes grew to historical highs, which drove higher transaction costs and increased support for expanded capacity.

Staff costs increased due to higher performance incentives, which rose in line with revenue growth, and due to the effect of additional people recruited throughout 2005 and in early 2006. Business support areas, such as market risk, credit and operations staff, also grew to support the expansion of various business lines. Transition of senior executives also contributed to higher compensation costs.



### *Private Banking (PB)*

During 2007 and 2006, additional resources have been allocated to expand products and services provided to high net worth customers served by the PB business segment. As a result, total average loans and deposit balances were 7% and 13% higher, respectively, for 2007 compared with 2006. Assets under management also increased 4%. However, these increases were offset by higher operating expenses and lower one time gains from the sale of assets in 2007, as compared with 2006.

The following table summarizes results for the PB segment.

| <b>Year Ended December 31</b>              | <b>2007</b> | <b>2006</b> | <b>2005</b> | <b>2007 Compared to 2006</b> |          | <b>2006 Compared to 2005</b> |          |
|--|-------------|-------------|-------------|------------------------------|----------|------------------------------|----------|
|  |             |             |             | <b>Increase (Decrease)</b>   |          | <b>Increase (Decrease)</b>   |          |
|  |             |             |             | <b>Amount</b>                | <b>%</b> | <b>Amount</b>                | <b>%</b> |
| <b>(\$ in millions)</b>                    |             |             |             |                              |          |                              |          |
| Net interest income .....                  | \$ 198      | \$ 199      | \$ 174      | \$ (1)                       | (1)      | \$ 25                        | 14       |
| Other revenues .....                       | 291         | 303         | 260         | (12)                         | (4)      | 43                           | 17       |
| Total revenues .....                       | 489         | 502         | 434         | (13)                         | (3)      | 68                           | 16       |
| Provision (credit) for credit losses ..... | 10          | 36          | (3)         | (26)                         | (72)     | 39                           | *        |
|  | 479         | 466         | 437         | 13                           | 3        | 29                           | 7        |
| Operating expenses .....                   | 345         | 308         | 270         | 37                           | 12       | 38                           | 14       |
| Income before income tax expense .....     | 134         | 158         | 167         | (24)                         | (15)     | (9)                          | (5)      |
| Income tax expense .....                   | 32          | 57          | 64          | (25)                         | (44)     | (7)                          | (11)     |
| Net income .....                           | \$ 102      | \$ 101      | \$ 103      | \$ 1                         | 1        | \$ (2)                       | (2)      |

\* Not meaningful.

### *2007 Compared to 2006*

Net interest income for 2007 was impacted by higher average balances for loans and deposits, offset by lower interest spreads.

The PB business segment includes an equity investment in a non-consolidated foreign HSBC affiliate (the foreign equity investment). During the third quarter of 2006, the foreign equity investment sold a portion of its investment in a foreign equity fund to another HSBC affiliate. During the second quarter of 2007, the foreign equity investment sold its remaining investment in the foreign equity fund. The decrease in equity investment holdings resulted in lower equity earnings of \$47 million included in other revenues in 2007. This was largely offset by higher commission and fee revenues from managed products, derivatives and annuity products.

On December 31, 2007, HUSI completed the sale of its Wealth and Tax Advisory Services (WTAS) subsidiary to an independent firm formed by certain members of the WTAS management team. In exchange for the net assets of WTAS, HUSI received cash and secured promissory notes as well as an option to purchase a limited amount of common equity in future years. HUSI recognized a gain of \$18 million as a result of this transaction.

Increased operating expenses in 2007, as compared to 2006 mainly resulted from higher staff costs related to business expansion initiatives.

The provision for credit losses includes the impact of an \$8 million charge off in 2007 related to a specific client relationship, for which no allowance was previously recorded. For 2006, the provision includes a \$29 million charge for a combination of charge offs and higher allowances related to a specific real estate investment loan relationship for which no specific allowance was previously recorded.

## 2006 Compared to 2005

During 2006 and 2005 additional resources have been allocated to expand products and services provided to high net worth customers served by this business segment, resulting in increased loan and deposit balances, and a corresponding increase in net interest income.

Fee income from wealth and tax advisory services was significantly higher for 2006, due to expanded services offered to customers. In addition, during 2006, earnings from a foreign equity investment increased \$44 million due to its sale of shares in a foreign equity fund to an HSBC affiliate. Excluding this transaction, equity earnings from this foreign equity investment were also generally higher in 2006. In the second quarter of 2005, HUSI sold its shares in the same foreign equity fund to an HSBC affiliate resulting in a gain of \$48 million.

Increased operating expenses for 2006 mainly resulted from additional resources being allocated to this segment to expand the services provided. Higher personnel costs were driven by increased staff count and by increased compensation expenses related to transition of senior executives. In addition, fees charged by HSBC affiliates grew in 2006 due to higher technology related costs and higher charges related to global outsourcing services.

Increased provision for credit losses during 2006 directly related to a specific commercial loan relationship for which a combination of charge offs and increased allowances for credit losses resulted in a \$29 million provision. Further commentary regarding credit quality begins on page 59 of this Form 10-K.

## Other

### Overview

The Other segment primarily includes an equity investment in HSBC Republic Bank (Suisse) S.A., and adjustments made at the corporate level for fair value option accounting related to certain debt issued.

### Operating Results

The following table summarizes results for the Other segment.

| Year Ended December 31                        | 2007    | 2006    | 2005    | 2007 Compared to 2006 |      | 2006 Compared to 2005 |    |
|---|---------|---------|---------|-----------------------|------|-----------------------|----|
|   |         |         |         | Increase (Decrease)   |      | Increase (Decrease)   |    |
|   |         |         |         | Amount                | %    | Amount                | %  |
| <b>(\$ in millions)</b>                       |         |         |         |                       |      |                       |    |
| Net interest (loss) .....                     | \$ (12) | \$ (10) | \$ (22) | \$ (2)                | (20) | \$ 12                 | 55 |
| Other revenues (expense) .....                | 216     | (46)    | 28      | 262                   | *    | (74)                  | *  |
| Total revenues (expense) .....                | 204     | (56)    | 6       | 260                   | *    | (62)                  | *  |
| Provision for credit losses .....             | -       | -       | -       | -                     | -    | -                     | -  |
|   | 204     | (56)    | 6       | 260                   | *    | (62)                  | *  |
| Operating expenses .....                      | 4       | 2       | -       | 2                     | 100  | 2                     | -  |
| Income (loss) before income tax expense ..... | 200     | (58)    | 6       | 258                   | *    | (64)                  | *  |
| Income tax expense (benefit) ....             | 57      | (35)    | 8       | 92                    | *    | (43)                  | *  |
| Net income (loss) .....                       | \$ 143  | \$ (23) | \$ (2)  | \$ 166                | *    | \$ (21)               | *  |

\* Not meaningful.

The increase in other revenues for 2007 primarily resulted from decreases in the fair value of certain debt instruments to which fair value option accounting is applied, due to widening credit spreads, as compared to 2006.

The reduction in other revenues for 2006 primarily resulted from increases in the fair value of certain debt instruments to which fair value option accounting is applied, due to narrowing credit spreads, as compared to 2005.

## Credit Quality

### Overview

HUSI enters into a variety of transactions in the normal course of business that involve both on and off-balance sheet credit risk. Principal among these activities is lending to various commercial, institutional, governmental and individual customers. HUSI participates in lending activity throughout the U.S. and, on a limited basis, internationally.

HUSI's approach toward credit risk management is summarized on pages 77-78 of this Form 10-K.

HUSI's methodology and accounting policies related to its allowance for credit losses are presented in Critical Accounting Policies beginning on page 25 and in Note 2 of the consolidated financial statements beginning on page 103 of this Form 10-K.

### Nonaccruing Loans

HUSI's policies and practices for placing loans on nonaccruing status are summarized in Note 2 of the consolidated financial statements, beginning on page 103 of this Form 10-K.

Nonaccruing loan statistics are summarized in the following table.

|  | 2007          | 2006          | 2005          | 2004          | 2003          |
|--|---------------|---------------|---------------|---------------|---------------|
| <b>(\$ in millions)</b>                    |               |               |               |               |               |
| Nonaccruing loans                          |               |               |               |               |               |
| Balance at end of period:                  |               |               |               |               |               |
| Commercial:                                |               |               |               |               |               |
| Construction and other real estate .....   | \$ 34         | \$ 33         | \$ 15         | \$ 33         | \$ 30         |
| Other commercial .....                     | 89            | 69            | 70            | 117           | 233           |
| Total commercial .....                     | <u>123</u>    | <u>102</u>    | <u>85</u>     | <u>150</u>    | <u>263</u>    |
| Consumer:                                  |               |               |               |               |               |
| Residential mortgages .....                | 640           | 265           | 138           | 99            | 78            |
| Credit card receivables .....              | 1             | 1             | -             | -             | 22            |
| Other consumer loans .....                 | -             | -             | -             | 1             | 3             |
| Total consumer loans .....                 | <u>641</u>    | <u>266</u>    | <u>138</u>    | <u>100</u>    | <u>103</u>    |
| Total nonaccruing loans .....              | \$ <u>764</u> | \$ <u>368</u> | \$ <u>223</u> | \$ <u>250</u> | \$ <u>366</u> |
| As a percent of loans:                     |               |               |               |               |               |
| Commercial:                                |               |               |               |               |               |
| Construction and other real estate .....   | .40 %         | .37 %         | .16 %         | .40 %         | .43 %         |
| Other commercial .....                     | .30           | .34           | .38           | .80           | 2.00          |
| Total commercial .....                     | <u>.32</u>    | <u>.35</u>    | <u>.31</u>    | <u>.65</u>    | <u>1.41</u>   |
| Consumer:                                  |               |               |               |               |               |
| Residential mortgages .....                | 1.81          | .67           | .31           | .21           | .29           |
| Credit card receivables .....              | .01           | .01           | -             | -             | 1.89          |
| Other consumer loans .....                 | -             | -             | -             | .03           | .15           |
| Total consumer loans .....                 | <u>1.12</u>   | <u>.44</u>    | <u>.22</u>    | <u>.16</u>    | <u>.35</u>    |
| Total .....                                | <u>.80 %</u>  | <u>.41 %</u>  | <u>.25 %</u>  | <u>.29 %</u>  | <u>.76 %</u>  |
| Interest income on nonaccruing loans       |               |               |               |               |               |
| (Year ended December 31):                  |               |               |               |               |               |
| Amount which would have been recorded      |               |               |               |               |               |
| had the associated loans been current in   |               |               |               |               |               |
| accordance with their original terms ..... | \$ 49         | \$ 24         | \$ 25         | \$ 23         | \$ 28         |
| Amount actually recorded .....             | 7             | 8             | 12            | 17            | 12            |

Increase in consumer nonaccruing loans in 2007 was related primarily to sub-prime residential mortgage loans held for sale and occurred as a result of illiquidity in the U.S. mortgage market. This increase also relates to a portfolio of higher quality nonconforming residential mortgage loans which HUSI purchased from HSBC Finance Corporation in order to hold in the residential mortgage loan portfolio. Certain loans in the Home Equity Line of Credit (HELOC) portfolio and other prime mortgage loan portfolio have also contributed to this increase. Refer to Note 8 of this Form 10-K for additional credit quality statistics on nonaccruing loans.

Interest that has been accrued but unpaid on loans placed on nonaccruing status generally is reversed and reduces current income at the time loans are so categorized. Interest income on these loans may be recognized to the extent of cash payments received. In those instances where there is doubt as to collectibility of principal, any cash interest payments received are applied as reductions of principal. Loans are not reclassified as accruing until interest and principal payments are brought current and future payments are reasonably assured.

### ***Impaired Loans***

A loan is considered to be impaired when it is deemed probable that all principal and interest amounts due, according to the contractual terms of the loan agreement, will not be collected. Probable losses from impaired loans are quantified and recorded as a component of the overall allowance for credit losses. Generally, impaired loans include loans in nonaccruing status, loans which have been assigned a specific allowance for credit losses, loans which have been partially or wholly charged off, and loans designated as troubled debt restructurings. Impaired loan statistics are summarized in the following table. Refer to Note 8 on this Form 10-K for more information on impaired loans.

|                                      | 2007   | 2006   | 2005  | 2004   | 2003   |
|--------------------------------------|--------|--------|-------|--------|--------|
| <b>(in millions)</b>                 |        |        |       |        |        |
| Impaired loans:                      |        |        |       |        |        |
| Balance at end of period .....       | \$ 123 | \$ 100 | \$ 90 | \$ 236 | \$ 267 |
| Amount with impairment reserve ..... | 41     | 35     | 27    | 210    | 179    |
| Impairment reserve .....             | 15     | 13     | 10    | 18     | 86     |

### ***Criticized Assets***

Criticized asset classifications are based on the risk rating standards of HUSI's primary regulator. Problem loans are assigned various criticized facility grades under HUSI's allowance for credit losses methodology. The following facility grades are deemed to be criticized.

***Special Mention*** – generally includes loans that are protected by collateral and/or the credit worthiness of the customer, but are potentially weak based upon economic or market circumstances which, if not checked or corrected, could weaken HUSI's credit position at some future date.

***Substandard*** – includes loans that are inadequately protected by the underlying collateral and/or general credit worthiness of the customer. These loans present a distinct possibility that HUSI will sustain some loss if the deficiencies are not corrected. This category also includes certain non-investment grade securities, as required by HUSI's principal regulator.

***Doubtful*** – includes loans that have all the weaknesses exhibited by substandard loans, with the added characteristic that the weaknesses make collection or liquidation in full of the recorded loan highly improbable. However, although the possibility of loss is extremely high, certain factors exist which may strengthen the credit at some future date, and therefore the decision to charge off the loan is deferred. Loans graded as doubtful are required to be placed in nonaccruing status.

Criticized assets are summarized in the following table.

|                         | December 31,<br>2007 | Increase (Decrease) from |             |                   |            |
|-------------------------|----------------------|--------------------------|-------------|-------------------|------------|
|                         |                      | December 31, 2006        |             | December 31, 2005 |            |
|                         |                      | Amount                   | %           | Amount            | %          |
| <b>(\$ in millions)</b> |                      |                          |             |                   |            |
| Special mention:        |                      |                          |             |                   |            |
| Commercial loans .....  | \$ <u>2,402</u>      | \$ <u>1,151</u>          | <u>92</u>   | \$ <u>1,742</u>   | <u>264</u> |
| Substandard:            |                      |                          |             |                   |            |
| Commercial loans .....  | <u>625</u>           | <u>(56)</u>              | <u>(8)</u>  | <u>471</u>        | <u>306</u> |
| Consumer loans .....    | <u>1,168</u>         | <u>567</u>               | <u>94</u>   | <u>714</u>        | <u>157</u> |
|                         | <u>1,793</u>         | <u>511</u>               | <u>40</u>   | <u>1,185</u>      | <u>195</u> |
| Doubtful:               |                      |                          |             |                   |            |
| Commercial loans .....  | <u>25</u>            | <u>(7)</u>               | <u>(22)</u> | <u>1</u>          | <u>4</u>   |
| Total .....             | \$ <u>4,220</u>      | \$ <u>1,655</u>          | <u>65</u>   | \$ <u>2,928</u>   | <u>227</u> |

The increase in criticized commercial loans is addressed under Commercial Loan Credit Quality on page 64. Higher substandard consumer loans primarily relate to private label credit card receivables and, to a lesser extent, to residential mortgage loans acquired from HSBC Finance Corporation.

## Provision and Allowance for Credit Losses

An analysis of the provision for credit losses is provided on page 37 of this Form 10-K.

An analysis of overall changes in the allowance for credit losses and related allowance ratios is presented in the following table.

| Year Ended December 31  | 2007      | 2006      | 2005      | 2004      | 2003      |
|---|-----------|-----------|-----------|-----------|-----------|
| <b>(\$ in millions)</b>   |           |           |           |           |           |
| Total loans at year end .....                                   | \$ 94,949 | \$ 90,237 | \$ 90,342 | \$ 84,947 | \$ 48,474 |
| Average total loans .....                                       | 89,462    | 88,853    | 87,898    | 60,328    | 44,187    |
| Allowance for credit losses:                                    |           |           |           |           |           |
| Balance at beginning of year .....                              | \$ 897    | \$ 846    | \$ 788    | \$ 399    | \$ 493    |
| Allowance related to acquisitions and (dispositions), net ..... | -         | (8)       | -         | 485       | (15)      |
| Charge offs:  |           |           |           |           |           |
| Commercial .....  | 147       | 136       | 75        | 54        | 160       |
| Consumer:   |           |           |           |           |           |
| Residential mortgages .....                                     | 70        | 37        | 24        | 15        | 3         |
| Credit card receivables .....                                   | 935       | 728       | 659       | 65        | 59        |
| Other consumer loans .....                                      | 117       | 111       | 113       | 23        | 21        |
| Total consumer loans .....                                      | 1,122     | 876       | 796       | 103       | 83        |
| Total charge offs .....   | 1,269     | 1,012     | 871       | 157       | 243       |
| Recoveries on loans charged off:                                |           |           |           |           |           |
| Commercial .....  | 28        | 38        | 71        | 60        | 35        |
| Consumer:   |           |           |           |           |           |
| Residential mortgages .....                                     | 1         | 2         | 1         | 2         | 1         |
| Credit card receivables .....                                   | 198       | 170       | 146       | 8         | 8         |
| Other consumer loans .....                                      | 37        | 38        | 37        | 8         | 7         |
| Total consumer loans .....                                      | 236       | 210       | 184       | 18        | 16        |
| Total recoveries .....  | 264       | 248       | 255       | 78        | 51        |
| Total net charge offs .....                                     | 1,005     | 764       | 616       | 79        | 192       |
| Provision charged (credited) to income .....                    | 1,522     | 823       | 674       | (17)      | 113       |
| Balance at end of year .....                                    | \$ 1,414  | \$ 897    | \$ 846    | \$ 788    | \$ 399    |
| Allowance ratios:   |           |           |           |           |           |
| Total net charge offs to average loans:                         |           |           |           |           |           |
| Commercial .....  | .38 %     | .35 %     | .02 %     | (.03) %   | .63 %     |
| Consumer:   |           |           |           |           |           |
| Residential mortgages .....                                     | .18       | .08       | .05       | .04       | .01       |
| Credit card receivables .....                                   | 4.12      | 3.49      | 3.81      | 4.69      | 4.57      |
| Other consumer loans .....                                      | 3.23      | 2.47      | 2.41      | .73       | .75       |
| Total consumer loans .....                                      | 1.53      | 1.10      | .96       | .21       | .28       |
| Total loans .....   | 1.12 %    | .86 %     | .70 %     | .13 %     | .43 %     |
| Year-end allowance to:  |           |           |           |           |           |
| Year-end total loans .....                                      | 1.49 %    | .99 %     | .94 %     | .93 %     | .82 %     |
| Year-end total nonaccruing loans (1).....                       | 185.08 %  | 243.75 %  | 379.37 %  | 315.20 %  | 109.02 %  |

- (1) The increased allowance for credit losses at the end of 2007, 2006, 2005 and 2004 resulted from the acquisition of the private label credit card receivables from HSBC Finance Corporation. As these receivable balances are typically maintained as accruing until charged off, there were no loan balances included in this portfolio which were classified as nonaccruing, resulting in a significant increase in the ratio of allowance to nonaccruing loans for 2007, 2006, 2005 and 2004 as compared with prior years.

Changes in the allowance for credit losses during 2007 and 2006 by general loan categories, are summarized in the following tables.

| <b>Year Ended December 31</b>                   | <b>Commercial</b> | <b>Residential Mortgage</b> | <b>Credit Card</b> | <b>Other Consumer</b> | <b>Unallocated</b> | <b>Total</b>    |
|---|-------------------|-----------------------------|--------------------|-----------------------|--------------------|-----------------|
| <b>(in millions)</b>                            |                   |                             |                    |                       |                    |                 |
| <b>2007</b>                                     |                   |                             |                    |                       |                    |                 |
| Balance at beginning of year .....              | \$ <u>203</u>     | \$ <u>31</u>                | \$ <u>626</u>      | \$ <u>26</u>          | \$ <u>11</u>       | \$ <u>897</u>   |
| Allowance related to dispositions ...           | -                 | -                           | -                  | -                     | -                  | -               |
| Charge offs .....                               | <u>147</u>        | <u>70</u>                   | <u>935</u>         | <u>117</u>            | -                  | <u>1,269</u>    |
| Recoveries .....                                | <u>28</u>         | <u>1</u>                    | <u>198</u>         | <u>37</u>             | -                  | <u>264</u>      |
| Net charge offs .....                           | <u>119</u>        | <u>69</u>                   | <u>737</u>         | <u>80</u>             | -                  | <u>1,005</u>    |
| Provision charged to income .....               | <u>196</u>        | <u>126</u>                  | <u>1,108</u>       | <u>83</u>             | <u>9</u>           | <u>1,522</u>    |
| Balance at end of year .....                    | \$ <u>280</u>     | \$ <u>88</u>                | \$ <u>997</u>      | \$ <u>29</u>          | \$ <u>20</u>       | \$ <u>1,414</u> |
| <b>2006</b>                                     |                   |                             |                    |                       |                    |                 |
| Balance at beginning of year .....              | \$ <u>162</u>     | \$ <u>34</u>                | \$ <u>600</u>      | \$ <u>36</u>          | \$ <u>14</u>       | \$ <u>846</u>   |
| Allowance related to dispositions ...           | -                 | -                           | (8)                | -                     | -                  | (8)             |
| Charge offs .....                               | <u>136</u>        | <u>37</u>                   | <u>728</u>         | <u>111</u>            | -                  | <u>1,012</u>    |
| Recoveries .....                                | <u>38</u>         | <u>2</u>                    | <u>170</u>         | <u>38</u>             | -                  | <u>248</u>      |
| Net charge offs .....                           | <u>98</u>         | <u>35</u>                   | <u>558</u>         | <u>73</u>             | -                  | <u>764</u>      |
| Provision charged (credited)<br>to income ..... | <u>139</u>        | <u>32</u>                   | <u>592</u>         | <u>63</u>             | <u>(3)</u>         | <u>823</u>      |
| Balance at end of year .....                    | \$ <u>203</u>     | \$ <u>31</u>                | \$ <u>626</u>      | \$ <u>26</u>          | \$ <u>11</u>       | \$ <u>897</u>   |

An allocation of the allowance for credit losses by major loan categories is presented in the following table. The 2004 decrease in the unallocated portion noted in the table is due to a refinement in the allowance methodology during that year.

|                               | <b>2007</b>     |                            | <b>2006</b>   |                            | <b>2005</b>   |                            | <b>2004</b>   |                            | <b>2003</b>   |                            |
|-------------------------------|-----------------|----------------------------|---------------|----------------------------|---------------|----------------------------|---------------|----------------------------|---------------|----------------------------|
|                               | <b>Amount</b>   | <b>% of Loans to Total</b> | <b>Amount</b> | <b>% of Loans to Total</b> | <b>Amount</b> | <b>% of Loans to Total</b> | <b>Amount</b> | <b>% of Loans to Total</b> | <b>Amount</b> | <b>% of Loans to Total</b> |
| <b>(\$ in millions)</b>       |                 |                            |               |                            |               |                            |               |                            |               |                            |
| Commercial .....              | \$ <u>280</u>   | <u>40</u>                  | \$ 203        | 33                         | \$ 162        | 31                         | \$ 182        | 27                         | \$ 252        | 39                         |
| Consumer:                     |                 |                            |               |                            |               |                            |               |                            |               |                            |
| Residential mortgages .....   | <u>88</u>       | <u>37</u>                  | 31            | 44                         | 34            | 49                         | 20            | 55                         | 13            | 55                         |
| Credit card receivables ..... | <u>997</u>      | <u>21</u>                  | 626           | 20                         | 600           | 17                         | 553           | 14                         | 54            | 2                          |
| Other consumer .....          | <u>29</u>       | <u>2</u>                   | 26            | 3                          | 36            | 3                          | 20            | 4                          | 16            | 4                          |
| Unallocated reserve .....     | <u>20</u>       | -                          | 11            | -                          | 14            | -                          | 13            | -                          | 64            | -                          |
| Total                         | \$ <u>1,414</u> | <u>100</u>                 | \$ <u>897</u> | <u>100</u>                 | \$ <u>846</u> | <u>100</u>                 | \$ <u>788</u> | <u>100</u>                 | \$ <u>399</u> | <u>100</u>                 |

## Commercial Loan Credit Quality

Components of the commercial allowance for credit losses, as well as movements in comparison with prior years, are summarized in the following table.

|  | December 31,<br>2007 | Increase (Decrease) from |           |                   |           |
|--|----------------------|--------------------------|-----------|-------------------|-----------|
|  |                      | December 31, 2006        |           | December 31, 2005 |           |
|  |                      | Amount                   | %         | Amount            | %         |
| <b>(\$ in millions)</b>                |                      |                          |           |                   |           |
| On-balance sheet allowance:            |                      |                          |           |                   |           |
| Specific .....                         | \$ 15                | \$ 1                     | 7         | \$ 6              | 67        |
| Collective .....                       | 265                  | 76                       | 40        | 116               | 78        |
| Transfer risk .....                    | -                    | -                        | -         | (4)               | (100)     |
|  | <u>280</u>           | <u>77</u>                | <u>38</u> | <u>118</u>        | <u>73</u> |
| Unallocated .....                      | 20                   | 9                        | 82        | 6                 | 43        |
| Total on-balance sheet allowance ..... | <u>300</u>           | <u>86</u>                | <u>40</u> | <u>124</u>        | <u>70</u> |
| Off-balance sheet allowance .....      | 103                  | 5                        | 5         | 15                | 17        |
| Total commercial allowances .....      | <u>\$ 403</u>        | <u>\$ 91</u>             | <u>29</u> | <u>\$ 139</u>     | <u>53</u> |

### 2007

HUSI's growth initiatives have resulted in a continuing trend of growth in the size and complexity of the commercial loan portfolio. In addition, certain segments of the economy continue to show signs of slowing, resulting in higher probabilities of default, which is a key driver for credit grading. The resulting net increase in criticized assets, in combination with increased loan balances, resulted in higher specific and collective allowances at December 31, 2007.

Overall, commercial loan credit quality remains stable and well-controlled. Higher total criticized loan balances for 2007 as compared with 2006 (refer to page 61 of this Form 10-K) resulted mainly from downgrades in real estate and middle market exposures. Total nonaccruing commercial loans, as a percentage of total commercial loans, remain low and are flat year over year. Based upon evaluation of the repayment capacity of the obligors, including support from adequately margined collateral, performance on guarantees, and other mitigating factors, impairment is moderately higher in 2007 as compared with 2006, and is adequately reflected in the allowances for specific and collective impairment.

Provisions on commercial loans have increased in 2007, as compared to 2006, primarily due to a change in loan loss reserve methodology for HUSI's small business revolving line of credit product. Additionally, commercial real estate provisions have increased as a result of customer downgrades. Any sudden and/or unexpected adverse economic events or trends could significantly affect credit quality and increase provisions for credit losses.

### 2006

Criticized asset classifications are based on the risk rating standards of HUSI's primary regulator. Higher substandard criticized assets (refer to page 61 of this Form 10-K) resulted mainly from downgrades in auto and insurance industry exposures within the Global Banking and Markets business segment, and middle market commercial exposures within CMB. The downgrades resulted in part from changes in the credit metrics for specific credits within these industries and portfolios. Total nonaccruing commercial loans remain low as a percentage of total commercial loans.

During 2006, HUSI's management began to make more extensive use of available tools to more actively manage net exposure within its corporate loan portfolios with an increased syndication capacity as well as increased use of credit default swaps to economically hedge and reduce certain exposures.



### *Credit Card Receivable Credit Quality*

Credit card receivables are primarily private label receivables, including closed and open ended contracts, acquired from HSBC Finance Corporation. Receivables included in the private label credit card portfolio are generally maintained in accruing status until being charged off six months after delinquency. The following table provides credit quality data for credit card receivables.

| <b>December 31</b>   | <b>2007</b> |        | <b>2006</b> |        |
|--|-------------|--------|-------------|--------|
| (\$ in millions)   |             |        |             |        |
| Accruing credit card receivables contractually past due 90 days or more:     |             |        |             |        |
| Balance at end of period .....   | \$          | 432    |             | \$ 339 |
| As a percent of total credit card receivables .....                          |             | 2.23 % |             | 1.86 % |
| Allowance for credit losses associated with credit card receivables:         |             |        |             |        |
| Balance at end of period .....   | \$          | 997    |             | \$ 626 |
| As a percent of total credit card receivables .....                          |             | 5.14 % |             | 3.43 % |
| Net charge offs of credit card receivables:                                  |             |        |             |        |
| Total for the year ended .....   | \$          | 737    |             | \$ 558 |
| Net charge offs as a percent of annual average credit card receivables ..... |             | 4.12 % |             | 3.49 % |

#### **2007**

The allowance for credit losses associated with credit card receivables increased 59% to \$997 million in 2007. Net charge off and provision activity was higher during 2007 as compared to 2006 due to increased private label and MasterCard/Visa credit card receivable balances and to higher delinquencies within these portfolios, which have resulted in a higher collective allowance balance. Additionally, the increased allowance for credit losses associated with credit card receivables reflects a refinement in the methodology used to estimate inherent losses on private label loans less than 30 days delinquent, which increased credit loss reserves by \$107 million in the fourth quarter. Underwriting criteria are continually being reviewed and will be modified as necessary based on the current economic environment.

#### **2006**

The allowance for credit losses associated with credit card receivables increased 4% to \$626 million for 2006. Net charge off and provision activity during 2006, as well as the allowance balance at December 31, 2006, are generally consistent with increased private label credit card receivable balances (refer to page 52 of this Form 10-K for commentary regarding credit card receivables).

### *Residential Mortgage Loan Credit Quality*

#### **2007**

The increase in the allowance for credit losses related to residential mortgage loans during 2007 was primarily related to increased delinquencies and charge offs in the portfolio of higher quality nonconforming residential mortgage loans which HUSI purchased from HSBC Finance Corporation in order to hold in the residential mortgage loan portfolio. Also contributing to this increase are delinquencies and charge offs within the Home Equity Line of Credit (HELOC) portfolio, primarily due to continued deterioration in the housing markets. Other prime mortgage loans are also experiencing minimal deterioration.

Additional disclosures regarding certain risk concentrations inherent within the residential mortgage loan portfolio are provided beginning on page 66 of this Form 10-K.

2006

The allowance for credit losses related to residential mortgage loans decreased 9% during 2006. Lower loan balances resulted in lower allowance requirements during the year. HUSI's residential mortgage portfolio is primarily comprised of prime mortgage loans, for which credit quality remained strong during 2006 and 2005.

*Reserve for Off-Balance Sheet Exposures*

HUSI maintains a separate reserve for credit risk associated with certain off-balance sheet exposures including letters of credit, unused commitments to extend credit and financial guarantees. This reserve, included in other liabilities, was \$105 million and \$98 million at December 31, 2007 and 2006, respectively.

*Concentrations of Credit Risk*

A concentration of credit risk is defined as a significant credit exposure with an individual or group engaged in similar activities or affected similarly by economic conditions. HUSI enters into a variety of transactions in the normal course of business that involve both on and off-balance sheet credit risk. Principal among these activities is lending to various commercial, institutional, governmental and individual customers. HUSI participates in lending activity throughout the United States and internationally. In general, HUSI controls the varying degrees of credit risk involved in on and off-balance sheet transactions through specific credit policies. These policies and procedures provide for a strict approval, monitoring and reporting process. It is HUSI's policy to require collateral when it is deemed appropriate. Varying degrees and types of collateral are secured depending upon management's credit evaluation.

As with any nonconforming and non-prime loan products, HUSI utilizes high underwriting standards and prices these loans in a manner that is appropriate to compensate for higher risk.

Certain residential mortgage loans have high loan-to-value (LTV) ratios and no mortgage insurance, which could result in potential inability to recover the entire investment in loans involving foreclosed or damaged properties.

HUSI also offers interest-only residential mortgage loans. These interest-only loans allow customers to pay only the accruing interest for a period of time, which results in lower payments during the initial loan period. Depending on a customer's financial situation, the subsequent increase in the required payment attributable to loan principal could affect a customer's ability to repay the loan at some future date when the interest rate resets and/or principal payments are required.

Outstanding balances of high LTV and interest-only loans are summarized in the following table.

| <b>December 31</b>   | <b>2007</b>     | <b>2006</b>      |
|--|-----------------|------------------|
| <b>(in millions)</b>   |                 |                  |
| Residential mortgage loans with high LTV and no mortgage insurance ..... | \$ 2,345        | \$ 3,079         |
| Interest-only residential mortgage loans .....                           | <u>6,161</u>    | <u>7,537</u>     |
| Total .....  | <u>\$ 8,506</u> | <u>\$ 10,616</u> |

Concentrations of first and second liens within the residential mortgage loan portfolio are summarized in the following table. Amounts in the table exclude loans held for sale.

| <b>December 31</b>   | <b>2007</b>      | <b>2006</b>      |
|----------------------|------------------|------------------|
| <b>(in millions)</b> |                  |                  |
| Closed end:          |                  |                  |
| First lien .....     | \$ 28,315        | \$ 31,876        |
| Second lien .....    | 1,096            | 474              |
| Revolving:           |                  |                  |
| Second lien .....    | <u>3,082</u>     | <u>3,231</u>     |
| Total .....          | <u>\$ 32,493</u> | <u>\$ 35,581</u> |

HUSI also offers adjustable rate residential mortgage loans which allow it to adjust pricing on the loan in line with market movements. At December 31, 2007, HUSI had approximately \$17.9 billion in adjustable rate residential mortgage loans. In 2008, approximately \$2.8 billion of adjustable rate residential mortgage loans will experience their first interest rate reset. In 2009, approximately \$8.9 billion of adjustable rate residential mortgage loans will experience their first interest rate reset. As interest rates have risen over the last three years, many adjustable rate loans are expected to require a significantly higher monthly payment following their first adjustment. A customer's financial situation at the time of the interest rate reset could affect the customer's ability to repay the loan after the adjustment.

Regional exposure at December 31, 2007 for certain loan portfolios is summarized in the following table.

| December 31, 2007                 | Commercial<br>Construction and<br>Other Real<br>Estate Loans | Residential<br>Mortgage<br>Loans | Credit<br>Card<br>Receivables |
|-----------------------------------|--|----------------------------------|-------------------------------|
| New York State .....              | 51 %   | 26 %                             | 10 %                          |
| North Central United States ..... | 3  | 11                               | 24                            |
| North Eastern United States ..... | 9  | 12                               | 14                            |
| Southern United States .....      | 18   | 23                               | 28                            |
| Western United States .....       | 19   | 28                               | 24                            |
| Total .....                       | 100 %  | 100 %                            | 100 %                         |

### *Cross-Border Net Outstandings*

Cross-border net outstandings, as calculated in accordance with Federal Financial Institutions Examination Council (FFIEC) guidelines, are amounts payable to HUSI by residents of foreign countries regardless of the currency of claim and local country claims in excess of local country obligations. Cross-border net outstandings include deposits placed with other banks, loans, acceptances, securities available for sale, trading securities, revaluation gains on foreign exchange and derivative contracts and accrued interest receivable. Excluded from cross-border net outstandings are, among other things, the following: local country claims funded by non-local country obligations (U.S. dollar or other non-local currencies), principally certificates of deposit issued by a foreign branch, where the providers of funds agree that, in the event of the occurrence of a sovereign default or the imposition of currency exchange restrictions in a given country, they will not be paid until such default is cured or currency restrictions lifted or, in certain circumstances, they may accept payment in local currency or assets denominated in local currency (hereinafter referred to as constraint certificates of deposit); and cross-border claims that are guaranteed by cash or other external liquid collateral. Cross-border net outstandings that exceed .75% of total assets at year-end are summarized in the following table.

| (in millions)             | Banks and<br>Other Financial<br>Institutions | Commercial<br>and<br>Industrial | Total     |
|---------------------------|--|---------------------------------|-----------|
| <b>December 31, 2007:</b> |  |                                 |           |
| France .....              | \$ 1,562                                     | \$ 21                           | \$ 1,583  |
| Canada .....              | 833  | 1,011                           | 1,844     |
| United Kingdom .....      | 2,697  | 1,204                           | 3,901     |
| Germany .....             | 2,017  | 60                              | 2,077     |
| Brazil .....              | 1,741  | 715                             | 2,456     |
|                           | \$ 8,850                                     | \$ 3,011                        | \$ 11,861 |
| <b>December 31, 2006:</b> |  |                                 |           |
| France .....              | \$ 1,782                                     | \$ 49                           | \$ 1,831  |
| Canada .....              | 1,305  | 793                             | 2,098     |
| United Kingdom .....      | 1,738  | 1,127                           | 2,865     |
|                           | \$ 4,825                                     | \$ 1,969                        | \$ 6,794  |
| <b>December 31, 2005:</b> |  |                                 |           |
| United Kingdom .....      | \$ 1,497                                     | \$ 970                          | \$ 2,467  |

### *Credit and Market Risks Associated with Derivative Contracts*

Credit (or repayment) risk in derivative instruments is minimized by entering into transactions with high quality counterparties, including other HSBC entities. Counterparties include financial institutions, government agencies, both foreign and domestic, corporations, funds (mutual funds, hedge funds, etc.), insurance companies, including monoline insurance companies, and private clients. These counterparties are subject to regular credit review by the credit risk management department. Most derivative contracts are governed by an International Swaps and Derivatives Association Master Agreement. Depending on the type of counterparty and the level of expected activity, bilateral collateral arrangements may also be required.

The total risk in a derivative contract is a function of a number of variables, such as:

- whether counterparties exchange notional principal;
- volatility of interest rates, currencies, equity or corporate reference entity used as the basis for determining contract payments;
- maturity and liquidity of contracts;
- credit worthiness of the counterparties in the transaction; and
- existence and value of collateral received from counterparties to secure exposures.

The following table presents credit risk exposure and net fair value associated with derivative contracts. In the table, current credit risk exposure is the recorded fair value of derivative receivables, which represents revaluation gains from the marking to market of derivative contracts held for trading purposes, for all counterparties with an International Swaps and Derivatives Association Master Agreement in place.

Future credit risk exposure in the following table is measured using rules contained in the risk-based capital guidelines published by U.S. banking regulatory agencies. The risk exposure calculated in accordance with the risk-based capital guidelines potentially overstates actual credit exposure, because:

- the risk-based capital guidelines ignore collateral that may have been received from counterparties to secure exposures; and
- the risk-based capital guidelines compute exposures over the life of derivative contracts. However, many contracts contain provisions that allow a bank to close out the transaction if the counterparty fails to post required collateral, or is downgraded below a certain rating by external ratings agencies, or contracts may be subject to break clauses at specific dates. As a result, these contracts have potential future exposures that are often much smaller than the future exposures derived from the risk-based capital guidelines.

The net credit risk exposure amount in the following table does not reflect the impact of bilateral netting (i.e., netting with a single counterparty when a bilateral netting agreement is in place). However, the risk-based capital guidelines recognize that bilateral netting agreements reduce credit risk and therefore allow for reductions of risk-weighted assets when netting requirements have been met. In addition, risk-based capital rules require that netted exposures of various counterparties be assigned risk-weightings, which result in risk-weighted amounts for regulatory capital purposes that are a fraction of the original netted exposures.

| <b>December 31</b>                           | <b>2007</b>      | <b>2006</b>      |
|--|------------------|------------------|
| <b>(in millions)</b>                         |                  |                  |
| Risk associated with derivative contracts:   |                  |                  |
| Current credit risk exposure .....           | \$ 14,711        | \$ 11,398        |
| Future credit risk exposure .....            | <u>74,236</u>    | <u>72,447</u>    |
| Total risk exposure .....                    | <b>88,947</b>    | 83,845           |
| Less: collateral held against exposure ..... | <u>(5,148)</u>   | <u>(3,989)</u>   |
| Net credit risk exposure .....               | <b>\$ 83,799</b> | <b>\$ 79,856</b> |

The table below summarizes the risk profile of the counterparties of HUSI's on balance sheet exposure to derivative contracts, net of cash and other highly liquid collateral. The exposure in the unrated category are exposures to counterparties that have not been rated by an external rating agency. These counterparties are, however, rated according to HUSI's Internal Credit Rating System and exposure is mostly equivalent to investment grade. Refer to pages 77-79 of this Form 10-K for additional commentary relating to the Internal Credit Rating System.

| Rating equivalent at December 31 | Percent of Current Credit Risk Exposure, Net of Collateral |              |
|----------------------------------|--|--------------|
|                                  | 2007   | 2006         |
| AAA to AA- .....                 | 52 %   | 46 %         |
| A+ to A- .....                   | 29   | 31           |
| BBB+ to BBB- .....               | 4  | 15           |
| BB+ to B- .....                  | 5  | 4            |
| CCC+ and below .....             | *  | *            |
| Unrated .....                    | 10   | 4            |
| Total .....                      | <u>100</u> %   | <u>100</u> % |

\* Less than .5 percent.

HUSI enters into basis trades to monetize the basis difference between a bond and a credit default swap (CDS). In a basis trade, HUSI subscribes newly-issued floating rate investment grade mortgage backed or asset backed securities and contemporaneously buys credit protection from monoline insurers for a premium. The sponsoring monoline provides financial guaranty to HUSI if there is a credit event. When the bond spread is higher than the CDS spread, the basis is "negative" and the trade is described as a negative basis trade. The monolines typically do not post collateral and HUSI trades with monolines based on their credit ratings. As of December 31, 2007, HUSI had approximately \$5,911 million notional of CDS under the negative basis arrangements with monolines.

Due to recent downgrades in HUSI's internal credit ratings of monoline insurance companies (refer to Credit Risk Management beginning on page 77 of this Form 10-K for additional commentary relating to HUSI's credit rating system), fair value adjustments have been recorded due to counterparty credit exposures. As of December 31, 2007, this exposure totaled \$1,083 million. HUSI recorded write-downs on these contracts of approximately \$287 million, which reflects the decreased credit quality of these entities and concerns over their ability to perform at December 31, 2007. The exposure relating to monoline insurance companies which are rated CCC+ and below has been fully written down as of December 31, 2007.

Market risk is the adverse effect that a change in market liquidity, interest rates, currency, or implied volatility rates has on the value of a financial instrument. HUSI manages the market risk associated with interest rate and foreign exchange contracts by establishing and monitoring limits as to the types and degree of risk that may be undertaken. HUSI also manages the market risk associated with the trading derivatives through hedging strategies that correlate the rates, price and spread movements. HUSI measures this risk daily by using Value at Risk (VAR) and other methodologies. Refer to Market Risk Management, beginning on page 84 of this Form 10-K, for commentary regarding the use of VAR analyses to monitor and manage interest rate and other market risks.

HUSI's Asset and Liability Policy Committee is responsible for monitoring and defining the scope and nature of various strategies utilized to manage interest rate risk that are developed through its analysis of data from financial simulation models and other internal and industry sources. The resulting hedge strategies are then incorporated into HUSI's overall interest rate risk management and trading strategies.

## *Off-Balance Sheet Arrangements and Contractual Obligations*

### *Off-Balance Sheet Arrangements*

As part of its normal operations, HUSI enters into various off-balance sheet arrangements with affiliates and third parties. These arrangements arise principally in connection with HUSI's lending and client intermediation activities and involve primarily extensions of credit and guarantees.

As a financial services provider, HUSI routinely extends credit through loan commitments and lines and letters of credit and provides financial guarantees, including derivative transactions that meet the definition of a guarantee under FIN 45. The contractual amounts of these financial instruments represent HUSI's maximum possible credit exposure in the event that a counterparty draws down the full commitment amount or HUSI is required to fulfill its maximum obligation under a guarantee.

The following table presents total contractual amounts and maturity information related to HUSI's off-balance sheet arrangements. Many of these commitments and guarantees expire unused or without default; as a result, HUSI believes that the contractual amount is not representative of the actual future credit exposure or funding requirements. Descriptions of the various arrangements follow the table.

|  | Balance at December 31, 2007 |                                   |                       |            | Balance at<br>December 31,<br>2006 |
|--|------------------------------|-----------------------------------|-----------------------|------------|------------------------------------|
|  | One<br>Year<br>or Less       | Over One<br>Through<br>Five Years | Over<br>Five<br>Years | Total      |                                    |
| <i>(in millions)</i>                                       |                              |                                   |                       |            |                                    |
| Standby letters of credit, net of participations (1) ..... | \$ 6,527                     | \$ 2,371                          | \$ 123                | \$ 9,021   | \$ 7,259                           |
| Commercial letters of credit .....                         | 818                          | 116                               | -                     | 934        | 795                                |
| Credit derivatives considered<br>guarantees (2) .....      | 20,854                       | 406,684                           | 222,705               | 650,243    | 431,631                            |
| Other commitments to extend credit:                        |                              |                                   |                       |            |                                    |
| Commercial .....   | 30,640                       | 25,204                            | 3,197                 | 59,041     | 55,862                             |
| Consumer .....   | 10,053                       | -                                 | -                     | 10,053     | 9,627                              |
| Total .....  | \$ 68,892                    | \$ 434,375                        | \$ 226,025            | \$ 729,292 | \$ 505,174                         |

(1) Includes \$598 million and \$542 million issued for the benefit of HSBC affiliates at December 31, 2007 and 2006, respectively.

(2) Includes \$98,250 million and \$71,908 million issued for the benefit of HSBC affiliates at December 31, 2007 and 2006, respectively.

### *Letters of Credit*

HUSI may issue a letter of credit for the benefit of a customer, authorizing a third party to draw on the letter for specified amounts under certain terms and conditions. The issuance of a letter of credit is subject to HUSI's credit approval process and collateral requirements. HUSI issues two types of letters of credit, commercial and standby.

- A commercial letter of credit is drawn down on the occurrence of an expected underlying transaction, such as the delivery of goods. Upon the occurrence of the transaction, the amount drawn under the commercial letter of credit is recorded as a receivable from the customer in other assets and as a liability to the vendor in other liabilities until settled.
- A standby letter of credit is issued to third parties for the benefit of a customer and is essentially a guarantee that the customer will perform, or satisfy some obligation, under a contract. It irrevocably obligates HUSI to pay a third party beneficiary when a customer either: (1) in the case of a performance standby letter of credit, fails to perform some contractual non-financial obligation, or (2) in the case of a financial standby letter of credit, fails to repay an outstanding loan or debt instrument.

Fees are charged for issuing letters of credit commensurate with the customer's credit evaluation and the nature of any collateral. Included in other liabilities are deferred fees on standby letters of credit, representing the fair value of HUSI's "stand ready obligation to perform" under these guarantees, amounting to \$25 million and \$21 million at December 31, 2007 and 2006, respectively. Fees are recognized ratably over the term of the standby letter of credit. Also included in other liabilities is an allowance for credit losses on unfunded standby letters of credit of \$27 million and \$25 million at December 31, 2007 and 2006, respectively.

#### *Credit Derivatives Considered Guarantees*

HUSI enters into credit derivative contracts both for its own benefit and to satisfy the needs of its customers. Credit derivatives are arrangements that provide for one party (the "beneficiary") to transfer the credit risk of a "reference asset" to another party (the "guarantor"). Under this arrangement the guarantor assumes the credit risk associated with the reference asset without directly purchasing it. The beneficiary agrees to pay to the guarantor a specified fee. In return, the guarantor agrees to pay the beneficiary an agreed upon amount if there is a default during the term of the contract.

In accordance with its policy, HUSI offsets most of the market risk it assumes in selling credit guarantees through a credit derivative contract with another counterparty. Credit derivatives, although having characteristics of a guarantee, are accounted for as derivative instruments and are carried at fair value. The commitment amount included in the table on the preceding page is the maximum amount that HUSI could be required to pay, without consideration of the approximately equal amount receivable from third parties and any associated collateral.

#### *Other Commitments to Extend Credit*

Other commitments to extend credit include arrangements whereby HUSI is contractually obligated to extend credit in the form of loans, participations in loans, lease financing receivables, or similar transactions. Consumer commitments comprise unused credit card lines and commitments to extend credit secured by residential properties. HUSI has the right to change or terminate any terms or conditions of a customer's credit card or home equity line of credit account, upon notification to the customer. Commercial commitments comprise primarily those related to secured and unsecured loans and lines of credit and certain asset purchase commitments. In connection with its commercial lending activities, HUSI provides liquidity support to a number of multi-seller and single-seller asset backed commercial paper conduits (ABCP conduits) sponsored by affiliates and third parties. These ABCP conduits and HUSI's variable interests in them are more fully described in Note 27 Variable Interest Entities beginning on page 155 of this Form 10-K.

HUSI provides liquidity support to ABCP conduits in the form of liquidity loan agreements and liquidity asset purchase agreements. Liquidity facilities provided to multi-seller conduits support transactions associated with a specific seller of assets to the conduit and HUSI would only be required to provide support in the event of certain triggers associated with those transactions and the underlying assets. Liquidity facilities provided to single-seller conduits are not identified with specific transactions or assets and HUSI would be required to provide support upon occurrence of certain triggers that generally affect the conduit as a whole. HUSI's obligations are generally *pari passu* with that of other institutions that also provide liquidity support to the same conduit or for the same transactions. HUSI does not provide any program-wide credit enhancements to ABCP conduits.

Under the terms of these liquidity agreements, the ABCP conduits may call upon HUSI to lend money or to purchase certain assets upon the occurrence of certain trigger events. These trigger events are generally limited to market disruptions and declines in the value of the underlying assets that result in an inability of the ABCP conduit to issue new commercial paper to replace maturing commercial paper. With regard to a multi-seller liquidity facility, the maximum amount that HUSI could be required to advance upon the occurrence of a trigger event is generally limited to the lesser of the amount of outstanding commercial paper related to the supported transaction and the balance of the assets underlying that transaction adjusted by a funding formula that excludes defaulted and impaired assets. Under a single-seller liquidity facility, the maximum amount that HUSI and other liquidity providers could be required to advance is also generally limited to each provider's pro-rata share of the lesser of the amount of outstanding commercial paper and the balance of unimpaired performing assets held by the conduit. As a result, the maximum amount that HUSI would be required to fund may be significantly less than the maximum contractual amount specified by the liquidity agreement.

The tables below present information on HUSI's liquidity facilities with ABCP conduits at December 31, 2007 excluding facilities with certain multi-seller ABCP conduits that are subject to agreements affecting HUSI's obligations and which are separately discussed in the commentary following the tables. The maximum exposure to loss presented in the first table represents the maximum contractual amount of loans and asset purchases HUSI could be required to make under the liquidity agreements. This amount does not reflect the funding limits discussed above and also assumes that HUSI suffers a total loss on all amounts advanced and all assets purchased from the ABCP conduits. As such, HUSI believes that this measure significantly overstates its expected loss exposure.

| Conduit Type                                 | Maximum Exposure to Loss | Conduit Assets (1) |                                | Conduit Funding (1) |                              |
|--|--------------------------|--------------------|--------------------------------|---------------------|------------------------------|
|  |                          | Total Assets       | Weighted Average Life (Months) | Commercial Paper    | Weighted Average Life (Days) |
| (\$ in millions)                             |                          |                    |                                |                     |                              |
| HSBC affiliate sponsored (multi-seller)..... | \$ 9,301                 | \$ 6,502           | 37                             | \$ 6,499            | 24                           |
| Third-party sponsored:                       |                          |                    |                                |                     |                              |
| Multi-seller .....                           | 296                      | 296                | 60                             | 296                 | 3                            |
| Single-seller .....                          | 1,149                    | 26,227             | 37                             | 24,837              | 35                           |
| Total .....                                  | \$ <u>10,746</u>         | \$ <u>33,025</u>   |                                | \$ <u>31,632</u>    |                              |

- (1) For multi-seller conduits, the amounts presented represent only the specific assets and related funding supported by HUSI's liquidity facilities. For single-seller conduits, the amounts presented represent the total assets and funding of the conduit.



| Asset Class                           | Average<br>Asset Mix | Average Credit Quality (1) |       |       |
|---------------------------------------|----------------------|----------------------------|-------|-------|
|                                       |                      | Aaa                        | Aa    | A     |
| <u>Multi-seller conduits</u>          |                      |                            |       |       |
| Debt securities backed by:            |                      |                            |       |       |
| Credit card receivables .....         | 29 %                 | 59 %                       |       | 41 %  |
| Auto loans and leases .....           | 26                   |                            |       | 100 % |
| Trade receivables .....               | 20                   | 22 %                       | 18 %  | 60 %  |
| Other securities .....                | 11                   | 100 %                      |       |       |
| Capital calls .....                   | 4                    |                            |       | 100 % |
| Collateralized debt obligations ..... | 3                    | 100 %                      |       |       |
| Mortgages .....                       | 3                    |                            |       | 100 % |
| Auto dealer floor plan loans .....    | 3                    |                            |       | 100 % |
| Consumer loans .....                  | 1                    |                            |       | 100 % |
| Total .....                           | <u>100 %</u>         |                            |       |       |
| <u>Single-seller conduits</u>         |                      |                            |       |       |
| Debt securities backed by:            |                      |                            |       |       |
| Auto loans and leases .....           | 82 %                 | 98 %                       | 2 %   |       |
| Commercial property leases .....      | 2                    |                            |       | 100 % |
| Loans and trade receivables:          |                      |                            |       |       |
| Auto loans and leases .....           | 16                   |                            | 100 % |       |
| Total .....                           | <u>100 %</u>         |                            |       |       |

- (1) Credit quality is based on Standard and Poor's ratings at December 31, 2007 except for loans and trade receivables held by single-seller conduits, which are based on HUSI's internal ratings.

HUSI receives fees for providing these liquidity facilities. Credit risk on these obligations is managed by subjecting them to HUSI's normal underwriting and risk management processes.

During the second half of 2007, asset backed commercial paper markets experienced a decline in liquidity as concerns surrounding U.S. sub-prime residential mortgages spilled over into other credit markets. As a result, issuers of asset backed commercial paper found it increasingly difficult to refinance maturing commercial paper and many found it necessary to draw on liquidity facilities or obtain additional support in other forms. Despite market difficulties, none of the ABCP conduits included in the tables above drew on the liquidity facilities provided by HUSI during 2007. HUSI did, however, provide support to several HSBC-affiliate sponsored ABCP conduits by purchasing up to \$1.16 billion of A-1/P-1 rated commercial paper issued by them. The majority of commercial paper purchased was repaid upon maturity, although HUSI continued to hold \$306 million of such paper at December 31, 2007.

As noted, the tables above do not include information on liquidity facilities that HUSI provides to certain multi-seller ABCP conduits that are subject to agreements affecting HUSI's contractual obligations under the facilities. As a result of difficulties in the asset backed commercial paper markets, HUSI entered into various agreements during the second half of 2007 that modified its obligations with respect to these facilities. Under one of these agreements, known as the Montreal Accord, the adhering parties agreed not to trade, trigger default provisions, pursue liquidity or collateral calls, or exercise security rights over assets held by the covered conduits while they work to restructure outstanding commercial paper into longer-term securities. Separately, HUSI agreed to purchase and hold a specified amount of commercial paper issued by certain conduits covered by HUSI liquidity facilities. While the parties to these arrangements also agreed not to trigger defaults, make liquidity calls, or exercise security rights, the sponsors of these conduits agreed to meet certain collateral calls made by HUSI. As of December 31, 2007, one of the conduits subject to the Montreal Accord had been restructured and, as a result, HUSI no longer had any obligation to, or amounts due from, the restructured conduit. At December 31, 2007, the total amount of liquidity facilities HUSI provided to multi-seller ABCP conduits subject to and awaiting restructure under the various agreements was \$1.4 billion (net of participations of \$414 million, which includes a \$312 million participation that expired on December 31, 2007), of which \$10 million had been funded. Additionally, HUSI is a party to various derivative transactions with these conduits. The current exposure to these contracts is fully

collateralized. Commercial paper purchased and held by HUSI in connection with these agreements was \$408 million at December 31, 2007 and is reported in securities available for sale.

In addition to the facilities provided to ABCP conduits, HUSI also provides a \$50 million liquidity facility to a third-party sponsored multi-seller structured investment vehicle (SIV). This SIV and HUSI's involvement with it is more fully described in Note 27 Variable Interest Entities beginning on page 155 of this Form 10-K. At December 31, 2007, \$19 million of this facility had been funded and is recorded in loans on HUSI's balance sheet. The funded and unfunded amounts related to this liquidity facility were considered in the determination of HUSI's allowance for loan losses and its reserve for off-balance sheet exposures, respectively, at December 31, 2007. In January 2008, HUSI funded the remainder of the facility and, as a result of a significant downgrade in the borrower's credit rating, recorded a specific allowance against the fully drawn facility.

### *Money Market Funds*

HUSI has established and manages a number of constant net asset value (CNAV) money market funds that invest in shorter-dated highly-rated money market securities to provide investors with a highly liquid and secure investment. These funds price the assets in their portfolio on an amortized cost basis, which enables them to create and liquidate shares at a constant price. The funds, however, are not permitted to price their portfolios at amortized cost if that amount varies by more than 50 basis points from the portfolio's market value. In that case, the fund would be required to price its portfolio at market value and consequently would no longer be able to create or liquidate shares at a constant price.

At December 31, 2007, one of HUSI's sponsored CNAV funds, which had total net assets of \$7.6 billion, held \$558 million of investments issued by SIVs. As a result of recent market conditions and rating agency actions, these investments have experienced declines in market value. HUSI has no legal obligation, and currently has no plan, to offer financial support to this fund in the event that it is unable to maintain a constant net asset value as a result of becoming unable to value its assets at amortized cost. This fund has, however, received support from an affiliate of HUSI, which in January 2008 provided a letter of limited indemnity in relation to certain of the fund's SIV investments.

HUSI does not consolidate the CNAV funds it sponsors as they are not VIEs and HUSI does not hold a majority voting interest.

### *Contractual Obligations*

Obligations to make future payments under contracts are presented in the following table.

| <b>December 31, 2007</b>  | <b>One<br/>Year<br/>or Less</b> | <b>Over One<br/>Through<br/>Five Years</b> | <b>Over<br/>Five<br/>Years</b> | <b>Total</b>     |
|---|---------------------------------|--|--------------------------------|------------------|
| <b>(in millions)</b>  |                                 |  |                                |                  |
| Subordinated long-term debt and perpetual capital notes (1) .....   | \$ 250                          | \$ 779                                     | \$ 4,726                       | \$ 5,755         |
| Other long-term debt, including capital lease obligations (1) ..... | 8,628                           | 8,851                                      | 5,102                          | 22,581           |
| Pension and other postretirement benefit obligations (2) .....      | 62                              | 287  | 471                            | 820              |
| Minimum future rental commitments on operating leases (3) .....     | 106                             | 362  | 288                            | 756              |
| Purchase obligations (4) .....                                      | 83                              | 31   | -                              | 114              |
| Total .....   | <u>\$ 9,129</u>                 | <u>\$ 10,310</u>                           | <u>\$ 10,587</u>               | <u>\$ 30,026</u> |

- (1) Represents future principal payments related to debt instruments included in Note 15 of the consolidated financial statements beginning on page 128 of this Form 10-K.
- (2) Represents estimated future employee service expected to be paid based on assumptions used to measure HUSI's benefit obligation at December 31, 2007. See Note 23 of the consolidated financial statements beginning on page 144 of this Form 10-K.
- (3) Represents expected minimum lease payments under noncancellable operating leases for premises and equipment included in Note 25 of the consolidated financial statements beginning on page 152 of this Form 10-K.
- (4) Represents binding agreements for facilities management and maintenance contracts, custodial account processing services, internet banking services, consulting services, real estate services and other services.

## ***Risk Management***

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### ***Overview***

Some degree of risk is inherent in virtually all of HUSI's activities. For the principal activities undertaken by HUSI, the most important types of risks are considered to be credit, interest rate, market, liquidity, operational, fiduciary and reputational. Market risk broadly refers to price risk inherent in mark to market positions taken on trading and non-trading instruments. Operational risk technically includes legal and compliance risk. However, since compliance risk, including anti-money laundering (AML) risk, has such broad scope within HUSI's businesses, it is addressed below as a separate functional discipline. During 2007, there were no significant changes to the policies or approach for managing various types of risk, although HUSI continues to monitor current market conditions and will adjust risk management policies and procedures if deemed necessary.

The objective of HUSI's risk management system is to identify, measure and monitor risks so that:

- the potential costs can be weighed against the expected rewards from taking the risks;
- appropriate disclosures can be made to all concerned parties;
- adequate protections, capital and other resources can be put in place to weather all significant risks; and
- compliance with all relevant laws, regulations and regulatory requirements is ensured through staff education, adequate processes and controls, and ongoing monitoring efforts.

Historically, HUSI's approach toward risk management has emphasized a culture of business line responsibility combined with central requirements for diversification of customers and businesses. Extensive centrally determined requirements for controls, limits, reporting and the escalation of issues have been detailed in HUSI's and HSBC's policies and procedures. In addition, HUSI has a formal independent compliance function, the staff of which has been aligned with, and has advised, each business and support function.

As a result of an increasingly complex business environment, increased regulatory scrutiny, and the evolution of improved risk management tools and standards, HUSI has significantly upgraded, and continues to upgrade, its methodologies and systems. New practices and techniques have been developed that involve data development, modeling, simulation and analysis, management information systems development, self-assessment, and staff education programs.

Risk management oversight begins with HUSI's Board of Directors and its various committees, principally the Audit Committee. Specific oversight of various risk management processes is provided by the Risk Management Committee, which was assisted by three principal subcommittees through 2007:

- the Asset and Liability Policy Committee;
- the Operational Risk Management Committee; and
- the Credit Risk Committee.

The Risk Management Committee and each sub-committee were chartered by the Board of Directors. While the charters were tailored to reflect the roles and responsibilities of each committee, they all had the following common themes:

- defining risk appetites, policies and limits;
- monitoring and assessing exposures, trends and the effectiveness of risk management;
- reporting to the Board of Directors; and
- promulgating a suitable risk taking, risk management, and compliance culture.

Day-to-day management of credit risk is performed by the Co-Chief Credit Officers. For retail consumer loan portfolios, such as credit cards, installment loans, and residential mortgages, the consumer credit management skills and tools of HSBC Finance Corporation are leveraged. Day-to-day management of interest rate and market risk is centralized principally under the Treasurer. Operational, fiduciary, and compliance risk is decentralized and is the responsibility of each business and support unit. However, for all risk types, there are independent risk specialists that set standards, develop new risk methodologies, maintain central risk databases, and conduct reviews and analysis. The Chief Operating Officer, the Co-Chief Credit Officers and the Executive Vice President for Compliance and Anti-Money Laundering provide day-to-day oversight of these activities and work closely with internal audit and senior risk specialists at HNAH and HSBC.

## ***Economic and Regulatory Capital***

### ***Economic Capital***

Economic capital is defined as the amount of capital required to sustain a business through a complete business cycle, enabling the business to absorb unexpected losses and thus limit the probability of insolvency. Economic capital is measured at the business unit level based on four categories of risk:

- Credit risk
- Operational risk
- Market risk
- Interest rate risk

HUSI has begun a process to quantify additional risks, beyond the few risks quantified under economic capital. The quantification process is undertaken in conjunction with the HBUS Internal Capital Adequacy Assessment Process (ICAAP), and will include an evaluation of risks such as pension risk, liquidity risk, business risk, strategic risk and other risks. ICAAP is being developed in conjunction with the HBUS adoption of the Basel II framework as adopted by the U.S. Regulators.

Whereas regulatory capital is traditionally only calculated at the total bank level as a measure of the minimum capital needed for regulatory compliance and is based on the amount of capital maintained in relation to risk-weighted assets at a specific point in time, economic capital is actually a measure of risk. As a result, economic capital can be compared to total corporate capital resources and, since it can be assigned to each business unit according to its risk characteristics, it can be used to establish business performance measures, make pricing decisions or set portfolio guidelines.

Economic capital is an internal measure developed by HUSI based on its unique set of diverse businesses, risk appetites, and management practices. In 2004, HUSI began to calculate economic capital from statistical analyses of possible losses related to credit, market, interest rate and operational risk. HUSI calculates economic capital sufficient to cover losses over a one year time horizon at a 99.95% confidence level. This is consistent with HBUS's "AA" rating, as "AA" rated credits have historically defaulted at a rate of about .05% per year. The one year time horizon is also consistent with traditional planning and budgeting time horizons. Quantification of possible losses related to fiduciary and reputational risk, are broadly covered under the credit, market and operational risk measurements.

### ***Basel Capital Standards***

In December 2007, U.S. regulators published a final rule regarding Risk-Based Capital Standards. This final rule represents the U.S. adoption of the Basel II Capital Accord. The final rule will become effective April 1, 2008, and requires HUSI to adopt its provisions no later than April 1, 2011. Final adoption must be preceded by a parallel run period of at least four quarters.

An implementation plan for the new rule must be presented to the HUSI Board of Directors prior to October 1, 2008, in compliance with the final rule. The implementation plan will detail HUSI's readiness for adopting the new standard, as well as the expected timing for adoption.

In addition, HUSI continues to support the HSBC Group implementation of the Basel II framework, as adopted by the Financial Services Authority (FSA). HUSI supplies data regarding credit risk, operational risk, and market risk to support the Group's regulatory capital and risk weighted asset calculations. Revised FSA capital adequacy rules for the HSBC Group became effective January 1, 2008.

### ***Credit Risk Management***

Credit risk is the potential that a borrower or counterparty will default on a credit obligation, as well as the impact on the value of credit instruments due to changes in the probability of borrower default.

For HUSI, credit risk is inherent in various on and off-balance sheet instruments and arrangements:

- in loan portfolios;
- in investment portfolios;
- in unfunded commitments such as letters of credit and lines of credit that customers can draw upon; and
- in treasury instruments, such as interest rate swaps which, if more valuable today than when originally contracted, may represent an exposure to the counterparty to the contract.

While credit risk exists widely within HUSI, diversification among various commercial and consumer portfolios helps HUSI to lessen risk exposure. Analysis of HUSI's credit quality begins on page 59 of this Form 10-K.

HUSI assesses, monitors and controls credit risk with formal standards, policies and procedures. An independent Credit Risk function is maintained under the direction of Co-Chief Credit Officers, who report directly to the Chief Executive Officer of HUSI.

The responsibilities of the credit risk function include:

- *Formulating credit risk policies* - HUSI's policies are designed to ensure that various retail and commercial business units operate within clear standards of acceptable credit risk. HUSI's policies ensure that the HSBC standards are consistently implemented across all businesses and that all regulatory requirements are also considered. Credit policies are reviewed and approved annually by the Audit Committee.
- *Approving new credit exposures and independently assessing large exposures annually* - The Co-Chief Credit Officers delegate credit authority to various lending units throughout HUSI. However, most large credits are reviewed and approved centrally through a dedicated Credit Approval Unit that reports directly to the Co-Chief Credit Officers. In addition, the Co-Chief Credit Officers coordinate the approval of material credits with HSBC Group Credit Risk which, subject to certain agreed-upon limits, will review and concur on material new and renewal transactions.
- *Maintaining and developing the governance and operation of HUSI's risk rating system* - HUSI utilizes a two-dimensional credit risk rating system in order to categorize exposures meaningfully and enable focused management of the risks involved. This ratings system is comprised of a 22 category Customer Risk Rating which considers the probability of default of an obligor and a separate assessment of a transaction's potential loss given default. Rating methodologies are based upon a wide range of analytics and market data-based tools, which are core inputs to the assessment of counterparty risk. Although automated risk rating processes are increasingly used, for larger facilities the ultimate responsibility for setting risk grades rests in each case with the final approving executive. Risk grades are reviewed frequently and amendments, where necessary, are implemented promptly.

- *Measuring portfolio credit risk* - Over the past few years, the advanced credit ratings system has been used to implement a credit economic capital risk measurement system to measure the risk in HUSI's credit portfolios, using the measure in certain internal and Board of Directors reporting. Simulation models are used to determine the amount of unexpected losses, beyond expected losses, that HUSI must be prepared to support with capital given its targeted debt rating. Monthly credit economic capital reports are generated and reviewed with management and the business units. Efforts continue to refine both the inputs and assumptions used in the credit economic capital model to increase its usefulness in pricing and the evaluation of large and small commercial and retail customer portfolio products and business unit return on risk.
- *Monitoring portfolio performance* - HUSI has implemented a credit data warehouse to centralize the reporting of its credit risk, support the analysis of risk using tools such as economic capital, and to calculate its credit loss reserves. This data warehouse also supports HSBC's wider effort to meet the requirements of Basel II and to generate credit reports for management and the Board of Directors.
- *Establishing counterparty and portfolio limits* - HUSI monitors and limits its exposure to individual counterparties and to the combined exposure of related counterparties. In addition, selected industry portfolios, such as real estate and structured products, are subject to caps that are established by the Co-Chief Credit Officers and reviewed where appropriate by management committees and the Board of Directors. Counterparty credit exposure related to derivative activities is also managed under approved limits. Since the exposure related to derivatives is variable and uncertain, HUSI uses internal risk management methodologies to calculate the 95% worst-case potential future exposure for each customer. These methodologies take into consideration, among other factors, cross-product close-out netting, collateral received from customers under Collateral Support Annexes (CSAs), termination clauses, and off-setting positions within the portfolio.
- *Managing problem commercial loans* - Special attention is paid to problem loans. When appropriate, HUSI's Special Credits Unit provides customers with intensive management and control support in order to help them avoid default wherever possible and maximize recoveries.
- *Establishing allowances for credit losses* - The Co-Chief Credit Officers share the responsibility with the Chief Financial Officer for establishing appropriate levels of allowances for credit losses inherent in various loan portfolios.
- *Overseeing retail credit risk* - Each retail business unit is supported by dedicated advanced risk analytics units. The Co-Chief Credit Officers provide independent oversight of credit risk associated with these retail portfolios and is supported by expertise from HNAH's Retail Credit Management unit.
- *Chairing the Credit Risk Management Committee* - The Co-Chief Credit Officers chair the Credit Risk Management Committee, which is responsible for strategic and collective oversight of the scope of risk taken, the adequacy of the tools used to measure it, and the adequacy of reporting.

### ***Asset/Liability Management***

Asset and liability management includes management of liquidity, interest rate and market risk. Liquidity risk is the potential that an institution will be unable to meet its obligations as they become due or fund its customers because of inadequate cash flow or the inability to liquidate assets or obtain funding itself. Market risk includes both interest rate and trading risk. Interest rate risk is the potential impairment of net interest income due to mismatched pricing between accrual accounted assets and liabilities. Market risk is the potential for losses in daily mark to market positions (mostly trading) due to adverse movements in money, foreign exchange, equity or other markets. In managing these risks, HUSI seeks to protect both its income stream and the value of its assets.

HUSI has substantial, but historically well controlled, interest rate risk in large part as a result of its portfolio of residential mortgages and mortgage backed securities, which consumers can prepay without penalty, and its large base of demand and savings deposits. These deposits can be withdrawn by consumers at will, but historically they have been a stable source of relatively low cost funds. Market risk exists principally in treasury businesses and to a lesser extent in the residential mortgage business where mortgage servicing rights and the pipeline of forward mortgage sales are hedged. HUSI has little foreign currency exposure from investments in overseas operations, which are limited in scope. Total equity investments, excluding stock owned in the Federal Reserve and New York Federal Home Loan Bank, represent less than 4% of total available for sale securities.

The management of liquidity, interest rate and most market risk is centralized in treasury and mortgage banking operations. In all cases, the valuation of positions and tracking of positions against limits is handled independently by HUSI's finance units. Oversight of all liquidity, interest rate and market risks is provided by the Asset and Liability Policy Committee (ALCO) which is chaired by the Chief Financial Officer. Subject to the approval of the HUSI Board of Directors and HSBC, ALCO sets the limits of acceptable risk, monitors the adequacy of the tools used to measure risk, and assesses the adequacy of reporting. ALCO also conducts contingency planning with regard to liquidity.

### ***Liquidity Risk Management***

Liquidity risk is the risk that an institution will be unable to meet its obligations as they become due because of an inability to liquidate assets or obtain adequate funding. Liquidity is managed to provide the ability to generate cash to meet lending, deposit withdrawal and other commitments at a reasonable cost in a reasonable amount of time, while maintaining routine operations and market confidence. HUSI plans its market funding in conjunction with HSBC Finance Corporation and HSBC, as the markets increasingly view debt issuances from the separate companies within the context of their common parent company. Liquidity management is performed at HUSI and at HBUS. Each entity is required to have sufficient liquidity for a crisis situation. ALCO is responsible for the development and implementation of related policies and procedures to ensure that the minimum liquidity ratios and a strong overall liquidity position are maintained.

In carrying out this responsibility, ALCO projects cash flow requirements and determines the level of liquid assets and available funding sources to have at HUSI's disposal, with consideration given to anticipated deposit and balance sheet growth, contingent liabilities, and the ability to access wholesale funding markets. HUSI's liquidity management approach includes increased deposits, potential sales (e.g. residential mortgage loans), and securitizations/conduits (e.g. credit cards) in liquidity contingency plans. In addition, ALCO monitors the overall mix of deposit and funding concentrations to avoid undue reliance on individual funding sources and large deposit relationships. It must also maintain a liquidity management contingency plan, which identifies certain potential early indicators of liquidity problems, and actions that can be taken both initially and in the event of a liquidity crisis, to minimize the long-term impact on HUSI's business and customer relationships. In the event of a cash flow crisis, HUSI's objective is to fund cash requirements without access to the wholesale unsecured funding market for at least one year. Contingency funding needs will be satisfied primarily through the sale of the investment portfolio and liquidation of the residential mortgage portfolio. Securities may be sold or used as collateral in a repurchase agreement depending on the scenario. Portions of the mortgage portfolio may be sold, securitized, or used for collateral at the FHLB to increase borrowings.

Deposits from a diverse mix of "core" retail, commercial and public sources and online savings accounts represent a significant, cost-effective and stable source of liquidity under normal operating conditions. Total deposits increased \$14 billion and \$13 billion during 2007 and 2006, respectively. Online savings account growth was \$4 billion and \$6 billion for 2007 and 2006, respectively.

HUSI's ability to regularly attract wholesale funds at a competitive cost is enhanced by strong ratings from the major credit ratings agencies. At December 31, 2007, HUSI and HBUS maintained the following long and short-term debt ratings:

|                             | Moody's    | S&P         | Fitch      | DBRS *     |
|-----------------------------|------------|-------------|------------|------------|
| <b>HUSI:</b>                |            |             |            |            |
| Short-term borrowings ..... | <b>P-1</b> | <b>A-1+</b> | <b>F1+</b> | <b>R-1</b> |
| Long-term debt .....        | <b>Aa3</b> | <b>AA-</b>  | <b>AA</b>  | <b>AA</b>  |
| <b>HBUS:</b>                |            |             |            |            |
| Short-term borrowings ..... | <b>P-1</b> | <b>A-1+</b> | <b>F1+</b> | <b>R-1</b> |
| Long-term debt .....        | <b>Aa2</b> | <b>AA</b>   | <b>AA</b>  | <b>AA</b>  |

\* Dominion Bond Rating Service.

Numerous factors, internal and external, may impact HUSI's access to and costs associated with issuing debt in the global capital markets. These factors include HUSI's debt ratings, overall economic conditions, overall capital markets volatility and the effectiveness of HUSI's management of credit risks inherent in its customer base.

Cash resources, short-term investments and a trading asset portfolio are available to provide highly liquid funding for HUSI. Additional liquidity is provided by debt securities. Approximately \$5 billion of debt securities in this portfolio at December 31, 2007 are expected to mature in 2008. The remaining \$18 billion of debt securities not expected to mature in 2008 are available to provide liquidity by serving as collateral for secured borrowings, or if needed, by being sold. Further liquidity is available through HUSI's ability to sell or securitize loans in secondary markets through whole-loan sales and securitizations. In 2007, HUSI sold residential mortgage loans of approximately \$15 billion. The amount of residential mortgage loans and credit card receivables available to be sold or securitized totaled approximately \$51 billion at December 31, 2007.

The economics and long-term business impact of obtaining liquidity from assets must be weighed against the economics of obtaining liquidity from liabilities, along with consideration given to the associated capital ramifications of these two alternatives. Currently, assets would be used to supplement liquidity derived from liabilities only in a crisis scenario.

It is the policy of HBUS to maintain both primary and secondary collateral in order to ensure precautionary borrowing availability from the Federal Reserve. Primary collateral is that which is physically maintained at the Federal Reserve, and serves as a safety net against any unexpected funding shortfalls that may occur. Secondary collateral is collateral that is acceptable to the Federal Reserve, but is not maintained there. If unutilized borrowing capacity were to be low, secondary collateral would be identified and maintained as necessary. Further liquidity is available from the Federal Home Loan Bank of New York. As of December 31, 2007, HUSI had outstanding advances of \$5.5 billion. HUSI has access to further borrowings based on the amount of mortgages pledged as collateral to the FHLB.

As of December 31, 2007, dividends from HBUS to HUSI would require the approval of the OCC, in accordance with 12 USC 60. Refer to Note 19 for further details. In determining the extent of dividends to pay, HBUS must also consider the effect of dividend payments on applicable risk-based capital and leverage ratio requirements, as well as policy statements of federal regulatory agencies that indicate that banking organizations should generally pay dividends out of current operating earnings.

HUSI filed a shelf registration statement with the Securities and Exchange Commission in April 2006, under which it may issue debt securities, preferred stock, either separately or represented by depositary shares, warrants, purchase contracts and units. HUSI satisfies the eligibility requirements for designation as a "well-known seasoned issuer" which allows it to file a registration statement that does not have a limit on issuance capacity. HUSI's ability to issue debt under the registration statement is limited by the debt issuance authority granted by the Board. HUSI is currently authorized to issue up to \$7 billion, of which \$6.2 billion is available. During 2007, HUSI issued \$.4 billion of senior debt from this shelf.



In December 2006, HBUS increased the size of its Global Bank Note Program from \$20 billion to \$40 billion, which provides for issuance of subordinated and senior notes. Borrowings from the Global Bank Note Program totaled \$1.5 billion in 2007, of which \$.5 billion was subordinated. There is approximately \$21 billion of availability remaining.

At December 31, 2007, HUSI also had a \$2.5 billion back-up credit facility for issuances of commercial paper.

### ***Interest Rate Risk Management***

HUSI is subject to interest rate risk associated with the repricing characteristics of its balance sheet assets and liabilities. Specifically, as interest rates change, amounts of interest earning assets and liabilities fluctuate, and interest earning assets reprice at intervals that do not correspond to the maturities or repricing patterns of interest bearing liabilities. This mismatch between assets and liabilities in repricing sensitivity results in shifts in net interest income as interest rates move. To help manage the risks associated with changes in interest rates, and to manage net interest income within ranges of interest rate risk that management considers acceptable, HUSI uses derivative instruments such as interest rate swaps, options, futures and forwards as hedges to modify the repricing characteristics of specific assets, liabilities, forecasted transactions or firm commitments.

The following table shows the repricing structure of assets and liabilities as of December 31, 2007. For assets and liabilities whose cash flows are subject to change due to movements in interest rates, such as the sensitivity of mortgage loans to prepayments, data is reported based on the earlier of expected repricing or maturity and reflects anticipated prepayments based on the current rate environment. The resulting “gaps” are reviewed to assess the potential sensitivity to earnings with respect to the direction, magnitude and timing of changes in market interest rates. Data shown is as of year end, and one-day figures can be distorted by temporary swings in assets or liabilities.

| <b>December 31, 2007</b>   | <b>Within<br/>One<br/>Year</b> | <b>After One<br/>But Within<br/>Five Years</b> | <b>After Five<br/>But Within<br/>Ten Years</b> | <b>After<br/>Ten<br/>Years</b> | <b>Total</b>   |
|--|--------------------------------|--|--|--------------------------------|----------------|
| <b>(in millions)</b>   |                                |  |  |                                |                |
| Commercial loans .....   | \$ 35,100                      | \$ 2,034                                       | \$ 700   | \$ 89                          | \$ 37,923      |
| Residential mortgages .....  | 17,179                         | 13,851   | 2,713  | 1,637                          | 35,380         |
| Credit card receivables .....  | 13,140                         | 6,275  | -  | -                              | 19,415         |
| Other consumer loans .....   | 1,285                          | 945  | 1  | -                              | 2,231          |
| Total loans .....  | <u>66,704</u>                  | <u>23,105</u>                                  | <u>3,414</u>                                   | <u>1,726</u>                   | <u>94,949</u>  |
| Securities available for sale and securities<br>held to maturity ..... | 5,633                          | 6,689  | 4,851  | 5,680                          | 22,853         |
| Other assets .....   | <u>66,837</u>                  | <u>2,884</u>                                   | <u>850</u>                                     | <u>-</u>                       | <u>70,571</u>  |
| Total assets .....   | <u>139,174</u>                 | <u>32,678</u>                                  | <u>9,115</u>                                   | <u>7,406</u>                   | <u>188,373</u> |
| Domestic deposits (1):   |                                |  |  |                                |                |
| Savings and demand .....   | 42,027                         | 9,387  | 10,043   | -                              | 61,457         |
| Certificates of deposit .....  | 15,007                         | 573  | 129  | 68                             | 15,777         |
| Long-term debt .....   | 23,222                         | 2,939  | 1,657  | 450                            | 28,268         |
| Other liabilities/equity .....   | <u>73,604</u>                  | <u>8,743</u>                                   | <u>-</u>                                       | <u>524</u>                     | <u>82,871</u>  |
| Total liabilities and equity .....                                     | <u>153,860</u>                 | <u>21,642</u>                                  | <u>11,829</u>                                  | <u>1,042</u>                   | <u>188,373</u> |
| Total balance sheet gap .....  | <u>(14,686)</u>                | <u>11,036</u>                                  | <u>(2,714)</u>                                 | <u>6,364</u>                   | <u>-</u>       |
| Effect of derivative contracts .....                                   | <u>2,757</u>                   | <u>(1,043)</u>                                 | <u>(189)</u>                                   | <u>(1,525)</u>                 | <u>-</u>       |
| Total gap position .....   | \$ <u>(11,929)</u>             | \$ <u>9,993</u>                                | \$ <u>(2,903)</u>                              | \$ <u>4,839</u>                | \$ <u>-</u>    |

- (1) Does not include purchased or wholesale treasury deposits. The placement of administered deposits such as savings and demand for interest rate risk purposes reflects behavioral expectations associated with these balances. Long-term core balances are differentiated from more fluid balances in an effort to reflect anticipated shifts of non-core balances to other deposit products or equities over time.

Various techniques are utilized to quantify and monitor risks associated with the repricing characteristics of HUSI's assets, liabilities and derivative contracts.

In the course of managing interest rate risk, Present Value of a Basis Point (PVBP) analysis is utilized in conjunction with a combination of other risk assessment techniques, including economic value of equity, dynamic simulation modeling, capital risk and Value at Risk (VAR) analyses. The combination of these tools enables management to identify and assess the potential impact of interest rate movements and take appropriate action. This combination of techniques, with some focusing on the impact of interest rate movements on the value of the balance sheet (PVBP, economic value of equity, VAR) and others focusing on the impact of interest rate movements on earnings (dynamic simulation modeling) allows for comprehensive analyses from different perspectives.

A key element of managing interest rate risk is the management of the convexity of the balance sheet, largely resulting from the mortgage related products on the balance sheet. Convexity risk arises as mortgage loan consumers change their behavior significantly in response to large rate movements in market rates, but do not change behavior appreciably for smaller changes in market rates. Certain of the interest rate management tools described below, such as dynamic simulation modeling and economic value of equity, better capture the embedded convexity in the balance sheet, while measures such as PVBP are designed to capture the risk of smaller changes in rates.

Refer to Market Risk Management, beginning on page 84 of this Form 10-K, for commentary regarding the use of VAR analyses to monitor and manage interest rate and other market risks.

The assessment techniques discussed below act as a guide for managing interest rate risk associated with balance sheet composition and off-balance sheet hedging strategy (the risk position). Calculated values within limit ranges reflect an acceptable risk position, although possible future unfavorable trends may prompt adjustments to on or off-balance sheet exposure. Calculated values outside of limit ranges will result in consideration of adjustment of the risk position, or consideration of temporary dispensation from making adjustments.

#### ***Present Value of a Basis Point (PVBP)***

PVBP is the change in value of the balance sheet for a one basis point upward movement in all interest rates. The following table reflects the PVBP position at December 31, 2007.

| <b>December 31, 2007</b>                | <b>Values</b> |
|---|---------------|
| <b>(in millions)</b>                    |               |
| Institutional PVBP movement limit ..... | \$ 6.5        |
| PVBP position at period end .....       | .9            |

#### ***Economic Value of Equity***

Economic value of equity is the change in value of the assets and liabilities (excluding capital and goodwill) for either a 200 basis point gradual rate increase or decrease. The following table reflects the economic value of equity position at December 31, 2007.

| <b>December 31, 2007</b>  | <b>Values (%)</b> |
|---|-------------------|
| Institutional economic value of equity limit .....                                | +/- 20            |
| Projected change in value (reflects projected rate movements on January 1, 2008): |                   |
| Change resulting from a gradual 200 basis point increase in interest rates .....  | (5)               |
| Change resulting from a gradual 200 basis point decrease in interest rates .....  | (6)               |

The loss in value for a 200 basis point increase or decrease in rates is a result of the negative convexity of the residential whole loan and mortgage backed securities portfolios. If rates decrease, the projected prepayments related to these portfolios will accelerate, causing less appreciation than a comparable term, non-convex instrument.

If rates increase, projected prepayments will slow, which will cause the average lives of these positions to extend and result in a greater loss in market value.

### *Dynamic Simulation Modeling*

Various modeling techniques are utilized to monitor a number of interest rate scenarios for their impact on net interest income. These techniques include both rate shock scenarios which assume immediate market rate movements by as much as 200 basis points, as well as scenarios in which rates rise or fall by as much as 200 basis points over a twelve month period. The following table reflects the impact on net interest income of the scenarios utilized by these modeling techniques.

| <b>December 31, 2007</b>  | <b>Amount</b> | <b>%</b> |
|---|---------------|----------|
| <b>(\$ in millions)</b>   |               |          |
| Projected change in net interest income (reflects projected rate movements on January 1, 2008): |               |          |
| Institutional base earnings movement limit .....  |               | (10)     |
| Change resulting from a gradual 200 basis point increase in the yield curve .....               | \$ (251)      | (7)      |
| Change resulting from a gradual 200 basis point decrease in the yield curve .....               | 153           | 4        |
| Change resulting from a gradual 100 basis point increase in the yield curve .....               | (122)         | (3)      |
| Change resulting from a gradual 100 basis point decrease in the yield curve .....               | 93            | 2        |
| Other significant scenarios monitored (reflects projected rate movements on January 1, 2008):   |               |          |
| Change resulting from an immediate 100 basis point increase in the yield curve .....            | (179)         | (5)      |
| Change resulting from an immediate 100 basis point decrease in the yield curve .....            | 117           | 3        |
| Change resulting from an immediate 200 basis point increase in the yield curve .....            | (366)         | (10)     |
| Change resulting from an immediate 200 basis point decrease in the yield curve .....            | 129           | 3        |

The projections do not take into consideration possible complicating factors such as the effect of changes in interest rates on the credit quality, size and composition of the balance sheet. Therefore, although this provides a reasonable estimate of interest rate sensitivity, actual results will vary from these estimates, possibly by significant amounts.

### *Capital Risk/Sensitivity of Other Comprehensive Income*

Large movements of interest rates could directly affect some reported capital balances and ratios. The mark to market valuation of available for sale securities is credited on a tax effective basis to accumulated other comprehensive income. Although this valuation mark is excluded from Tier 1 and Tier 2 capital ratios, it is included in two important accounting based capital ratios: the tangible common equity to tangible assets and the tangible common equity to risk weighted assets. As of December 31, 2007, HUSI had an available for sale securities portfolio of approximately \$20 billion with a net negative mark to market of \$314 million included in tangible common equity of \$7 billion. An increase of 25 basis points in interest rates of all maturities would lower the mark to market by approximately \$138 million to a net loss of \$452 million with the following results on the tangible capital ratios.

| <b>December 31, 2007</b>                             | <b>Actual</b> | <b>Proforma – Reflecting<br/>25 Basis Points<br/>Increase in Rates</b> |
|--|---------------|--|
| Tangible common equity to tangible assets .....      | 3.93 %        | 3.89 %   |
| Tangible common equity to risk weighted assets ..... | 5.39          | 5.33   |

## ***Market Risk Management***

### ***Value at Risk (VAR)***

VAR analysis is used to estimate the potential losses that could occur on risk positions as a result of movements in market rates and prices over a specified time horizon and to a given level of confidence. VAR calculations are performed for all material trading activities and as a tool for managing interest rate risk inherent in non-trading activities. HUSI calculates VAR daily for a one-day holding period to a 99% confidence level. At a 99% confidence level for a two-year observation period, HUSI is setting as its limit the fifth worst loss performance in the last 500 business days.

#### ***VAR - Overview***

The VAR methodology used by HUSI is based on historical simulation. The historical simulation model derives plausible future scenarios from historical market rate data, taking account of inter-relationships between different markets and rates, such as the relationship between interest rates and foreign exchange rates. Potential movements in market prices are calculated with reference to market data from the last two years. The model incorporates the impact of option features in the underlying exposures.

For reporting purposes, in the second quarter of 2006, HUSI changed the assumed holding period from a ten-day period to a one-day period as this reflects the way HUSI manages its risk positions. Comparative VAR amounts have been restated to reflect this change.

Although a valuable guide to risk, VAR should always be viewed in the context of its limitations. For example:

- the use of historical data as a proxy for estimating future events may not encompass all potential events, particularly those which are extreme in nature;
- the use of a one-day holding period assumes that all positions can be liquidated or hedged in one day. This may not fully reflect the market risk arising at times of severe liquidity shortages, when a one-day holding period may be insufficient to liquidate or hedge all positions fully;
- the use of a 99% confidence level, by definition, does not take into account losses that might occur beyond this level of confidence; and
- VAR is calculated on the basis of exposures outstanding at the close of business and therefore does not necessarily reflect intra-day exposures.

#### ***VAR - Trading Activities***

HUSI's management of market risk is based on restricting individual operations to trading within a list of permissible instruments, and enforcing rigorous approval procedures for new products. In particular, trading in the more complex derivative products is restricted to offices with appropriate levels of product expertise and robust control systems.

In addition, at both portfolio and position levels, market risk in trading portfolios is monitored and controlled using a complementary set of techniques, including VAR and various techniques for monitoring interest rate risk (refer to pages 81-83 of this Form 10-K). These techniques quantify the impact on capital of defined market movements.

Trading portfolios reside primarily within the Markets unit of the Global Banking and Markets business segment, which include warehoused residential mortgage loans purchased for securitizations and within the mortgage banking subsidiary included within the PFS business segment. Portfolios include foreign exchange, derivatives, precious metals (gold, silver, platinum), equities and money market instruments including “repos” and securities. Trading occurs as a result of customer facilitation, proprietary position taking, and economic hedging. In this context, economic hedging may include, for example, forward contracts to sell residential mortgages and derivative contracts which, while economically viable, may not satisfy the hedge requirements of Statement of Financial Accounting Standards No. 133, Accounting for Derivative Instruments and Hedging Activities (SFAS 133).

The trading portfolios have defined limits pertaining to items such as permissible investments, risk exposures, loss review, balance sheet size and product concentrations. “Loss review” refers to the maximum amount of loss that may be incurred before senior management intervention is required.

The following table summarizes trading VAR for 2007.

|                        | December 31, | Full Year 2007 |         |         | December 31, |
|------------------------|--------------|----------------|---------|---------|--------------|
|                        | 2007         | Minimum        | Maximum | Average | 2006         |
| Total trading .....    | \$ 25        | \$ 9           | \$ 32   | \$ 18   | \$ 9         |
| Precious metals .....  | 2            | *              | 4       | 1       | 2            |
| Equities .....         | *            | *              | 4       | *       | *            |
| Foreign exchange ..... | 3            | -              | 3       | 1       | 2            |
| Interest rate .....    | 17           | 7              | 38      | 16      | 13           |

\* Less than \$500 thousand.

The following table summarizes the frequency distribution of daily market risk-related revenues for Treasury trading activities during calendar year 2007. Market risk-related Treasury trading revenues include realized and unrealized gains (losses) related to Treasury trading activities, but exclude the related net interest income. Analysis of the 2007 gain (loss) data shows that the largest daily gain was \$114 million and the largest daily loss was \$33 million.

| Ranges of daily Treasury trading revenue earned from market risk-related activities (\$ in millions) | Below \$(5) | \$(5) to \$0 | \$0 to \$5 | \$5 to \$10 | Over \$10 |
|--|-------------|--------------|------------|-------------|-----------|
| Number of trading days market risk-related revenue was within the stated range .....                 | 39          | 58           | 92         | 38          | 23        |

#### ***VAR - Non-trading Activities***

The principal objective of market risk management of non-trading portfolios is to optimize net interest income. Market risk in non-trading portfolios arises principally from mismatches between the future yield on assets and their funding cost, as a result of interest rate changes. Analysis of this risk is complicated by having to make assumptions on optionality in certain product areas, for example, mortgage prepayments, and from behavioral assumptions regarding the economic duration of liabilities which are contractually repayable on demand. The prospective change in future net interest income from non-trading portfolios will be reflected in the current realizable value of these positions, should they be sold or closed prior to maturity. In order to manage this risk optimally, market risk in non-trading portfolios is transferred to Global Markets or to separate books managed under the supervision of ALCO. Once market risk has been consolidated in Global Markets or ALCO-managed books, the net exposure is typically managed through the use of interest rate swaps within agreed-upon limits.

The following table summarizes non-trading VAR for 2007, assuming a 99% confidence level for a two-year observation period and a one-day “holding period”.

|                      | December 31, | Full Year 2007 |         |         | December 31, |
|----------------------|--------------|----------------|---------|---------|--------------|
|                      | 2007         | Minimum        | Maximum | Average | 2006         |
| <b>(in millions)</b> |              |                |         |         |              |
| Interest rate .....  | \$ 46        | \$ 18          | \$ 56   | \$ 33   | \$ 24        |

### *Trading Activities – HSBC Mortgage Corporation (USA)*

HSBC Mortgage Corporation (USA) is HUST’s mortgage banking subsidiary. Trading occurs in mortgage banking operations as a result of an economic hedging program intended to offset changes in value of mortgage servicing rights and the salable loan pipeline. Economic hedging may include, for example, forward contracts to sell residential mortgages and derivative instruments used to protect the value of MSR’s.

MSR’s are assets that represent the present value of net servicing income (servicing fees, ancillary income, escrow and deposit float, net of servicing costs). MSR’s are separately recognized upon the sale of the underlying loans or at the time that servicing rights are purchased. MSR’s are subject to interest rate risk, in that their value will decline as a result of actual and expected acceleration of prepayment of the underlying loans in a falling interest rate environment.

Interest rate risk is mitigated through an active hedging program that uses trading securities and derivative instruments to offset changes in value of MSR’s. Since the hedging program involves trading activity, risk is quantified and managed using a number of risk assessment techniques.

### *Rate Shock Analysis*

Modeling techniques are used to monitor certain interest rate scenarios for their impact on the economic value of net hedged MSR’s, as reflected in the following table.

| December 31, 2007  | Value  |
|--|--------|
| <b>(in millions)</b>   |        |
| Projected change in net market value of hedged MSR’s portfolio (reflects projected rate movements on January 1, 2008): |        |
| Value of hedged MSR’s portfolio .....  | \$ 494 |
| Change resulting from an immediate 50 basis point decrease in the yield curve:   |        |
| Change limit (no worse than) .....   | (16)   |
| Calculated change in net market value .....  | 3      |
| Change resulting from an immediate 50 basis point increase in the yield curve:   |        |
| Change limit (no worse than) .....   | (8)    |
| Calculated change in net market value .....  | 1      |
| Change resulting from an immediate 100 basis point increase in the yield curve:  |        |
| Change limit (no worse than) .....   | (12)   |
| Calculated change in net market value .....  | 5      |

### *Economic Value of MSR’s*

The economic value of the net, hedged MSR’s portfolio is monitored on a daily basis for interest rate sensitivity. If the economic value declines by more than established limits for one day or one month, various levels of management review, intervention and/or corrective actions are required.

### *Hedge Volatility*

The following table summarized the frequency distribution of the weekly economic value of the MSR asset during calendar year 2007. This includes the change in the market value of the MSR asset net of changes in the market value of the underlying hedging positions used to hedge the asset. The changes in economic value are adjusted for changes in MSR valuation assumptions that were made during the course of the year.

| <b>Ranges of mortgage economic value from market risk-related activities</b>          | <b>Below \$ (2)</b> | <b>\$(2) to \$0</b> | <b>\$0 to \$2</b> | <b>\$2 to \$4</b> | <b>Over \$4</b> |
|---|---------------------|---------------------|-------------------|-------------------|-----------------|
| <b>(\$ in millions)</b>   |                     |                     |                   |                   |                 |
| Number of trading weeks market risk-related revenue was within the stated range ..... | 12                  | 12                  | 20                | 4                 | 4               |

### ***Operational Risk***

Operational risk is the risk of loss arising through fraud, unauthorized activities, error, omission, inefficiency, system failure or from external events. It is inherent in every business organization and covers a wide spectrum of issues.

HUSI has established an independent Operational Risk Management discipline. The Operational Risk Management Committee, chaired by the Chief Operating Officer, is responsible for oversight of the operational risks being taken, the analytic tools used to monitor those risks, and reporting. Results from this Committee are communicated to the Risk Management Committee and subsequently to the Audit Committee of the Board of Directors. Business unit line management is responsible for managing and controlling all risks and for communicating and implementing all control standards. A Corporate Operational Risk Coordinator provides functional oversight by coordinating the following activities:

- maintaining a network of business line Operational Risk Coordinators;
- developing scoring and risk assessment tools and databases;
- providing training and developing awareness; and
- independently reviewing and reporting the assessments of operational risks.

Management of operational risk includes identification, assessment, monitoring, control and mitigation, rectification and reporting of the results of risk events, including losses and compliance with local regulatory requirements. These key components of the Operational Risk Management process have been communicated by issuance of a high level standard. Key features within the standard that have been addressed in HUSI's Operational Risk Management program include:

- each business and support department is responsible for the identification and management of their operational risks;
- each risk is evaluated and scored by its likelihood to occur, its potential impact on shareholder value and by exposure based on the effectiveness of current controls to prevent or mitigate losses. An operational risk automated database is used to record risk assessments and track risk mitigation action plans. The risk assessments are reviewed at least annually, or as business conditions change;
- key risk indicators are established where appropriate, and monitored/tracked; and
- the database is also used to track operational losses for analysis of root causes, comparison with risk assessments and lessons learned.

Management practices include standard monthly reporting to business line managers, senior management and the Operational Risk Management Committee of high risks, risk mitigation action plan exceptions, losses and key risk indicators. Monthly certification of internal controls includes an operational risk attestation. Operational Risk Management is an integral part of the new product development process and the management performance measurement process. An online certification process, attesting to the completeness and accuracy of operational risk, is completed by senior business management on an annual basis.

Analysis of primary types of operational risks reflects a 60% concentration in process risk. The remaining 40% is divided fairly equally between the other three primary operational risk types - systems, people and external events. The same percent distribution of primary operational risk types applies for the higher or more critical operational risks. Within the process risk type, approximately 85% of this risk is concentrated within internal and external reporting and payment/settlement/delivery risk.

Internal audits, including audits by specialist teams in information technology and treasury, provide an important check on controls and test institutional compliance with the Operational Risk Management policy.

### ***Compliance Risk***

Compliance risk is the risk arising from failure to comply with relevant laws, regulations and regulatory requirements governing the conduct of specific businesses. It is a composite risk that can result in regulatory sanctions, financial penalties, litigation exposure and loss of reputation. Compliance risk is inherent throughout the HUSI organization.

Consistent with HSBC's commitment to ensure adherence with applicable regulatory requirements for all of its world-wide affiliates, HUSI has implemented a multi-faceted Compliance Risk Management Program. This program addresses the following priorities, among other issues:

- anti-money laundering (AML) regulations;
- fair lending laws;
- dealings with affiliates;
- the Community Reinvestment Act;
- permissible activities; and
- conflicts of interest.

Oversight of the Compliance Risk Management Program is provided by the Audit Committee of the Board of Directors through the Risk Management Committee. The effectiveness of the overall compliance program was overseen and counsel was provided to line and compliance management on major potential issues, strategic policy-making decisions and reputational risk matters. Internal audit, through continuous monitoring and periodic audits, tests the effectiveness of the overall Compliance Risk Management Program.

The Compliance Risk Management program elements include identification, assessment, monitoring, control and mitigation of the risk and timely resolution of the results of risk events. The execution of the Program is generally performed by line management, with oversight provided by Corporate Compliance. Controls for mitigating compliance risk are incorporated into business operating policies and procedures. Processes are in place to ensure controls are appropriately updated to reflect changes in regulatory requirements as well as changes in business practices, including new or revised products, services and marketing programs. A wide range of compliance training is provided to relevant staff, including mandated programs for such areas as anti-money laundering, fair lending and privacy.



The independent Corporate Compliance function is comprised of units focusing on General Compliance and Anti-Money Laundering (AML) compliance, as well as various compliance teams supporting specific business units. The Corporate Compliance function is responsible for the following activities:

- advising management on compliance matters;
- providing independent assessment, monitoring and review; and
- reporting compliance issues to HUSI senior management and Board of Directors, as well as to HSBC Group Compliance.

The Corporate Compliance function has established a rigorous independent review program which includes assessing the effectiveness of controls and testing for adherence to compliance policies and procedures. The review program is executed by centralized review teams and specialized business compliance officers who work collaboratively to complement each others efforts.

### ***Fiduciary Risk***

Fiduciary risk is the risk associated with offering services honestly and properly to clients in a fiduciary capacity in accordance with Regulation 12 CFR 9, Fiduciary Activity of National Banks. Fiduciary capacity is defined in the regulation as:

- serving traditional fiduciary duties such as trustee, executor, administrator, registrar of stocks and bonds, guardian, receiver or assignee;
- providing investment advice for a fee; or
- processing investment discretion on behalf of another.

Fiduciary risks, as defined above, reside in Private Banking businesses (including Investment Management, Personal Trust, Custody, Middle Office Operations) and other business lines outside of Private Banking (including Corporate Trust). However, HUSI's Fiduciary Risk Management infrastructure is also responsible for fiduciary risks associated with certain SEC regulated Registered Investment Advisors (RIA), which lie outside of the traditional regulatory fiduciary risk definition for banks. The fiduciary risks present in both banking and RIA business lines almost always occur where HUSI is entrusted to handle and execute client business affairs and transactions in a fiduciary capacity. HUSI's policies and procedures for addressing fiduciary risks generally address various risk categories including suitability, conflicts, fairness, disclosure, fees, AML, operational, safekeeping, efficiencies, etc.

Oversight for the Fiduciary Risk Management function falls to the Fiduciary Risk Management Committee of the Risk Management Committee. This committee is chaired by the Managing Director - Private Banking. The Senior Vice President - Fiduciary Risk is responsible for an independent Fiduciary Risk Management Unit that is responsible for day to day oversight of the Fiduciary Risk Management function. The main goals and objectives of this unit include:

- development and implementation of control self assessments, which have been completed for all fiduciary businesses;
- developing, tracking and collecting rudimentary key risk indicators (KRIs), and collecting data regarding errors associated with these risks. KRIs for each fiduciary business are in the process of being expanded;
- designing, developing and implementing risk monitoring tools, approaches and programs for the relevant business lines and senior management that will facilitate the identification, evaluation, monitoring, measurement, management and reporting of fiduciary risks. In this regard, a common database is used for compliance, operational and fiduciary risks; and
- ongoing development and implementation of more robust and enhanced key risk indicator/key performance indicator process with improved risk focused reporting.

## ***Business Continuity Planning***

HUSI is committed to the protection of employees, customers and shareholders by a quick response to all threats to the organization, whether they are of a physical or financial nature. HUSI is governed by the HNAH Crisis Management Framework, which provides an enterprise-wide response and communication approach for managing major business continuity events or incidents. It is designed to be flexible and is scaled to the scope and magnitude of the event or incident.

The Crisis Management Framework works in tandem with the HNAH Corporate Contingency Planning Policy, business continuity plans and key business continuity committees to manage events. The North American Crisis Management Committee, a 24/7 standing committee, is activated to manage the Crisis Management process in concert with senior HUSI management. This committee provides critical strategic management of business continuity crisis issues, risk management, communication, coordination and recovery management. In particular, the HNAH Crisis Management Committee has implemented an enterprise-wide plan, response and communication approach for pandemic preparedness. This was tested in 2007 as part of the U.S. Pandemic Simulations exercise. Tactical management of business continuity issues is handled by the Corporate and Local Incident Response Teams in place at each major site. HUSI also has designated an Institutional Manager for Business Continuity who plays a key role on the Crisis Management Committee. All major business and support functions have a senior representative assigned to HUSI's Business Continuity Planning Committee, which is chaired by the Institutional Manager.

HUSI has dedicated certain work areas as hot and warm backup sites, which serve as primary business recovery locations. HUSI has concentrations of major operations in both upstate and downstate New York. This geographic split of major operations is leveraged to provide secondary business recovery sites for many critical business and support areas of HUSI. Remote working arrangements are also a key component of HUSI's business continuity approach.

HUSI has built its own data center with the intention of developing the highest level of resiliency for disaster recovery as defined by industry standards. Data is mirrored synchronously to the disaster recovery site across duplicate dark fiber loops. A high level of network backup resiliency has been established. In a disaster situation, HUSI is positioned to bring main systems and server applications online within predetermined timeframes.

HUSI tests business continuity and disaster recovery resiliency and capability through routine contingency tests and actual events. Business continuity and disaster recovery programs have been strengthened in numerous areas as a result of these tests or actual events. There is a continuing effort to enhance the program well beyond the traditional business resumption and disaster recovery model.

In 2003, HUSI determined the applicability of the Interagency Paper on "Sound Practices to Strengthen the Resiliency of the U.S. Financial System". HUSI has met the requirements of the paper for the businesses impacted by the compliance due date.

## ***Glossary of Terms***

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***Balance Sheet Management*** – Represents HUSI’s activities to manage interest rate risk associated with the repricing characteristics of balance sheet assets and liabilities.

***Efficiency Ratio*** – Ratio of total operating expenses, reduced by minority interests, to the sum of net interest income and other revenues.

***Federal Reserve*** – the Federal Reserve Board; the principal regulator for HUSI.

***Global Bank Note Program*** – \$40 billion note program, under which HBUS issues senior and subordinated debt.

***Goodwill*** – Represents the excess of purchase price over the fair value of identifiable net assets acquired, reduced by liabilities assumed, for business combinations.

***HBMD*** – HSBC National Bank (USA); a wholly-owned U.S. banking subsidiary of HUSI.

***HBUS*** – HSBC Bank USA, National Association; HUSI’s principal wholly-owned U.S. banking subsidiary.

***HMUS*** – HSBC Markets (USA) Inc.; an indirect wholly-owned subsidiary of HNAH, and a holding company for investment banking and markets subsidiaries in the U.S.

***HNAH*** – HSBC North America Holdings Inc.; a wholly-owned subsidiary of HSBC and HSBC’s top-tier bank holding company in North America.

***HNAI*** – HSBC North America Inc.; an indirect wholly-owned subsidiary of HNAH.

***HSBC*** – HSBC Holdings plc.; HNAH’s U.K. parent company.

***HSBC Affiliate*** – any direct or indirect subsidiary of HSBC outside of the HUSI consolidated group of entities.

***HSBC Finance Corporation*** – an indirect wholly-owned consumer finance company subsidiary of HNAH.

***HTCD*** – HSBC Trust Company (Delaware); a wholly-owned U.S. banking subsidiary of HUSI.

***HTSU*** – HSBC Technology & Services (USA) Inc.; an indirect wholly-owned subsidiary of HNAH which provides information technology services to all subsidiaries of HNAH and to other subsidiaries of HSBC.

***HUSI*** – HSBC USA Inc.; the registrant, and a wholly-owned subsidiary of HNAI.

***Intangible Assets*** – Assets (not including financial assets) that lack physical substance. HUSI’s acquired intangible assets include mortgage servicing rights and favorable lease arrangements.

***Mortgage Servicing Rights (MSRs)*** – Intangible assets representing the right to service mortgage loans, which are recognized at the time the related loans are sold or the rights are acquired.

***Net Interest Margin to Earning Assets*** – Net interest income divided by average interest earning assets for a given period.

***Net Interest Margin to Total Assets*** – Net interest income divided by average total assets for a given period.

***Nonaccruing Loans*** – Loans for which interest is no longer accrued because ultimate collection is unlikely.

***OCC*** – the Office of the Comptroller of the Currency; the principal regulator for HBUS.

***Private Label Receivable Portfolio (PLRP)*** – Loan and credit card receivable portfolio acquired from HSBC Finance Corporation on December 29, 2004.

***Rate of Return on Common Shareholder's Equity*** – Net income, reduced by preferred dividends, divided by average common shareholder's equity for a given period.

***Rate of Return on Total Assets*** – Net income after taxes divided by average total assets for a given period.

***SEC*** – The Securities and Exchange Commission.

***Total Average Shareholders' Equity to Total Assets*** – Average total shareholders' equity divided by average total assets for a given period.

***Total Period End Shareholders' Equity to Total Assets*** – Total shareholders' equity divided by total assets as of a given date.

### ***Item 7A. Quantitative and Qualitative Disclosures about Market Risk***

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Refer to pages 81-87 in Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operations, for commentary and analysis regarding "Interest Rate Risk Management" and "Market Risk Management".

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## CONSOLIDATED AVERAGE BALANCES AND INTEREST RATES - THREE YEARS

The following table shows the year to date average balances of the principal components of assets, liabilities and shareholders' equity together with their respective interest amounts and rates earned or paid, presented on a taxable equivalent basis.

| (in millions)   | 2007              |          |        |
|---|-------------------|----------|--------|
|   | Balance           | Interest | Rate*  |
| <i>Assets</i>   |                   |          |        |
| Interest bearing deposits with banks .....                                | \$ 5,557          | \$ 309   | 5.56 % |
| Federal funds sold and securities purchased under resale agreements ..... | 11,671            | 610      | 5.23   |
| Trading assets .....  | 11,380            | 633      | 5.56   |
| Securities .....  | 23,156            | 1,221    | 5.27   |
| <i>Loans</i>  |                   |          |        |
| Commercial .....  | 31,396            | 2,017    | 6.42   |
| <i>Consumer:</i>  |                   |          |        |
| Residential mortgages .....   | 37,694            | 2,042    | 5.42   |
| Credit cards .....  | 17,897            | 1,764    | 9.86   |
| Other consumer .....  | 2,475             | 249      | 10.07  |
| Total consumer .....  | 58,066            | 4,055    | 6.99   |
| Total loans .....   | 89,462            | 6,072    | 6.79   |
| Other .....   | 3,977             | 221      | 5.57   |
| Total earning assets .....  | 145,203           | \$ 9,066 | 6.24 % |
| Allowance for credit losses .....   | (1,006)           |          |        |
| Cash and due from banks .....   | 3,019             |          |        |
| Other assets .....  | 24,713            |          |        |
| <b>Total assets</b> .....   | <b>\$ 171,929</b> |          |        |
| <i>Liabilities and Shareholders' Equity</i>                               |                   |          |        |
| <i>Deposits in domestic offices</i>                                       |                   |          |        |
| Savings deposits .....  | \$ 43,228         | \$ 1,376 | 3.18 % |
| Other time deposits .....   | 22,651            | 1,267    | 5.60   |
| <i>Deposits in foreign offices</i>  |                   |          |        |
| Foreign banks deposits .....  | 9,863             | 454      | 4.61   |
| Other time and savings .....  | 15,490            | 743      | 4.80   |
| Total interest bearing deposits .....                                     | 91,232            | 3,840    | 4.21   |
| Short-term borrowings .....   | 9,838             | 357      | 3.63   |
| Long-term debt .....  | 28,629            | 1,443    | 5.04   |
| Total interest bearing liabilities .....                                  | 129,699           | 5,640    | 4.35   |
| Net interest income / Interest rate spread .....                          |                   | \$ 3,426 | 1.89 % |
| Noninterest bearing deposits .....  | 13,737            |          |        |
| Other liabilities .....   | 16,430            |          |        |
| Total shareholders' equity .....  | 12,063            |          |        |
| <b>Total liabilities and shareholders' equity</b> .....                   | <b>\$ 171,929</b> |          |        |
| Net interest margin on average earning assets .....                       |                   |          | 2.36 % |
| Net interest margin on average total assets .....                         |                   |          | 1.99 % |

\* Rates are calculated on unrounded numbers.

Total weighted average rate earned on earning assets is interest and fee earnings divided by daily average amounts of total interest earning assets, including the daily average amount on nonperforming loans. Loan interest for the years ended December 31, 2007, 2006 and 2005 included fees of \$40 million, \$53 million and \$47 million, respectively.

| 2006              |                 |               | 2005              |                 |               |
|-------------------|-----------------|---------------|-------------------|-----------------|---------------|
| Balance           | Interest        | Rate*         | Balance           | Interest        | Rate*         |
| \$ 3,927          | \$ 225          | 5.73 %        | \$ 3,577          | \$ 120          | 3.35 %        |
| 10,326            | 526             | 5.10          | 5,481             | 190             | 3.48          |
| 10,893            | 418             | 3.84          | 7,234             | 275             | 3.80          |
| 22,177            | 1,145           | 5.16          | 19,024            | 899             | 4.73          |
| 28,080            | 1,764           | 6.28          | 24,192            | 1,233           | 5.10          |
| 41,826            | 2,211           | 5.29          | 47,093            | 2,321           | 4.93          |
| 15,987            | 1,329           | 8.31          | 13,455            | 812             | 6.04          |
| 2,960             | 268             | 9.07          | 3,158             | 264             | 8.36          |
| <u>60,773</u>     | <u>3,808</u>    | <u>6.27</u>   | <u>63,706</u>     | <u>3,397</u>    | <u>5.33</u>   |
| <u>88,853</u>     | <u>5,572</u>    | <u>6.27</u>   | <u>87,898</u>     | <u>4,630</u>    | <u>5.27</u>   |
| <u>1,569</u>      | <u>91</u>       | <u>5.78</u>   | <u>647</u>        | <u>32</u>       | <u>4.95</u>   |
| <u>137,745</u>    | <u>\$ 7,977</u> | <u>5.79 %</u> | <u>123,861</u>    | <u>\$ 6,146</u> | <u>4.96 %</u> |
| (932)             |                 |               | (910)             |                 |               |
| 3,977             |                 |               | 3,717             |                 |               |
| <u>22,033</u>     |                 |               | <u>20,508</u>     |                 |               |
| <u>\$ 162,823</u> |                 |               | <u>\$ 147,176</u> |                 |               |
| \$ 34,910         | \$ 981          | 2.81 %        | \$ 25,536         | \$ 318          | 1.25 %        |
| 24,134            | 1,152           | 4.77          | 25,845            | 822             | 3.18          |
| 8,020             | 392             | 4.89          | 8,440             | 255             | 3.03          |
| <u>14,127</u>     | <u>588</u>      | <u>4.16</u>   | <u>14,173</u>     | <u>376</u>      | <u>2.65</u>   |
| <u>81,191</u>     | <u>3,113</u>    | <u>3.83</u>   | <u>73,994</u>     | <u>1,771</u>    | <u>2.39</u>   |
| 10,131            | 300             | 2.96          | 10,868            | 270             | 2.48          |
| <u>29,484</u>     | <u>1,457</u>    | <u>4.94</u>   | <u>25,274</u>     | <u>1,025</u>    | <u>4.06</u>   |
| <u>120,806</u>    | <u>4,870</u>    | <u>4.03</u>   | <u>110,136</u>    | <u>3,066</u>    | <u>2.78</u>   |
|                   | <u>\$ 3,107</u> | <u>1.76 %</u> |                   | <u>\$ 3,080</u> | <u>2.18 %</u> |
| 12,869            |                 |               | 11,529            |                 |               |
| 17,111            |                 |               | 13,957            |                 |               |
| <u>12,037</u>     |                 |               | <u>11,554</u>     |                 |               |
| <u>\$ 162,823</u> |                 |               | <u>\$ 147,176</u> |                 |               |
|                   |                 | <u>2.26 %</u> |                   |                 | <u>2.49 %</u> |
|                   |                 | <u>1.91 %</u> |                   |                 | <u>2.09 %</u> |

***Item 8. Financial Statements and Supplementary Data***

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## Report of Independent Registered Public Accounting Firm

The Board of Directors and Shareholders of  
HSBC USA Inc.:

We have audited the accompanying consolidated balance sheets of HSBC USA Inc. and subsidiaries (the Company) as of December 31, 2007 and 2006, and the related consolidated statements of income, changes in shareholders' equity, and cash flows for each of the years in the three-year period ended December 31, 2007, and the accompanying consolidated balance sheets of HSBC Bank USA, National Association and subsidiaries (the Bank) as of December 31, 2007 and 2006. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of the Company as of December 31, 2007 and 2006, and the results of its operations and its cash flows for each of the years in the three-year period ended December 31, 2007, and the financial position of the Bank as of December 31, 2007 and 2006, in conformity with U.S. generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the Company's internal control over financial reporting as of December 31, 2007, based on criteria established in *Internal Control – Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated March 3, 2008 expressed an unqualified opinion on the effectiveness of the Company's internal control over financial reporting.

/s/ KPMG LLP

New York, New York  
March 3, 2008

**CONSOLIDATED STATEMENTS OF INCOME**

| <b>Year Ended December 31,</b>                                    | <b>2007</b>   | <b>2006</b>     | <b>2005</b>   |
|---|---------------|-----------------|---------------|
| <b>(in millions)</b>  |               |                 |               |
| Interest income:  |               |                 |               |
| Loans.....  | \$ 6,072      | \$ 5,572        | \$ 4,630      |
| Securities.....   | 1,193         | 1,119           | 882           |
| Trading assets.....   | 633           | 418             | 275           |
| Short-term investments.....                                       | 919           | 751             | 310           |
| Other.....  | 221           | 91              | 32            |
| <b>Total interest income.....</b>                                 | <b>9,038</b>  | <b>7,951</b>    | <b>6,129</b>  |
| Interest expense:   |               |                 |               |
| Deposits.....   | 3,840         | 3,113           | 1,771         |
| Short-term borrowings.....  | 357           | 300             | 270           |
| Long-term debt.....   | 1,443         | 1,457           | 1,025         |
| <b>Total interest expense.....</b>                                | <b>5,640</b>  | <b>4,870</b>    | <b>3,066</b>  |
| Net interest income.....  | 3,398         | 3,081           | 3,063         |
| Provision for credit losses.....                                  | 1,522         | 823             | 674           |
| <b>Net interest income after provision for credit losses.....</b> | <b>1,876</b>  | <b>2,258</b>    | <b>2,389</b>  |
| Other revenues:   |               |                 |               |
| Credit card fees.....   | 843           | 580             | 323           |
| Trust income.....   | 101           | 88              | 87            |
| Service charges.....  | 216           | 204             | 195           |
| Other fees and commissions.....                                   | 490           | 401             | 304           |
| Trading revenues.....   | 129           | 755             | 395           |
| Securities gains, net.....  | 112           | 29              | 106           |
| HSBC affiliate income.....  | 172           | 208             | 130           |
| Residential mortgage banking revenue.....                         | 74            | 96              | 64            |
| Other (loss) income.....  | (290)         | 202             | 307           |
| <b>Total other revenues.....</b>                                  | <b>1,847</b>  | <b>2,563</b>    | <b>1,911</b>  |
| Operating expenses:   |               |                 |               |
| Salaries and employee benefits.....                               | 1,352         | 1,300           | 1,052         |
| Support services from HSBC affiliates.....                        | 1,162         | 1,076           | 919           |
| Occupancy expense, net.....                                       | 243           | 221             | 182           |
| Other expenses.....   | 829           | 658             | 605           |
| <b>Total operating expenses.....</b>                              | <b>3,586</b>  | <b>3,255</b>    | <b>2,758</b>  |
| Income before income tax expense.....                             | 137           | 1,566           | 1,542         |
| Income tax (benefit) expense.....                                 | (1)           | 530             | 566           |
| <b>Net income.....</b>  | <b>\$ 138</b> | <b>\$ 1,036</b> | <b>\$ 976</b> |

The accompanying notes are an integral part of the consolidated financial statements.

**CONSOLIDATED BALANCE SHEETS**

| <b>December 31,</b>   | <b>2007</b>       | <b>2006</b>       |
|---|-------------------|-------------------|
| <b>(in millions)</b>  |                   |                   |
| <b>Assets</b>   |                   |                   |
| Cash and due from banks .....   | \$ 3,567          | \$ 3,359          |
| Interest bearing deposits with banks .....  | 5,618             | 1,921             |
| Federal funds sold and securities purchased under agreements to resell .....  | 13,677            | 13,775            |
| Trading assets .....  | 37,036            | 23,630            |
| Securities available for sale .....   | 19,962            | 19,783            |
| Securities held to maturity (fair value of \$2,945 million and \$3,040 million at<br>December 31, 2007 and 2006, respectively) .....                    | 2,891             | 2,972             |
| Loans .....   | 94,949            | 90,237            |
| Less - allowance for credit losses .....  | 1,414             | 897               |
| Loans, net .....  | <u>93,535</u>     | <u>89,340</u>     |
| Properties and equipment, net .....   | 568               | 540               |
| Intangible assets .....   | 534               | 521               |
| Goodwill .....  | 2,701             | 2,716             |
| Other assets .....  | 8,284             | 6,260             |
| <b>Total assets</b> .....   | <u>\$ 188,373</u> | <u>\$ 164,817</u> |
| <b>Liabilities</b>  |                   |                   |
| Deposits in domestic offices:   |                   |                   |
| Noninterest bearing .....   | \$ 13,889         | \$ 12,813         |
| Interest bearing (includes \$1,479 million and \$1,322 million of deposits recorded<br>at fair value at December 31, 2007 and 2006, respectively) ..... | 68,237            | 61,538            |
| Deposits in foreign offices:  |                   |                   |
| Noninterest bearing .....   | 1,030             | 727               |
| Interest bearing .....  | 33,072            | 27,068            |
| Total deposits .....  | <u>116,228</u>    | <u>102,146</u>    |
| Trading liabilities .....   | 16,253            | 12,314            |
| Short-term borrowings .....   | 11,832            | 5,073             |
| Interest, taxes and other liabilities .....   | 4,555             | 3,771             |
| Long-term debt .....  | 28,268            | 29,252            |
| <b>Total liabilities</b> .....  | <u>177,136</u>    | <u>152,556</u>    |
| <b>Shareholders' equity</b>   |                   |                   |
| Preferred stock .....   | 1,565             | 1,690             |
| Common shareholder's equity:  |                   |                   |
| Common stock (\$5 par; 150,000,000 shares authorized;<br>706 shares issued and outstanding) .....   | -                 | -                 |
| Capital surplus .....   | 8,123             | 8,124             |
| Retained earnings .....   | 1,901             | 2,661             |
| Accumulated other comprehensive loss .....  | (352)             | (214)             |
| Total common shareholder's equity .....   | <u>9,672</u>      | <u>10,571</u>     |
| <b>Total shareholders' equity</b> .....   | <u>11,237</u>     | <u>12,261</u>     |
| <b>Total liabilities and shareholders' equity</b> .....   | <u>\$ 188,373</u> | <u>\$ 164,817</u> |

The accompanying notes are an integral part of the consolidated financial statements.

(1) Less than \$500 thousand

**CONSOLIDATED STATEMENTS OF CHANGES  
IN SHAREHOLDERS' EQUITY**

|   | 2007                    | 2006                    | 2005                    |
|---|-------------------------|-------------------------|-------------------------|
| <b>(in millions)</b>  |                         |                         |                         |
| <b>Preferred stock</b>  |                         |                         |                         |
| Balance, January 1, .....   | \$ 1,690                | \$ 1,316                | \$ 500                  |
| Preferred stock issuances.....  | -                       | 374                     | 891                     |
| Preferred stock redemptions.....  | (125)                   | -                       | (75)                    |
| Balance, December 31,.....  | <u>1,565</u>            | <u>1,690</u>            | <u>1,316</u>            |
| <b>Common stock</b>   |                         |                         |                         |
| Balance, January 1 and December 31,.....  | - (1)                   | - (1)                   | - (1)                   |
| <b>Capital surplus</b>  |                         |                         |                         |
| Balance, January 1,.....  | 8,124                   | 8,118                   | 8,418                   |
| Capital contribution from parent.....   | 4                       | 15                      | 3                       |
| Preferred stock issuance costs.....   | (1)                     | (9)                     | (22)                    |
| Employee benefit plans and other.....   | (4)                     | -                       | (281)                   |
| Balance, December 31,.....  | <u>8,123</u>            | <u>8,124</u>            | <u>8,118</u>            |
| <b>Retained earnings</b>  |                         |                         |                         |
| Balance, January 1,.....  | 2,661                   | 2,172                   | 1,917                   |
| Net income.....   | 138                     | 1,036                   | 976                     |
| Cash dividends declared on preferred stock.....   | (98)                    | (88)                    | (46)                    |
| Cash dividends declared on common stock.....  | (800)                   | (455)                   | (675)                   |
| Cumulative effect of change in accounting principle relating to<br>mortgage servicing rights.....   | -                       | (4)                     | -                       |
| Balance, December 31,.....  | <u>1,901</u>            | <u>2,661</u>            | <u>2,172</u>            |
| <b>Accumulated other comprehensive loss</b>   |                         |                         |                         |
| Balance, January 1,.....  | (214)                   | (12)                    | 31                      |
| Net change in net unrealized losses on securities available for sale, net of tax.....   | 11                      | (71)                    | (149)                   |
| Net change in net unrealized (losses) gains on derivatives<br>classified as cash flow hedges, net of tax.....                                   | (165)                   | (106)                   | 104                     |
| Net change in net unrealized gains on interest only<br>strip receivables, net of tax.....   | -                       | (7)                     | 7                       |
| Unrecognized actuarial gains, transition obligation and prior service<br>costs relating to pension and postretirement benefits, net of tax..... | 12                      | -                       | -                       |
| Foreign currency translation adjustments, net of tax.....   | 4                       | -                       | (5)                     |
| Other comprehensive loss, net of tax.....   | (138)                   | (184)                   | (43)                    |
| Cumulative effect of change in accounting principle relating to pension<br>and post retirement benefits, net of tax.....                        | -                       | (18)                    | -                       |
| Balance, December 31,.....  | <u>(352)</u>            | <u>(214)</u>            | <u>(12)</u>             |
| <b>Total shareholders' equity, December 31,.....</b>  | <b>\$ <u>11,237</u></b> | <b>\$ <u>12,261</u></b> | <b>\$ <u>11,594</u></b> |
| <b>Comprehensive income</b>   |                         |                         |                         |
| Net income.....   | \$ 138                  | \$ 1,036                | \$ 976                  |
| Other comprehensive loss, net of tax.....   | (138)                   | (184)                   | (43)                    |
| <b>Comprehensive income.....</b>  | <b>\$ -</b>             | <b>\$ 852</b>           | <b>\$ 933</b>           |

The accompanying notes are an integral part of the consolidated financial statements.

(1) Less than \$500 thousand

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**CONSOLIDATED STATEMENTS OF CASH FLOWS**


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| Year ended December 31,  | 2007            | 2006            | 2005            |
|--|-----------------|-----------------|-----------------|
| <i>(in millions)</i>   |                 |                 |                 |
| <b><i>Cash flows from operating activities</i></b>   |                 |                 |                 |
| Net income .....   | \$ 138          | \$ 1,036        | \$ 976          |
| Adjustments to reconcile net income to net cash<br>(used in) provided by operating activities: |                 |                 |                 |
| Depreciation, amortization and deferred taxes .....  | 3               | 503             | 442             |
| Provision for credit losses .....  | 1,522           | 823             | 674             |
| Net change in other assets and liabilities .....   | (1,109)         | 1,359           | 495             |
| Net change in loans held for sale to HSBC Markets (USA) Inc. (HMUS):                           |                 |                 |                 |
| Loans acquired from originators .....  | (5,026)         | (16,089)        | (5,061)         |
| Sales of loans to HMUS .....   | 6,198           | 15,867          | 2,188           |
| Net change in other loans held for sale .....  | (1,718)         | 63              | 63              |
| Net change in loans attributable to tax refund anticipation loans program:                     |                 |                 |                 |
| Originations of loans .....  | (17,433)        | (16,100)        | (15,100)        |
| Sales of loans to HSBC Finance Corporation, including premium .....                            | 17,645          | 15,888          | 15,100          |
| Net change in trading assets and liabilities .....   | (9,152)         | (2,352)         | (2,001)         |
| Net change in fair value of derivatives and hedged items .....                                 | 770             | 689             | (248)           |
| Net cash (used in) provided by operating activities .....                                      | <u>(8,162)</u>  | <u>1,687</u>    | <u>(2,472)</u>  |
| <b><i>Cash flows from investing activities</i></b>   |                 |                 |                 |
| Net change in interest bearing deposits with banks .....                                       | (3,697)         | 329             | 526             |
| Net change in federal funds sold and securities purchased under agreements to resell .....     | 98              | (9,207)         | (1,442)         |
| Net change in securities available for sale:   |                 |                 |                 |
| Purchases of securities available for sale .....   | (14,175)        | (8,043)         | (12,301)        |
| Proceeds from sales of securities available for sale .....                                     | 5,157           | 2,611           | 3,825           |
| Proceeds from maturities of securities available for sale .....                                | 8,928           | 3,203           | 4,273           |
| Net change in securities held to maturity:   |                 |                 |                 |
| Purchases of securities held to maturity .....   | (260)           | (166)           | (694)           |
| Proceeds from maturities of securities held to maturity .....                                  | 341             | 364             | 1,401           |
| Net change in loans:   |                 |                 |                 |
| Originations, net of collections .....   | 18,714          | 23,083          | 19,405          |
| Loans purchased from HSBC Finance Corporation .....  | (24,169)        | (23,908)        | (23,084)        |
| Net cash used for acquisitions of properties and equipment .....                               | (99)            | (81)            | (29)            |
| Other, net .....   | (182)           | (193)           | (240)           |
| Net cash used in investing activities .....  | <u>(9,344)</u>  | <u>(12,008)</u> | <u>(8,360)</u>  |
| <b><i>Cash flows from financing activities</i></b>   |                 |                 |                 |
| Net change in deposits .....   | 14,082          | 11,854          | 10,310          |
| Net change in short-term borrowings .....  | 6,759           | (1,293)         | (2,936)         |
| Net change in long-term debt:  |                 |                 |                 |
| Issuance of long-term debt .....   | 5,607           | 6,860           | 6,127           |
| Repayment of long-term debt .....  | (7,710)         | (8,019)         | (706)           |
| Preferred stock (redemption) issuance, net of issuance costs .....                             | (126)           | 365             | 794             |
| Other increases (decreases) in capital surplus .....   | -               | 15              | (278)           |
| Dividends paid .....   | (898)           | (543)           | (720)           |
| Net cash provided by financing activities .....  | <u>17,714</u>   | <u>9,239</u>    | <u>12,591</u>   |
| Net change in cash and due from banks .....  | 208             | (1,082)         | 1,759           |
| Cash and due from banks at beginning of period .....   | 3,359           | 4,441           | 2,682           |
| <b><i>Cash and due from banks at end of period</i></b> .....                                   | <u>\$ 3,567</u> | <u>\$ 3,359</u> | <u>\$ 4,441</u> |
| Cash paid for: Interest .....  | \$ 5,733        | \$ 4,815        | \$ 2,785        |
| Income taxes .....   | 462             | 504             | 566             |

The accompanying notes are an integral part of the consolidated financial statements.

**CONSOLIDATED BALANCE SHEETS**

| <b>December 31,</b><br><b>(in millions)</b>  | <b>2007</b>              | <b>2006</b>              |
|--|--------------------------|--------------------------|
| <b>Assets</b>  |                          |                          |
| Cash and due from banks.....   | \$ 3,545                 | \$ 3,297                 |
| Interest bearing deposits with banks.....  | 5,402                    | 1,794                    |
| Federal funds sold and securities purchased under agreements to resell.....  | 13,676                   | 13,704                   |
| Trading assets .....   | 35,718                   | 22,343                   |
| Securities available for sale .....  | 19,676                   | 19,500                   |
| Securities held to maturity (fair value of \$2,867 million and \$2,926 million at<br>December 31, 2007 and 2006, respectively).....                    | 2,816                    | 2,864                    |
| Loans.....   | 94,141                   | 90,125                   |
| Less - allowance for credit losses.....  | 1,414                    | 894                      |
| Loans, net.....  | <u>92,727</u>            | <u>89,231</u>            |
| Properties and equipment, net.....   | 555                      | 538                      |
| Intangible assets.....   | 534                      | 521                      |
| Goodwill .....   | 2,111                    | 2,111                    |
| Other assets.....  | 7,732                    | 5,629                    |
| <b>Total assets.....</b>   | <b>\$ <u>184,492</u></b> | <b>\$ <u>161,532</u></b> |
| <b>Liabilities</b>   |                          |                          |
| Deposits in domestic offices:  |                          |                          |
| Noninterest bearing.....   | \$ 13,873                | \$ 12,818                |
| Interest bearing (includes \$1,479 million and \$1,322 million of deposits<br>recorded at fair value at December 31, 2007 and 2006, respectively)..... | 68,124                   | 61,474                   |
| Deposits in foreign offices:   |                          |                          |
| Noninterest bearing.....   | 1,030                    | 727                      |
| Interest bearing.....  | 36,731                   | 29,842                   |
| Total deposits.....  | <u>119,758</u>           | <u>104,861</u>           |
| Trading liabilities.....   | 16,223                   | 12,300                   |
| Short-term borrowings.....   | 7,938                    | 2,698                    |
| Interest, taxes and other liabilities.....   | 4,202                    | 3,249                    |
| Long-term debt.....  | 24,829                   | 26,166                   |
| <b>Total liabilities.....</b>  | <b><u>172,950</u></b>    | <b><u>149,274</u></b>    |
| <b>Shareholder's equity</b>  |                          |                          |
| Common shareholder's equity:   |                          |                          |
| Common stock (\$100 par; 50,000 shares authorized;<br>20,005 shares issued and outstanding).....   | 2                        | 2                        |
| Capital surplus.....   | 10,123                   | 10,124                   |
| Retained earnings .....  | 1,769                    | 2,348                    |
| Accumulated other comprehensive loss.....  | (352)                    | (216)                    |
| <b>Total shareholder's equity.....</b>   | <b><u>11,542</u></b>     | <b><u>12,258</u></b>     |
| <b>Total liabilities and shareholder's equity.....</b>   | <b>\$ <u>184,492</u></b> | <b>\$ <u>161,532</u></b> |

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

### *Note 1. Organization*

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HSBC USA Inc., incorporated under the laws of Maryland, is a New York State based bank holding company, and an indirect wholly owned subsidiary of HSBC North America Holdings Inc. (HNAH). HSBC USA Inc. and its subsidiaries are collectively referred to as “HUSI”.

HNAH is an indirect wholly owned subsidiary of HSBC Holdings plc (HSBC). Effective January 1, 2004, HSBC created a new North American organizational structure, HNAH, as the top-tier bank holding company parent. HUSI routinely conducts transactions in the normal course of business with HNAH’s other principal direct and indirect subsidiaries, which include:

- HSBC Finance Corporation, a consumer finance company;
- HSBC Bank USA, National Association (HBUS), HUSI’s principal banking subsidiary;
- HSBC Bank Canada (HBCA), a Canadian banking subsidiary;
- HSBC Markets (USA) Inc. (HMUS), a holding company for investment banking and markets subsidiaries in the U.S.; and
- HSBC Technology & Services (USA) Inc. (HTSU), a provider of information technology services for other HNAH subsidiaries and to other subsidiaries of HSBC.

On July 1, 2004, HUSI consolidated its then existing banking operations under a single national charter, following approval from the Office of the Comptroller of the Currency (OCC).

### *Note 2. Summary of Significant Accounting Policies and New Accounting Pronouncements*

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#### *Significant Accounting Policies*

##### *Basis of Presentation*

The accounting and reporting policies of HUSI conform to accounting principles generally accepted in the United States of America (U.S. GAAP). The preparation of financial statements in conformity with U.S. GAAP requires the use of estimates and assumptions that affect reported amounts in the financial statements and accompanying notes. Actual results could differ from those estimates. Certain reclassifications have been made to prior year amounts to conform with the current year’s presentation.

##### *Principles of Consolidation*

The consolidated financial statements include the accounts of HUSI and its subsidiaries. HUSI consolidates subsidiaries in which it holds, directly or indirectly, more than 50% of the voting rights, or where it exercises control. In addition, HUSI consolidates variable interest entities (VIEs) where it is deemed to be the primary beneficiary.

HUSI assesses whether an entity is a VIE and, if so, whether HUSI is its primary beneficiary at the time of initial involvement with the entity. HUSI’s involvement is subsequently reassessed only upon the occurrence of certain changes in the entity’s governing documents or planned operations that result in changes to the entity’s equity structure or its expected losses. HUSI’s assessment is made in accordance with FASB Interpretation No. 46 (Revised), Consolidation of Variable Interest Entities, (FIN 46(R)). FIN 46(R) defines a VIE as an entity in which the equity investment at risk is not sufficient to finance the entity’s activities, where the equity investors lack certain characteristics of a controlling financial interest, or where voting rights are not proportionate to the economic interests of a particular equity investor and the entity’s activities are conducted primarily on behalf of that investor. FIN 46(R) requires a VIE to be consolidated by its primary beneficiary, which is the entity that absorbs a majority of the VIE’s expected losses, receives a majority of the VIE’s expected residual returns, or both.

Entities that are deemed to be qualifying special purpose entities (QSPEs), as defined by Statement of Financial Accounting Standards No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities (SFAS 140), such as certain trusts to which HUSI has transferred receivables, are not consolidated.

All material intercompany accounts and transactions have been eliminated. Investments in companies in which the percentage of ownership is at least 20%, but not more than 50%, are generally accounted for under the equity method and reported as equity method investments in other assets.

#### *Use of Estimates and Assumptions*

The preparation of financial statements in accordance with U.S. GAAP requires management to make estimates and assumptions that affect amounts reported in the financial statements and related footnote disclosures. Estimates used in connection with fair value measurements, consolidation assessments related to variable interest entities, impairments of assets, provisions for losses from credit-related exposures and contingencies, and tax-related reserves are often complex and may significantly impact the amounts reported for those items. Current market conditions increase the risk and uncertainty associated with these estimates and assumptions and, although management uses its best judgment, actual results could differ from estimated amounts.

#### *Transfers of Financial Assets and Securitizations*

Transfers of financial assets in which HUSI surrenders control over the transferred assets are accounted for as sales. Control is generally considered to have been surrendered when (i) the transferred assets are legally isolated from HUSI and its creditors, even in bankruptcy or other receivership, (ii) the transferee (or, if the transferee is a QSPE, the holders of its beneficial interests) has the right to pledge or exchange the assets (or beneficial interests held, for a holder of a QSPE's beneficial interests) without any constraints that would provide a benefit to HUSI, and (iii) HUSI has no obligation, right, or option to reclaim or repurchase the assets. If the sale criteria are met, the transferred assets are removed from HUSI's balance sheet. If the sale criteria are not met, the transfer is recorded as a secured borrowing in which the assets remain on HUSI's balance sheet and the proceeds from the transaction are recognized as a liability. For a majority of financial asset transfers, it is clear whether or not HUSI has surrendered control. For other transfers, such as in connection with complex transactions or where HUSI has continuing involvement such as servicing responsibilities, HUSI generally obtains a legal opinion as to whether the transfer results in a true sale by law.

HUSI securitizes certain private label credit card receivables where securitization provides an attractive source of funding. Prior to the third quarter of 2004, private label credit card securitizations utilized revolving trusts that met the definition of a QSPE under SFAS 140. All new private label credit card securitization transactions since the third quarter of 2004 have been structured as secured financings using trusts that are not QSPEs. Transfers of receivables to QSPE trusts established prior to the third quarter of 2004, including transfers of receivables to support previously issued securities, were structured and recorded as sales until the third quarter of 2006. HUSI provided limited recourse to investors in connection with these sales and recorded a provision for estimated probable losses under the recourse provisions. In the third quarter of 2006, the QSPE trusts established prior to the third quarter of 2004 were restructured and no longer meet the definition of a QSPE. As a result, subsequent transfers of receivables to these trusts to support previously issued securities no longer qualify for sale treatment and are recorded as secured financings. Refer to Note 9, Securitizations and Secured Financings, on page 124 of these consolidated financial statements for additional information on these transactions.



### ***Foreign Currency Translation***

HUSI has foreign operations in several countries. The accounts of HUSI's foreign operations are measured using local currency as the functional currency. Assets and liabilities are translated into U.S. dollars at the rate of exchange in effect on the balance sheet date. Income and expenses are translated at average monthly exchange rates. Net exchange gains or losses resulting from such translation are included in common shareholder's equity as a component of accumulated other comprehensive income. Foreign currency denominated transactions in other than the local functional currency are translated using the period end exchange rate with any foreign currency transaction gain or loss recognized currently in income.

### ***Cash and Cash Equivalents***

For the purpose of reporting cash flows, cash and cash equivalents include cash on hand and amounts due from banks.

### ***Resale and Repurchase Agreements***

HUSI enters into purchases and borrowings of securities under agreements to resell (resale agreements) and sales of securities under agreements to repurchase (repurchase agreements) substantially identical securities. Resale and repurchase agreements are generally accounted for as secured lending and secured borrowing transactions, respectively.

The amounts advanced under resale agreements and the amounts borrowed under repurchase agreements are carried on the consolidated balance sheets at the amount advanced or borrowed, plus accrued interest to date. Interest earned on resale agreements is reported as interest income. Interest paid on repurchase agreements is reported as interest expense. HUSI offsets resale and repurchase agreements executed with the same counterparty under legally enforceable netting agreements that meet the applicable netting criteria as permitted by U.S. GAAP.

Repurchase agreements may require HUSI to deposit cash or other collateral with the lender. In connection with resale agreements, it is the policy of HUSI to obtain possession of collateral, which may include the securities purchased, with market value in excess of the principal amount loaned. The market value of the collateral subject to the resale and repurchase agreements is regularly monitored, and additional collateral is obtained or provided when appropriate, to ensure appropriate collateral coverage of these secured financing transactions.

### ***Collateral***

HUSI pledges assets as collateral as required for various transactions involving security repurchase agreements, public deposits, Treasury tax and loan notes, derivative agreements, short-term borrowings and long-term borrowings. Assets that have been pledged as collateral, including those that can be sold or repledged by the secured party, continue to be reported on HUSI's consolidated balance sheets.

HUSI also accepts collateral, primarily as part of various transactions involving security resale agreements. Collateral accepted by HUSI, including collateral that can be sold or repledged by HUSI, is excluded from HUSI's consolidated balance sheets.

The market value of collateral accepted or pledged by HUSI is regularly monitored and additional collateral is obtained or provided as necessary to ensure appropriate collateral coverage in these transactions.

### ***Trading Assets and Liabilities***

Financial instruments utilized in trading activities are stated at fair value. Fair value is generally based on quoted market prices at trade date. If quoted market prices are not available, fair values are estimated based on dealer quotes, pricing models or quoted prices for instruments with similar characteristics. The validity of internal pricing models is regularly substantiated by reference to actual market prices realized upon sale or liquidation of these instruments. Realized and unrealized gains and losses are recognized in trading revenues.

### ***Securities***

Debt securities that HUSI has the ability and intent to hold to maturity are reported at cost, adjusted for amortization of premiums and accretion of discounts, which are recognized as adjustments to yield over the expected lives of the related securities. Securities acquired principally for the purpose of selling them in the near term are classified as trading assets and reported at fair value with unrealized gains and losses included in earnings.

Equity securities that are not quoted on a recognized exchange are not considered to have a readily determinable fair value, and are recorded at cost, less any provisions for impairment. Unquoted equity securities, which include Federal Home Loan Bank (FHLB) stock, Federal Reserve Bank (FRB) stock and MasterCard Class B securities, are recorded in other assets.

All other securities are classified as available for sale and carried at fair value, with unrealized gains and losses, net of related income taxes, recorded as adjustments to common shareholder's equity as a component of accumulated other comprehensive income.

Securities that are classified as trading are stated at fair value. Fair value is generally based on quoted market prices at trade date. If quoted market prices are not available, fair values are estimated based on dealer quotes, pricing models or quoted prices for instruments with similar characteristics. The validity of internal pricing models is regularly substantiated by reference to actual market prices realized upon sale or liquidation of these instruments.

Realized gains and losses on sales of securities not classified as trading assets are computed on a specific identified cost basis and are reported in other revenues as security gains, net. HUSI regularly evaluates its securities to identify declines in fair value that are considered other-than-temporary. Any decline in the fair value of investments, which is deemed to be other-than-temporary is charged against current earnings in other revenues and a new cost basis is established for the security. Fair value adjustments to trading securities and gains and losses on the sale of such securities are reported in other revenues as trading revenues.

### ***Loans***

Loans are stated at their amortized cost, which represents the principal amount outstanding, net of unearned income, charge offs, unamortized purchase premium or discount, unamortized nonrefundable fees and related direct loan origination costs and purchase accounting fair value adjustments. Loans are further reduced by the allowance for credit losses.

Loans that are classified as held for sale are carried at the lower of aggregate cost or market value and remain presented as loans in the consolidated balance sheets. Fair value is determined based on quoted fair market prices for similar loans, outstanding investor commitments or discounted cash flow analysis using market assumptions. Increases in the valuation allowance utilized to adjust loans that are classified as held for sale to market value, and subsequent recoveries of prior allowances recorded, are recorded in other income in the consolidated income statement.

Premiums and discounts and purchase accounting fair value adjustments are recognized as adjustments to yield over the expected lives of the related loans. Interest income is recorded based on methods that result in level rates of return over the terms of the loans.

Restructured loans are loans for which the original contractual terms have been permanently modified to provide for terms that are less than HUSI would be willing to accept for new loans with comparable risk because of deterioration in the borrower's financial condition. Interest on these loans is accrued at the effective rates.

### ***Loan Charge Off Policies and Practices***

Commercial loan balances are charged off at the time all or a portion of the balance is deemed uncollectible.

Consumer loan charge off policies, which vary by product, are summarized below.

#### ***Residential Mortgage Loans***

Carrying values in excess of net realizable value are charged off at or before the time foreclosure is completed or when settlement is reached with the borrower. If foreclosure is not pursued, and there is no reasonable expectation for recovery, the account is generally charged off no later than the end of the month in which the account becomes six months contractually delinquent.

#### ***Auto Finance***

Carrying values in excess of net realizable value are generally charged off no later than the month in which the account becomes four months contractually delinquent.

#### ***MasterCard<sup>1</sup>/Visa<sup>2</sup> and Private Label Credit Card Loans***

Loan balances are generally charged off by the end of the month in which the account becomes six months contractually delinquent.

#### ***Other Consumer Loans***

Loan balances are generally charged off the month following the month in which the account becomes four months contractually delinquent.

### ***Nonaccruing Loan Policies and Practices***

HUSI's nonaccruing policies vary by product and are summarized below.

#### ***Commercial***

Commercial loans are categorized as nonaccruing when, in the opinion of management, reasonable doubt exists with respect to the ultimate collectibility of interest or principal based on certain factors including period of time past due and adequacy of collateral. At the time a loan is classified as nonaccruing, any accrued interest recorded on the loan is generally deemed uncollectible and charged against income. Interest income on these loans is subsequently recognized only to the extent of cash received or until the loan is placed on accrual status. In those instances where there is doubt as to collectibility of principal, any interest payments received are applied to principal. Loans are not reclassified as accruing until interest and principal payments are brought current and future payments are reasonably assured.

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<sup>1</sup> MasterCard is a registered trademark of MasterCard, Incorporated.

<sup>2</sup> Visa is a registered trademark of Visa USA, Inc.

### *Consumer*

Residential mortgage loans are generally designated as nonaccruing when contractually delinquent for more than three months. Credit card receivables and other consumer loans generally accrue interest until charge off.

### *Loan Fees and Costs*

Nonrefundable fees and related direct costs associated with the origination of loans are deferred and netted against outstanding loan balances. The amortization of net deferred fees, which include points on real estate secured loans and costs, is recognized in interest income, generally by the interest method, based on the estimated or contractual lives of the related loans. Amortization periods are periodically adjusted for loan prepayments and changes in other market assumptions. Annual fees on MasterCard/Visa and Home Equity Line of Credit (HELOC), net of direct lending costs, are deferred and amortized on a straight-line basis over one year. Nonrefundable fees related to lending activities other than direct loan origination are recognized as other revenues over the period in which the related service is provided. This includes fees associated with the issuance of loan commitments where the likelihood of the commitment being exercised is considered remote. In the event of the exercise of the commitment, the remaining unamortized fee is recognized in interest income over the loan term using the interest method. Other credit-related fees, such as standby letter of credit fees, loan syndication and agency fees are recognized as other operating income over the period the related service is performed.

### *Allowance for Credit Losses*

HUSI maintains an allowance for credit losses that is, in the judgment of management, adequate to absorb estimated probable losses of principal, interest and fees inherent in its commercial and consumer loan portfolios. The adequacy of the allowance for credit losses is assessed within the context of appropriate U.S. GAAP guidance, and is based, in part, upon an evaluation of various factors including:

- an analysis of individual exposures where applicable;
- current and historical loss experience;
- changes in the overall size and composition of the portfolio; and
- specific adverse situations and general economic conditions.

HUSI also assesses the overall adequacy of the allowance for credit losses by considering key ratios such as reserves to nonperforming loans and reserves as a percentage of net charge offs in developing its loss reserve estimates. Loss estimates are reviewed periodically and adjustments are reported in earnings when they become known. These estimates are influenced by factors outside of the control of HUSI management, such as consumer payment patterns and economic conditions, and there is uncertainty inherent in these estimates, making it reasonably possible that they could change.

For commercial and select consumer loan assets, HUSI conducts a periodic assessment on a loan-by-loan basis of losses it believes to be inherent in the loan portfolio. When it is deemed probable, based upon known facts and circumstances, that full contractual interest and principal on an individual loan will not be collected in accordance with its contractual terms, the loan is considered impaired. An impairment reserve is established based upon the present value of expected future cash flows, discounted at the loan's original effective interest rate, or as a practical expedient, the loan's observable market price or the fair value of the collateral if the loan is collateral dependent. Generally, impaired loans include loans in nonaccruing status, loans which have been assigned a specific allowance for credit losses, loans which have been partially charged off, and loans designated as troubled debt restructures. Problem commercial loans are assigned various criticized facility grades under the allowance for credit losses methodology.

Formula-based reserves are also established against commercial loans when, based upon an analysis of relevant data, it is probable that a loss has been incurred and the amount of that loss can be reasonably estimated, even though an actual loss has yet to be identified. A separate reserve for credit losses associated with off-balance sheet exposures including letters of credit, guarantees to extend credit and financial guarantees is also maintained and included in other liabilities, which incorporates estimates of the probability that customers will actually draw upon off-balance sheet obligations. This estimation methodology uses the probability of default from the customer rating assigned to each counterparty, the “Loss Given Default” rating assigned to each transaction or facility based on the collateral securing the transaction, and the measure of exposure based on the transaction. These reserves are determined by reference to continuously monitored and updated historical loss rates or factors, derived from a migration analysis which considers net charge off experience by loan and industry type in relation to internal credit grading.

Probable losses for pools of homogeneous consumer loans are generally estimated using a roll rate migration analysis that estimates the likelihood that a loan will progress through the various stages of delinquency, or buckets, and ultimately charge off. This analysis considers delinquency status, loss experience and severity and takes into account whether loans are in bankruptcy, have been restructured, rewritten, or are subject to forbearance, an external debt management plan, hardship, modification, extension or deferment. The allowance for credit losses on consumer receivables also takes into consideration the loss severity expected based on the underlying collateral, if any, for the loan in the event of default. In addition, loss estimates on consumer receivables are maintained to reflect HUSI’s judgment of portfolio risk factors, which may not be fully reflected in the statistical roll rate calculation. Risk factors considered in establishing loss reserves on consumer loans include recent growth, product mix, bankruptcy trends, geographic concentrations, economic conditions, portfolio seasoning, account management policies and practices and current levels of charge offs and delinquencies.

#### ***Repossessed Collateral***

Real estate owned with the intent to sell within a reasonable period is classified as held for sale at the date of foreclosure and is valued at the lower of cost or fair value less estimated costs to sell and is recorded in other assets. The valuation reserve is created to recognize write down to fair value less costs to sell. These values are periodically reviewed and adjusted against valuation allowance but not in excess of cumulative loss previously recognized. Costs of holding real estate and related gains and losses on disposition are credited or charged to operations as incurred as a component of operating expense.

#### ***Properties and Equipment, Net***

Properties and equipment are recorded at cost, net of accumulated depreciation. Depreciation is recorded on a straight-line basis over the estimated useful lives of the related assets, which generally range from 3 to 40 years. Leasehold improvements are depreciated over the lesser of the economic useful life of the improvement or the term of the lease. Costs of maintenance and repairs are expensed as incurred. Impairment testing is performed whenever events or changes in circumstances indicate that the carrying amount may not be recoverable.

#### ***Mortgage Servicing Rights***

Effective January 1, 2006, upon adoption of SFAS 156, mortgage servicing rights (MSRs) are initially measured at fair value at the time that the related loans are sold and periodically re-measured using the fair value measurement method. MSRs are measured at fair value at each reporting date with changes in fair value reflected in earnings in the period that the changes occur. Prior to January 1, 2006, MSRs were recorded at the lower of cost or fair value as required by previous accounting requirements.

MSRs are subject primarily to interest rate risk, in that their fair value will fluctuate as a result of changes in the interest rate environment. Fair value is determined based upon the application of valuation models and other inputs. The valuation models incorporate assumptions market participants would use in estimating future cash flows. These assumptions include expected prepayments, default rates and market based option adjusted spreads.

HUSI uses certain derivative financial instruments including options and interest rate swaps to protect against the decline in economic value of MSRs. These instruments have not been designated as qualifying hedges in accordance with U.S. GAAP guidelines and are therefore recorded as trading assets that are marked to market through earnings.

### ***Goodwill***

Goodwill, representing the excess of purchase price over the fair value of identifiable net assets acquired, results from purchase business combinations. Goodwill is not amortized, but is reviewed for impairment annually using a discounted cash flow methodology. Impairment is reviewed earlier if circumstances indicate that the carrying amount may not be recoverable. HUSI considers significant and long-term changes in industry and economic conditions to be primary indicators of potential impairment.

### ***Income Taxes***

HNAH files a consolidated federal income tax return, which includes HUSI. Deferred tax assets and liabilities are recognized for the estimated future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases, as well as the estimated future tax consequences attributable to net operating loss and tax credit carryforwards. These deferred tax assets and liabilities are measured using the tax rates and laws that are expected to be in effect. A valuation allowance is established if, based on available evidence, it is more likely than not that some portion or all of the deferred tax asset will not be realized. Foreign taxes paid are applied as credits to reduce federal income taxes payable, to the extent that such credits can be utilized.

HUSI has entered into tax allocation agreements with HNAH and its subsidiary entities included in the consolidated return which governs the timing and amount of income tax payments required by the various entities. Generally, such agreements allocate taxes to members of the affiliated group based on the calculation of tax on a separate return basis, adjusted for the utilization or limitation of credits of the consolidated group.

### ***Derivative Financial Instruments***

Derivative financial instruments are recognized on the consolidated balance sheets at their fair value. On the date a derivative contract is entered into, HUSI designates it as either:

- a qualifying hedge of the fair value of a recognized asset or liability or of an unrecognized firm commitment (fair value hedge);
- a qualifying hedge of the variability of cash flows to be received or paid related to a recognized asset, liability or forecasted transaction (cash flow hedge); or
- as a trading or non-qualifying hedge.

Changes in the fair value of a derivative that has been designated and qualifies as a fair value hedge, along with the changes in the fair value of the hedged asset or liability that is attributable to the hedged risk (including losses or gains on firm commitments), are recorded in current period earnings. Changes in the fair value of a derivative that has been designated and qualifies as a cash flow hedge, to the extent effective as a hedge, are recorded in accumulated other comprehensive income, net of income taxes, and reclassified into earnings in the period during which the hedged item affects earnings. Ineffectiveness is reflected in current earnings. Changes in the fair value of derivatives held for trading purposes or which do not qualify for hedge accounting are reported in current period earnings.

At the inception of each hedge, HUSI formally documents all relationships between hedging instruments and hedged items, as well as its risk management objective and strategy for undertaking various hedge transactions, the nature of the hedged risk, and how hedge effectiveness and ineffectiveness will be measured. This process includes linking all derivatives that are designated as fair value or cash flow hedges to specific assets and liabilities on the balance sheet or to specific firm commitments or forecasted transactions. HUSI also formally assesses, both at inception and on a recurring basis, whether the derivatives that are used in hedging transactions are highly effective in offsetting changes in fair values or cash flows of hedged items and whether they are expected to continue to be highly effective in future periods. This assessment is conducted using statistical regression analysis.

Earnings volatility may result from the on-going mark to market of certain economically viable derivative contracts that do not satisfy the hedging requirements under U.S. GAAP, as well as from the hedge ineffectiveness associated with the qualifying contracts.

#### *Embedded Derivatives*

HUSI may acquire or originate a financial instrument that contains a derivative instrument “embedded” within it. Upon origination or acquisition of any such instrument, HUSI assesses whether the economic characteristics of the embedded derivative are clearly and closely related to the economic characteristics of the principal component of the financial instrument (i.e., the host contract) and whether a separate instrument with the same terms as the embedded instrument would meet the definition of a derivative instrument. With the adoption of Statement of Financial Accounting Standards No. 155, Accounting for Certain Hybrid Financial Instruments (SFAS 155), the election now exists to account for an entire financial instrument at fair value through profit and loss if the financial instrument contains an embedded derivative that would otherwise require bifurcation. Hybrid financial instruments that HUSI has elected to carry at fair value continue to be reported in their existing balance sheet classification.

When it is determined that: (1) the embedded derivative possesses economic characteristics that are not clearly and closely related to the economic characteristics of the host contract; and (2) a separate instrument with the same terms would qualify as a derivative instrument, the embedded derivative is either separated from the host contract (bifurcated), carried at fair value, and designated as a trading instrument or the entire financial instrument is carried at fair value with all changes in fair value recorded to current period earnings. If bifurcation is elected, any gain recognized at inception related to the derivative is effectively embedded in the host contract and is recognized over the life of the financial instrument.

#### *Hedge Discontinuation*

HUSI discontinues hedge accounting prospectively when:

- the derivative is no longer effective or expected to be effective in offsetting changes in the fair value or cash flows of a hedged item (including firm commitments or forecasted transactions);
- the derivative expires or is sold, terminated, or exercised;
- it is unlikely that a forecasted transaction will occur;
- the hedged firm commitment no longer meets the definition of a firm commitment; or
- the designation of the derivative as a hedging instrument is no longer appropriate.

When hedge accounting is discontinued because it is determined that the derivative no longer qualifies as an effective fair value or cash flow hedge, the derivative will continue to be carried on the balance sheet at fair value.

In the case of a fair value hedge of a recognized asset or liability, as long as the hedged item continues to exist on the balance sheet, the hedged item will no longer be adjusted for changes in fair value. The basis adjustment that had previously been recorded to the hedged item during the period from the designation date to the hedge discontinuation date is recognized as an adjustment to the yield of the hedged item over the remaining life of the hedged item.

In the case of a cash flow hedge of a recognized asset or liability, as long as the hedged item continues to exist on the balance sheet, the effective portion of the changes in fair value of the hedging derivative will no longer be reclassified into other comprehensive income. The balance applicable to the discontinued hedging relationship will be recognized in earnings over the remaining life of the hedged item as an adjustment to yield. If the hedged item was a firm commitment or forecasted transaction that is not expected to occur, any amounts recorded on the balance sheet related to the hedged item, including any amounts recorded in accumulated other comprehensive income, are reclassified to current period earnings.

In the case of either a fair value hedge or a cash flow hedge, if the previously hedged item is sold or extinguished, the basis adjustment to the underlying asset or liability or any remaining unamortized other comprehensive income balance will be reclassified to current period earnings.

In all other situations in which hedge accounting is discontinued, the derivative will be carried at fair value on the consolidated balance sheets, with changes in its fair value recognized in current period earnings unless redesignated as a qualifying hedge.

#### *Day One Revenue Recognition*

HUSI recognizes gains and losses at the inception of derivative transactions only when the fair value of the transaction can be verified to similar market transactions or if all significant pricing model assumptions can be verified to observable market data. If profit or loss is not recognized at inception due to market observability, the net unrealized gain or loss associated with these transactions is recorded in trading and is offset by a reserve until the transaction can be verified to observable market data.

#### *Interest Rate Lock and Purchase Agreements*

HUSI enters into commitments to originate residential mortgage loans whereby the interest rate on the loan is set prior to funding (rate lock commitments). HUSI also enters into commitments to purchase residential mortgage loans through its correspondent channel (purchase commitments). Both rate lock and purchase commitments for residential mortgage loans that are classified as held for sale are derivatives. Rate lock and purchase commitments that are considered to be derivatives are recorded at fair value in other assets or other liabilities in the consolidated balance sheets. Changes in fair value are recorded in other income in the consolidated statements of income.

#### *Pension and Other Postretirement Benefits*

At December 31, 2006, as a result of the adoption of SFAS 158, Employer's Accounting for Defined Benefit Pension and Other Postretirement Plans, HUSI recognized the funded status of the postretirement benefit plans on the consolidated balance sheets with the offset to accumulated other comprehensive income. Prior to 2006, the funded status of these plans was not recognized on the consolidated balance sheets. Net postretirement benefit cost charged to current earnings related to these plans is based on various actuarial assumptions regarding expected future experience.

Certain HUSI employees are participants in various defined contribution and other non-qualified supplemental retirement plans. HUSI's contributions to these plans are charged to current earnings.

Through various subsidiaries, HUSI maintains various 401(k) plans covering substantially all employees. Employer contributions to the plan, which are charged to current earnings, are based on employee contributions.



### ***Stock-Based Compensation***

HUSI uses the fair value method of accounting for stock awards granted to employees under various stock option and employee stock purchase plans. Stock compensation costs are recognized prospectively for all new awards granted under these plans. Compensation expense relating to share options is calculated using a binomial lattice methodology that is based on the underlying assumptions of the Black-Scholes option pricing model and is charged to expense over the vesting period, generally three to five years. When modeling awards with vesting dependent on performance targets, these performance targets are incorporated into the model using Monte Carlo simulation. The expected life of these awards depends on the behavior of the award holders, which is incorporated into the model consistent with historic observable data.

Compensation expense relating to restricted stock rights (RSRs) is based upon the market value of the RSRs on the date of grant and is charged to earnings over the vesting period of the RSRs, generally three to five years.

### ***Transactions With Related Parties***

In the normal course of business, HUSI enters into transactions with HSBC and its subsidiaries. These transactions occur at prevailing market rates and terms and include funding arrangements, administrative and operational support, and other miscellaneous services. All material related party balances and transactions among various direct and indirect subsidiaries of HUSI are eliminated in consolidation.

### ***New Accounting Pronouncements***

In June 2006, the FASB issued Interpretation No. 48, Accounting for Uncertainty in Income Taxes - an interpretation of FASB Statement No. 109 (FIN 48). FIN 48 establishes threshold and measurement attributes for financial statement measurement and recognition of tax positions taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. The adoption of FIN 48 on January 1, 2007 did not have a material impact on HUSI's financial position or results of operations. Refer to Note 17 beginning on page 133 of this Form 10-K.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157, Fair Value Measurements (SFAS 157). SFAS 157 defines fair value, establishes a framework for measuring fair value and expands the disclosure requirements for fair value measurements. In addition, SFAS 157 nullifies footnote 3 to EITF Issue No. 02-3, Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities, which prohibited the recognition of gains or losses at the inception of a derivative contract unless the fair value of the derivative contract is determined based on observable market price or other valuation technique that incorporate observable market data. SFAS 157 also requires HUSI to consider its own credit risk when measuring the fair value of liabilities including but not limited to debt issuances and derivative contracts. HUSI adopted SFAS 157 effective January 1, 2008. In accordance with the transition provisions of SFAS 157, HUSI recorded an after-tax cumulative-effect adjustment of approximately \$36 million as an increase to the opening balance of retained earnings at the date of adoption.

In April 2007, the FASB issued FASB Staff Position No. FIN 39-1, Amendment of FASB Interpretation No. 39 (FSP FIN 39-1). FSP FIN 39-1 allows entities that are party to a master netting arrangement to offset the receivable or payable recognized upon payment or receipt of cash collateral against fair value amounts recognized for derivative instruments that have been offset under the same master netting arrangement in accordance with FASB Interpretation No. 39. The guidance in FSP FIN 39-1 is effective for fiscal years beginning after November 15, 2007, with early adoption permitted. Entities are required to recognize the effects of applying FSP FIN 39-1 as a change in accounting principle through retrospective application for all financial statements presented unless it is impracticable to do so. HUSI adopted FSP FIN 39-1 during the second quarter of 2007, the impact of which is described in Note 5 of these consolidated financial statements.

In February 2007, the FASB issued Statement of Financial Accounting Standards No. 159, The Fair Value Option for Financial Assets and Financial Liabilities (SFAS 159), which creates an alternative measurement method for certain financial assets and liabilities. SFAS 159 permits fair value to be used for both the initial and subsequent measurements on a contract-by-contract election, with changes in fair value to be recognized in earnings as those changes occur. This election is referred to as the “fair value option”. SFAS 159 also requires additional disclosures to compensate for the lack of comparability that will arise from the use of the fair value option. HUSI adopted SFAS 159 on January 1, 2008 and elected the fair value option for certain fixed rate debt obligations, certain portfolios of loans held for sale, structured notes as well as other financial instruments. The adoption resulted in a cumulative-effect after-tax increase to the January 1, 2008 opening balance of retained earnings of approximately \$77 million.

In November 2007, the SEC issued Staff Accounting Bulletin 109, Written Loan Commitments Recorded at Fair Value Through Earnings (SAB 109), which supersedes SAB 105, Application of Accounting Principles to Loan Commitments. SAB 109 revises the views expressed by the staff in SAB 105 to specify that the expected net future cash flows related to the associated servicing of a loan should be included in the measurement of written loan commitments that are accounted for at fair value through earnings. SAB 109 is effective for derivative loan commitments issued or modified in fiscal quarters beginning after December 15, 2007. The adoption of SAB 109 is not expected to have a material impact on the HUSI consolidated financial statements.

In December 2007, the FASB issued Statement of Financial Accounting Standards No. 141 (Revised), Business Combinations (SFAS 141(R)). This statement requires an acquirer to recognize the assets acquired, liabilities assumed and any noncontrolling interest in the acquiree at fair value as of the date of acquisition. This replaces the guidance in Statement 141 which required the cost of an acquisition to be allocated to the individual assets acquired and liabilities assumed based on their estimated fair values. SFAS 141(R) also changes the recognition and measurement criteria for certain assets and liabilities including those arising from contingencies, contingent consideration, and bargain purchases. SFAS 141(R) is effective for business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008.

In December 2007, the FASB issued Statement of Financial Accounting Standards No. 160, Noncontrolling Interests in Consolidated Financial Statements (SFAS 160). This statement amends ARB 51 and provides guidance on the accounting and reporting of noncontrolling interests in a subsidiary and for the deconsolidation of a subsidiary. SFAS 160 requires disclosure of the amounts of consolidated net income attributable to the parent and to the noncontrolling interest on the face of the consolidated statements of income. This statement also requires expanded disclosures that identify and distinguish between parent and noncontrolling interests. SFAS 160 is effective for fiscal years beginning on or after December 15, 2008.

### ***Note 3. Acquisitions and Divestitures***

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#### ***2007***

On December 31, 2007, HUSI completed the sale of its Wealth and Tax Advisory Services (WTAS) subsidiary to an independent firm formed by certain members of the WTAS management team. In exchange for the net assets of WTAS, HUSI received cash and secured promissory notes, as well as an option to purchase a limited amount of common equity in future years. HUSI recognized a gain of \$15 million as a result of this transaction.

There were no other material business acquisitions or divestitures in 2007.

#### ***2006 and 2005***

There were no material business acquisitions or divestitures during 2006 or 2005.

#### ***Note 4. Federal Funds Sold and Securities Purchased Under Agreements to Resell***

Federal funds sold and securities borrowed or purchased under agreements to resell are summarized in the following table.

| <b>December 31</b>                                    | <b>2007</b>      | <b>2006</b>      |
|---|------------------|------------------|
| <b>(in millions)</b>                                  |                  |                  |
| Federal funds sold .....                              | \$ 975           | \$ 6,781         |
| Securities purchased under agreements to resell ..... | <u>12,702</u>    | <u>6,994</u>     |
| Total .....   | <u>\$ 13,677</u> | <u>\$ 13,775</u> |

Funds generated from deposits growth during 2007 were primarily invested in short-term investments such as Federal funds sold and securities purchased under agreements to resell.

#### ***Note 5. Trading Assets and Liabilities***

Trading assets and liabilities are summarized in the following table.

| <b>December 31</b>                       | <b>2007</b>      | <b>2006</b>      |
|--|------------------|------------------|
| <b>(in millions)</b>                     |                  |                  |
| Trading assets:                          |                  |                  |
| U.S. Treasury .....                      | \$ 460           | \$ 646           |
| U.S. Government agency .....             | 3,009            | 1,902            |
| Asset backed securities .....            | 2,942            | 3,053            |
| Corporate bonds .....                    | 1,296            | 1,420            |
| Other securities .....                   | 5,830            | 4,903            |
| Precious metals .....                    | 8,788            | 2,716            |
| Fair value of derivatives .....          | <u>14,711</u>    | <u>8,990</u>     |
|  | <u>\$ 37,036</u> | <u>\$ 23,630</u> |
| Trading liabilities:                     |                  |                  |
| Securities sold, not yet purchased ..... | \$ 1,444         | \$ 1,914         |
| Payables for precious metals .....       | 1,523            | 1,336            |
| Fair value of derivatives .....          | <u>13,286</u>    | <u>9,064</u>     |
|  | <u>\$ 16,253</u> | <u>\$ 12,314</u> |

During the second quarter of 2007, HUSI adopted the reporting requirements of FASB Staff Position No. FIN 39-1, Amendment of FASB Interpretation No. 39 (refer to Note 2 of these consolidated financial statements). In accordance with this standard, HUSI offsets fair value amounts recognized for the obligation to return cash collateral or the right to reclaim cash collateral against the fair value of derivative instruments executed with the same counterparty under a master netting agreement. As a result of application of this standard, certain reclassifications have been made to the December 31, 2006 consolidated balance sheet, as noted below.

At December 31, 2007 and December 31, 2006, the fair value of derivatives included in trading assets have been reduced by \$3.6 billion and \$2.4 billion, respectively, of amounts recognized for the obligation to return cash collateral received under master netting agreements with derivative counterparties. At December 31, 2006, these amounts were originally reported as interest bearing deposits.

At December 31, 2007 and December 31, 2006, the fair value of derivatives included in trading liabilities have been reduced by \$5.6 billion and \$1.7 billion, respectively, of amounts recognized for the right to reclaim cash collateral paid under master netting agreements with derivative counterparties. At December 31, 2006, \$4 billion of these amounts were originally reported as interest bearing deposits with banks and \$1.3 billion were reported as other assets.

**Note 6. Securities**

At December 31, 2007 and 2006, HUSI held no securities of any single issuer (excluding the U.S. Treasury, U.S. Government sponsored enterprises and U.S. Government agencies) with a book value that exceeded 10% of shareholders' equity. The amortized cost and fair value of the available for sale and held to maturity securities portfolios are summarized in the following table.

| <b>December 31, 2007</b>                                    | <b>Amortized<br/>Cost</b> | <b>Gross<br/>Unrealized<br/>Gains</b> | <b>Gross<br/>Unrealized<br/>Losses</b> | <b>Fair<br/>Value</b> |
|---|---------------------------|---------------------------------------|--|-----------------------|
| <b>(in millions)</b>  |                           |                                       |  |                       |
| Securities available for sale:                              |                           |                                       |  |                       |
| U.S. Treasury .....   | \$ 1                      | \$ -                                  | \$ -                                   | \$ 1                  |
| U.S. Government sponsored enterprises (1) .....             | 11,141                    | 60                                    | (271)                                  | 10,930                |
| U.S. Government agency issued or guaranteed .....           | 3,193                     | 13                                    | (34)                                   | 3,172                 |
| Obligations of U.S. states and political subdivisions ..... | 668                       | 3                                     | (3)                                    | 668                   |
| Asset backed securities .....                               | 1,563                     | 2                                     | (72)                                   | 1,493                 |
| Other domestic debt securities .....                        | 2,649                     | 15                                    | (25)                                   | 2,639                 |
| Foreign debt securities .....                               | 1,036                     | 1                                     | (3)                                    | 1,034                 |
| Equity securities .....                                     | 25                        | -                                     | -                                      | 25                    |
| Securities available for sale .....                         | <u>\$ 20,276</u>          | <u>\$ 94</u>                          | <u>\$ (408)</u>                        | <u>\$ 19,962</u>      |
| Securities held to maturity:                                |                           |                                       |  |                       |
| U.S. Government sponsored enterprises (1) .....             | \$ 1,862                  | \$ 42                                 | \$ (22)                                | \$ 1,882              |
| U.S. Government agency issued or guaranteed .....           | 528                       | 24                                    | (1)                                    | 551                   |
| Obligations of U.S. states and political subdivisions ..... | 255                       | 14                                    | -                                      | 269                   |
| Other domestic debt securities .....                        | 176                       | 1                                     | (4)                                    | 173                   |
| Foreign debt securities .....                               | 70                        | -                                     | -                                      | 70                    |
| Securities held to maturity .....                           | <u>\$ 2,891</u>           | <u>\$ 81</u>                          | <u>\$ (27)</u>                         | <u>\$ 2,945</u>       |

(1) Includes primarily mortgage backed securities issued by the Federal National Mortgage Association (FNMA) and the Federal Home Loan Mortgage Corporation (FHLMC).

| <b>December 31, 2006</b>                                    | <b>Amortized<br/>Cost</b> | <b>Gross<br/>Unrealized<br/>Gains</b> | <b>Gross<br/>Unrealized<br/>Losses</b> | <b>Fair<br/>Value</b> |
|---|---------------------------|---------------------------------------|--|-----------------------|
| <b>(in millions)</b>  |                           |                                       |  |                       |
| Securities available for sale:                              |                           |                                       |  |                       |
| U.S. Treasury .....   | \$ 1,535                  | \$ 3                                  | \$ (8)                                 | \$ 1,530              |
| U.S. Government sponsored enterprises (1) .....             | 10,682                    | 30                                    | (257)                                  | 10,455                |
| U.S. Government agency issued or guaranteed .....           | 3,793                     | 6                                     | (72)                                   | 3,727                 |
| Obligations of U.S. states and political subdivisions ..... | 515                       | 4                                     | (1)                                    | 518                   |
| Asset backed securities .....                               | 578                       | 1                                     | (3)                                    | 576                   |
| Other domestic debt securities .....                        | 1,343                     | 3                                     | (19)                                   | 1,327                 |
| Foreign debt securities .....                               | 860                       | 7                                     | (3)                                    | 864                   |
| Equity securities .....                                     | 775                       | 11                                    | -                                      | 786                   |
| Securities available for sale .....                         | <u>\$ 20,081</u>          | <u>\$ 65</u>                          | <u>\$ (363)</u>                        | <u>\$ 19,783</u>      |
| Securities held to maturity:                                |                           |                                       |  |                       |
| U.S. Government sponsored enterprises (1) .....             | \$ 1,845                  | \$ 43                                 | \$ (17)                                | \$ 1,871              |
| U.S. Government agency issued or guaranteed .....           | 584                       | 25                                    | (2)                                    | 607                   |
| Obligations of U.S. states and political subdivisions ..... | 325                       | 19                                    | -                                      | 344                   |
| Other domestic debt securities .....                        | 167                       | 2                                     | (2)                                    | 167                   |
| Foreign debt securities .....                               | 51                        | -                                     | *                                      | 51                    |
| Securities held to maturity .....                           | <u>\$ 2,972</u>           | <u>\$ 89</u>                          | <u>\$ (21)</u>                         | <u>\$ 3,040</u>       |

(1) Includes primarily mortgage backed securities issued by the Federal National Mortgage Association (FNMA) and the Federal Home Loan Mortgage Corporation (FHLMC).

\* Less than \$500 thousand.

A summary of gross unrealized losses and related fair values, classified as to the length of time the losses have existed, is presented in the following table.

| December 31, 2007   | One Year or Less     |                         |                                    | Greater Than One Year |                         |                                    |
|---|----------------------|-------------------------|------------------------------------|-----------------------|-------------------------|------------------------------------|
|   | Number of Securities | Gross Unrealized Losses | Aggregate Fair Value of Investment | Number of Securities  | Gross Unrealized Losses | Aggregate Fair Value of Investment |
| (\$ in millions)  |                      |                         |                                    |                       |                         |                                    |
| Securities available for sale:                              |                      |                         |                                    |                       |                         |                                    |
| U.S. Government sponsored enterprises (1) .....             | 48                   | \$ (57)                 | \$ 1,581                           | 565                   | \$ (214)                | \$ 5,818                           |
| U.S. Government agency issued or guaranteed .....           | 9                    | *                       | 13                                 | 440                   | (34)                    | 1,607                              |
| Obligations of U.S. states and political subdivisions ..... | 43                   | (2)                     | 256                                | 13                    | (1)                     | 106                                |
| Asset backed securities .....                               | 33                   | (70)                    | 969                                | 15                    | (2)                     | 127                                |
| Other domestic debt securities .....                        | 31                   | (13)                    | 642                                | 50                    | (12)                    | 735                                |
| Foreign debt securities .....                               | 5                    | (1)                     | 71                                 | 6                     | (2)                     | 158                                |
| Securities available for sale .....                         | <u>169</u>           | <u>\$ (143)</u>         | <u>\$ 3,532</u>                    | <u>1,089</u>          | <u>\$ (265)</u>         | <u>\$ 8,551</u>                    |
| Securities held to maturity:                                |                      |                         |                                    |                       |                         |                                    |
| U.S. Government sponsored enterprises (1) .....             | 11                   | \$ (3)                  | \$ 87                              | 20                    | \$ (19)                 | \$ 377                             |
| U.S. Government agency issued or guaranteed .....           | 1                    | *                       | 15                                 | 82                    | (1)                     | 42                                 |
| Obligations of U.S. states and political subdivisions ..... | 7                    | *                       | 4                                  | -                     | -                       | -                                  |
| Other domestic debt securities .....                        | 3                    | (1)                     | 41                                 | 7                     | (3)                     | 66                                 |
| Foreign debt securities .....                               | -                    | -                       | -                                  | -                     | -                       | -                                  |
| Securities held to maturity .....                           | <u>22</u>            | <u>\$ (4)</u>           | <u>\$ 147</u>                      | <u>109</u>            | <u>\$ (23)</u>          | <u>\$ 485</u>                      |

(1) Includes primarily mortgage backed securities issued by FNMA and FHLMC.

\* Less than \$500 thousand.

| December 31, 2006   | One Year or Less     |                         |                                    | Greater Than One Year |                         |                                    |
|---|----------------------|-------------------------|------------------------------------|-----------------------|-------------------------|------------------------------------|
|   | Number of Securities | Gross Unrealized Losses | Aggregate Fair Value of Investment | Number of Securities  | Gross Unrealized Losses | Aggregate Fair Value of Investment |
| (\$ in millions)  |                      |                         |                                    |                       |                         |                                    |
| Securities available for sale:                              |                      |                         |                                    |                       |                         |                                    |
| U.S. Treasury .....   | 8                    | \$ (1)                  | \$ 527                             | 6                     | \$ (7)                  | \$ 566                             |
| U.S. Government sponsored enterprises (1) .....             | 211                  | (114)                   | 3,158                              | 482                   | (143)                   | 5,042                              |
| U.S. Government agency issued or guaranteed .....           | 691                  | (40)                    | 2,334                              | 268                   | (32)                    | 1,076                              |
| Obligations of U.S. states and political subdivisions ..... | 12                   | (1)                     | 85                                 | 3                     | *                       | 27                                 |
| Asset backed securities .....                               | 6                    | *                       | 81                                 | 19                    | (3)                     | 293                                |
| Other domestic debt securities .....                        | 10                   | (1)                     | 153                                | 56                    | (18)                    | 910                                |
| Foreign debt securities .....                               | 6                    | (1)                     | 191                                | 11                    | (2)                     | 227                                |
| Securities available for sale .....                         | <u>944</u>           | <u>\$ (158)</u>         | <u>\$ 6,529</u>                    | <u>845</u>            | <u>\$ (205)</u>         | <u>\$ 8,141</u>                    |
| Securities held to maturity:                                |                      |                         |                                    |                       |                         |                                    |
| U.S. Government sponsored enterprises (1) .....             | 23                   | \$ *                    | \$ 15                              | 22                    | \$ (17)                 | \$ 389                             |
| U.S. Government agency issued or guaranteed .....           | 49                   | *                       | 21                                 | 169                   | (2)                     | 35                                 |
| Obligations of U.S. states and political subdivisions ..... | 1                    | *                       | *                                  | 9                     | *                       | 4                                  |
| Other domestic debt securities .....                        | 2                    | *                       | 22                                 | 4                     | (2)                     | 33                                 |
| Foreign debt securities .....                               | 2                    | *                       | 51                                 | -                     | -                       | -                                  |
| Securities held to maturity .....                           | <u>77</u>            | <u>\$ *</u>             | <u>\$ 109</u>                      | <u>204</u>            | <u>\$ (21)</u>          | <u>\$ 461</u>                      |

(1) Includes primarily mortgage backed securities issued by FNMA and FHLMC.

\* Less than \$500 thousand.

Gross unrealized losses have increased within the available for sale securities portfolio during 2007, due to the impact of general increases in market interest rates on HUSI's portfolios, which are primarily fixed rate securities. Since substantially all of these securities are high credit grade (i.e., AAA or AA), and HUSI has the ability and intent to hold these securities until maturity or a market price recovery, they are not considered to be other than temporarily impaired.

The following table summarizes realized gains and losses on investment securities transactions attributable to available for sale and held to maturity securities. Amounts in the table include net realized losses of \$11 million reported in residential mortgage banking revenue in the consolidated statement of income for 2005.

| <b>Year Ended December 31</b><br><b>(in millions)</b> | <b>Gross<br/>Realized<br/>Gains</b> | <b>Gross<br/>Realized<br/>(Losses)</b> | <b>Net<br/>Realized<br/>Gains</b> |
|---|-------------------------------------|--|-----------------------------------|
| <b><u>2007</u></b>                                    |                                     |  |                                   |
| Securities available for sale .....                   | \$ 67                               | \$ (17)                                | \$ 50                             |
| Securities held to maturity:                          |                                     |  |                                   |
| Maturities, calls and mandatory redemptions .....     | <u>1</u>                            | <u>-</u>                               | <u>1</u>                          |
|   | <u>\$ 68</u>                        | <u>\$ (17)</u>                         | <u>\$ 51</u>                      |
| <b><u>2006</u></b>                                    |                                     |  |                                   |
| Securities available for sale .....                   | \$ 34                               | \$ (6)                                 | \$ 28                             |
| Securities held to maturity:                          |                                     |  |                                   |
| Maturities, calls and mandatory redemptions .....     | <u>1</u>                            | <u>-</u>                               | <u>1</u>                          |
|   | <u>\$ 35</u>                        | <u>\$ (6)</u>                          | <u>\$ 29</u>                      |
| <b><u>2005</u></b>                                    |                                     |  |                                   |
| Securities available for sale .....                   | \$ 107                              | \$ (13)                                | \$ 94                             |
| Securities held to maturity:                          |                                     |  |                                   |
| Maturities, calls and mandatory redemptions .....     | <u>1</u>                            | <u>-</u>                               | <u>1</u>                          |
|   | <u>\$ 108</u>                       | <u>\$ (13)</u>                         | <u>\$ 95</u>                      |

The amortized cost and fair values of securities available for sale and securities held to maturity at December 31, 2007, by contractual maturity are summarized in the following table. Expected maturities differ from contractual maturities because borrowers have the right to prepay obligations without prepayment penalties in certain cases. Securities available for sale amounts exclude equity securities with a fair value and cost of \$25 million as they do not have stated maturities.

The following table also reflects the distribution of maturities of debt securities held at December 31, 2007, together with the approximate taxable equivalent yield of the portfolio. The yields shown are calculated by dividing annual interest income, including the accretion of discounts and the amortization of premiums, by the amortized cost of securities outstanding at December 31, 2007. Yields on tax-exempt obligations have been computed on a taxable equivalent basis using applicable statutory tax rates.

| Taxable<br>Equivalent<br>Basis                                    | Within<br>One<br>Year |        | After One<br>But Within<br>Five Years |        | After Five<br>But Within<br>Ten Years |        | After<br>Ten<br>Years |        |
|---|-----------------------|--------|---------------------------------------|--------|---------------------------------------|--------|-----------------------|--------|
|   | Amount                | Yield  | Amount                                | Yield  | Amount                                | Yield  | Amount                | Yield  |
| (\$ in millions)  |                       |        |                                       |        |                                       |        |                       |        |
| Available for sale:   |                       |        |                                       |        |                                       |        |                       |        |
| U.S. Treasury .....   | \$ *                  | - %    | \$ 1                                  | 4.62 % | \$ -                                  | - %    | \$ -                  | - %    |
| U.S. Government<br>sponsored enterprises .....                    | 230                   | 2.94   | 348                                   | 6.00   | 579                                   | 5.06   | 9,984                 | 5.08   |
| U.S. Government agency<br>issued or guaranteed .....              | *                     | 6.65   | 72                                    | 3.51   | 66                                    | 4.99   | 3,055                 | 4.92   |
| Obligations of U.S.<br>states and political<br>subdivisions ..... | -                     | -      | -                                     | -      | 64                                    | 5.04   | 604                   | 5.02   |
| Asset backed securities .....                                     | 1                     | 4.84   | 193                                   | 4.27   | 49                                    | 5.22   | 1,320                 | 5.17   |
| Other domestic debt<br>securities .....                           | 10                    | 4.00   | 95                                    | 5.36   | 54                                    | 4.88   | 2,490                 | 5.40   |
| Foreign debt securities .....                                     | 799                   | 5.21   | 86                                    | 6.03   | 46                                    | 6.02   | 105                   | 6.85   |
| Total amortized cost .....  | <u>\$ 1,040</u>       | 4.69 % | <u>\$ 795</u>                         | 5.28 % | <u>\$ 858</u>                         | 5.10 % | <u>\$ 17,558</u>      | 5.11 % |
| Total fair value .....  | <u>\$ 1,039</u>       |        | <u>\$ 774</u>                         |        | <u>\$ 858</u>                         |        | <u>\$ 17,266</u>      |        |
| Held to maturity:   |                       |        |                                       |        |                                       |        |                       |        |
| U.S. Government<br>sponsored enterprises .....                    | \$ *                  | 7.09 % | \$ 8                                  | 7.08 % | \$ 69                                 | 6.05 % | \$ 1,785              | 5.89 % |
| U.S. Government agency<br>issued or guaranteed .....              | 1                     | 6.82   | 2                                     | 7.26   | 7                                     | 8.69   | 518                   | 6.41   |
| Obligations of U.S.<br>states and political<br>subdivisions ..... | 10                    | 5.93   | 44                                    | 5.44   | 38                                    | 4.99   | 163                   | 5.10   |
| Other domestic debt<br>securities .....                           | -                     | -      | -                                     | -      | -                                     | -      | 176                   | 5.80   |
| Foreign debt securities .....                                     | 70                    | 3.92   | -                                     | -      | -                                     | -      | -                     | -      |
| Total amortized cost .....  | <u>\$ 81</u>          | 4.22 % | <u>\$ 54</u>                          | 5.77 % | <u>\$ 114</u>                         | 5.85 % | <u>\$ 2,642</u>       | 5.94 % |
| Total fair value .....  | <u>\$ 82</u>          |        | <u>\$ 57</u>                          |        | <u>\$ 121</u>                         |        | <u>\$ 2,685</u>       |        |

\* Less than \$500 thousand.

Investments in Federal Home Loan Bank (FHLB) stock, Federal Reserve Bank (FRB) stock, and MasterCard Class B shares of \$373 million, \$304 million and \$56 million, respectively, were included in other assets at December 31, 2007. Investments in FHLB stock, FRB stock and MasterCard Class B shares of \$360 million, \$306 million and \$57 million, respectively, were included in other assets at December 31, 2006.



## Note 7. Loans

A distribution of the loan portfolio, including loans held for sale, is summarized in the following table.

|   | December 31, 2007      |                    |                  | December 31, 2006      |                    |                  |
|---|------------------------|--------------------|------------------|------------------------|--------------------|------------------|
|   | Loans Held<br>for Sale | All Other<br>Loans | Total<br>Loans   | Loans Held<br>for Sale | All Other<br>Loans | Total<br>Loans   |
| <b>(in millions)</b>                    |                        |                    |                  |                        |                    |                  |
| Commercial loans:                       |                        |                    |                  |                        |                    |                  |
| Construction and other real estate .... | \$ 26                  | \$ 8,428           | \$ 8,454         | \$ 102                 | \$ 8,816           | \$ 8,918         |
| Other commercial .....                  | 1,939                  | 27,530             | 29,469           | -                      | 20,564             | 20,564           |
|   | <u>1,965</u>           | <u>35,958</u>      | <u>37,923</u>    | <u>102</u>             | <u>29,380</u>      | <u>29,482</u>    |
| Consumer loans:                         |                        |                    |                  |                        |                    |                  |
| Sub-prime residential mortgages .....   | 1,869                  | -                  | 1,869            | 2,582                  | -                  | 2,582            |
| Other residential mortgages.....        | 1,018                  | 32,493             | 33,511           | 1,645                  | 35,581             | 37,226           |
| Credit card receivables .....           | -                      | 19,415             | 19,415           | -                      | 18,260             | 18,260           |
| Other consumer .....                    | 418                    | 1,813              | 2,231            | 394                    | 2,293              | 2,687            |
|   | <u>3,305</u>           | <u>53,721</u>      | <u>57,026</u>    | <u>4,621</u>           | <u>56,134</u>      | <u>60,755</u>    |
| Total loans .....                       | \$ <u>5,270</u>        | \$ <u>89,679</u>   | \$ <u>94,949</u> | \$ <u>4,723</u>        | \$ <u>85,514</u>   | \$ <u>90,237</u> |

In December 2004, HUSI acquired a \$12 billion private label loan portfolio from HSBC Finance Corporation. The portfolio consisted of approximately \$11 billion of private label credit card receivables and \$1 billion of other consumer and commercial loans. The customer relationships were retained by HSBC Finance Corporation. By agreement, HUSI is purchasing additional credit card receivables generated from customer accounts at fair value on a daily basis. During 2007 and 2006, underlying customer balances included within the private label portfolio have revolved, and new relationships have been added, bringing the total private label credit card portfolio balance to approximately \$17 billion at December 31, 2007 and 2006.

Residential mortgage loan originations generally declined during 2007 and 2006 due to a rising interest rate environment. In addition, originations of various adjustable rate residential mortgage loan products that would have been retained on the consolidated balance sheets prior to 2005 were being sold in the secondary market beginning in 2005 and throughout 2007 and 2006, also as a result of strategic balance sheet initiatives to enhance liquidity and to address interest rate risk. These factors contributed to the overall decrease in residential mortgage loans during 2007 and 2006.

HUSI has loans outstanding to certain executive officers and directors. The loans were made on substantially the same terms, including interest rates and collateral, as those prevailing at the same time for comparable transactions with other persons and do not involve more than normal risk of collectibility. The aggregate amount of such loans did not exceed 5% of shareholders' equity at December 31, 2007 and 2006.

### Loans Held for Sale

HUSI originates commercial loans in connection with its participation in a number of leveraged acquisition finance syndicates. A substantial majority of these loans were originated with the intent of selling them to unaffiliated third parties and are classified as other commercial loans held for sale at December 31, 2007. Commercial loans held for sale under this program are classified as other commercial loans in the above table and were \$1.9 billion at December 31, 2007.

Residential mortgage loans held for sale include sub-prime residential mortgage loans acquired from unaffiliated third parties and from HSBC Finance Corporation, with the intent of selling the loans to HMUS. Also included in other residential mortgage loans held for sale are prime mortgage loans originated and held for sale primarily to various governmental agencies.

Other consumer loans held for sale consists primarily of student loans.

Loans held for sale are recorded at the lower of cost or market value. The cost of loans held for sale exceeded market value at December 31, 2007 and December 31, 2006, resulting in the recording of a valuation allowance. Changes in the valuation allowance utilized to adjust loans held for sale to market value, that is included in the determination of net income, are summarized in the following table and reflect the recording of substantial valuation adjustments as a result of adverse conditions in the corporate credit and U.S. residential mortgage markets. Also, see commentary regarding changes in the valuation allowance included in the Management's Discussion and Analysis of Financial Condition and Results of Operation (MD&A) on page 45 of this Form 10-K.

The valuation allowance related to loans held for sale is presented in the following table.

|  | 2007            | 2006           |
|--|-----------------|----------------|
| <b>(in millions)</b>   |                 |                |
| Balance at beginning of year .....                             | \$ (29)         | \$ (26)        |
| Increase in allowance for net reductions in market value ..... | (512)           | (120)          |
| Releases of valuation allowance for loans sold .....           | 66              | 117            |
| Balance at end of year .....                                   | <u>\$ (475)</u> | <u>\$ (29)</u> |

Loans held for sale are subject to credit risk and interest rate risk, in that their value will fluctuate as a result of changes in market conditions, as well as the interest rate and credit environment. Interest rate risk for residential mortgage loans held for sale is partially mitigated through an economic hedging program to offset changes in the fair value of the mortgage loans held for sale. There was a loss of \$8 million recognized from the economic hedges of loans held for sale for 2007, compared to a \$68 million gain for 2006.

***Note 8. Allowance for Credit Losses and Credit Quality Statistics***

An analysis of the allowance for credit losses is presented in the following table.

|   | 2007            | 2006          | 2005          |
|---|-----------------|---------------|---------------|
| <b>(in millions)</b>  |                 |               |               |
| Balance at beginning of year .....  | \$ 897          | \$ 846        | \$ 788        |
| Provision charged to income .....   | 1,522           | 823           | 674           |
| Charge offs .....   | (1,269)         | (1,012)       | (871)         |
| Recoveries .....  | 264             | 248           | 255           |
| Allowance related to dispositions, net .....  | -               | (8)           | -             |
| Balance at end of year .....  | <u>\$ 1,414</u> | <u>\$ 897</u> | <u>\$ 846</u> |
| Non-United States transfer risk reserves included in the allowance<br>for credit losses ..... | <u>\$ -</u>     | <u>\$ -</u>   | <u>\$ 4</u>   |

## Credit Quality Statistics

Nonaccruing loans information is summarized in the following table.

| <b>December 31</b>                       | <b>2007</b>   | <b>2006</b>   |
|--|---------------|---------------|
| <b>(in millions)</b>                     |               |               |
| Nonaccruing loans                        |               |               |
| Commercial:                              |               |               |
| Construction and other real estate ..... | \$ 34         | \$ 33         |
| Other commercial .....                   | <u>89</u>     | <u>69</u>     |
| Total commercial .....                   | <u>123</u>    | <u>102</u>    |
| Consumer:                                |               |               |
| Residential mortgages .....              | 640           | 265           |
| Credit card receivables .....            | <u>1</u>      | <u>1</u>      |
| Total consumer loans .....               | <u>641</u>    | <u>266</u>    |
| Total nonaccruing loans .....            | <u>\$ 764</u> | <u>\$ 368</u> |

Interest income on nonaccruing loans is summarized in the following table.

| <b>Year Ended December 31</b>  | <b>2007</b> | <b>2006</b> | <b>2005</b> |
|--|-------------|-------------|-------------|
| <b>(in millions)</b>   |             |             |             |
| Interest income on nonaccruing loans:  |             |             |             |
| Amount which would have been recorded had the associated loans<br>been current in accordance with their original terms ..... | \$ 49       | \$ 24       | \$ 25       |
| Amount actually recorded .....   | 7           | 8           | 12          |

Additional credit quality statistics are summarized in the following table.

| <b>December 31</b>   | <b>2007</b>   | <b>2006</b>   |
|--|---------------|---------------|
| <b>(in millions)</b>   |               |               |
| Accruing loans contractually past due 90 days or more as to principal or interest: |               |               |
| Total commercial .....   | \$ <u>8</u>   | \$ <u>22</u>  |
| Consumer:  |               |               |
| Residential mortgages .....  | -             | 11            |
| Credit card receivables .....  | 432           | 339           |
| Other consumer loans .....   | <u>16</u>     | <u>16</u>     |
| Total consumer loans .....   | <u>448</u>    | <u>366</u>    |
| Total accruing loans contractually past due 90 days or more .....                  | <u>\$ 456</u> | <u>\$ 388</u> |
| Impaired loans:  |               |               |
| Balance at end of period .....   | \$ 123        | \$ 100        |
| Amount with impairment reserve .....   | 41            | 35            |
| Impairment reserve .....   | 15            | 13            |
| Other real estate and owned assets:  |               |               |
| Balance at end of period .....   | \$ 71         | \$ 53         |

### ***Note 9. Securitizations and Secured Financings***

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On December 29, 2004, HUSI acquired a domestic private label loan portfolio from HSBC Finance Corporation, without recourse, which included securitized private label credit card receivables and retained interest assets related to these securitizations. The securitization transactions utilized revolving trusts structured as QSPEs and transfers of receivables to these QSPE trusts were structured to receive sale treatment under SFAS 140.

Under IFRS, HUSI's private label credit card securitizations do not qualify for sale treatment and are treated as secured financings. In order to align its accounting treatment with that of HSBC, all new securitizations of private label credit cards since the third quarter of 2004 have been structured as secured financings under U.S. GAAP. In addition, the last remaining securitization trust agreement related to the securitized private label credit card receivables acquired from HSBC Finance Corporation in 2004 was amended in the third quarter of 2006. As a result, the related securitization trust no longer qualifies as a QSPE. Subsequent transfers of receivables to this trust, which are required to support previously issued securities, no longer qualify for sale treatment under U.S. GAAP and are recorded as secured financings. As of the amendment date, HUSI also began consolidating the trust as its primary beneficiary and all outstanding investments, credit card receivables and liabilities related to the trust are recorded on HUSI's consolidated balance sheets.

Refer to Note 27, Variable Interest Entities (VIEs), on page 155 of this Form 10-K for additional information about the assets of private label credit card securitization trusts consolidated by HUSI.

### ***Note 10. Properties and Equipment, Net***

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The composition of properties and equipment, net of accumulated depreciation, is summarized in the following table.

| <b>December 31</b>                         | <b>Depreciable</b>  | <b>2007</b> | <b>2006</b> |
|--|---------------------|-------------|-------------|
| <b>(\$ in millions)</b>                    | <b>Life (Years)</b> |             |             |
| Land .....                                 | -                   | \$ 76       | \$ 79       |
| Buildings .....                            | 5-40                | 832         | 754         |
| Furniture and equipment .....              | 3-7                 | 360         | 519         |
| Total .....                                |                     | 1,268       | 1,352       |
| Less: accumulated depreciation .....       |                     | (700)       | (812)       |
| Properties and equipment, net .....        |                     | \$ 568      | \$ 540      |
| Depreciation expense during the year ..... |                     | \$ 71       | \$ 79       |

**Note 11. Intangible Assets**

The following table summarizes the composition of intangible assets.

| <b>December 31</b>              | <b>2007</b>   | <b>2006</b>   |
|---------------------------------|---------------|---------------|
| <b>(in millions)</b>            |               |               |
| Mortgage servicing rights ..... | \$ 494        | \$ 474        |
| Other .....                     | 40            | 47            |
| Intangible assets .....         | <u>\$ 534</u> | <u>\$ 521</u> |

***Mortgage Servicing Rights (MSRs)***

HUSI recognizes the right to service mortgage loans as a separate and distinct asset at the time the loans are sold. Servicing fees collected by HUSI are included in residential mortgage banking revenue, and were \$116 million, \$100 million and \$76 million for the years ended December 31, 2007, 2006 and 2005, respectively.

Effective January 1, 2006, HUSI adopted SFAS 156 electing to measure this one class of MSRs at fair value. Upon adoption, HUSI recorded a cumulative effect adjustment to beginning retained earnings of less than \$1 million, representing the difference between the fair value and the carrying amount of MSRs as of the date of adoption.

MSRs are subject to credit and interest rate risk, in that their value will fluctuate as a result of changes in the interest rate environment. Interest rate risk is mitigated through an active economic hedging program that uses securities and derivatives to offset changes in the fair value of MSRs. Since the hedging program involves trading activity, risk is quantified and managed using a number of risk assessment techniques, which are addressed in more detail under Market Risk Management beginning on page 84 of this Form 10-K.

MSRs are initially measured at fair value at the time that the related loans are sold, and periodically remeasured using the fair value measurement method. MSRs are measured at fair value at each reporting date with changes in fair value of the asset reflected in residential mortgage banking revenue in the period that the changes occur. Fair value is determined based upon the application of valuation models and other inputs. The valuation models incorporate assumptions market participants would use in estimating future cash flows. These assumptions include expected prepayments, default rates and market-based option adjusted spreads. The reasonableness of these valuation models is periodically validated by reference to external independent broker valuations and industry surveys.

Fair value of MSRs is calculated using the following critical assumptions.

|   | <b>December 31,<br/>2007</b> | <b>December 31,<br/>2006</b> |
|---|------------------------------|------------------------------|
| Annualized constant prepayment rate (CPR) ..... | <b>21.40 %</b>               | 20.80 %                      |
| Constant discount rate .....                    | <b>10.44 %</b>               | 10.34 %                      |
| Weighted average life .....                     | <b>4.9 years</b>             | 4.8 years                    |

The following table summarizes MSRs activity for the years ended December 31, 2007 and 2006, the reporting periods since adoption of SFAS 156.

| <b>Year Ended December 31</b>  | <b>2007</b>   | <b>2006</b>   |
|--|---------------|---------------|
| <b>(in millions)</b>   |               |               |
| Fair value of MSRs:  |               |               |
| Beginning balance .....  | \$ 474        | \$ 418        |
| Additions related to loan sales .....  | 124           | 100           |
| Changes in fair value due to:  |               |               |
| Change in valuation inputs or assumptions used in the valuation models ..... | (19)          | 43            |
| Realization of cash flows .....  | (85)          | (87)          |
| Ending balance .....   | \$ <u>494</u> | \$ <u>474</u> |

Information regarding residential mortgage loans serviced for others, which are not included in the consolidated balance sheet, is summarized in the following table.

| <b>Year Ended December 31</b>  | <b>2007</b>      | <b>2006</b>      |
|--|------------------|------------------|
| <b>(in millions)</b>   |                  |                  |
| Outstanding principal balances at period end .....   | \$ <u>37,401</u> | \$ <u>34,736</u> |
| Custodial balances maintained and included in noninterest bearing deposits at period end ..... | \$ <u>596</u>    | \$ <u>647</u>    |

### ***Other Intangible Assets***

Other intangible assets include favorable lease arrangements and customer lists. The weighted-average amortization period for these intangible assets is 75 months at December 31, 2007. Total amortization expense was approximately \$6 million for 2007 and 2006. Scheduled amortization is approximately \$6 million per year for 2008 through 2012.

### ***Note 12. Goodwill***

During the third quarter of 2007, HUSI completed its annual impairment test of goodwill. At the testing date, HUSI determined that the fair value of each of its reporting units exceeded its carrying value. As a result, no impairment loss was required to be recognized.

The following table presents a summary of changes in goodwill.

| <b>Year Ended December 31</b>                 | <b>2007</b>     | <b>2006</b>     |
|---|-----------------|-----------------|
| <b>(in millions)</b>                          |                 |                 |
| Balance at beginning of year .....            | \$ 2,716        | \$ 2,694        |
| Purchase accounting adjustment .....          | -               | 22              |
| Reductions related to business disposals..... | (15)            | -               |
| Balance at the end of the year .....          | \$ <u>2,701</u> | \$ <u>2,716</u> |

During December 2007, HUSI sold the Wealth and Tax Advisory business, which resulted in a reduction to goodwill of approximately \$15 million.

As a result of a difficult business climate and the market volatility which occurred during the second half of 2007, HUSI performed an interim goodwill test in the Global Banking and Markets business segment, formerly Corporate, Investment Banking and Markets (CIBM), as of December 31, 2007. The results of this test showed the fair value of this business unit exceeded the carrying value including goodwill that was assigned. Based on these results, HUSI determined goodwill was not impaired in this business segment at December 31, 2007.

### Note 13. Deposits

The aggregate amounts of time deposit accounts (primarily certificates of deposits), each with a minimum of \$100,000 included in domestic office deposits, were approximately \$17 billion and \$19 billion at December 31, 2007 and 2006, respectively. Certain domestic deposits meet the definition of a hybrid financial instrument as defined in SFAS 155. As a result, deposits totaling \$1,479 million and \$1,322 million at December 31, 2007 and 2006, respectively, are being carried at fair value with all changes in fair value recorded to profit and loss. The scheduled maturities of all time deposits at December 31, 2007 is summarized in the following table.

|                      | Domestic<br>Offices | Foreign<br>Offices | Total            |
|----------------------|---------------------|--------------------|------------------|
| <b>(in millions)</b> |                     |                    |                  |
| 2008:                |                     |                    |                  |
| 0-90 days .....      | \$ 14,812           | \$ 11,317          | \$ 26,129        |
| 91-180 days .....    | 4,577               | 461                | 5,038            |
| 181-365 days .....   | 3,199               | 229                | 3,428            |
|                      | <u>22,588</u>       | <u>12,007</u>      | <u>34,595</u>    |
| 2009 .....           | 380                 | -                  | 380              |
| 2010 .....           | 141                 | -                  | 141              |
| 2011 .....           | 88                  | -                  | 88               |
| 2012 .....           | 26                  | -                  | 26               |
| Later years .....    | 199                 | -                  | 199              |
|                      | <u>\$ 23,422</u>    | <u>\$ 12,007</u>   | <u>\$ 35,429</u> |

Overdraft deposits, which are classified as loans, were approximately \$2,281 million and \$1,727 million at December 31, 2007 and 2006, respectively.

### Note 14. Short-Term Borrowings

The following table summarizes the components of short-term borrowings. At December 31, 2007 and 2006, there were no categories of short-term borrowings that exceeded 30% of total shareholders' equity.

| December 31<br>(in millions)                      | 2007             | 2006            |
|---|------------------|-----------------|
| Federal funds purchased (day to day) .....        | \$ 2,055         | \$ 77           |
| Securities sold under repurchase agreements ..... | 2,247            | 1,328           |
| Commercial paper .....                            | 3,925            | 2,414           |
| Precious metals .....                             | 3,078            | 1,146           |
| Other .....                                       | 527              | 108             |
| Total short-term borrowings .....                 | <u>\$ 11,832</u> | <u>\$ 5,073</u> |

At December 31, 2007 and 2006, HUSI had an unused line of credit from HSBC of \$2.5 billion and \$2 billion, respectively. This line of credit does not require compensating balance arrangements and commitment fees are not significant. The interest rate is comparable to third party rates for a line of credit with similar terms.

At December 31, 2007 and 2006, HUSI had an unused line of credit from its parent, HSBC North America Inc. (HNAI), of \$150 million. The interest rate is comparable to third party rates for a line of credit with similar terms.

As a member of the New York Federal Home Loan Bank (FHLB), HUSI has a secured borrowing facility, which is collateralized by residential mortgage loans. At December 31, 2007 and 2006, the facility included \$5.5 billion and \$5.0 billion, respectively, of borrowings included in long-term debt (see Note 15). The facility also allows access to further short-term borrowings based upon the amount of residential mortgage loans pledged as collateral with the FHLB, which were undrawn as of December 31, 2007 and 2006.

## Note 15. Long-Term Debt

The composition of long-term debt is presented in the following table. Interest rates on floating rate notes are determined periodically by formulas based on certain money market rates or, in certain instances, by minimum interest rates as specified in the agreements governing the issues. Interest rates in effect at December 31, 2007 are shown in parentheses.

| <b>December 31</b>   | <b>2007</b>          | <b>2006</b>      |
|--|----------------------|------------------|
| <b>(in millions)</b>   |                      |                  |
| Issued by HUSI or its subsidiaries other than HBUS:  |                      |                  |
| Non-subordinated debt:   |                      |                  |
| Medium-Term Floating Rate Notes due 2008-2012 (4.42% - 5.10%) .....                              | \$ 357               | \$ 53            |
| 8.375% Debentures due 2007 .....   | -                    | 100              |
| Floating Rate Extendible Notes due 2008 (5.04%) .....  | <u>1,500</u>         | <u>1,499</u>     |
|  | <b>1,857</b>         | <b>1,652</b>     |
| Subordinated debt:   |                      |                  |
| Fixed Rate Subordinated Notes due 2008-2097 (5.88% - 9.70%) .....                                | <b>1,489</b>         | 1,496            |
| Perpetual Capital Notes (5.63%) .....  | <b>127</b>           | 127              |
| Junior Subordinated Debentures due 2026-2032 (7.75% - 8.38%) .....                               | <u>866</u>           | <u>1,061</u>     |
|  | <b>2,482</b>         | <b>2,684</b>     |
| Total issued by HUSI or its subsidiaries other than HBUS .....                                   | <u><b>4,339</b></u>  | <u>4,336</u>     |
| Issued or acquired by HBUS or its subsidiaries:  |                      |                  |
| Non-subordinated debt:   |                      |                  |
| Global Bank Note Program:  |                      |                  |
| Medium-Term Notes due 2008-2040 (.78% - 5.94%) .....   | <b>2,927</b>         | 2,108            |
| 3.875% Fixed Rate Senior Global Bank Notes due 2009 .....  | <b>1,945</b>         | 1,943            |
| 5.43% Fixed Rate Senior Global Bank Notes due 2009 .....   | -                    | 20               |
| Floating Rate Senior Global Bank Notes due 2009 (5.19% - 5.29%) .....                            | <b>1,798</b>         | 4,646            |
| Floating Rate Non-USD Senior Global Bank Notes due 2008-2009 (2.59% - 4.88%) .....               | <b>1,459</b>         | 1,328            |
| 4.95% Fixed Rate Senior Notes due 2012 .....   | <u>25</u>            | <u>25</u>        |
|  | <b>8,154</b>         | 10,070           |
| Federal Home Loan Bank of New York (FHLB) advances:  |                      |                  |
| Fixed Rate FHLB advances due 2008-2037 (2.01% - 7.24%) .....                                     | <b>9</b>             | 10               |
| Floating Rate FHLB advances due 2008-2036 (4.88% - 5.25%) .....                                  | <u>5,500</u>         | <u>5,000</u>     |
|  | <b>5,509</b>         | 5,010            |
| Precious metal leases due 2008-2014 (.10% - 1.70%) .....   | <b>1,044</b>         | 729              |
| Private label credit card secured financing due 2008-2012 (4.67% - 5.35%), refer to Note 9 ..... | <b>1,549</b>         | 2,134            |
| Secured financings with Structured Note Vehicles, refer to Note 27 .....                         | <b>2,486</b>         | 2,542            |
| Other:   |                      |                  |
| 5.99% Fixed Rate Note due 2011 .....   | <b>350</b>           | 350              |
| Floating Rate Note due 2011 (5.49%) .....  | <b>1</b>             | 4                |
| 6.60% Fixed Rate Note due 2021 .....   | <b>1,009</b>         | 858              |
| 3.99% Non-USD Senior Debt due 2044 .....   | <b>579</b>           | 530              |
| Other .....  | <u>22</u>            | <u>34</u>        |
|  | <b>1,961</b>         | 1,776            |
| Total non-subordinated debt .....  | <u><b>20,703</b></u> | <u>22,261</u>    |
| Subordinated debt:   |                      |                  |
| 4.625% Global Subordinated Notes due 2014 .....  | <b>996</b>           | 995              |
| Global Bank Note Program:  |                      |                  |
| Fixed Rate Global Bank Notes due 2017-2035 (5.63% - 6.00%) .....                                 | <b>2,215</b>         | 1,643            |
| Total subordinated debt .....  | <u>3,211</u>         | <u>2,638</u>     |
| Total issued or acquired by HBUS or its subsidiaries .....                                       | <u><b>23,914</b></u> | <u>24,899</u>    |
| Obligations under capital leases .....   | <b>15</b>            | 17               |
| Total long-term debt .....   | <b>\$ 28,268</b>     | <b>\$ 29,252</b> |



The table excludes \$900 million of long-term debt issued by HBUS or its subsidiaries payable to HUSI. Of this amount, the earliest note is due to mature in 2012 and the latest note is due to mature in 2097.

***Debt Issued by HUSI or its Subsidiaries other than HBUS***

In April 2006, HUSI filed an S-3 Shelf Registration Statement (the 2006 shelf) with the Securities and Exchange Commission. Under the 2006 shelf, HUSI may issue debt securities or preferred stock, either separately or represented by depositary shares, warrants, purchase contracts and units comprised of any combination of one or more of the aforementioned securities. The 2006 shelf, which has no dollar limit, replaced a shelf filed in 2005 in the amount of \$2.3 billion. The Medium-Term Floating Rate Notes due 2008–2012 were issued under the 2006 shelf.

All of the Medium-Term Floating Rate Notes at December 31, 2007 and December 31, 2006 meet the definition of hybrid financial instruments under SFAS 155, which was adopted in 2006, (see Note 2) and are being carried at fair value.

The \$1.5 billion Floating Rate Extendible Notes were issued by HUSI in November 2005. These senior debt securities require the noteholders to decide each month whether or not to extend the maturity date of their notes by one month beyond the initial maturity date of December 15, 2006. In no event will the maturity of the notes be extended beyond December 15, 2011, the final maturity date. If on any election date a noteholder decides not to extend the maturity of all or any portion of the principal amount of his notes, the notes will mature on the previously elected maturity date, which will be the maturity date that is twelve months from the current election date. On the August 2007 election date, noteholders of \$749,500,000 of this debt exercised their option not to extend the maturity date of their notes. These notes will mature on August 15, 2008. On the September 2007 election date, noteholders of \$690,000,000 of this debt exercised their option not to extend the maturity date of their notes. These notes will mature on September 15, 2008. On the October 2007 election date, noteholders of the remaining \$60,500,000 of this debt elected not to extend the maturity of their notes. Therefore, these notes will mature on October 15, 2008. Interest is payable on the notes in arrears on the 15<sup>th</sup> day of each month, commencing December 15, 2005. The interest rate will be determined by reference to the one-month LIBOR, plus or minus the applicable spread for that particular interest period. The spread for each interest period ranges from minus 2 basis points for the interest period ending December 15, 2006 to plus 1 basis point for the interest period ending October 15, 2008.

The Junior Subordinated Debentures due 2026-2032 are held by four capital funding trusts established by HUSI to issue guaranteed capital debt securities in the form of preferred stock backed by the debentures and guaranteed by HUSI. The trusts also issued common stock, all of which is held by HUSI and recorded in other assets. The debentures issued to the capital funding trusts, less the amount of their common stock held by HUSI, qualify as Tier 1 capital. Although the capital funding trusts are VIEs, HUSI's investment in their common stock is not deemed to be a variable interest because that stock is not deemed to be equity at risk. HUSI holds no other interests in the capital funding trusts and therefore is not their primary beneficiary and does not consolidate them. During September 2007, HUSI exercised its right to redeem \$206 million of the 7.53% Junior Subordinated Debentures that had an original maturity date of December 4, 2026.

### *Debt Issued by HBUS or its Subsidiaries*

In December 2006, HBUS increased the size of its Global Bank Note Program from \$20 billion to \$40 billion. The Global Bank Note Program provides for the issuance of fixed rate and floating rate, senior and subordinated notes. The following debt issues were made under this program in 2007 and 2006.

- In August 2007, HBUS issued \$500 million of 6.00% Subordinated Bank Notes due 2017. Interest is paid semiannually on February 9 and August 9 of each year, commencing on February 9, 2008 and ending on the stated maturity date of August 9, 2017. These notes may not be redeemed by HBUS.
- In November 2006, HBUS issued the \$20 million 5.43% Senior Notes due 2009. Interest is paid semiannually on May 20 and November 20 of each year, commencing on May 20, 2007 and ending on the stated maturity date of November 20, 2009. HBUS exercised its right to redeem these notes in whole on November 20, 2007.
- Certain Medium-Term Notes issued in 2006 meet the definition of hybrid financial instruments under SFAS 155, which was adopted in 2006 (see Note 2). Medium-Term Notes totaling \$1,403 million and \$849 million at December 31, 2007 and 2006, respectively, are being carried at fair value.

Other includes certain notes totaling \$1.4 billion and \$1.2 billion at December 31, 2007 and 2006, respectively, which resulted from 2006 structured financing transactions.

As of December 31, 2007, the contractual scheduled maturities for total long-term debt over the next five years are as follows.

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| <i>(in millions)</i> |          |
|----------------------|----------|
| 2008 .....           | \$ 8,875 |
| 2009 .....           | 5,970    |
| 2010 .....           | 1,868    |
| 2011 .....           | 962      |
| 2012 .....           | 824      |

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### *Note 16. Derivative Instruments and Hedging Activities*

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HUSI is party to various derivative financial instruments as an end user (1) for asset and liability management purposes; (2) in order to offset the risk associated with changes in the value of various assets and liabilities accounted for in the trading account; (3) to protect against changes in value of its mortgage servicing rights portfolio; and (4) for trading in its own account.

HUSI is also an international dealer in derivative instruments denominated in U.S. dollars and other currencies which include futures, forwards, swaps and options related to interest rates, foreign exchange rates, equity indices, commodity prices and credit, focusing on structuring of transactions to meet clients' needs.

#### *Fair Value Hedges*

Specifically, interest rate swaps that call for the receipt of a variable market rate and the payment of a fixed rate and short forward contracts are utilized under fair value strategies to hedge the risk associated with changes in the risk free rate component of the value of certain fixed rate investment securities. Interest rate swaps that call for the receipt of a fixed rate and payment of a variable market rate are utilized to hedge the risk associated with changes in the risk free rate component of certain fixed rate debt obligations. The regression method is utilized in order to satisfy the retrospective and prospective assessment of hedge effectiveness for SFAS 133.

HUSI recognized net (losses) gains of approximately \$(8) million, \$10 million and \$2 million for the years ended December 31, 2007, 2006 and 2005, respectively, (reported as other income in the consolidated statements of income), which represented the ineffective portion of all fair value hedges.

For the years ended December 31, 2007, 2006 and 2005, \$5 million, \$5 million and \$7 million of gains related to the basis adjustment of terminated and/or redesignated fair value hedge relationships were amortized to earnings. During 2008, HUSI expects to amortize \$7 million of remaining gains to earnings resulting from these terminated and/or redesignated fair value hedges.

### ***Cash Flow Hedges***

Similarly, interest rate swaps and futures contracts that call for the payment of a fixed rate are utilized under the cash flow strategy to hedge the forecasted repricing of certain deposit liabilities. In order to satisfy the retrospective and prospective assessment of hedge effectiveness for SFAS 133, the regression method is utilized. Ineffectiveness is recorded to the statement of income on a monthly basis. The total ineffectiveness of all cash flow hedges was \$1.4 million for the year ended December 31, 2007 and was less than \$1 million for the years ended December 31, 2006 and 2005.

Gains or losses on derivative contracts that are reclassified from accumulated other comprehensive income to current period earnings pursuant to this strategy, are included in interest expense on deposit liabilities during the periods that net income is impacted by the underlying liabilities. As of December 31, 2007, approximately \$66 million of deferred net losses on derivative instruments accumulated in other comprehensive income are expected to be included in earnings during 2008.

At December 31, 2007, the net unrealized loss on derivatives included in accumulated other comprehensive income was \$157 million, net of income taxes. Of this amount, the \$68 million gain represents the effective portion of the net gains on derivatives that qualify as cash flow hedges, and the \$89 million loss relates to terminated and/or redesignated derivatives. For the years ended December 31, 2007 and 2006, respectively, \$12 million of losses and \$35 million of gains related to terminated and/or redesignated cash flow hedge relationships were amortized to earnings from other comprehensive income. During 2008, HUSI expects to amortize \$66 million of remaining gains to earnings resulting from these terminated and/or redesignated cash flow hedges.

### ***Trading and Other Activities***

HUSI enters into certain derivative contracts for purely trading purposes in order to realize profits from short-term movements in interest rates, commodity prices, foreign exchange rates and credit spreads. In addition, certain derivative contracts are accounted for on a full mark to market basis through current earnings even though they were acquired for the purpose of protecting the economic value of certain assets and liabilities.

### *Notional Values of Derivative Contracts*

The following table summarizes the notional values of derivative contracts.

| <b>December 31</b>                         | <b>2007</b>         | <b>2006</b>         |
|--|---------------------|---------------------|
| <b>(in millions)</b>                       |                     |                     |
| Interest rate:                             |                     |                     |
| Futures and forwards .....                 | \$ 96,077           | \$ 94,204           |
| Swaps .....                                | 1,874,340           | 1,906,688           |
| Options written .....                      | 97,198              | 510,023             |
| Options purchased .....                    | 102,015             | 544,026             |
|  | <u>2,169,630</u>    | <u>3,054,941</u>    |
| Foreign exchange:                          |                     |                     |
| Swaps, futures and forwards .....          | 534,988             | 394,621             |
| Options written .....                      | 87,730              | 61,406              |
| Options purchased .....                    | 86,350              | 63,795              |
| Spot .....                                 | 39,963              | 32,654              |
|  | <u>749,031</u>      | <u>552,476</u>      |
| Commodities, equities and precious metals: |                     |                     |
| Swaps, futures and forwards .....          | 49,080              | 43,620              |
| Options written .....                      | 19,394              | 12,263              |
| Options purchased .....                    | 18,730              | 16,115              |
|  | <u>87,204</u>       | <u>71,998</u>       |
| Credit derivatives .....                   | <u>1,252,337</u>    | <u>816,422</u>      |
| Total .....                                | <u>\$ 4,258,202</u> | <u>\$ 4,495,837</u> |

The total notional amounts in the table above relate primarily to HUSI's trading activities. Notional amounts included in the table related to non-trading fair value, cash flow and economic hedging activities were \$15 billion and \$27 billion at December 31, 2007 and 2006, respectively.

**Note 17. Income Taxes**

Total income taxes were allocated as follows.

| <b>Year Ended December 31</b>   | <b>2007</b>    | <b>2006</b>   | <b>2005</b>   |
|---|----------------|---------------|---------------|
| <b>(in millions)</b>  |                |               |               |
| Income tax (benefit) expense .....  | \$ (1)         | \$ 530        | \$ 566        |
| To shareholders' equity as tax charge (benefit):                              |                |               |               |
| Net unrealized losses on securities available for sale .....                  | (13)           | (22)          | (111)         |
| Unrealized (losses) gains on derivatives classified as cash flow hedges ..... | (74)           | (106)         | 78            |
| Unrealized (losses) gains on interest-only strip receivables .....            | -              | (4)           | 4             |
| Employer accounting for post-retirement plans .....                           | 5              | (13)          | -             |
| Foreign currency translation, net .....                                       | 2              | -             | (4)           |
|   | <u>\$ (81)</u> | <u>\$ 385</u> | <u>\$ 533</u> |

The components of income tax expense follow.

| <b>Year Ended December 31</b>            | <b>2007</b>   | <b>2006</b>   | <b>2005</b>   |
|--|---------------|---------------|---------------|
| <b>(in millions)</b>                     |               |               |               |
| Current:                                 |               |               |               |
| Federal .....                            | \$ 301        | \$ 466        | \$ 484        |
| State and local .....                    | 40            | 51            | 90            |
| Foreign .....                            | 28            | 18            | 7             |
| Total current .....                      | <u>369</u>    | <u>535</u>    | <u>581</u>    |
| Deferred, primarily federal .....        | (370)         | (5)           | (15)          |
| Total income tax (benefit) expense ..... | <u>\$ (1)</u> | <u>\$ 530</u> | <u>\$ 566</u> |

The following table is an analysis of the difference between effective rates based on the total income tax provision attributable to pretax income and the statutory U.S. Federal income tax rate.

| <b>Year Ended December 31</b>                                | <b>2007</b>   | <b>2006</b>   | <b>2005</b>   |
|--|---------------|---------------|---------------|
| Statutory rate .....   | 35.0 %        | 35.0 %        | 35.0 %        |
| Increase (decrease) due to:                                  |               |               |               |
| State and local income taxes .....                           | 14.3          | 2.1           | 4.2           |
| Adjustment of tax rate used to value deferred taxes .....    | 17.4          | -             | -             |
| Goodwill related to disposition of WTAS business .....       | 3.8           | -             | -             |
| Valuation allowance .....                                    | 4.4           | -             | -             |
| Validation of deferred tax balances .....                    | (20.5)        | 1.1           | -             |
| Release of tax reserves .....                                | (6.3)         | (.7)          | (.3)          |
| Tax exempt interest income .....                             | (11.1)        | (.9)          | (.7)          |
| Low income housing and miscellaneous other tax credits ..... | (34.1)        | (1.8)         | (1.4)         |
| Non-taxable income .....                                     | (5.5)         | -             | -             |
| Other items .....  | 1.9           | (1.0)         | (.1)          |
| Effective income tax rate .....                              | <u>(.7) %</u> | <u>33.8 %</u> | <u>36.7 %</u> |

The components of the net deferred tax position are presented in the following table.

| <b>December 31</b>   | <b>2007</b>   | <b>2006</b>   |
|--|---------------|---------------|
| <b>(in millions)</b>                                       |               |               |
| Deferred tax assets:                                       |               |               |
| Allowance for credit losses .....                          | \$ 524        | \$ 296        |
| Benefit accruals .....                                     | 120           | 100           |
| Accrued expenses not currently deductible .....            | 102           | 80            |
| LOCOM adjustments .....                                    | 136           | -             |
| Unrealized losses on securities available for sale .....   | 112           | 122           |
| Investment securities .....                                | 88            | 20            |
| Accrued pension cost .....                                 | 5             | 14            |
| Premium on purchased receivables .....                     | -             | 4             |
| Total deferred tax assets before valuation allowance ..... | <u>1,087</u>  | <u>636</u>    |
| Valuation allowance .....                                  | <u>(7)</u>    | <u>-</u>      |
| Total deferred tax assets .....                            | <u>1,080</u>  | <u>636</u>    |
| Less deferred tax liabilities:                             |               |               |
| Lease financing income accrued .....                       | (6)           | 7             |
| Deferred gain recognition .....                            | (48)          | 34            |
| Depreciation and amortization .....                        | 22            | 6             |
| Interest and discount income .....                         | 201           | 168           |
| Deferred fees/costs .....                                  | 86            | 97            |
| Mortgage servicing rights .....                            | 150           | 177           |
| Net purchase discount on acquired companies .....          | 7             | 6             |
| Other .....  | <u>93</u>     | <u>40</u>     |
| Total deferred tax liabilities .....                       | <u>505</u>    | <u>535</u>    |
| Net deferred tax asset .....                               | <u>\$ 575</u> | <u>\$ 101</u> |

Realization of deferred tax assets is contingent upon the generation of future taxable income or the existence of sufficient taxable income within the carryback period. Based upon the level of historical taxable income and the scheduled reversal of the deferred tax liabilities over the periods in which the deferred tax assets are deductible, management believes that it is more likely than not HUSI would realize the benefits of these deductible differences, net of the valuation allowance noted above. The valuation allowance relates primarily to potential limitations on the utilization of excess foreign tax credits.

At December 31, 2007, HUSI had foreign tax credit carryforwards of \$6 million for U.S. federal income tax purposes which expire as follows: \$2 million in 2016 and \$4 million in 2017.

As discussed in Note 2, HUSI adopted FIN 48 effective January 1, 2007. The adoption resulted in the recognition of additional current tax liabilities and offsetting deferred tax assets of \$11 million. A reconciliation of the beginning and ending amount of unrecognized tax benefits is as follows.

|  |    |             |
|--|----|-------------|
| <b>(in millions)</b>   |    |             |
| Balance at January 1, 2007 .....                                   | \$ | 86          |
| Additions based on tax positions related to the current year ..... |    | 23          |
| Additions for tax positions of prior years .....                   |    | 27          |
| Reductions for tax positions of prior years .....                  |    | <u>(21)</u> |
| Balance at December 31, 2007 .....                                 | \$ | <u>115</u>  |

The state tax portion of this amount is reflected gross and not reduced by federal tax effect. The total amount of unrecognized tax benefits at December 31, 2007 that, if recognized, would affect the effective income tax rate is \$56 million.

Major taxing jurisdictions for HUSI and tax years for each that remain subject to examination are as follows.

|                |                |
|----------------|----------------|
| U.S. Federal   | 2004 and later |
| New York State | 1992 and later |
| New York City  | 1995 and later |

The U.S. federal audit of the 2004 and 2005 tax years, as well as certain state audits, have a reasonable possibility of being effectively settled within the next 12 months. No estimate as to the potential outcome of these audits is possible at this time.

HUSI recognizes accrued interest and penalties, if any, related to unrecognized tax benefits in other operating expenses. As of January 1, 2007, we had accrued \$16 million for the payment of interest associated with uncertain tax positions. During the twelve months ended December 31, 2007, we increased our accrual for the payment of interest associated with uncertain positions by \$11 million.

### *Note 18. Preferred Stock*

The following table presents information related to the issues of preferred stock outstanding.

| December 31  | Shares<br>Outstanding<br>2007 | Dividend<br>Rate<br>2007 | Amount<br>Outstanding |                 |
|--|-------------------------------|--------------------------|-----------------------|-----------------|
|  |                               |                          | 2007                  | 2006            |
| <b>(\$ in millions)</b>  |                               |                          |                       |                 |
| Floating Rate Non-Cumulative Preferred Stock, Series F<br>(\$25 stated value) .....  | 20,700,000                    | 6.159 %                  | \$ 517                | \$ 517          |
| 14,950,000 Depositary Shares each representing a one-fortieth<br>interest in a share of Floating Rate Non-Cumulative Preferred<br>Stock, Series G (\$1,000 stated value) ..... | 373,750                       | 6.159                    | 374                   | 374             |
| 14,950,000 Depositary Shares each representing a one-fortieth<br>interest in a share of 6.50% Non-Cumulative Preferred Stock,<br>Series H (\$1,000 stated value) .....         | 373,750                       | 6.500                    | 374                   | 374             |
| 6,000,000 Depositary shares each representing a one-fourth<br>interest in a share of Adjustable Rate Cumulative Preferred<br>Stock, Series D (\$100 stated value) .....        | 1,500,000                     | 4.500                    | 150                   | 150             |
| \$2.8575 Cumulative Preferred Stock (\$50 stated value) .....  | 3,000,000                     | 5.715                    | 150                   | 150             |
| CTUS Inc. Preferred Stock .....  | 100                           | -                        | *                     | *               |
| Dutch Auction Rate Transferable Securities™ Preferred<br>Stock (DARTS):  |                               |                          |                       |                 |
| Series A (\$100,000 stated value) .....  | -                             | 4.527                    | -                     | 63              |
| Series B (\$100,000 stated value) .....  | -                             | 4.565                    | -                     | 62              |
|  |                               |                          | \$ <u>1,565</u>       | \$ <u>1,690</u> |

\* Less than \$500 thousand.

### *Preferred Stock*

In May 2006, HUSI issued 14,950,000 depositary shares, each representing one-fortieth of a share of 6.50% Non-Cumulative Preferred Stock, Series H (\$1,000 stated value). Total issue proceeds, net of \$9 million of underwriting fees and other expenses, were \$365 million. When and if declared by HUSI's Board of Directors, dividends of 6.50% per annum on the stated value per share will be payable quarterly on the first calendar day of January, April, July and October of each year. The Series H Preferred Stock may be redeemed at the option of HUSI, in whole or in part, on or after July 1, 2011 at \$1,000 per share, plus accrued and unpaid dividends for the then-current dividend period.

Dividends on the Floating Rate Non-Cumulative Series F Preferred Stock are non-cumulative and will be payable when and if declared by the Board of Directors of HUSI quarterly on the first calendar day of January, April, July and October of each year. Dividends on the stated value per share are payable for each dividend period at a rate equal to a floating rate per annum of .75% above three month LIBOR, but in no event will the rate be less than 3.5% per annum. The Series F Preferred Stock may be redeemed at the option of HUSI, in whole or in part, on or after April 7, 2010 at a redemption price equal to \$25 per share, plus accrued and unpaid dividends for the then-current dividend period.

Dividends on the Floating Rate Non-Cumulative Series G Preferred Stock are non-cumulative and will be payable when and if declared by the Board of Directors of HUSI quarterly on the first calendar day of January, April, July and October of each year. Dividends on the stated value per share are payable for each dividend period at a rate equal to a floating rate per annum of .75% above three month LIBOR, but in no event will the rate be less than 4% per annum. The Series G Preferred Stock may be redeemed at the option of HUSI, in whole or in part, on or after January 1, 2011 at a redemption price equal to \$1,000 per share, plus accrued and unpaid dividends for the then-current dividend period.

The Adjustable Rate Cumulative Preferred Stock, Series D is redeemable, as a whole or in part, at the option of HUSI at \$100 per share (or \$25 per depository share), plus accrued and unpaid dividends. The dividend rate is determined quarterly, by reference to a formula based on certain benchmark market interest rates, but will not be less than 4½% or more than 10½% per annum for any applicable dividend period.

The \$2.8575 Cumulative Preferred Stock may be redeemed at the option of HUSI, in whole or in part, on or after October 1, 2007 at \$50 per share, plus accrued and unpaid dividends. Dividends are paid quarterly.

HUSI acquired CTUS Inc., a unitary thrift holding company, in 1997 from CT Financial Services Inc. (the Seller). CTUS owned First Federal Savings and Loan Association of Rochester (First Federal). The acquisition agreement provided that HUSI issue preferred shares to the Seller. The preferred shares provide for, and only for, a contingent dividend or redemption equal to the amount of recovery, net of taxes and costs, if any, by First Federal resulting from the pending action against the United States government alleging breaches by the government of contractual obligations to First Federal following passage of the Financial Institutions Reform, Recovery and Enforcement Act of 1989. HUSI issued 100 preferred shares at a par value of \$1.00 per share in connection with the acquisition.

In November 2007, HUSI redeemed all issued shares of DARTS Preferred Stock, Series A and B at their stated value of \$100,000 per share, resulting in total cash payment of \$125 million.



**Note 19. Retained Earnings and Regulatory Capital Requirements**

Bank dividends are a major source of funds for payment by HUSI of shareholder dividends and along with interest earned on investments, cover HUSI's operating expenses which consist primarily of interest on outstanding debt. Under 12 USC 60, the approval of the OCC is required if the total of all dividends declared by HBUS in any year exceeds the cumulative net profits for that year, combined with the profits for the two preceding years reduced by dividends attributable to those years. Under a separate restriction, payment of dividends is prohibited in amounts greater than undivided profits then on hand, after deducting actual losses and bad debts. Bad debts are debts due and unpaid for a period of six months unless well secured, as defined, and in the process of collection. These rules restrict HBUS from paying dividends to HUSI as of December 31, 2007, as cumulative net profits for 2007, 2006 and 2005 are less than dividends attributable to those years.

Additional information regarding regulation, supervision and capital for HUSI and HBUS begins on page 10 of this Form 10-K.

Capital amounts and ratios of HUSI and HBUS, calculated in accordance with current banking regulations, are summarized in the following table. In December 2007, U.S. regulators published a revision to the regulatory capital rules which will go into effect on April 1, 2008. This revision will significantly affect the ratios shown in the table below. HUSI's approach toward implementing the Basel II framework is summarized on page 76 of this Form 10-K.

| December 31                               | 2007           |                                    |              | 2006           |                                    |              |
|---|----------------|------------------------------------|--------------|----------------|------------------------------------|--------------|
|   | Capital Amount | Well-Capitalized Minimum Ratio (1) | Actual Ratio | Capital Amount | Well-Capitalized Minimum Ratio (1) | Actual Ratio |
| (\$ in millions)                          |                |                                    |              |                |                                    |              |
| Total capital (to risk weighted assets):  |                |                                    |              |                |                                    |              |
| HUSI .....                                | \$ 15,276      | 10.00 %                            | 11.29 %      | \$ 15,501      | 10.00 %                            | 12.58 %      |
| HBUS .....                                | 15,330         | 10.00                              | 11.40        | 14,998         | 10.00                              | 12.23        |
| Tier 1 capital (to risk weighted assets): |                |                                    |              |                |                                    |              |
| HUSI .....                                | 9,639          | 6.00                               | 7.12         | 10,577         | 6.00                               | 8.58         |
| HBUS .....                                | 9,696          | 6.00                               | 7.21         | 10,278         | 6.00                               | 8.38         |
| Tier 1 capital (to average assets):       |                |                                    |              |                |                                    |              |
| HUSI .....                                | 9,639          | 3.00 (2)                           | 5.34         | 10,577         | 3.00                               | 6.36         |
| HBUS .....                                | 9,696          | 5.00                               | 5.46         | 10,278         | 5.00                               | 6.29         |
| Risk weighted assets:                     |                |                                    |              |                |                                    |              |
| HUSI .....                                | 135,339        |                                    |              | 123,262        |                                    |              |
| HBUS .....                                | 134,501        |                                    |              | 122,652        |                                    |              |

- (1) HUSI and HBUS are categorized as "well-capitalized", as defined by their principal regulators. To be categorized as well-capitalized under regulatory guidelines, a banking institution must have the minimum ratios reflected in the above table, and must not be subject to a directive, order, or written agreement to meet and maintain specific capital levels.
- (2) There is no Tier 1 leverage ratio component in the definition of a well-capitalized bank holding company. The ratio shown is the minimum required ratio.

**Note 20. Accumulated Other Comprehensive Loss**

Accumulated other comprehensive loss includes certain items that are reported directly within a separate component of shareholders' equity. The following table presents changes in accumulated other comprehensive loss balances.

|   | 2007            | 2006            | 2005           |
|---|-----------------|-----------------|----------------|
| <b>(in millions)</b>  |                 |                 |                |
| Unrealized (losses) gains on available for sale securities:   |                 |                 |                |
| Balance, January 1 .....  | \$ (199)        | \$ (128)        | \$ 21          |
| Increase (decrease) in fair value, net of taxes of \$(15), \$10, and \$71, in<br>2007, 2006 and 2005, respectively .....                                  | 42              | (55)            | (94)           |
| Net gains on sale of securities reclassified to net income, net of<br>taxes of \$19, \$12, and \$40 in 2007, 2006 and 2005, respectively .....            | (31)            | (16)            | (55)           |
| Net change .....  | <u>11</u>       | <u>(71)</u>     | <u>(149)</u>   |
| Balance, December 31 .....  | <u>(188)</u>    | <u>(199)</u>    | <u>(128)</u>   |
| Unrealized (losses) gains on derivatives classified as cash flow hedges:  |                 |                 |                |
| Balance, January 1 .....  | (8)             | 98              | (6)            |
| Change in unrealized (loss) gain net of taxes of \$72, \$106, and \$(78) in<br>2007, 2006 and 2005, respectively .....                                    | (165)           | (106)           | 104            |
| Net change .....  | <u>(165)</u>    | <u>(106)</u>    | <u>104</u>     |
| Balance, December 31 .....  | <u>(173)</u>    | <u>(8)</u>      | <u>98</u>      |
| Unrealized gains on interest-only strip receivables:  |                 |                 |                |
| Balance, January 1 .....  | -               | 7               | -              |
| Change in unrealized gains on interest-only strip receivables,<br>net of taxes of \$4 and \$(4) in 2006 and 2005, respectively .....                      | -               | (7)             | 7              |
| Net change .....  | <u>-</u>        | <u>(7)</u>      | <u>7</u>       |
| Balance, December 31 .....  | <u>-</u>        | <u>-</u>        | <u>7</u>       |
| Foreign currency translation adjustments:   |                 |                 |                |
| Balance, January 1 .....  | 11              | 11              | 16             |
| Translation gains, net of taxes of \$2 and \$4 in 2007 and 2005,<br>respectively .....  | 4               | *               | (5)            |
| Net change .....  | <u>4</u>        | <u>*</u>        | <u>(5)</u>     |
| Balance, December 31 .....  | <u>15</u>       | <u>11</u>       | <u>11</u>      |
| Unfunded postretirement benefits liability:   |                 |                 |                |
| Balance, January 1 .....  | (18)            | -               | -              |
| Cumulative effect of change in accounting for pension and postretirement<br>benefits, net of taxes of \$13 in 2006 .....                                  | -               | (18)            | -              |
| Change in unfunded postretirement liability, net of taxes of \$(6) in 2007 .....  | 12              | -               | -              |
| Net change .....  | <u>12</u>       | <u>(18)</u>     | <u>-</u>       |
| Balance, December 31 .....  | <u>(6)</u>      | <u>(18)</u>     | <u>-</u>       |
| <b>Summary of accumulated other comprehensive loss:</b>   |                 |                 |                |
| Accumulated other comprehensive (loss) income, January 1 .....  | (214)           | (12)            | 31             |
| Other comprehensive loss, net of tax .....  | (150)           | (184)           | (43)           |
| Cumulative effect of change in accounting for pension and<br>postretirement benefits and change in unfunded postretirement<br>liability, net of tax ..... | 12              | (18)            | -              |
| Accumulated other comprehensive loss, December 31 .....   | <u>\$ (352)</u> | <u>\$ (214)</u> | <u>\$ (12)</u> |

\* Less than \$500 thousand.

**Note 21. Related Party Transactions**

In the normal course of business, HUSI conducts transactions with HSBC and its subsidiaries (HSBC affiliates). These transactions occur at prevailing market rates and terms. All extensions of credit by HBUS to other HSBC affiliates are legally required to be secured by eligible collateral. The following table presents related party balances and the income and expense generated by related party transactions.

| <b>December 31</b>   | <b>2007</b>      | <b>2006</b>      | <b>2005</b>      |
|--|------------------|------------------|------------------|
| <b>(in millions)</b>   |                  |                  |                  |
| Assets:  |                  |                  |                  |
| Cash and due from banks .....  | \$ 97            | \$ 179           | \$ 121           |
| Interest bearing deposits with banks .....                                   | 134              | 59               | 67               |
| Federal funds sold and securities purchased under agreements to resell ..... | 356              | 141              | 111              |
| Trading assets .....   | 11,640           | 6,895            | 5,386            |
| Loans .....  | 2,007            | 813              | 1,562            |
| Other .....  | 390              | 226              | 79               |
| Total assets .....   | <u>\$ 14,624</u> | <u>\$ 8,313</u>  | <u>\$ 7,326</u>  |
| Liabilities:   |                  |                  |                  |
| Deposits .....   | \$ 13,088        | \$ 12,233        | \$ 10,133        |
| Trading liabilities .....  | 14,552           | 6,473            | 4,545            |
| Short-term borrowings .....  | 982              | 464              | 698              |
| Other .....  | 840              | 254              | 104              |
| Total liabilities .....  | <u>\$ 29,462</u> | <u>\$ 19,424</u> | <u>\$ 15,480</u> |

| <b>December 31</b>  | <b>2007</b> | <b>2006</b> | <b>2005</b> |
|---|-------------|-------------|-------------|
| <b>(in millions)</b>  |             |             |             |
| Interest income .....   | \$ 178      | \$ 51       | \$ 40       |
| Interest expense .....  | 424         | 408         | 293         |
| HSBC affiliate income:  |             |             |             |
| Other fees and commissions:   |             |             |             |
| HSBC .....  | 67          | 28          | 34          |
| HSBC Finance Corporation .....  | 18          | 12          | 13          |
| HMUS .....  | 13          | 5           | 18          |
| Other HSBC affiliates .....   | 7           | 6           | 6           |
| Service charges .....   | 11          | 15          | 15          |
| Gains on sales of loans to HMUS .....   | 18          | 106         | 18          |
| Gains on sales of refund anticipation loans to HSBC Finance Corporation ..... | 23          | 22          | 19          |
| Other HSBC affiliates income .....  | 15          | 14          | 7           |
| Support services from HSBC affiliates:  |             |             |             |
| Fees paid to HSBC Finance Corporation .....                                   | 468         | 452         | 415         |
| Fees paid to HMUS .....   | 238         | 227         | 162         |
| Fees paid to HTSU for technology services .....                               | 260         | 235         | 216         |
| Fees paid to other HSBC affiliates .....                                      | 196         | 162         | 126         |

### *Transactions Conducted with HSBC Finance Corporation*

- Support services from HSBC affiliates includes charges by HSBC Finance Corporation under various service level agreements for loan origination and servicing as well as other operational and administrative support.
- By agreement, HUSI purchases receivables generated by private label and MasterCard<sup>1</sup>/Visa<sup>2</sup> credit card relationships on a daily basis at a value that approximates fair value, as determined by an independent third party. Premiums paid are amortized to interest income over the estimated life of the receivables purchased. HSBC Finance Corporation continues to service the customer relationships, for which they charged HUSI servicing fees of \$374 million and \$367 million, respectively, for the year ended December 31, 2007 and 2006 for the private label credit relationships. HUSI was charged service fees of \$61 million and \$38 million, respectively, for the year ended December 31, 2007 and 2006 for the MasterCard/Visa credit card relationship. Activity related to these portfolios is summarized in the following table.

| <b>For the year ended December 31</b><br><b>(in millions)</b> | <b>Private Label</b> |                  | <b>MasterCard/Visa</b> |                 |
|---|----------------------|------------------|------------------------|-----------------|
|   | <b>2007</b>          | <b>2006</b>      | <b>2007</b>            | <b>2006</b>     |
| Receivables acquired from HSBC Finance Corporation:           |                      |                  |                        |                 |
| Balance at beginning of period .....                          | \$ 16,973            | \$ 14,355        | \$ 1,287               | \$ 1,159        |
| Receivables acquired .....                                    | 21,341               | 21,591           | 2,828                  | 2,317           |
| Customer payments, net charge offs and other activity .....   | <u>(20,887)</u>      | <u>(18,973)</u>  | <u>(2,127)</u>         | <u>(2,189)</u>  |
| Balance at end of period .....                                | <u>\$ 17,427</u>     | <u>\$ 16,973</u> | <u>\$ 1,988</u>        | <u>\$ 1,287</u> |
| Premiums paid to HSBC Finance Corporation:                    |                      |                  |                        |                 |
| Unamortized balance at beginning of period .....              | \$ 188               | \$ 320           | \$ 15                  | \$ 12           |
| Premiums paid .....   | 329                  | 367              | 105                    | 39              |
| Amortization .....  | <u>(405)</u>         | <u>(499)</u>     | <u>(77)</u>            | <u>(36)</u>     |
| Unamortized balance at end of period .....                    | <u>\$ 112</u>        | <u>\$ 188</u>    | <u>\$ 43</u>           | <u>\$ 15</u>    |

- HUSI services a portfolio of residential mortgage loans owned by HSBC Finance Corporation. The related service fee income was \$10.5 million and \$4.3 million for the year ended December 31, 2007 and 2006, respectively.
- HUSI's wholly-owned subsidiaries HBUS and HSBC Trust Company (Delaware), N.A. (HTCD) are the originating lenders for a federal income tax refund anticipation loan program for clients of various third party tax preparers, which are managed by HSBC Finance Corporation. By agreement, HBUS and HTCD process applications, fund and subsequently sell these loans to HSBC Finance Corporation. For the year ended December 31, 2007 and 2006, HBUS and HTCD originated approximately \$17 billion and \$16 billion, respectively, that were sold to HSBC Finance Corporation. This resulted in gains of \$23 million and \$22 million, respectively, for the year ended December 31, 2007 and 2006.
- Certain of HUSI's consolidated subsidiaries have secured lines of credit totaling \$1.0 billion with HSBC Finance Corporation. There were no balances outstanding under any of these lines of credit at December 31, 2007 or 2006.
- In 2006, HUSI began acquiring residential mortgage loans at fair value from HSBC Finance Corporation with the original intent of selling these loans to HMUS (see "Transactions Conducted with HMUS" on the next page). For the year ended December 31, 2007, HUSI acquired \$615 million of loans from HSBC Finance Corporation for a net discount of \$12 million.

<sup>1</sup> MasterCard is a registered trademark of MasterCard, Incorporated.

<sup>2</sup> Visa is a registered trademark of Visa USA, Inc.

### ***Transactions Conducted with HMUS***

- HUSI utilizes HMUS for broker dealer, debt and preferred stock underwriting, customer referrals, loan syndication and other treasury and traded markets related services, pursuant to service level agreements. Fees charged by HMUS for broker dealer, loan syndication services, treasury and traded markets related services are included in support services from HSBC affiliates. Debt underwriting fees charged by HMUS are deferred as a reduction of long-term debt and amortized to interest expense over the life of the related debt. Preferred stock issuance costs charged by HMUS are recorded as a reduction of capital surplus. Customer referral fees paid to HMUS are netted against customer fee income, which is included in other fees and commissions.
- In 2005, HUSI began acquiring residential mortgage loans from unaffiliated third parties with the original intent of selling these loans for HMUS. During 2006, HUSI also began acquiring residential mortgage loans from HSBC Finance Corporation under this program. HUSI maintains no ownership interest in the residential mortgage loans after sale. Under this program, HUSI sold \$6.2 billion and \$15.9 billion of loans to HMUS during the year ended December 31, 2007 and 2006, respectively. Total gains on sale were \$18 million and \$106 million for the year ended December 31, 2007 and 2006, respectively. Refer to page 9 of this Form 10-K for further information regarding this program.
- During the first quarter of 2007, as part of a strategy to consolidate certain investments into a common HSBC entity in North America, HUSI sold certain non-marketable investments to HMUS resulting in total net gains of \$6 million. The carrying value of these investments totaled \$10 million at the time of the sale.

### ***Other Transactions with HSBC Affiliates***

At December 31, 2007 and 2006, HUSI had an unused line of credit with HSBC of \$2.5 billion and \$2 billion, respectively.

HUSI has extended loans and lines of credit to various other HSBC affiliates totaling \$1.6 billion, of which \$225 million was outstanding at December 31, 2007. HUSI has also extended a subordinated loan to HSBC Securities (USA) Inc. in the amount of \$500 million, of which \$350 million was outstanding at December 31, 2007.

HUSI routinely enters into derivative transactions with HSBC Finance Corporation and other HSBC affiliates as part of a global HSBC strategy to offset interest rate or other market risks associated with debt issues, derivative contracts or other financial transactions with unaffiliated third parties. At December 31, 2007 and December 31, 2006, the aggregate notional amounts of all derivative contracts with other HSBC affiliates were approximately \$996 billion and \$772 billion, respectively. The net credit risk exposure (defined as the recorded fair value of derivative receivables) related to these contracts was approximately \$12 billion and \$7 billion at December 31, 2007 and 2006, respectively. HUSI, within its Global Banking and Markets business, accounts for these transactions on a mark to market basis, with the change in value of contracts with HSBC affiliates substantially offset by the change in value of related contracts entered into with unaffiliated third parties.

Domestic employees of HUSI participate in a defined benefit pension plan sponsored by HNAH. Additional information regarding pensions is provided in Note 23 of these consolidated financial statements, beginning on page 144 of this Form 10-K.

Employees of HUSI participate in one or more stock compensation plans sponsored by HSBC. HUSI's share of the expense of these plans on a pre-tax basis for the year ended December 31, 2007 and 2006 was approximately \$68 million and \$74 million, respectively. As of December 31, 2007, HUSI's share of compensation cost related to nonvested stock compensation plans was approximately \$84 million, which is expected to be recognized over a weighted-average period of 1.5 years. A description of these stock compensation plans begins on page 142 of this Form 10-K.

HUSI declared and paid dividends of \$800 million and \$455 million for the year ended December 31, 2007 and 2006, respectively, to its parent company, HNAI.

**Note 22. Stock Option Plans and Restricted Share Plans**

Options have been granted to employees of HUSI under the HSBC Holdings Group Share Option Plan (the Group Share Option Plan) and under the HSBC Holdings Savings-Related Share Option Plan (Sharesave). Since the shares and contribution commitment have been granted directly by HSBC, the offset to compensation expense was a credit to capital surplus, representing a contribution of capital from HSBC.

The following table presents information for each plan. Descriptions of each plan follow the table.

| December 31   | 2007    | 2006    | 2005    |
|---|---------|---------|---------|
| <b>Restricted Share Plan:</b>                             |         |         |         |
| Total compensation expense recognized (in millions) ..... | \$ 68   | \$ 59   | \$ 44   |
| <b>Sharesave (5 year vesting period):</b>                 |         |         |         |
| Total options granted .....                               | 132,000 | 83,000  | 262,000 |
| Fair value per option granted .....                       | \$ 4.09 | \$ 3.49 | \$ 3.78 |
| Total compensation expense recognized (in millions) ..... | \$ 1    | \$ *    | \$ *    |
| Significant assumptions used to calculate fair value:     |         |         |         |
| Risk free interest rate .....                             | 4.6 %   | 5.0 %   | 4.3 %   |
| Expected life (years) .....                               | 5       | 5       | 5       |
| Expected volatility .....                                 | 17 %    | 17 %    | 20 %    |
| <b>Sharesave (3 year vesting period):</b>                 |         |         |         |
| Total options granted .....                               | 445,000 | 274,000 | 510,000 |
| Fair value per option granted .....                       | \$ 4.25 | \$ 3.42 | \$ 3.73 |
| Total compensation expense recognized (in millions) ..... | \$ 1    | \$ 1    | \$ 1    |
| Significant assumptions used to calculate fair value:     |         |         |         |
| Risk free interest rate .....                             | 4.6 %   | 5.0 %   | 4.3 %   |
| Expected life (years) .....                               | 3       | 3       | 3       |
| Expected volatility .....                                 | 17 %    | 17 %    | 20 %    |
| <b>Sharesave (1 year vesting period):</b>                 |         |         |         |
| Total options granted .....                               | 145,000 | 81,000  |         |
| Fair value per option granted .....                       | \$ 3.71 | \$ 2.60 |         |
| Total compensation expense recognized (in millions) ..... | \$ *    | \$ *    |         |
| Significant assumptions used to calculate fair value:     |         |         |         |
| Risk free interest rate .....                             | 4.9 %   | 5.0 %   |         |
| Expected life (years) .....                               | 1       | 1       |         |
| Expected volatility .....                                 | 17 %    | 17 %    |         |
| <b>Group Share Option Plan:</b>                           |         |         |         |
| Total options granted .....                               | -       | -       | -       |
| Fair value per option granted .....                       | \$ -    | \$ -    | \$ -    |
| Total compensation expense recognized (in millions) ..... | \$ (2)  | \$ 14   | \$ 6    |
| Significant assumptions used to calculate fair value:     |         |         |         |
| Risk free interest rate .....                             | - %     | - %     | - %     |
| Expected life (years) .....                               | -       | -       | -       |
| Expected volatility .....                                 | - %     | - %     | - %     |

\* Less than \$500 thousand

### ***Restricted Share Plans***

Awards are granted to key individuals in the form of performance and non-performance restricted shares. The awards are based on an individual's demonstrated performance and future potential. Performance related restricted shares generally vest after three years from date of grant, based on HSBC's Total Shareholder Return (TSR) relative to a benchmark TSR during the performance period. TSR is defined as the growth in share value and declared dividend income during the period and the benchmark is composed of HSBC's peer group of financial institutions. If the performance conditions are met, the shares vest and are released to the recipients two years later. Non-performance restricted shares are released to the recipients based on continued service, typically at the end of a three year vesting period.

### ***Sharesave Plans***

Sharesave is an employee share option plan that enables eligible employees to enter into savings contracts of one, three or five year terms, with the ability to decide at the end of the contract term to either use their accumulated savings to purchase HSBC ordinary shares at a discounted option price or have the savings plus interest repaid in cash. The one year savings contracts were offered to employees for the first time in 2006. Employees can save up to \$450 per month over all their Sharesave savings contracts. The option price is determined at the beginning of the offering period of each plan year and represents a 20% discount, for the three and five year savings contracts, and a 15% discount for the one year contract, from the average price in London on the HSBC ordinary shares over the five trading days preceding the offering. On contracts of three year or five year terms, the options are exercisable at the 20% discounted stock option price within six months following the third or fifth anniversary of the beginning of the relevant savings contracts. Upon the completion of a one year savings contract, if the share price is higher than the option price, the option will automatically be exercised and the shares will be purchased at the 15% discounted stock option price. The shares will then be transferred to a holding account where they will be held for one additional year, or until the employee decides to sell the shares. Regardless of the length of the savings contract, employees can decide to have their accumulated savings plus interest refunded to them at the end of the contract period, rather than choosing to exercise their purchase option.

The fair value of options granted under Sharesave plans is estimated as of the date of grant using a third party option pricing model.

### ***Group Share Option Plan***

The Group Share Option Plan was a discretionary long-term incentive compensation plan available prior to 2005, to certain HUSI employees based on performance criteria. Options were granted at market value and are normally exercisable between the third and tenth anniversaries of the date of grant, subject to vesting conditions.

No options were granted under the Group Share Option Plan in 2005, 2006 or 2007, since the plan was terminated by HSBC in May 2005. In lieu of options, employees now receive grants of HSBC Holdings ordinary shares subject to certain vesting conditions (refer to Restricted Share Plans above). All stock option grants under the Group Share Option Plan have fully vested and the associated expense fully recognized. In addition, a credit of \$2 million was recognized in 2007 which reflects an adjustment to the expense accrued on the stock options granted in 2004, which was the last year of stock option grants under the Group Share Option Plan.

**Note 23. Pension and Other Postretirement Benefits**

**Defined Benefit Pension Plans**

In November 2004, sponsorship of the defined benefit pension plan of HUSI and the defined benefit pension plan of HSBC Finance Corporation was transferred to HNAH. Effective January 1, 2005, the two separate plans were combined into a single HNAH defined benefit pension plan which facilitates the development of a unified employee benefit policy and unified employee benefit plan administration for HSBC companies operating in the U.S. As a result, the pension asset relating to HUSI's defined benefit plan of \$279 million, net of tax, was transferred to HNAH as a capital transaction in the first quarter of 2005.

In 2006, HUSI adopted SFAS 158, which requires balance sheet recognition of the funded status of pension and other postretirement benefit plans. Since HUSI's main pension plan was transferred to HNAH in 2005, adoption of SFAS 158 had no significant balance sheet impact related to pension obligations. The impact of SFAS 158 on other postretirement benefit plans is summarized on page 146 of this Form 10-K.

The components of pension expense for the defined benefit plan reflected in HUSI's consolidated statements of income are shown in the table below. The pension expense for the years ended December 31, 2007, 2006 and 2005 reflect the portion of the pension expense of the combined HNAH pension plan which has been allocated to HUSI.

| <b>Year Ended December 31</b>                        | <b>2007</b>  | <b>2006</b>  | <b>2005</b> |
|--|--------------|--------------|-------------|
| <b>(in millions)</b>                                 |              |              |             |
| Service cost—benefits earned during the period ..... | \$ 31        | \$ 30        | \$ 27       |
| Interest cost on projected benefit obligation .....  | 72           | 65           | 62          |
| Expected return on assets .....                      | (91)         | (84)         | (89)        |
| Amortization of prior service cost .....             | 1            | 1            | 1           |
| Recognized losses .....                              | 9            | 16           | 5           |
| Pension expense .....                                | \$ <u>22</u> | \$ <u>28</u> | \$ <u>6</u> |

The assumptions used in determining pension expense of the defined benefit plan are as follows:

|  | <b>2007</b> | <b>2006</b> | <b>2005</b> |
|--|-------------|-------------|-------------|
| Discount rate .....                                    | 5.90 %      | 5.70 %      | 6.00 %      |
| Salary increase assumption .....                       | 3.75        | 3.75        | 3.75        |
| Expected long-term rate of return on plan assets ..... | 8.00        | 8.00        | 8.33        |

A reconciliation of beginning and ending balances of the fair value of plan assets associated with the HNAH defined benefit pension plan is shown below.

| <b>Year Ended December 31</b>                        | <b>2007</b>     | <b>2006</b>     |
|--|-----------------|-----------------|
| <b>(in millions)</b>                                 |                 |                 |
| Fair value of plan assets at beginning of year ..... | \$ 2,568        | \$ 2,384        |
| Actual return on plan assets .....                   | 185             | 246             |
| Benefits paid .....                                  | (136)           | (62)            |
| Fair value of plan assets at end of year .....       | \$ <u>2,617</u> | \$ <u>2,568</u> |

HUSI does not currently anticipate making employer contributions to the defined benefit plan in 2008.



The allocation of the pension plan assets for the HNAH defined benefit pension plan is summarized in the following table:

| <b>December 31</b>      | <b>Percentage of Plan Assets</b> |              |
|-------------------------|----------------------------------|--------------|
|                         | <b>2007</b>                      | <b>2006</b>  |
| Equity securities ..... | <b>69</b> %                      | 69 %         |
| Debt securities .....   | <b>31</b>                        | 30           |
| Other .....             | -                                | 1            |
| Total .....             | <u><b>100</b></u> %              | <u>100</u> % |

There were no investments in HSBC ordinary shares or American depository shares at December 31, 2007 and 2006.

The primary objective of the HNAH defined benefit pension plan is to provide eligible employees with regular pension benefits. Since the plans are governed by the Employee Retirement Income Security Act of 1974 (ERISA), ERISA regulations serve as guidance for the management of plan assets. Consistent with prudent standards of preservation of capital and maintenance of liquidity, the goals of the plans are to earn the highest possible rate of return consistent with the tolerance for risk as determined by the investment committee in its role as a fiduciary. In carrying out these objectives, short-term fluctuations in the value of plan assets are considered secondary to long-term investment results. A third party and an HSBC affiliate are retained by HNAH to provide investment consulting services such as recommendations on the type of funds to be invested in and monitoring the performance of fund managers. In order to achieve the return objectives of the plans, the plans are diversified to ensure that adverse results from one security or security class will not have an unduly detrimental effect on the entire investment portfolio. Assets are diversified by type, characteristic and number of investments as well as by investment style of management organization. Equity securities are invested in large, mid and small capitalization domestic stocks as well as international stocks.

A reconciliation of beginning and ending balances of the projected benefit obligation of the HNAH defined benefit pension plan is shown in the following table.

| <b>Year Ended December 31</b>                           | <b>2007</b>            | <b>2006</b>     |
|---|------------------------|-----------------|
| <b>(in millions)</b>                                    |                        |                 |
| Projected benefit obligation at beginning of year ..... | \$ <b>2,698</b>        | \$ 2,530        |
| Service cost .....                                      | <b>111</b>             | 102             |
| Interest cost .....                                     | <b>160</b>             | 145             |
| Actuarial (gains) losses .....                          | <b>(86)</b>            | (17)            |
| Benefits paid .....                                     | <b>(136)</b>           | (62)            |
| Projected benefit obligation at end of year .....       | \$ <u><b>2,747</b></u> | \$ <u>2,698</u> |

HUSI's share of the projected benefit obligation of the HNAH defined benefit pension plan was approximately \$1.2 billion at December 31, 2007 and 2006. The accumulated benefit obligation for the HNAH defined benefit pension plan was approximately \$2.4 billion at December 31, 2007 and 2006. HUSI's share of the accumulated benefit obligation at December 31, 2007 and 2006 was approximately \$1.1 billion. These amounts are included in HNAH's consolidated balance sheets.

Estimated future benefit payments for the HNAH defined benefit pension plan and HUSI's share of those estimated payments are summarized in the following table.

|                      | <b>HNAH</b>   | <b>HUSI's Share</b> |
|----------------------|---------------|---------------------|
| <b>(in millions)</b> |               |                     |
| 2008 .....           | \$ <b>133</b> | \$ <b>54</b>        |
| 2009 .....           | <b>142</b>    | <b>58</b>           |
| 2010 .....           | <b>151</b>    | <b>61</b>           |
| 2011 .....           | <b>163</b>    | <b>66</b>           |
| 2012 .....           | <b>181</b>    | <b>70</b>           |
| 2013-2017 .....      | <b>1,027</b>  | <b>436</b>          |

The assumptions used in determining the projected benefit obligation of the defined benefit pension plan are summarized in the following table.

| <b>December 31</b>               | <b>2007</b>   | <b>2006</b> |
|----------------------------------|---------------|-------------|
| Discount rate .....              | <b>6.55</b> % | 5.90 %      |
| Salary increase assumption ..... | <b>3.75</b>   | 3.75        |

***Postretirement Plans Other Than Pensions***

HUSI's employees also participate in several plans which provide medical, dental and life insurance benefits to retirees and eligible dependents. These plans cover substantially all employees who meet certain age and vested service requirements. HUSI has instituted dollar limits on payments under the plans to control the cost of future medical benefits.

As discussed in Note 2, the adoption of SFAS 158 resulted in additional pension liability of \$31 million, a related deferred tax asset of \$13 million, and an offset to other comprehensive income of \$18 million at December 31, 2006.

The net postretirement benefit cost included the following components.

| <b>Year Ended December 31</b>                          | <b>2007</b>        | <b>2006</b>  | <b>2005</b>  |
|--|--------------------|--------------|--------------|
| <b>(in millions)</b>                                   |                    |              |              |
| Service cost – benefits earned during the period ..... | \$ <b>1</b>        | \$ 1         | \$ 2         |
| Interest cost .....                                    | <b>6</b>           | 6            | 7            |
| Amortization of transition obligation .....            | <b>3</b>           | 3            | 3            |
| Amortization of recognized actuarial gain .....        | <b>(1)</b>         | -            | -            |
| Net periodic postretirement benefit cost .....         | \$ <u><b>9</b></u> | \$ <u>10</u> | \$ <u>12</u> |

The assumptions used in determining the net periodic postretirement benefit cost for HUSI's postretirement benefit plans are shown in the following table.

| <b>December 31</b>               | <b>2007</b>   | <b>2006</b> | <b>2005</b> |
|----------------------------------|---------------|-------------|-------------|
| Discount rate .....              | <b>5.90</b> % | 5.70 %      | 6.00 %      |
| Salary increase assumption ..... | <b>3.75</b>   | 3.75        | 3.75        |

A reconciliation of the beginning and ending balances of the accumulated postretirement benefit obligation is shown in the following table.

| <b>Year Ended December 31</b>                             | <b>2007</b>         | <b>2006</b>   |
|---|---------------------|---------------|
| <b>(in millions)</b>                                      |                     |               |
| Accumulated benefit obligation at beginning of year ..... | \$ <b>103</b>       | \$ 119        |
| Service cost .....  | <b>1</b>            | 1             |
| Interest cost .....                                       | <b>6</b>            | 6             |
| Participant contributions .....                           | <b>1</b>            | 1             |
| Actuarial gains .....                                     | <b>(8)</b>          | (13)          |
| Benefits paid .....                                       | <b>(10)</b>         | (11)          |
| Accumulated benefit obligation at end of year .....       | \$ <u><b>93</b></u> | \$ <u>103</u> |

HUSI's postretirement benefit plans are funded on a pay-as-you-go basis. Estimated future benefit payments for HUSI's postretirement plans are summarized in the following table.

| <b>(in millions)</b> |      |
|----------------------|------|
| 2008 .....           | \$ 8 |
| 2009 .....           | 8    |
| 2010 .....           | 8    |
| 2011 .....           | 8    |
| 2012 .....           | 8    |
| 2013-2017 .....      | 35   |

The assumptions used in determining the benefit obligation of HUSI's postretirement benefit plans at December 31 are as follows:

|                                  | <b>2007</b> | <b>2006</b> |
|----------------------------------|-------------|-------------|
| Discount rate .....              | 6.55 %      | 5.90 %      |
| Salary increase assumption ..... | 3.75        | 3.75        |

A 9.6 percent annual rate of increase in the gross cost of covered health care benefits was assumed for 2007. This rate of increase is assumed to decline gradually to 5 percent in 2014.

Assumed health care cost trend rates have an effect on the amounts reported for health care plans. A one-percentage point change in assumed health care cost trend rates would increase (decrease) service and interest costs and the postretirement benefit obligation as follows:

|   | <b>One Percent<br/>Increase</b> | <b>One Percent<br/>Decrease</b> |
|---|---------------------------------|---------------------------------|
| <b>(in millions)</b>  |                                 |                                 |
| Effect on total of service and interest cost components ..... | \$ *                            | \$ *                            |
| Effect on postretirement benefit obligation .....             | 1                               | (1)                             |

\* Less than \$500 thousand

### ***Other Plans***

HUSI maintains a 401(k) plan covering substantially all employees. Employer contributions to the plan are based on employee contributions. Total expense recognized for this plan was approximately \$36 million, \$34 million and \$33 million in 2007, 2006 and 2005, respectively.

Certain employees are participants in various defined contribution and other non-qualified supplemental retirement plans. Total expense recognized for these plans was immaterial in 2007, 2006 and 2005.

### ***Note 24. Business Segments***

HUSI has five distinct segments that it utilizes for management reporting and analysis purposes, which are generally based upon customer groupings, as well as products and services offered. Descriptions of HUSI's business segments are presented on pages 6 and 7 of this Form 10-K.

Effective January 1, 2007, corporate goals of HUSI are based upon results reported under International Financial Reporting Standards (IFRS), which are utilized by HSBC to prepare its consolidated financial statements. Operating results for HUSI are now being monitored and reviewed, trends are being evaluated, and decisions are being made about allocating certain resources on an IFRS basis. As a result, business segment results are reported on an IFRS basis to align with the revised internal reporting mechanism for monitoring performance. Results for 2006 and 2005 have been restated on an IFRS basis to conform with 2007 presentation.

Net interest income of each segment represents the difference between actual interest earned on assets and interest paid on liabilities of the segment, adjusted for a funding charge or credit. Segments are charged a cost to fund assets (e.g. customer loans) and receive a funding credit for funds provided (e.g. customer deposits) based on equivalent market rates. The objective of these charges/credits is to transfer interest rate risk from the segments to one centralized unit in Treasury and more appropriately reflect the profitability of segments.

Certain other revenue and operating expense amounts are also apportioned among the business segments based upon the benefits derived from this activity or the relationship of this activity to other segment activity. For segment reporting purposes, these inter-segment transactions are accounted for as if they were with third parties and have not been eliminated.

Results for each segment on an IFRS basis, as well as a reconciliation of total results under IFRS to U.S. GAAP consolidated totals, are provided in the following tables. Descriptions of the significant differences between IFRS and U.S. GAAP that impact HUSI's results follow the tables.

| December 31,<br>2007              | IFRS Consolidated Amounts |           |           |                               |          |         |                           | (4)<br>IFRS<br>Adjustments | (5)<br>IFRS<br>Reclassifications | U.S. GAAP<br>Consolidated<br>Totals |            |
|-----------------------------------|---------------------------|-----------|-----------|-------------------------------|----------|---------|---------------------------|----------------------------|----------------------------------|-------------------------------------|------------|
|                                   | PFS                       | CF        | CMB       | Global Banking<br>and Markets | PB       | Other   | Intersegmental<br>Revenue |                            |                                  |                                     | Total      |
| <b>(in millions)</b>              |                           |           |           |                               |          |         |                           |                            |                                  |                                     |            |
| Net interest                      |                           |           |           |                               |          |         |                           |                            |                                  |                                     |            |
| income (1) .....                  | \$ 1,102                  | \$ 951    | \$ 814    | \$ 321                        | \$ 198   | \$ (12) | \$ (652)                  | \$ 2,722                   | \$ 17                            | \$ 659                              | \$ 3,398   |
| Other revenues .....              | 559                       | 294       | 259       | 46                            | 291      | 216     | 652                       | 2,317                      | (313)                            | (157)                               | 1,847      |
| Total revenues .....              | 1,661                     | 1,245     | 1,073     | 367                           | 489      | 204     | -                         | 5,039                      | (296)                            | 502                                 | 5,245      |
| Provision for credit              |                           |           |           |                               |          |         |                           |                            |                                  |                                     |            |
| losses (3) .....                  | 139                       | 1,187     | 126       | 35                            | 10       | -       | -                         | 1,497                      | 33                               | (8)                                 | 1,522      |
|                                   | 1,522                     | 58        | 947       | 332                           | 479      | 204     | -                         | 3,542                      | (329)                            | 510                                 | 3,723      |
| Operating expenses                |                           |           |           |                               |          |         |                           |                            |                                  |                                     |            |
| (2) .....                         | 1,302                     | 33        | 558       | 803                           | 345      | 4       | -                         | 3,045                      | 30                               | 511                                 | 3,586      |
| Income before                     |                           |           |           |                               |          |         |                           |                            |                                  |                                     |            |
| income tax expense..              | 220                       | 25        | 389       | (471)                         | 134      | 200     | -                         | 497                        | (359)                            | (1)                                 | 137        |
| Income tax expense ...            | 52                        | 7         | 92        | (129)                         | 32       | 57      | -                         | 111                        | (111)                            | (1)                                 | (1)        |
| Net income .....                  | \$ 168                    | \$ 18     | \$ 297    | \$ (342)                      | \$ 102   | \$ 143  | \$ -                      | \$ 386                     | \$ (248)                         | \$ -                                | \$ 138     |
| <b>Balances at end of period:</b> |                           |           |           |                               |          |         |                           |                            |                                  |                                     |            |
| Total assets .....                | \$ 36,322                 | \$ 22,145 | \$ 18,851 | \$ 162,757                    | \$ 6,191 | \$ 193  | \$ -                      | \$ 246,459                 | \$ (58,120)                      | \$ 34                               | \$ 188,373 |
| Total loans .....                 | 31,015                    | 21,639    | 16,831    | 28,389                        | 5,416    | -       | -                         | 103,290                    | -                                | (8,341)                             | 94,949     |
| Goodwill .....                    | 925                       | -         | 368       | 497                           | 325      | -       | -                         | 2,115                      | 586                              | -                                   | 2,701      |
| Total deposits .....              | 42,642                    | 35        | 18,164    | 41,983                        | 12,247   | 2       | -                         | 115,073                    | -                                | 1,155                               | 116,228    |

- Net interest income of each segment represents the difference between actual interest earned on assets and interest paid on liabilities of the segment adjusted for a funding charge or credit. Segments are charged a cost to fund assets (e.g. customer loans) and receive a funding credit for funds provided (e.g. customer deposits) based on equivalent market rates.
- Expenses for the segments include fully apportioned corporate overhead expenses.
- The provision assigned to the segments is based on the segments' net charge offs and the change in allowance for credit losses.
- Represents adjustments associated with differences between IFRS and U.S. GAAP bases of accounting. These adjustments, which are more fully described beginning on page 150 of this Form 10-K, consist of the following:

|   | Net<br>Interest<br>Income | Other<br>Revenues | Provision<br>for Credit<br>Losses | Operating<br>Expenses | Income<br>before Income<br>Tax Expense | Total<br>Assets |
|---|---------------------------|-------------------|-----------------------------------|-----------------------|--|-----------------|
| <b>(in millions)</b>                                    |                           |                   |                                   |                       |  |                 |
| Unquoted equity securities .....                        | \$ -                      | \$ (90)           | \$ -                              | \$ -                  | \$ (90)                                | \$ -            |
| Fair value option .....                                 | (2)                       | (190)             | -                                 | -                     | (192)                                  | -               |
| Loan origination .....                                  | (15)                      | (9)               | -                                 | (2)                   | (22)                                   | -               |
| Loan impairment .....                                   | 22                        | -                 | 26                                | -                     | (4)                                    | -               |
| Purchase accounting/deferred taxes .....                | -                         | -                 | -                                 | (4)                   | 4                                      | -               |
| Stock based compensation .....                          | -                         | -                 | -                                 | (2)                   | 2                                      | -               |
| Property .....  | -                         | (7)               | -                                 | 14                    | (21)                                   | -               |
| Pension cost .....                                      | -                         | -                 | -                                 | 24                    | (24)                                   | -               |
| Recording derivative assets and liabilities gross ..... | -                         | -                 | -                                 | -                     | -                                      | (58,120)        |
| Other .....   | 12                        | (17)              | 7                                 | -                     | (12)                                   | -               |
| Total .....   | \$ 17                     | \$ (313)          | \$ 33                             | \$ 30                 | \$ (359)                               | \$ (58,120)     |

- Represents differences in financial statement presentation between IFRS and U.S. GAAP.

| December 31,<br>2006              | IFRS Consolidated Amounts |           |                               |            |          |         |                           | (4)<br>IFRS | (5)<br>IFRS | U.S. GAAP<br>Consolidated<br>Totals |            |
|-----------------------------------|---------------------------|-----------|-------------------------------|------------|----------|---------|---------------------------|-------------|-------------|-------------------------------------|------------|
|                                   | PFS                       | CF        | Global Banking<br>and Markets |            |          | Other   | Intersegmental<br>Revenue |             |             |                                     | Total      |
| <b>(in millions)</b>              |                           |           |                               |            |          |         |                           |             |             |                                     |            |
| Net interest                      |                           |           |                               |            |          |         |                           |             |             |                                     |            |
| income (1) .....                  | \$ 1,155                  | \$ 721    | \$ 746                        | \$ 235     | \$ 199   | \$ (10) | \$ (593)                  | \$ 2,453    | \$ 8        | \$ 620                              | \$ 3,081   |
| Other revenues .....              | 496                       | 105       | 273                           | 957        | 303      | (46)    | 593                       | 2,681       | 41          | (159)                               | 2,563      |
| Total revenues .....              | 1,651                     | 826       | 1,019                         | 1,192      | 502      | (56)    | -                         | 5,134       | 49          | 461                                 | 5,644      |
| Provision for credit              |                           |           |                               |            |          |         |                           |             |             |                                     |            |
| losses (3) .....                  | 52                        | 654       | 70                            | 3          | 36       | -       | -                         | 815         | 5           | 3                                   | 823        |
|                                   | 1,599                     | 172       | 949                           | 1,189      | 466      | (56)    | -                         | 4,319       | 44          | 458                                 | 4,821      |
| Operating expenses                |                           |           |                               |            |          |         |                           |             |             |                                     |            |
| (2) .....                         | 1,173                     | 31        | 503                           | 791        | 308      | 2       | -                         | 2,808       | (11)        | 458                                 | 3,255      |
| Income before                     |                           |           |                               |            |          |         |                           |             |             |                                     |            |
| income tax expense..              | 426                       | 141       | 446                           | 398        | 158      | (58)    | -                         | 1,511       | 55          | -                                   | 1,566      |
| Income tax expense ...            | 154                       | 50        | 155                           | 148        | 57       | (35)    | -                         | 529         | 1           | -                                   | 530        |
| Net income .....                  | \$ 272                    | \$ 91     | \$ 291                        | \$ 250     | \$ 101   | \$ (23) | \$ -                      | \$ 982      | \$ 54       | \$ -                                | \$ 1,036   |
| <b>Balances at end of period:</b> |                           |           |                               |            |          |         |                           |             |             |                                     |            |
| Total assets .....                | \$ 40,036                 | \$ 23,944 | \$ 17,979                     | \$ 107,881 | \$ 8,438 | \$ 350  | \$ -                      | \$ 198,628  | \$ (29,702) | \$ (4,109)                          | \$ 164,817 |
| Total loans .....                 | 35,625                    | 21,529    | 15,173                        | 18,319     | 5,476    | -       | -                         | 96,122      | -           | (5,885)                             | 90,237     |
| Goodwill .....                    | 925                       | -         | 368                           | 497        | 337      | -       | -                         | 2,127       | 589         | -                                   | 2,716      |
| Total deposits .....              | 37,470                    | 34        | 15,695                        | 31,893     | 10,687   | -       | -                         | 95,779      | -           | 6,367                               | 102,146    |

- Net interest income of each segment represents the difference between actual interest earned on assets and interest paid on liabilities of the segment adjusted for a funding charge or credit. Segments are charged a cost to fund assets (e.g. customer loans) and receive a funding credit for funds provided (e.g. customer deposits) based on equivalent market rates.
- Expenses for the segments include fully apportioned corporate overhead expenses.
- The provision assigned to the segments is based on the segments' net charge offs and the change in allowance for credit losses.
- Represents adjustments associated with differences between IFRS and U.S. GAAP bases of accounting. These adjustments, which are more fully described beginning on page 150 of this Form 10-K, consist of the following:

|   | Net<br>Interest<br>Income | Other<br>Revenues | Provision<br>for Credit<br>Losses | Operating<br>Expenses | Income<br>before Income<br>Tax Expense | Total<br>Assets |
|---|---------------------------|-------------------|-----------------------------------|-----------------------|--|-----------------|
| <b>(in millions)</b>                                    |                           |                   |                                   |                       |  |                 |
| Unquoted equity securities .....                        | \$ -                      | \$ (45)           | \$ -                              | \$ -                  | \$ (45)                                | \$ -            |
| Fair value option.....                                  | 6                         | 80                | -                                 | -                     | 86                                     | -               |
| Loan origination .....                                  | (1)                       | (11)              | -                                 | (20)                  | 8                                      | -               |
| Loan impairment .....                                   | 3                         | -                 | -                                 | -                     | 3                                      | -               |
| Purchase accounting/deferred taxes .....                | -                         | -                 | -                                 | (6)                   | 6                                      | -               |
| Stock based compensation .....                          | -                         | -                 | -                                 | (9)                   | 9                                      | -               |
| Property .....  | -                         | 17                | -                                 | 14                    | 3                                      | -               |
| Pension cost .....                                      | -                         | -                 | -                                 | 10                    | (10)                                   | -               |
| Recording derivative assets and liabilities gross ..... | -                         | -                 | -                                 | -                     | -                                      | (29,702)        |
| Other .....   | -                         | -                 | 5                                 | -                     | (5)                                    | -               |
| Total .....   | \$ 8                      | \$ 41             | \$ 5                              | \$ (11)               | \$ 55                                  | \$ (29,702)     |

- Represents differences in financial statement presentation between IFRS and U.S. GAAP.

| December 31,<br>2005                   | IFRS Consolidated Amounts |           |           |                               |          |         |                           | (4)<br>IFRS<br>Adjustments | (5)<br>IFRS<br>Reclassifications | U.S. GAAP<br>Consolidated<br>Totals |            |
|--|---------------------------|-----------|-----------|-------------------------------|----------|---------|---------------------------|----------------------------|----------------------------------|-------------------------------------|------------|
|  | PFS                       | CF        | CMB       | Global Banking<br>and Markets | PB       | Other   | Intersegmental<br>Revenue |                            |                                  |                                     | Total      |
| <i>(in millions)</i>                   |                           |           |           |                               |          |         |                           |                            |                                  |                                     |            |
| Net interest income ...                | \$ 948                    | \$ 641    | \$ 666    | \$ 348                        | \$ 174   | \$ (22) | \$ (233)                  | \$ 2,522                   | \$ (62)                          | \$ 603                              | \$ 3,063   |
| Other revenues .....                   | 704                       | (41)      | 183       | 738                           | 260      | 28      | 233                       | 2,105                      | (8)                              | (186)                               | 1,911      |
| Total revenues .....                   | 1,652                     | 600       | 849       | 1,086                         | 434      | 6       | -                         | 4,627                      | (70)                             | 417                                 | 4,974      |
| Provision for credit<br>losses .....   | 100                       | 662       | 27        | (52)                          | (3)      | -       | -                         | 734                        | (63)                             | 3                                   | 674        |
|  | 1,552                     | (62)      | 822       | 1,138                         | 437      | 6       | -                         | 3,893                      | (7)                              | 414                                 | 4,300      |
| Operating expenses<br>(2) .....        | 1,023                     | 39        | 378       | 644                           | 270      | -       | -                         | 2,354                      | (10)                             | 414                                 | 2,758      |
| Income before<br>income tax expense... | 529                       | (101)     | 444       | 494                           | 167      | 6       | -                         | 1,539                      | 3                                | -                                   | 1,542      |
| Income tax expense ...                 | 218                       | (38)      | 170       | 184                           | 64       | 8       | -                         | 606                        | (40)                             | -                                   | 566        |
| Net income .....                       | \$ 311                    | \$ (63)   | \$ 274    | \$ 310                        | \$ 103   | \$ (2)  | \$ -                      | \$ 933                     | \$ 43                            | \$ -                                | \$ 976     |
| <b>Balances at end of period:</b>      |                           |           |           |                               |          |         |                           |                            |                                  |                                     |            |
| Total assets .....                     | \$ 43,736                 | \$ 22,158 | \$ 16,770 | \$ 84,922                     | \$ 6,312 | \$ 321  | \$ -                      | \$ 174,219                 | \$ (20,393)                      | \$ (2,242)                          | \$ 151,584 |
| Total loans .....                      | 39,619                    | 20,311    | 14,502    | 13,838                        | 4,930    | -       | -                         | 93,200                     | -                                | (2,858)                             | 90,342     |
| Goodwill .....                         | 925                       | -         | 368       | 497                           | 337      | -       | -                         | 2,127                      | 567                              | -                                   | 2,694      |
| Total deposits .....                   | 31,360                    | 23        | 11,852    | 33,309                        | 7,981    | -       | -                         | 84,525                     | -                                | 5,767                               | 90,292     |

- Net interest income of each segment represents the difference between actual interest earned on assets and interest paid on liabilities of the segment adjusted for a funding charge or credit. Segments are charged a cost to fund assets (e.g. customer loans) and receive a funding credit for funds provided (e.g. customer deposits) based on equivalent market rates.
- Expenses for the segments include fully apportioned corporate overhead expenses.
- The provision assigned to the segments is based on the segments' net charge offs and the change in allowance for credit losses.
- Represents adjustments associated with differences between IFRS and U.S. GAAP bases of accounting. These adjustments, which are more fully described below, consist of the following:

|   | Net<br>Interest<br>Income | Other<br>Revenues | Provision<br>for Credit<br>Losses | Operating<br>Expenses | Income<br>before Income<br>Tax Expense | Total<br>Assets |
|---|---------------------------|-------------------|-----------------------------------|-----------------------|--|-----------------|
| <i>(in millions)</i>                                    |                           |                   |                                   |                       |  |                 |
| Unquoted equity securities .....                        | \$ -                      | \$ -              | \$ -                              | \$ -                  | \$ -                                   | \$ -            |
| Fair value option .....                                 | -                         | (33)              | -                                 | -                     | (33)                                   | -               |
| Loan origination .....                                  | (5)                       | (8)               | -                                 | (24)                  | 11                                     | -               |
| Loan impairment .....                                   | (4)                       | -                 | (24)                              | -                     | 20                                     | -               |
| Purchase accounting/deferred taxes .....                | -                         | -                 | -                                 | 20                    | (20)                                   | -               |
| Stock based compensation .....                          | -                         | -                 | -                                 | (29)                  | 29                                     | -               |
| Property .....  | -                         | 21                | -                                 | 15                    | 6                                      | -               |
| Pension cost .....                                      | -                         | -                 | -                                 | 8                     | (8)                                    | -               |
| Recording derivative assets and liabilities gross ..... | -                         | -                 | -                                 | -                     | -                                      | (20,393)        |
| Other .....   | (53)                      | 12                | (39)                              | -                     | (2)                                    | -               |
| Total .....   | \$ (62)                   | \$ (8)            | \$ (63)                           | \$ (10)               | \$ 3                                   | \$ (20,393)     |

- Represents differences in financial statement presentation between IFRS and U.S. GAAP.

### ***Differences between IFRS and U.S. GAAP***

***Unquoted equity securities*** – Under IFRS, equity securities which are not quoted on a recognized exchange (MasterCard Class B shares), but for which fair value can be reliably measured, are required to be measured at fair value. Securities measured at fair value under IFRS are classified as either available for sale securities, with changes in fair value recognized in shareholders' equity, or as trading securities, with changes in fair value recognized in income, as is the case with MasterCard Class B shares. Under U.S. GAAP, equity securities that are not quoted on a recognized exchange, are not considered to have a readily determinable fair value and are required to be measured at cost, less any provisions for known impairment, in other assets.

***Fair value option*** – Reflects the impact of applying the fair value option to certain debt instruments issued, and includes an adjustment of the initial valuation of the debt instruments. The debt is accounted for at amortized cost under U.S. GAAP.

*Loan origination* – Certain loan fees and incremental direct loan origination costs, including direct salaries but excluding overhead costs, are deferred and amortized to earnings over the life of the loan under IFRS. Certain loan fees and direct, but not necessarily incremental loan origination costs, including an apportionment of overhead in addition to direct salaries, are deferred and amortized to earnings under U.S. GAAP.

*Loan impairment* – No asset for future recoveries arising from written-off assets was recognized in the balance sheet under IFRS prior to January 1, 2005. The establishment of the recovery asset under IFRS associated with the private label credit card portfolio purchased from HSBC Finance Corporation results in higher earnings under IFRS than under U.S. GAAP. Subsequent recoveries are credited to earnings under U.S. GAAP, but are adjusted against the recovery asset under IFRS, resulting in lower earnings under IFRS. Net interest income is higher under IFRS than under U.S. GAAP due to the imputed interest on the recovery asset.

*Purchase accounting/deferred taxes* – In 2006, a deferred tax asset related to a previous acquisition was adjusted against the related goodwill account for U.S. GAAP reporting. Under IFRS, this adjustment was charged to earnings.

*Stock based compensation* – Some of the bonuses awarded in respect of 2002, 2003 and 2004 were recognized over the relevant vesting period and were, therefore, expensed in net income under IFRS during 2005. Under U.S. GAAP, these awards were expensed in the years for which they were granted. 2005 bonuses will be expensed over the vesting period under both IFRS and U.S. GAAP. Net income was, therefore, higher under U.S. GAAP in 2005. IFRS and U.S. GAAP are now largely aligned and this transition difference will be eliminated over the next few years.

*Property* – Under IFRS, the value of property held for own use reflects revaluation surpluses recorded prior to January 1, 2004. Consequently, the values of tangible fixed assets and shareholders' equity are lower under U.S. GAAP than under IFRS. There is a correspondingly lower depreciation charge and higher net income as well as higher gains (or smaller losses) on the disposal of fixed assets under U.S. GAAP. For investment properties, net income under U.S. GAAP does not reflect the unrealized gain or loss recorded under IFRS for the period.

*Pension costs* – Net income under U.S. GAAP is lower than under IFRS as a result of the amortization of the amount by which actuarial losses exceed gains beyond the 10 percent "corridor".

*Recording derivative assets and liabilities gross* – Under U.S. GAAP, derivative receivables and payables with the same counterparty may be reported net in the balance sheet when there is an executed International Swaps and Derivatives Association, Inc. (ISDA) Master Netting Arrangement. In addition, under U.S. GAAP, fair value amounts recognized for the obligation to return cash collateral received or the right to reclaim cash collateral paid are offset against the fair value of derivative instruments. Under IFRS, these agreements do not meet the requirements for offset, and therefore such derivative receivables and payables are presented gross on the balance sheet.

*Other* – In 2007, other includes the net impact of certain adjustments which represent a temporary difference between U.S. GAAP and IFRS. These adjustments were not individually material for the years ended 2007, 2006 and 2005.

## Note 25. Collateral, Commitments and Contingent Liabilities

### Pledged Assets

The following table presents pledged assets included in the consolidated balance sheets.

| December 31<br>(in millions)               | 2007             | 2006             |
|--|------------------|------------------|
| Interest bearing deposits with banks ..... | \$ 264           | \$ 764           |
| Trading assets (1) .....                   | 2,834            | 2,961            |
| Securities available for sale (2) .....    | 7,060            | 6,775            |
| Securities held to maturity .....          | 172              | 273              |
| Loans (3) .....                            | 8,416            | 8,426            |
| Other assets (4) .....                     | 2,889            | 849              |
| Total .....                                | <u>\$ 21,635</u> | <u>\$ 20,048</u> |

- (1) Trading assets are primarily pledged against liabilities associated with consolidated variable interest entities (refer to Note 27).
- (2) Securities available for sale are primarily pledged against various short-term borrowings.
- (3) Loans are primarily private label credit card receivables pledged against long-term borrowings and residential mortgage loans pledged against long-term borrowings from the Federal Home Loan Bank (refer to Note 15).
- (4) Other assets represent cash on deposit with non-banks related to derivative collateral support agreements.

Debt securities pledged as collateral that can be sold or repledged by the secured party continue to be reported on the consolidated balance sheets. The fair value of securities available for sale that can be sold or repledged was \$3,426 million and \$2,289 million at December 31, 2007 and 2006, respectively.

The fair value of collateral accepted by HUSI not reported on the consolidated balance sheets that can be sold or repledged was \$14,635 million and \$8,161 million at December 31, 2007 and 2006, respectively. This collateral was obtained under security resale agreements. Of this collateral, \$954 million and \$781 million has been sold or repledged as collateral under repurchase agreements or to cover short sales at December 31, 2007 and 2006, respectively.

### Lease Obligations

HUSI and its subsidiaries are obligated under a number of noncancellable leases for premises and equipment. Certain leases contain renewal options and escalation clauses. Expected minimum lease payments under noncancellable operating leases as of December 31, 2007, net of sublease rentals, are summarized in the following table.

| December 31<br>(in millions)       | 2007          | 2006          | 2005         |
|------------------------------------|---------------|---------------|--------------|
| Actual annual rental expense ..... | \$ <u>128</u> | \$ <u>111</u> | \$ <u>89</u> |
| Expected minimum future payments:  |               |               |              |
| 2008 .....                         | \$ 106        |               |              |
| 2009 .....                         | 102           |               |              |
| 2010 .....                         | 94            |               |              |
| 2011 .....                         | 87            |               |              |
| 2012 .....                         | 79            |               |              |
| Thereafter .....                   | <u>288</u>    |               |              |
|                                    | <u>\$ 756</u> |               |              |



## ***Litigation***

HUSI is named in and is defending legal actions in various jurisdictions arising from its normal business. One of these proceedings, which relates to a lawsuit against Visa U.S.A., Inc. (Visa) had a material impact on HUSI's pre-tax results during 2007, which is discussed more fully below. In addition, there was a conclusion during the last half of 2007 in the proceedings related to the "Princeton Note Matter", which is also more fully described below.

### ***Visa***

Over the past several years, Visa, as well as several of their member banks, have been involved in several different lawsuits challenging various practices of Visa in the United States of America.

In 1998, the United States Department of Justice filed an antitrust lawsuit against the Visa membership associations ("associations") alleging, among other things, that the associations had violated antitrust law and engaged in unfair practices by not allowing member banks to issue cards from competing brands, such as American Express and Discover Financial Services. In 2001, a New York district court entered judgment in favor of the Department of Justice and ordered the associations to repeal these policies. The United States Court of Appeals for the Second Circuit affirmed the district court and, on October 4, 2004, the United States Supreme Court denied certiorari in the case. In November 2004, American Express filed an antitrust lawsuit (the "Amex lawsuit") against Visa and several member banks alleging, among other things, that the defendants jointly and severally implemented and enforced illegal exclusionary agreements that prevented member banks from issuing American Express cards. The complaint requests civil monetary damages, which could be trebled. In November 2007, Visa entered into a settlement agreement with American Express to settle the Amex litigation, however the settlement is subject to certain approvals.

Separately, a number of merchants and merchant organizations have also filed antitrust lawsuits (the "Interchange lawsuits") against Visa and several member banks alleging, among other things, that the defendants conspired to fix the level of interchange fees. The complaints request civil monetary damages, which could be trebled. In October 2005, the Interchange lawsuits were consolidated before the United States District Court for the Eastern District of New York for certain purposes, including discovery.

In October 2007, Visa announced that it had completed restructuring transactions in preparation for its initial public offering planned for early 2008. HBUS has a membership interest in Visa. As a result of the indemnification agreement established as part of the restructuring, banks with a membership interest, including HBUS, have obligations to share in certain losses under various agreements with Visa in connection with this and other litigation. In light of this and the accounting guidance related to Visa matters received in November from the SEC, which stated that the modification of the Visa bylaws no longer exempts the indemnification agreement from the scope of FASB Accounting Interpretation No. 45, "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others", HBUS recorded a \$70 million liability for litigation related to Visa, which resulted in a corresponding pre-tax charge to litigation expense during the fourth quarter of 2007.

### ***Princeton Notes***

In relation to the Princeton Note Matter, as disclosed in HUSI's 2002 Annual Report on Form 10-K, two of the noteholders were initially excluded from the restitution order that was negotiated with the U.S. Government. Those noteholders were Maruzen Company, Limited and Yakult Honsha Co., Ltd. Those entities were excluded because a senior officer of one of the noteholders was being criminally prosecuted in Japan for his conduct relating to its Princeton Notes and the other noteholder was likely to recover from the Princeton Receiver an amount that exceeded its losses attributable to its funds transfers with Republic New York Securities Corporation, as calculated by the U.S. Government.

Both Maruzen and Yakult then commenced separate civil suits. Both of those civil suits sought compensatory, punitive, and treble damages pursuant to RICO and assorted fraud and breach of duty claims arising from unpaid Princeton Notes with face amounts totaling approximately \$125 million. No amount of compensatory damages was specified in either complaint. Those two complaints named HUSI, HBUS, and Republic New York Securities Corporation as defendants. The parties to those two cases recently engaged in separate settlement discussions, resulting in the conclusion of both cases during the second half of 2007. The settlements, individually and collectively, did not have a material impact on HUSI's consolidated results.

**Note 26. Off-Balance Sheet Financial Guarantee Arrangements**

As part of its normal operations, HUSI enters into various off-balance sheet financial guarantee arrangements with affiliates and third parties. These arrangements arise principally in connection with HUSI's lending and client intermediation activities and include standby letters of credit and certain derivative transactions that meet the definition of a guarantee under FIN 45. The contractual amounts of these financial instruments represent HUSI's maximum possible credit exposure in the event that HUSI is required to fulfill its maximum obligation under the contractual terms of the guarantee.

The following table presents total contractual amounts of HUSI's off-balance sheet financial guarantee arrangements. Descriptions of the various arrangements follow the table.

| <b>December 31</b>   | <b>2007</b>       | <b>2006</b>       |
|--|-------------------|-------------------|
| <b>(in millions)</b>                                       |                   |                   |
| Standby letters of credit, net of participations (1) ..... | \$ 9,021          | \$ 7,259          |
| Credit derivatives (2) .....                               | <u>650,243</u>    | <u>431,631</u>    |
| Total .....  | <u>\$ 659,264</u> | <u>\$ 438,890</u> |

(1) Includes \$598 million and \$542 million issued for the benefit of HSBC affiliates at December 31, 2007 and 2006, respectively.

(2) Includes \$98,250 million and \$71,908 million issued for the benefit of HSBC affiliates at December 31, 2007 and 2006, respectively.

**Standby Letters of Credit**

A standby letter of credit is issued to a third party for the benefit of a customer and is essentially a guarantee that the customer will perform, or satisfy some obligation, under a contract. It irrevocably obligates HUSI to pay a specified amount to the third party beneficiary when the customer fails to perform some contractual obligation. Two types of standby letters of credit are issued by HUSI: performance and financial. A performance standby letter of credit is issued where the customer is required to perform some nonfinancial contractual obligation, such as the performance of a specific act, whereas a financial standby letter of credit is issued where the customer's contractual obligation is of a financial nature, such as the repayment of a loan or debt instrument. The amount presented in the above table represents the total contractual amount of outstanding standby letters of credit, net of participations of \$9 billion and \$7 billion, at December 31, 2007 and 2006, respectively.

The issuance of a standby letter of credit is subject to HUSI's credit approval process and collateral requirements. Fees are charged for issuing standby letters of credit commensurate with the customer's credit evaluation and the nature of any collateral. Included in other liabilities are deferred fees on standby letters of credit, representing the fair value of the "stand ready obligation to perform" under these guarantees, amounting to \$25 million and \$21 million at December 31, 2007 and 2006, respectively. Also included in other liabilities is an allowance for credit losses on unfunded standby letters of credit of \$27 million and \$25 million at December 31, 2007 and 2006, respectively.

### ***Credit Derivatives***

Some derivative transactions to which HUSI is a party meet the definition of a guarantee under FIN 45. These consist primarily of certain credit derivative contracts, including credit default swaps, total return swaps and credit options, which HUSI enters into to satisfy the needs of its customers and, in certain cases, for its own benefit. Credit derivatives are arrangements that provide for one party (the “protection seller”) to pay another party (the “protection buyer”) an agreed upon amount if a specified credit event related to a “reference asset” occurs during the term of the contract. In exchange for the credit protection provided, the protection buyer agrees to pay a fee to the protection seller. Credit derivatives effectively transfer the credit risk of the reference asset to the protection seller, which is able to assume that risk without directly purchasing the asset. Where HUSI sells credit protection to a counterparty that holds the subject reference asset, it effectively provides a guarantee with respect to that asset.

HUSI records all derivative contracts at fair value. HUSI’s credit derivative agreements do not specify whether or not the counterparty holds the reference asset. The amounts disclosed in the table represent the total notional amount of all credit derivatives in which HUSI is the protection seller, which is the maximum amount that HUSI could be required to pay under those contracts. In accordance with established policies, HUSI offsets most of the risk it assumes in selling credit protection through credit derivatives by entering into offsetting contracts with other counterparties. Because they do not reflect the approximately equal amounts due from third parties under offsetting contracts, HUSI believes the contractual amounts presented are not representative of actual future credit exposure.

### ***Note 27. Variable Interest Entities (VIEs)***

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In the ordinary course of business, HUSI is involved with entities that are deemed to be VIEs and may hold variable interests in those entities. HUSI consolidates VIEs where it is deemed to be the primary beneficiary. Refer to Note 2 on page 103 of the consolidated financial statements for further discussion of HUSI’s policies regarding consolidation of VIEs.

At December 31, 2007 and 2006, HUSI held all or substantially all of the debt securities issued by several VIE trusts that were organized by an affiliate of HUSI and third parties to issue structured notes. The consolidated assets of these VIEs were \$213 million and \$193 million at December 31, 2007 and 2006, respectively and are reported in trading assets. Debt instruments issued by these VIEs and held by HUSI were eliminated in consolidation. Debt instruments issued by these VIEs and held by third parties were not material.

HUSI was also the primary beneficiary and consolidated a number of VIE trusts organized to securitize certain private label credit cards. At December 31, 2007 and 2006, the consolidated assets of these trusts were \$2,822 million and \$3,274 million, respectively and were reported in loans. Debt securities issued by these VIEs are reported as secured financings in long-term debt.

The assets of consolidated VIEs serve as collateral for the obligations of the VIEs. The holders of debt instruments issued by consolidated VIEs have no recourse to the general credit of HUSI.

HUSI also had significant involvement with other VIEs that were not consolidated at December 31, 2007 or 2006 because HUSI was not the primary beneficiary. The following table presents information on these VIEs.

|  | December 31, 2007 |                          | December 31, 2006 |                          |
|--|-------------------|--------------------------|-------------------|--------------------------|
|  | Total Assets      | Maximum Exposure to Loss | Total Assets      | Maximum Exposure to Loss |
| <b>(in millions)</b>                         |                   |                          |                   |                          |
| Asset backed commercial paper conduits ..... | \$ 32,886         | \$ 9,507                 | \$ 33,446         | \$ 8,194                 |
| Structured investment vehicles .....         | 6,337             | 50                       | 13,183            | 50                       |
| Structured note vehicles .....               | 8,350             | 1,488                    | 4,104             | 541                      |
| Investment funds .....                       | -                 | -                        | 717               | 2                        |
| Low income housing tax partnerships .....    | 705               | 115                      | 406               | 153                      |
| Total .....                                  | <u>\$ 48,278</u>  | <u>\$ 11,160</u>         | <u>\$ 51,856</u>  | <u>\$ 8,940</u>          |

HUSI is involved with VIEs primarily to facilitate client needs. Information on the types of VIEs with which HUSI is involved and the nature of its involvement and variable interests in those entities is presented below.

#### *Asset Backed Commercial Paper Conduits*

HUSI provides liquidity facilities to a number of multi-seller and single-seller asset backed commercial paper conduits (ABCP conduits) sponsored by HSBC affiliates and by third parties. These conduits support the financing needs of customers by facilitating their access to commercial paper markets.

Customers sell financial assets, typically trade receivables, to the ABCP conduits, which fund the purchases by issuing short-term highly-rated commercial paper collateralized by the assets acquired. In a multi-seller conduit, any number of companies may be originating and selling assets to the conduit whereas a single-seller conduit acquires assets from a single company. HUSI, along with other financial institutions, provides liquidity facilities to ABCP conduits in the form of lines of credit or asset purchase commitments. Liquidity facilities provided to multi-seller conduits support transactions associated with a specific seller of assets to the conduit and HUSI would only be required to provide support in the event of certain triggers associated with those transactions and assets. Liquidity facilities provided to single-seller conduits are not identified with specific transactions or assets and HUSI would be required to provide support upon occurrence of certain triggers that generally affect the conduit as a whole. HUSI's obligations are generally pari passu with that of other institutions that also provide liquidity support to the same conduit or for the same transactions. HUSI does not provide any program-wide credit enhancements to ABCP conduits.

Each seller of assets to an ABCP conduit typically provides collateral in the form of excess assets and therefore bears the risk of first loss related to the specific assets transferred. HUSI does not transfer its own assets to the conduits. It has no ownership interests in, performs no administrative duties for, and does not service any of the assets held by the conduits. HUSI is not the primary beneficiary and does not consolidate any of the ABCP conduits to which it provides liquidity facilities. Credit risk related to the liquidity facilities provided is managed by subjecting them to HUSI's normal underwriting and risk management processes. The maximum exposure to loss presented in the table above represents the maximum amount of loans and asset purchases HUSI could be required to make under the liquidity facilities it provides.

### *Structured Investment Vehicles*

HUSI provides a liquidity facility to a single structured investment vehicle (SIV) sponsored by a third party. This entity, which is deemed to be a VIE, seeks to earn a profit by investing in mostly highly rated longer-dated fixed income instruments and funding those investments by issuing cheaper short-term, highly rated commercial paper and medium term notes. HUSI does not transfer its own assets to the SIV. It has no ownership interests in, performs no administrative duties for, and does not service any of the assets the SIV holds. HUSI is not the primary beneficiary of the SIV and therefore does not consolidate the SIV. Credit risk related to the liquidity facility provided is managed through HUSI's normal underwriting and risk management processes. The maximum exposure to loss presented in the table above represents the maximum amount of loans that HUSI could be required to make under the liquidity facility it provides.

### *Structured Note Vehicles*

In the normal course of business, HUSI enters into derivative transactions with special purpose entities organized by HSBC affiliates and by third parties to issue structured notes. These entities, which are deemed to be VIEs, are organized as trusts and issue fixed or floating rate debt instruments backed by the financial assets they hold. They were established to create investments with specific risk profiles for investors.

HUSI's variable interests in these entities include derivative transactions, such as interest rate and currency swaps, and investments in their debt instruments. With respect to several of these VIEs, HUSI also holds variable interests in the form of total return swaps entered into in connection with the transfer of certain assets to the VIEs. In these transactions, HUSI transferred financial assets from its trading portfolio to the VIEs and entered into total return swaps under which it receives the total return on the transferred assets and pays a market rate of return. The transfers of assets in these transactions do not qualify as sales under the applicable accounting literature and are accounted for as secured borrowings. Accordingly, the transferred assets continue to be recognized as trading assets on HUSI's balance sheet and the funds received are recorded as liabilities in long-term debt.

In addition to its variable interests, HUSI holds credit default swaps with these structured note VIEs under which it receives credit protection on specified reference assets in exchange for the payment of a premium. Through these derivatives, the VIEs assume the credit risk associated with the reference assets, which is then passed on to the holders of the debt instruments they issue. Because they create rather than absorb variability, the credit default swaps held by HUSI are not considered variable interests.

HUSI records all investments in, and derivative contracts with, unconsolidated structured note vehicles at fair value on its balance sheet. HUSI's maximum exposure to loss is limited to the recorded amounts of these instruments.

### *Securitization Vehicles*

HUSI utilizes special purpose entities structured as trusts to securitize certain private label credit card receivables where securitization provides an attractive source of funding. HUSI transfers the credit card receivables to the trusts which in turn issue debt instruments collateralized by the transferred receivables.

Prior to 2006, several of the trusts used to securitize private label credit cards were structured as qualifying special purpose entities (QSPEs) as defined under SFAS 140. As the transferor of financial assets to these QSPEs, HUSI was not required to consolidate them. Since 2006, all of the trusts used by HUSI to securitize private label credit cards do not meet the QSPE criteria. As a result, these trusts are considered VIEs and are consolidated by HUSI as the primary beneficiary at December 31, 2007 and 2006.

### *Investment Funds*

HUSI is a sub-investment advisor to mutual funds structured as trusts and managed by an HSBC affiliate. As sub-investment advisor, HUSI receives a variable fee based on the value of funds and is therefore deemed to have a variable interest. HUSI has no ownership interest in these funds and is not their primary beneficiary. In addition, HUSI has no credit exposure to the funds as a result of its duties as an advisor. During 2006, the assets of certain of these trusts were liquidated, resulting in significantly reduced assets under management.

At December 31, 2006, HUSI was the counterparty to a total return swap with an unaffiliated hedge fund. The fund was deemed to be a VIE in which HUSI's swap represented a variable interest. HUSI did not hold shares in or have any other involvement with the fund and was not the primary beneficiary. HUSI's variable interest in the fund terminated during 2007.

### *Low Income Housing Partnerships*

HUSI invests as a limited partner in a number of low-income housing partnerships that operate qualified affordable housing projects and generate tax benefits, including federal low-income housing tax credits, for investors. Some of the partnerships are deemed to be VIEs because they do not have sufficient equity investment at risk or are structured with non-substantive voting rights. HUSI is not the primary beneficiary of these VIEs and does not consolidate them.

HUSI's investments in low-income housing partnerships are recorded using the equity method of accounting and are included in other assets on the consolidated balance sheet. The maximum exposure to loss shown in the table represents the recorded investment, net of estimated expected reductions in future tax liabilities and potential recapture of tax credits allowed in prior years.

### ***Note 28. Fair Value of Financial Instruments***

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Statement of Financial Accounting Standards No. 107, Disclosures about Fair Value of Financial Instruments (SFAS 107), requires the disclosure of the fair value of financial instruments for which it is practicable to estimate fair value. SFAS 107 does not require the disclosure of fair value information for certain financial instruments, including obligations under pension and certain other employee benefit plans, lease contracts, and equity-method investments, or for non-financial instruments such as goodwill and other intangibles. Accordingly, the fair value amounts disclosed in accordance with SFAS 107 should not be viewed as representing the fair value of HUSI as a whole.

The fair value of a financial instrument is the amount at which the instrument could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale. Where available, HUSI uses quoted market prices as estimates of the fair value of financial instruments. For financial instruments without quoted market prices, fair value represents management's best estimate based on a range of methods and assumptions, which are described below. The use of different assumptions could significantly affect the estimates of fair value; accordingly, the net values realized upon liquidation of the financial instruments could be materially different from the estimated fair values presented.

***Short-term financial assets and liabilities*** – The carrying value of certain financial assets and liabilities carried at cost is considered to approximate fair value because they are short-term in nature, bear interest rates that approximate market rates, and generally have minimal credit risk. These items include cash and due from banks, interest bearing deposits with banks, accrued interest receivable, customer acceptance assets and liabilities, short-term borrowings, and interest, taxes and other liabilities.

***Federal funds sold and purchased and securities purchased and sold under resale and repurchase agreements*** – Federal funds sold and purchased and securities purchased and sold under resale and repurchase agreements are recorded at cost. A significant majority of these transactions are short-term in nature and, as such, the recorded amounts approximate fair value. For transactions with long-dated maturities, fair value is based on dealer quotes for instruments with similar characteristics.

***Non-derivative trading assets and liabilities*** – Non-derivative trading assets and liabilities are recorded at fair value. Fair value is based on current market quotations, where available. Where quoted market prices are not available, fair value is estimated based on dealer quotes, quoted prices of similar instruments, or internally developed valuation models.

***Derivatives*** – Derivatives are recorded at fair value. Asset and liability positions in individual derivatives that are covered by legally enforceable master netting agreements, including cash collateral are offset and presented net in accordance with FIN 39 (as amended by FSP FIN 39-1).

Fair value of exchange traded derivatives is based on quoted market prices. Fair value of non-exchange traded derivatives is based on dealer quotes, quoted prices of similar instruments, or internally developed valuation models and includes adjustments for the credit quality of individual counterparties, lack of market liquidity, the potential impact of position concentrations on market values, and other factors that management deems necessary to determine a reasonable estimate of fair value.

The fair value of derivatives does not incorporate a valuation adjustment to reflect HUSI's credit quality.

***Securities*** – The fair value of securities is based on current market quotations, where available. If quoted market prices are not available, fair value is based on dealer quotes, quoted prices of similar instruments, or internally developed valuation models. Available for sale securities are recorded at fair value on the consolidated balance sheet, while held to maturity securities are generally recorded at historical cost. Cost and fair value information for securities is reported in Note 6 of the consolidated financial statements.

***Loans*** – Fair value is estimated separately for groups of similar loans. To the extent possible, loans are segregated into groups of similar loans based on loan type and maturity. Fair value for each group is estimated primarily by calculating the present value of expected cash flows using discount rates that approximate current market rates for loans with similar characteristics and adjusting for inherent credit risk. Where available, quoted market prices are used to estimate fair value for certain residential mortgages and commercial loans.

***Deposits*** – The carrying amount of deposits with no stated maturity (e.g., demand, savings, and certain money market deposits), which represents the amount payable upon demand, is considered to approximate fair value. For deposits with fixed maturities, fair value is estimated by discounting cash flows using market interest rates currently offered on deposits with similar characteristics and maturities.

***Long-term debt*** – The fair value of long-term debt is based on quoted market prices where such prices exist. If quoted market prices are not available, fair value is based on dealer quotes, quoted prices of similar instruments, or internally developed valuation models.

***Lending-related commitments*** – The fair value of commitments to extend credit, standby letters of credit and financial guarantees, is not included in the table. These instruments generate fees, which approximate those currently charged to originate similar commitments.

The following table presents the carrying amount and estimated fair value of financial assets and liabilities for which fair value disclosures are required under SFAS 107. The table does not include information on financial and non-financial assets and liabilities that are excluded from the scope of SFAS 107.

| December 31<br>(in millions)  | 2007              |                   | 2006              |                   |
|---|-------------------|-------------------|-------------------|-------------------|
|   | Carrying Value    | Fair Value        | Carrying Value    | Fair Value        |
| Financial assets:   |                   |                   |                   |                   |
| Short-term financial assets .....   | \$ 10,176         | \$ 10,176         | \$ 6,277          | \$ 6,277          |
| Federal funds sold and securities purchased under resale agreements ..... | 13,677            | 13,677            | 13,775            | 13,775            |
| Non-derivative trading assets .....                                       | 22,325            | 22,325            | 14,640            | 14,640            |
| Derivatives .....   | 14,781            | 14,781            | 9,188             | 9,188             |
| Securities .....  | 22,853            | 22,907            | 22,755            | 22,823            |
| Loans, net of allowance for credit losses .....                           | 93,535            | 92,849            | 89,340            | 88,314            |
| Total financial assets .....  | <u>\$ 177,347</u> | <u>\$ 176,715</u> | <u>\$ 155,975</u> | <u>\$ 155,017</u> |
| Financial liabilities:  |                   |                   |                   |                   |
| Short-term financial liabilities .....                                    | \$ 15,918         | \$ 15,918         | \$ 8,409          | \$ 8,409          |
| Deposits:   |                   |                   |                   |                   |
| Without fixed maturities .....  | 100,627           | 100,627           | 88,474            | 88,474            |
| Fixed maturities .....  | 15,601            | 15,630            | 13,672            | 13,656            |
| Non-derivative trading liabilities .....                                  | 2,967             | 2,967             | 3,250             | 3,250             |
| Derivatives .....   | 13,430            | 13,430            | 9,179             | 9,179             |
| Long-term debt .....  | 28,268            | 28,127            | 29,252            | 29,525            |
| Total financial liabilities .....   | <u>\$ 176,811</u> | <u>\$ 176,699</u> | <u>\$ 152,236</u> | <u>\$ 152,493</u> |



**Note 29. Financial Statements of HSBC USA Inc. (Parent)**

Condensed parent company financial statements follow.

| <b>Balance Sheets</b>  |    |               |                  |
|--|----|---------------|------------------|
| <b>December 31</b>   |    | <b>2007</b>   | <b>2006</b>      |
| <b>(in millions)</b>   |    |               |                  |
| <b>Assets:</b>   |    |               |                  |
| Cash and due from banks .....                                    | \$ | 2             | \$ -             |
| Interest bearing deposits with banks .....                       |    | 140           | 65               |
| Trading assets .....   |    | 1,937         | 1,352            |
| Securities purchased under resale agreements .....               |    | 1             | 71               |
| Securities available for sale .....                              |    | 276           | 238              |
| Securities held to maturity (fair value \$78 and \$114) .....    |    | 75            | 108              |
| Loans (net of allowance for credit losses of \$2 for 2006) ..... |    | 316           | 23               |
| Receivables from subsidiaries .....                              |    | 4,593         | 4,169            |
| Receivables from other HSBC affiliates .....                     |    | 487           | 82               |
| Investment in subsidiaries at amount of their net assets:        |    |               |                  |
| Banking .....  |    | 11,542        | 12,258           |
| Other .....  |    | 230           | 501              |
| Goodwill .....   |    | 589           | 604              |
| Other assets .....   |    | 195           | 196              |
| Total assets .....   | \$ | <u>20,383</u> | \$ <u>19,667</u> |
| <b>Liabilities:</b>  |    |               |                  |
| Interest, taxes and other liabilities .....                      | \$ | 101           | \$ 192           |
| Payables due to subsidiaries .....                               |    | 777           | 464              |
| Payables due to other HSBC affiliates .....                      |    | 4             | -                |
| Short-term borrowings .....                                      |    | 3,925         | 2,414            |
| Long-term debt (1) .....   |    | 4,339         | 4,336            |
| Total liabilities .....  |    | 9,146         | 7,406            |
| Shareholders' equity * .....                                     |    | 11,237        | 12,261           |
| Total liabilities and shareholders' equity .....                 | \$ | <u>20,383</u> | \$ <u>19,667</u> |

\* See Consolidated Statements of Changes in Shareholders' Equity, page 100.

- (1) Contractual scheduled maturities for the debt over the next five years are as follows: 2008, \$1,918 million; 2009, \$608 million; 2010, \$58 million; 2011, \$118 million and 2012, \$199 million.

| <b>Statements of Income</b>  |    |              |                 |               |
|--|----|--------------|-----------------|---------------|
| <b>Year Ended December 31</b>  |    | <b>2007</b>  | <b>2006</b>     | <b>2005</b>   |
| <b>(in millions)</b>   |    |              |                 |               |
| <b>Income:</b>   |    |              |                 |               |
| Dividends from banking subsidiaries .....                                    | \$ | 800          | \$ 855          | \$ 675        |
| Dividends from other subsidiaries .....                                      |    | 2            | 2               | 2             |
| Interest from subsidiaries .....   |    | 223          | 240             | 168           |
| Interest from other HSBC affiliates .....                                    |    | 12           | 5               | 9             |
| Other interest income .....  |    | 26           | 26              | 21            |
| Securities transactions .....  |    | 6            | (1)             | 13            |
| Other income .....   |    | 47           | 189             | 35            |
| Total income .....   |    | <u>1,116</u> | <u>1,316</u>    | <u>923</u>    |
| <b>Expenses:</b>   |    |              |                 |               |
| Interest .....   |    | 461          | 437             | 350           |
| (Credit) provision for credit losses .....                                   |    | (2)          | -               | -             |
| Other expenses .....   |    | 17           | 17              | 17            |
| Total expenses .....   |    | <u>476</u>   | <u>454</u>      | <u>367</u>    |
| Income before taxes and equity in undistributed income of subsidiaries ..... |    | 640          | 862             | 556           |
| Income tax (benefit) expense .....   |    | (54)         | 10              | (40)          |
| Income before equity in undistributed income of subsidiaries .....           |    | 694          | 852             | 596           |
| Equity in undistributed (loss) income of subsidiaries .....                  |    | (556)        | 184             | 380           |
| Net income .....   | \$ | <u>138</u>   | \$ <u>1,036</u> | \$ <u>976</u> |

| <b>Statements of Cash Flows</b>   |               |               |                |
|---|---------------|---------------|----------------|
| <b>Year Ended December 31</b>   | <b>2007</b>   | <b>2006</b>   | <b>2005</b>    |
| <b>(in millions)</b>  |               |               |                |
| Cash flows from operating activities:   |               |               |                |
| Net income .....  | \$ 138        | \$ 1,036      | \$ 976         |
| Adjustments to reconcile net income to net cash provided by operating activities: |               |               |                |
| Depreciation, amortization and deferred taxes .....                               | 2             | 2             | (3)            |
| (Credit) provision for credit losses .....  | (2)           | -             | -              |
| Net change in other accrued accounts .....  | (90)          | 74            | (77)           |
| Net change in fair value of non-trading derivatives .....                         | 308           | 39            | 5              |
| Undistributed loss (income) of subsidiaries .....                                 | 556           | (184)         | (380)          |
| Other, net .....  | (175)         | (465)         | (291)          |
| Net cash provided by operating activities .....                                   | <u>737</u>    | <u>502</u>    | <u>230</u>     |
| Cash flows from investing activities:   |               |               |                |
| Net change in interest bearing deposits with banks .....                          | (963)         | 451           | (1,930)        |
| Purchases of securities .....   | (38)          | (85)          | (174)          |
| Sales and maturities of securities .....  | 33            | 19            | 58             |
| Net originations and maturities of loans .....                                    | (343)         | 342           | 414            |
| Net change in investments in and advances to subsidiaries .....                   | 285           | (477)         | (490)          |
| Other, net .....  | 110           | (83)          | 181            |
| Net cash (used in) provided by investing activities .....                         | <u>(916)</u>  | <u>167</u>    | <u>(1,941)</u> |
| Cash flows from financing activities:   |               |               |                |
| Net change in short-term borrowings .....   | 1,511         | (206)         | 140            |
| Issuance of long-term debt, net of issuance costs .....                           | -             | -             | 1,497          |
| Repayment of long-term debt .....   | (306)         | (300)         | (3)            |
| Dividends paid .....  | (898)         | (543)         | (720)          |
| Reductions of capital surplus .....   | (1)           | (9)           | (22)           |
| Preferred stock issuance, net of redemptions .....                                | (125)         | 374           | 816            |
| Capital contribution from HNAI .....  | -             | 15            | 3              |
| Net cash provided by (used in) financing activities .....                         | <u>181</u>    | <u>(669)</u>  | <u>1,711</u>   |
| Net change in cash and due from banks .....                                       | 2             | -             | -              |
| Cash and due from banks at beginning of year .....                                | -             | -             | -              |
| Cash and due from banks at end of year .....                                      | <u>\$ 2</u>   | <u>\$ -</u>   | <u>\$ -</u>    |
| Cash paid for:  |               |               |                |
| Interest .....  | <u>\$ 475</u> | <u>\$ 428</u> | <u>\$ 349</u>  |

HBUS is subject to legal restrictions on certain transactions with its nonbank affiliates in addition to the restrictions on the payment of dividends to HUSI. See Note 19 on page 137 for further discussion.

## Quarterly Results of Operations (Unaudited)

The following table presents a quarterly summary of selected financial information.

| Quarter Ended                                 | December 31 | September 30 | June 30 | March 31 |
|---|-------------|--------------|---------|----------|
| <b>(in millions)</b>                          |             |              |         |          |
| <b>2007</b>                                   |             |              |         |          |
| Net interest income .....                     | \$ 878      | \$ 923       | \$ 807  | \$ 790   |
| Trading (loss) revenues .....                 | (348)       | 28           | 312     | 137      |
| Residential mortgage banking revenue .....    | 6           | 6            | 42      | 20       |
| Securities gains, net .....                   | 16          | 59           | 16      | 21       |
| Other income .....                            | 388         | 281          | 407     | 456      |
| Total other revenues .....                    | 62          | 374          | 777     | 634      |
| Operating expenses .....                      | 974         | 891          | 878     | 843      |
| Provision for credit losses .....             | 651         | 402          | 264     | 205      |
| (Loss) income before income tax expense ..... | (685)       | 4            | 442     | 376      |
| Income tax (benefit) expense .....            | (239)       | (17)         | 152     | 103      |
| Net (loss) income .....                       | \$ (446)    | \$ 21        | \$ 290  | \$ 273   |
| <b>2006</b>                                   |             |              |         |          |
| Net interest income .....                     | \$ 794      | \$ 777       | \$ 775  | \$ 735   |
| Trading revenues .....                        | 155         | 52           | 269     | 279      |
| Residential mortgage banking revenue .....    | 40          | 6            | 27      | 23       |
| Securities gains, net .....                   | 13          | 6            | 6       | 4        |
| Other income .....                            | 410         | 550          | 371     | 352      |
| Total other revenues .....                    | 618         | 614          | 673     | 658      |
| Operating expenses .....                      | 876         | 819          | 775     | 785      |
| Provision for credit losses .....             | 237         | 207          | 222     | 157      |
| Income before income tax expense .....        | 299         | 365          | 451     | 451      |
| Income tax expense .....                      | 101         | 121          | 165     | 143      |
| Net income .....                              | \$ 198      | \$ 244       | \$ 286  | \$ 308   |

## **P A R T III**

### ***Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure***

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There were no disagreements on accounting and financial disclosure matters between HUSI and its independent accountants during 2007.

#### ***Item 9A. Controls and Procedures***

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##### **Evaluation of Disclosure Controls and Procedures**

HUSI maintains a system of internal and disclosure controls and procedures designed to ensure that information required to be disclosed by HUSI in reports filed or submitted under the Securities Exchange Act of 1934, as amended, (the Exchange Act), is recorded, processed, summarized and reported on a timely basis. HUSI's Board of Directors, operating through its Audit Committee, which is comprised entirely of independent outside directors, provides oversight to the financial reporting process.

An evaluation was conducted, with the participation of the Chief Executive Officer and Chief Financial Officer, of the effectiveness of HUSI's disclosure controls and procedures as of the end of the period covered by this report. Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that HUSI's disclosure controls and procedures were effective as of the end of the period covered by this report, so as to alert them in a timely fashion to material information required to be disclosed in reports filed under the Exchange Act.

There have been no significant changes in HUSI's internal and disclosure controls or in other factors that could significantly affect internal and disclosure controls subsequent to the date that the evaluation was carried out.

## **Report of Management on Internal Control over Financial Reporting**

March 3, 2008

Management is responsible for establishing and maintaining an adequate internal control structure and procedures over financial reporting as defined in Rule 13a-15(f) of the Securities and Exchange Act of 1934, and has completed an assessment of the effectiveness of HSBC USA Inc.'s ("HUSI's") internal control over financial reporting as of December 31, 2007. In making the assessment, management used the criteria related to internal control over financial reporting described in "Internal Control – Integrated Framework" established by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

Based on the assessment performed, management concluded that as of December 31, 2007, HUSI's internal control over financial reporting was effective.

The effectiveness of HUSI's internal control over financial reporting as of December 31, 2007 has been audited by HUSI's independent registered public accounting firm, KPMG LLP, as stated in their report appearing in Part III Item 9A, Controls and Procedures, herein, which expressed an unqualified opinion of the effectiveness of HUSI's internal control over financial reporting as of December 31, 2007.

/s/ Gerard Mattia

Gerard Mattia  
Chief Financial Officer

/s/ Paul J. Lawrence

Paul J. Lawrence  
Chief Executive Officer

## Report of Independent Registered Public Accounting Firm

The Board of Directors and Shareholders of  
HSBC USA Inc.:

We have audited HSBC USA Inc. and subsidiaries' (the Company) internal control over financial reporting as of December 31, 2007, based on criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Report of Management on Internal Control over Financial Reporting. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2007, based on criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of the Company as of December 31, 2007 and 2006, and the related consolidated statements of income, changes in shareholders' equity, and cash flows for each of the years in the three-year period ended December 31, 2007 and the accompanying consolidated balance sheets of HSBC Bank USA, National Association and subsidiaries as of December 31, 2007 and 2006, and our report dated March 3, 2008 expressed an unqualified opinion on those consolidated financial statements.

/s/ KPMG LLP

New York, New York  
March 3, 2008

***Item 9B. Other Information***

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None.

## ***Item 10. Directors, Executive Officers and Corporate Governance***

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### ***Directors***

Set forth below is certain biographical information relating to the members of HUSI USA Inc.'s Board of Directors as of February 21, 2008. Each director is elected annually. There are no family relationships among the directors.

**Salvatore H. Alfiero**, age 70, joined the HUSI Board in 2000, the HBUS Board in 1996 and the HNAH Board in 2005. Mr. Alfiero has been the Chairman and Chief Executive Officer of Protective Industries, LLC since 2001. He is also a director of Phoenix Companies, Inc., Southwire Company and Fresh Del Monte Produce Company.

Mr. Alfiero is Chair of the Audit Committee and a member of the Nominating & Governance Committee.

**Donald K. Boswell**, age 56, joined the HUSI and HBUS Boards in 2002. Mr. Boswell has been the President and Chief Executive Officer of Western New York Public Broadcasting Association since 1998, and has been in public broadcasting since 1977.

Mr. Boswell is a member of the Fiduciary Committee and the Human Resources & Compensation Committee.

**James H. Cleave**, age 65, joined the HUSI and HBUS Boards in 1991. Mr. Cleave was the President and Chief Executive Officer of HUSI and HBUS from 1993 through 1997. Prior to that, he was President and Chief Executive Officer of HSBC Bank Canada and is currently a director and Vice Chairman of HSBC Bank Canada.

Mr. Cleave is a member of the Audit Committee and the Executive Committee.

**Dr. Frances D. Fergusson**, age 63, joined the HBUS Board in 1990 and the HUSI Board in 2000. She is President Emeritus of Vassar College and served as President from 1986 to 2006. Prior to that, Dr. Fergusson was Provost and Vice President for Academic Affairs, Bucknell University. Dr. Fergusson is also director of Wyeth Pharmaceuticals and Mattel, Inc., and president of the Board of Overseers of Harvard University.

Dr. Fergusson is the Chair of the Human Resources & Compensation Committee and a member of the Nominating & Governance Committee and the Executive Committee.

**Michael F. Geoghegan**, age 54, joined the HUSI and HBUS Boards as Chairman in September 2006. He joined HSBC in 1973 and has been an executive director of HSBC since 2004 and the HSBC Group Chief Executive since May 2006. Mr. Geoghegan served as Chief Executive of HSBC Bank plc from January 2004 to March 2006. He is a director and Chairman of HSBC Bank Canada, a director and Deputy Chairman of HSBC Bank plc and a director of The Hongkong and Shanghai Banking Corporation Limited, HSBC France and HSBC North America Holdings Inc. Mr. Geoghegan is also a non-executive director and Chairman of Young Enterprise UK.

**Stuart T. Gulliver**, age 48, joined the HUSI and HBUS Boards in September 2006. He has been the Chief Executive, Global Banking and Markets (formerly CIBM) and Group Investment businesses for HSBC since May 2006. Mr. Gulliver was appointed as a Group Managing Director and to the Group Management Board in 2004. He served as a Group General Manager from 2000 to 2004. Mr. Gulliver joined HSBC in 1980 and has held a number of key roles in various treasury and capital markets businesses, most recently as Co-Head of Corporate, Investment Banking and Markets (now Global Banking and Markets) from 2003 to 2006 and Head of Global Markets from 2002 to 2003. He is also a director of HSBC Bank plc, The Hongkong and Shanghai Banking Corporation Limited, HSBC Private Banking Holdings (Suisse) SA, and a director and Deputy Chairman of HSBC Trinkaus & Burkhardt AG.



**Richard A. Jalkut**, age 63, joined the HUSI Board in 2000 and the HBUS Board in 1992. Mr. Jalkut is the President and Chief Executive Officer of Telepacific Communications. He was a director of Birch Telecom, Inc. until June 2006. Formerly, he was the President and Chief Executive of Pathnet and, prior to that, President and Group Executive, NYNEX Telecommunications. Mr. Jalkut is also a director of IKON Office Solutions and Covad Communications.

Mr. Jalkut has been Lead Director of HUSI and HBUS since January 2005. He is the Chair of the Executive Committee, the Chair of the Nominating & Governance Committee and a member of the Audit Committee.

**Peter Kimmelman**, age 63, joined the HUSI and HBUS Boards in 2000. Mr. Kimmelman is a private investor and managing member of Peter Kimmelman Asset Management LLC, an investment advisory firm registered with the Securities and Exchange Commission. He was formerly a director of Republic New York Corporation and Republic National Bank of New York from 1976 until 1999.

Mr. Kimmelman is a member of the Audit Committee.

**Paul J. Lawrence**, age 46, joined the HUSI and HBUS Boards and was appointed President and Chief Executive Officer of HUSI and HBUS in 2007. Mr. Lawrence joined HSBC in 1982 and has held numerous positions in Asia and the United Kingdom. He was appointed Head of Global Banking and Markets (formerly CIBM), North America for HUSI and HBUS as of October 1, 2006. Mr. Lawrence held the position of Chief Executive Officer, The Hongkong and Shanghai Banking Corporation Limited, Singapore from 2002 through September 2006 and, prior to that, served as Chief Executive Officer of The Hongkong and Shanghai Banking Corporation Limited, Philippines. Mr. Lawrence has been an HSBC Group General Manager since 2005.

Mr. Lawrence is a member of the Executive Committee.

**Charles G. Meyer, Jr.**, age 70, joined the HUSI and HBUS Boards in 2000. Mr. Meyer is an architect and former President of Cord Meyer Development Company. Mr. Meyer was formerly a director of Republic National Bank of New York from 1987 until 1999.

Mr. Meyer is the Chair of the Fiduciary Committee and a member of the Nominating & Governance Committee.

**James L. Morice**, age 70, joined the HUSI and HBUS Boards in 2000. Mr. Morice has been the President and Chief Executive Officer of Morice Consulting, LLC, successor to the JLM Group LLC, a management consulting firm, since 2006. He was previously Executive Vice President and Director of NationsBuilders Insurance Services, Inc. Mr. Morice was a director of Republic New York Corporation and Republic National Bank of New York from 1987 until 1999 and a member of the Human Resources Committee of the University of New Haven from 2003 through 2005.

Mr. Morice is a member of the Fiduciary Committee and the Human Resources & Compensation Committee.

## *Executive Officers*

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Information regarding the executive officers of HSBC USA Inc. as of February 21, 2008 is presented in the following table.

| <b>Name</b>        | <b>Age</b> | <b>Year Appointed</b> | <b>Present Position</b>  |
|--------------------|------------|-----------------------|--|
| Paul J. Lawrence   | 46         | 2006                  | President and Chief Executive Officer  |
| Janet L. Burak     | 52         | 2004                  | Senior Executive Vice President & General Counsel  |
| Christopher Davies | 45         | 2007                  | Senior Executive Vice President, Commercial Banking  |
| David Dew          | 52         | 2007                  | Senior Executive Vice President & Chief Operating Officer  |
| Mark A. Hershey    | 55         | 2007                  | Senior Executive Vice President & Chief Credit Officer   |
| Gerard Mattia      | 43         | 2007                  | Senior Executive Vice President & Chief Financial Officer  |
| Kevin Newman       | 50         | 2007                  | Senior Executive Vice President, Personal Financial Services   |
| Marlon Young       | 52         | 2006                  | Managing Director, CEO Private Bank Americas   |
| Jeanne G. Ebersole | 46         | 2004                  | Executive Vice President, Human Resources  |
| Mark Martinelli    | 48         | 2007                  | Executive Vice President, Audit  |
| Joseph R. Simpson  | 46         | 2007                  | Executive Vice President & Controller  |
| Carolyn M. Wind    | 54         | 2005                  | Executive Vice President and Managing Director, Specialized Compliance, and Anti-Money Laundering Director and Bank Secrecy Act Compliance Officer |

Janet L. Burak, Senior Executive Vice President & General Counsel HUSI and HBUS since April 2004, and Secretary of HUSI and HBUS from April 2004 until September 1, 2007. In 2007, Ms. Burak was also appointed Regional Compliance Officer North America for HSBC, and Senior Executive Vice President & General Counsel for HNAH. Prior to April 2004, Ms. Burak served as an attorney with HSBC Finance Corporation for twelve years, most recently as Group General Counsel. Prior to joining HSBC Finance Corporation, she was an associate with Shearman & Sterling and an attorney with Citigroup.

Christopher Davies, Senior Executive Vice President, Commercial Banking since February 2007. Prior to this appointment, Mr. Davies was Head of Corporate and Institutional Banking with HSBC Securities (USA) Inc. from 2004 to February 2007. From 2003 to 2004, he was Head of Client Service and Marketing, Global CIB with HSBC Bank plc, and from 2000 to 2003 he was Credit & Banking Services Director with First Direct, Leeds. Mr. Davies has held various senior officer positions in credit, treasury and retail and commercial banking since joining Midland Bank plc, now known as HSBC Bank plc, in 1985.

David Dew, Senior Executive Vice President & Chief Operating Officer since March 2007. He served as Chief Administrative Officer for HUSI from February to March 2007 and as Senior Executive Vice President, Audit for HUSI and HSBC North America Inc. (HNAI) from January 2006 to February 2007. Prior to this appointment, Mr. Dew served as Chief Auditor, Group Audit, HSBC Finance Corporation from November 2004 to December 2005. He was Executive Director & Chief Operating Officer, The Saudi British Bank, Riyadh, Saudi Arabia from March 2001 to November 2004; Deputy Chief Executive Officer, The Hongkong and Shanghai Banking Corporation Limited, Singapore from September 1997 to March 2001; and Chief Executive Officer, HSBC Bank plc, Milan, Italy from November 1994 to September 1997. Mr. Dew has been an HSBC employee since 1977.

Mark A. Hershey, Senior Executive Vice President & Chief Credit Officer since May 2007. Prior to this appointment Mr. Hershey was Senior Executive Vice President, Co-Head Chief Credit Officer, from February to May 2007, and previously Senior Executive Vice President, Commercial Banking from 2005 to 2007 and Executive Vice President, Commercial Banking from 2000 to 2005. Mr. Hershey was a senior officer of Republic National Bank of New York when it was acquired by HSBC in December 1999.

Gerard Mattia, Senior Executive Vice President & Chief Financial Officer since March 2007. Prior to that, Mr. Mattia was Managing Director, Chief Financial Officer, CIBM North America, for HUSI and HBUS since 2004. Prior to joining HSBC, he held various positions within Bank of America, most recently as Chief Operating Officer, Quick & Reilly, during 2004 and as Chief Financial Officer, Quick & Reilly/Fleet Securities, Inc., from 2001 to 2004.

Kevin Newman, Senior Executive Vice President, Personal Financial Services, since April 2007 and previously Group General Manager, Personal Financial Services since October 2006. Prior to that, Mr. Newman served as Senior Executive Vice President, Personal Financial Services from September 2005 to October 2006 and as Executive Vice President, Personal Financial Services from December 2003 to September 2005. Prior to that, he served as Head of hsbc.com.

Marlon Young, Managing Director, CEO Private Bank Americas since October 2006. Mr. Young joined HSBC as Managing Director and Head of Domestic Private Banking for HBUS in March 2006. He served as Managing Director and Head of Private Client Lending for Smith Barney from 2004 through 2006. Prior to that, Mr. Young held various positions with Citigroup from 1979, most recently as Managing Director and Head of Citigroup Private Bank (Northeast Region) from 2000 through 2004.

Jeanne G. Ebersole, Executive Vice President, Human Resources since May 2004. Prior to this appointment, Ms. Ebersole had overall human resources responsibility for HSBC Finance Corporation's retail services, insurance services and refund lending businesses since August 2002. She held a variety of human resources positions after joining HSBC Finance Corporation in 1980.

Mark Martinelli, Executive Vice President, Audit since March 2007. Prior to that, Mr. Martinelli was President and Chief Executive Officer of hsbc.com since 2006, and Chief Financial Officer of hsbc.com from 2002 to 2006. Mr. Martinelli joined HSBC as part of Republic National Bank of New York in 1991, and has held various senior officer positions in Audit and Finance. Prior to joining HSBC, he was a senior manager with the public accounting firm of KPMG.

Joseph R. Simpson, Executive Vice President & Controller since April 2007. He was previously Controller and Chief Accounting Officer for HUSI and HBUS from 2003 to 2006. Prior to that, he held the positions of the Director of Management Information, the Manager of External Reporting and previous to that, Manager of Accounting Policy. Mr. Simpson has been with HUSI for over nineteen years.

Carolyn M. Wind, Executive Vice President and Managing Director, Specialized Compliance, and Anti-Money Laundering Director and Bank Secrecy Act Compliance Officer since April 2007. She served as Executive Vice President, Compliance from 2005 to April 2007. Ms. Wind was the Chief Compliance Officer for Republic New York Corporation when it was acquired by HSBC in December 1999. Prior to joining Republic New York Corporation, she was a senior national bank examiner with the Office of the Comptroller of the Currency (OCC).

## ***Corporate Governance***

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### ***Section 16(a) Beneficial Ownership Reporting Compliance***

Section 16(a) of the Exchange Act, as amended, requires our directors, executive officers and any persons who own more than 10 percent of a registered class of our equity securities to report their initial ownership and any subsequent change to the SEC and the New York Stock Exchange (“NYSE”). With respect to the issues of HUSI preferred stock outstanding, we reviewed copies of all reports furnished to us and obtained written representations from our directors and executive officers that no other reports were required. Based solely on a review of copies of such forms furnished to us and written representations from the directors and executive officers, all Section 16(a) filing requirements were complied with for the 2007 fiscal year.

## ***Board of Directors – Committees and Charters***

The Board of Directors of HSBC USA Inc. has five standing committees: the Audit Committee, the Executive Committee, the Fiduciary Committee, the Human Resources & Compensation Committee and the Nominating & Governance Committee. The charter of each of these committees, as well as the HSBC USA Inc. Corporate Governance Standards, are available upon written request to HSBC USA Inc., 452 Fifth Avenue, New York, New York 10018, Attention: Corporate Secretary.

### *Audit Committee*

The primary purpose of the Audit Committee is to assist the Board of Directors in fulfilling its oversight responsibilities relating to HUSI's system of internal controls over financial reporting and its accounting, auditing and financial reporting practices. The Audit Committee is currently comprised of the following independent directors (as defined by HSBC USA Inc.'s Corporate Governance Standards, which are based upon the rules of the New York Stock Exchange): Salvatore H. Alfiero (Chair), James H. Cleave, Richard A. Jalkut and Peter Kimmelman. The Board of Directors has determined that each of these individuals is financially literate. The Board of Directors has also determined that Messrs. Alfiero and Cleave qualify as Audit Committee financial experts.

### *Executive Committee*

The Executive Committee may exercise the powers and authority of the Board of Directors in the management of HUSI's business and affairs during the intervals between meetings of the Board of Directors. The Executive Committee is currently comprised of the following directors: Richard A. Jalkut (Chair and Lead Director), James H. Cleave, Dr. Frances D. Fergusson and Paul J. Lawrence.

### *Fiduciary Committee*

The primary purpose of the Fiduciary Committee is to supervise the fiduciary activities of HBUS to ensure the proper exercise of its fiduciary powers in accordance with 12 U.S.C. §92a – Trust Powers of National Banks and related regulations promulgated by the Office of the Comptroller of the Currency. The Fiduciary Committee is currently comprised of the following directors: Charles G. Meyer, Jr. (Chair), Donald K. Boswell and James L. Morice. All members of the Fiduciary Committee are independent directors under HSBC USA Inc.'s Corporate Governance Standards.

### *Human Resources & Compensation Committee*

The primary purpose of the Human Resources & Compensation Committee is to assist the Board of Directors in discharging its responsibilities related to the compensation of the Chief Executive Officer, other officers of HUSI holding a title of executive vice president and above and such other officers as may be designated by the Board of Directors. The Human Resources & Compensation Committee is currently comprised of the following directors: Dr. Frances D. Fergusson (Chair), Donald K. Boswell and James L. Morice. All members of the Human Resources & Compensation Committee are independent directors under HSBC USA Inc.'s Corporate Governance Standards.

The Charter of the Human Resources & Compensation Committee lists the primary responsibilities, powers and authorities of the committee. The listed items include: (i) review and approval of corporate goals and performance objectives relevant to the compensation of the Chief Executive Officer and certain other executive officers, evaluate the performance of the Chief Executive Officer and other executive officers in light of those goals and objectives, and review its findings with the Board of Directors in executive session; (ii) submit recommendations concerning base salary, performance-based cash and long-term equity-based incentive awards for the Chief Executive Officer and other executive officers to the Remuneration Committee of HSBC ("REMCO") for approval; (iii) recommend to REMCO equity incentives under HSBC plans to all employees, except those awards that the Chief Executive Officer may determine based upon a delegation of authority by REMCO; (iv) review and approve benefits and perquisites of the Chief Executive Officer and other executive officers to the extent such benefits are not available

to all employees; (v) review and recommend to REMCO any employment and severance arrangements for the Chief Executive Officer and other executive officers, as well as any severance payouts to such officers; (vi) review and consider "best practices" of peer companies with respect to compensation philosophies, policies and practices; (vii) review management's Compensation Discussion and Analysis ("CD&A") to be included in HUSI's Annual Report on Form 10-K, discuss the CD&A's content with management, and prepare the Compensation Committee Report concerning the CD&A and recommend to the Board of Directors that the CD&A be included in the Annual Report on Form 10-K; and (viii) engage in an annual self assessment with the goal for continuing improvement, and review and assess the adequacy of this charter at least annually and recommend any proposed changes to the Board of Directors for approval.

The Human Resources & Compensation Committee may in its discretion retain and discharge consultants to assist the committee in evaluating director, Chief Executive Officer or other executive officer compensation and to determine the appropriate terms of engagement and the fees to be paid to such consultants. The Chief Executive Officer is given full authority, which may be delegated, to establish the compensation and salary ranges for all other employees of HUSI and its subsidiaries whose salaries are not subject to review by the Human Resources & Compensation Committee and approval by REMCO. For more information about HUSI's compensation policies and programs, please see *Item 11. Executive Compensation - Compensation Discussion and Analysis*.

#### *Nominating & Governance Committee*

The primary purpose of the Nominating & Governance Committee is to assist the Board of Directors of HUSI in discharging its responsibilities related to identifying and nominating members of the Board of Directors to the Board, recommending to the Board the composition of each committee of the Board and the Chair of each committee, establishing and reviewing HUSI's corporate governance and making recommendations to the Board regarding compensation for service of the non-executive Board members. The Nominating & Governance Committee ensures that HUSI maintains "best practices" with respect to corporate governance in order to ensure effective representation of its stakeholders.

The Nominating & Governance Committee is currently comprised of the following directors: Richard A. Jalkut (Chair), Salvatore H. Alfiero, Dr. Frances D. Fergusson and Charles G. Meyer, Jr. All members of the Nominating & Governance Committee are independent directors under HSBC USA Inc.'s Corporate Governance Standards.

#### *Code of Ethics*

HUSI has adopted a code of ethics that is applicable to its chief executive officer, chief financial officer, chief accounting officer and controller, which is incorporated by reference to Exhibit 14 of this Form 10-K. HUSI also has a general code of ethics applicable to all employees that is referred to as its Statement of Business Principles and Code of Ethics. Both documents are available upon written request made to HSBC USA Inc., 452 Fifth Avenue, New York, New York 10018, Attention: Corporate Secretary.

### ***Item 11. Executive Compensation***

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#### *Compensation Discussion and Analysis*

The following compensation discussion and analysis (the "2007 CD&A") summarizes the principles, objectives and factors considered in evaluating and determining the compensation of HUSI's executive officers in 2007. Specific compensation information relating to HUSI's Chief Executive Officer (the "HUSI CEO") and Chief Financial Officer, a former Chief Executive Officer, who left HSBC in February 2007, a former Chief Financial Officer, who left that position in March 2007, and the next three most highly compensated executives is contained in this portion of the Form 10-K.

## *Oversight of Compensation Decisions*

### *Role of HSBC Holdings plc's Remuneration Committee and HSBC CEO*

HUSI is a wholly owned subsidiary of HSBC Holdings plc ("HSBC"). The Board of Directors of HSBC has the authority to delegate any of its powers, authorities and judgments to any committee consisting of one or more directors, and has established a Remuneration Committee ("REMCO") for the purpose of setting the remuneration policy for HSBC and remuneration of the more senior executives whose appointment requires HSBC Board of Directors' approval.

Compensation packages (including base salary, incentive awards and any long-term incentive awards) for certain senior executives whose appointment requires HSBC Board of Directors' approval are initially determined by Mr. Michael F. Geoghegan, the HSBC Group Chief Executive (the "HSBC CEO"). The HSBC CEO then forwards his determinations to REMCO which reviews the determinations to ensure they are in line with the remuneration policy for HSBC and if they are, it endorses those determinations.

In November 2006, REMCO delegated its authority for endorsement of base salaries and annual cash incentive awards relating to certain classes of executives to the HSBC CEO. Pursuant to a further delegation of authority from the HSBC CEO, Stuart T. Gulliver, HSBC Managing Director and Head of Global Banking and Markets, has approval authority over certain executives within the Global Banking and Markets businesses. However, REMCO retained exclusive authority to endorse base salaries and annual cash incentive award recommendations for the more senior executives within HSBC and its subsidiaries. REMCO also has exclusive authority with respect to all long-term incentive plans involving interests in HSBC ordinary shares. As a result, REMCO had final authority over the compensation recommendations made by the HSBC CEO in respect of Messrs. Lawrence and Newman and Ms. Derickson in 2007.

The members of REMCO in 2007 were Sir Mark Moody-Stuart (Chairman), William K.L. Fung (until May 2007), Sharon Hintze (until May 2007), Gwyn Morgan (as of May 2007) and J.D. Coombe, all of whom were or are non-executive directors of HSBC. REMCO has retained the services of Mercer Limited as advisers on matters of corporate governance, and Towers Perrin, a human resource consulting firm, to provide independent advice on global executive compensation issues.

### *Role of HUSI's Compensation Committee and Human Resources Executives*

The Human Resources and Compensation Committee of the Board of Directors of HUSI (the "Compensation Committee") generally seeks to ensure that HUSI's compensation policies and practices support the objectives of HUSI's compensation program, which are based upon the compensation strategy established by REMCO. As described below, in establishing executive compensation packages for 2007, other than for Mr. Lawrence, whose 2007 compensation was determined by the HSBC CEO, Ms. Derickson, whose 2007 compensation was determined pursuant to an employment agreement in effect at the time, Mr. Mattia, whose initial 2007 compensation was approved by the Head of Global Banking and Markets, and Mr. McKenna whose 2007 compensation was approved by the HUSI CEO, the Compensation Committee reviewed and endorsed advisory recommendations proposed by the HUSI CEO in consultation with HUSI Human Resources executives to HSBC's Group General Manager of Human Resources for submission to the HSBC CEO. In the case of Messrs. Lawrence and Newman and Ms. Derickson, the HSBC CEO recommended final remuneration under each element of compensation, including base salary and cash incentive awards, to REMCO and REMCO endorsed the awards. In the case of Ms. Burak and Mr. Dew, the HSBC CEO approved the awards. Additional information with regard to the Compensation Committee, including a description of the committee's responsibilities under its charter, is contained in the section of this Form 10-K entitled *Item 10. Directors, Executive Officers and Corporate Governance – Corporate Governance*.

Compensation for Sandra L. Derickson, the Chief Executive Officer of HUSI until February 20, 2007, was established pursuant to the terms of an employment agreement with HSBC Finance Corporation, which is described under *Compensation of Officers Reported in the Summary Compensation Table* below. Accordingly, the Compensation Committee did not review or make recommendations with respect to Ms. Derickson's compensation for 2007.

HUSI Human Resources executives consulted with Ms. Derickson in preparing 2007 annual compensation packages for executives holding a title of executive vice president and above (other than the Chief Executive Officer), including Ms. Burak and Messrs. Dew, McKenna and Newman. These compensation packages were also reviewed by Siddharth N. Mehta, the Chief Executive Officer of HNAH at the time. Any revisions to a compensation package recommended by the Chief Executive Officer of HNAH were reviewed and considered by the HUSI CEO prior to the package being submitted to the Compensation Committee for review. Following the departure of Mr. Mehta in February 2007, HNAH did not appoint a successor as Chief Executive Officer of HNAH until February 2008. Since February 2007, the Chief Operating Officer of HNAH performed the responsibilities with respect to compensation previously performed by the Chief Executive Officer of HNAH.

The Compensation Committee reviewed the compensation packages submitted to it, and approved or requested revisions to one or more of the components of annual compensation. The packages included recommendations for base salaries and advisory recommendations for preliminary performance-based cash awards and equity-based long-term incentive awards. Comparator and market data gathered by HNAH Human Resources executives was referenced by the Compensation Committee to evaluate the competitiveness of proposed executive compensation. The compensation packages, which consisted of Ms. Derickson's recommendations concerning each of Ms. Burak and Messrs. Dew and Newman, as approved or modified by the Chief Executive Officer of HNAH and Compensation Committee, and the Compensation Committee's recommendation with respect to Ms. Derickson's compensation, were forwarded to HSBC Human Resources management for submission to REMCO and the HSBC CEO, as appropriate. The compensation package with respect to Mr. McKenna, as approved or modified by the Compensation Committee, was submitted to the Chief Executive Officer of HNAH.

The HSBC CEO reviewed the 2007 compensation recommendations provided by the Compensation Committee, including incentive awards relating to 2006 performance, and forwarded the recommendations to REMCO for endorsement. The HSBC CEO was provided with comparator information from Towers Perrin based on the following peer group: American Express Company, Bank of America Corporation, Barclays, BNP Paribas, Capital One Financial, Citigroup, Inc., Countrywide Financial Corporation, FifthThird Bancorp, Deutsche Bank, National City Corporation, Royal Bank of Scotland, JP Morgan Chase, Santander, UBS, Royal Bank of Canada, US Bancorp, Wachovia Corporation, and Wells Fargo & Company (collectively, the "Comparator Group"). Comparator and market data was referenced by the HSBC CEO to evaluate the competitiveness of proposed executive compensation. As the performance-based cash awards were dependent upon satisfaction of objectives that could not be evaluated until the end of the performance measurement year (i.e., 2007), the final determination of this component of compensation was not made until the HSBC CEO and the Chief Operating Officer of HNAH received reports from management concerning satisfaction of corporate, business unit and individual objectives in January 2008. REMCO, the HSBC CEO or the Chief Operating Officer of HNAH, as appropriate, approved or revised the advisory recommendations provided by the Compensation Committee.

The terms of compensation for Mr. McKenna were agreed by the Chief Financial Officer of HNAH, in consultation with HUSI Human Resources executives, and were approved by the HUSI CEO.

Within the Global Banking and Markets businesses, senior executives prepared annual compensation package recommendations for executive officers within their business units. Accordingly, the discretion and judgment of senior management played a much more significant role in establishing appropriate compensation packages to be included in advisory recommendations to REMCO or the Head of Global Banking and Markets, as appropriate. As is the case for HUSI generally, however, performance-based cash awards are dependent upon performance of the individual, the local business unit and the business globally and, accordingly, cannot be determined until the end of the performance measurement year.

Mr. Lawrence succeeded Ms. Derickson as Chief Executive Officer on February 21, 2007. Prior to that date, Mr. Lawrence served as the Head of Global Banking and Markets, North America. The initial terms of Mr. Lawrence's 2007 compensation were endorsed by REMCO on the basis of advisory recommendations provided by the Head of Global Banking and Markets.

Mr. Mattia succeeded Mr. McKenna as Chief Financial Officer on March 27, 2007. Prior to that date, Mr. Mattia served as Chief Financial Officer for Global Banking and Markets, North America. The initial terms of Mr. Mattia's 2007 compensation were proposed by Mr. Lawrence, then Head of Global Banking and Markets, North America, and approved by the Head of Global Banking and Markets.

### ***Objectives of HUSI's Compensation Program***

HUSI's compensation program is designed to support the successful recruitment, development and retention of high performing executive talent and to provide incentive to those executives to achieve HUSI's short-term business objectives and to optimize its long-term financial returns. We focus on total compensation rather than individual elements of pay. HUSI's compensation program is designed to be competitive with the benchmark financial institutions included in the Comparator Group, which is comprised of U.S.-based organizations that compete with us for business, customers and executive talent. While most of these organizations are publicly-held companies, HUSI's operations are of comparable scale and complexity. Accordingly, HUSI's compensation program is designed to provide the flexibility to offer compensation that is competitive with the Comparator Group so that we may attract and retain the highest performing executives.

The philosophy underlying HUSI's executive compensation program, which is designed to promote the compensation strategy of our parent, HSBC, is discussed below. Across businesses, individual compensation recommendations reflect HSBC's strong stance with respect to diversity and equal opportunity for all employees within the context of meritocracy and performance.

### ***Link to Company Performance***

We seek to offer competitive base salaries with a significant portion of variable compensation components determined by measuring performance of the executive, his or her respective business unit, HUSI and HSBC. The performance-based cash compensation plans, which are more fully described under *Elements of Compensation – Annual Performance-Based Awards*, emphasize revenue and expense growth, profits and other key performance measures. Other considerations taken into account in setting compensation policies and making compensation decisions include demonstrated leadership, future potential, adherence to HSBC's ethical standards and the ability to leverage capabilities across businesses. Corporate, business unit and/or individual goals are established at the beginning of each year.

Compensation plans motivate our executives to improve the overall performance and profitability of HSBC as well as the specific region, unit or function to which they are assigned. Each executive's individual performance and contribution is considered in making salary adjustments and determining the amount of annual performance bonus paid and the value of HSBC equity-based awards granted each year.

In 2005, HSBC began to award long-term incentive share awards, called "Restricted Shares," which vest on a specified date if the executive remains employed through that date, and "Performance Shares," which require continued employment and satisfaction of corporate performance conditions designed to reinforce a long-term focus on HSBC's business strategy and delivering value to its shareholders. Performance Share awards may be granted to the most senior executives whose business units have the ability to have a direct impact on HSBC's consolidated results. Restricted Share awards may be granted to other high performing executives.



### ***Competitive Compensation Levels and Marketplace Research***

HUSI endeavors to maintain a compensation program that is competitive. We operate in a highly competitive business environment, in which our Comparator Group and other financial services companies continuously look to gain market share and competitive advantage by hiring top executive talent. On an annual basis, and as needed when recruiting, we compare the compensation for our executive officers to that of executives with similar responsibilities for companies of similar industry, size and complexity.

We research the types of compensation programs provided by other companies, compensation levels for executives, details of certain compensation programs, marketplace compensation trends, marketplace practices regarding compensation mix, stock vesting terms, equity ownership levels, the amount of compensation that is derived from equity incentives and the benefits provided to executives. We also research different aspects of performance, including the relationship between performance and compensation, a comparison of HUSI's historical performance to our Comparator Group and types of performance measures that are used by other companies for their annual and long-term incentive programs. In 2007, the Compensation Committee considered comparative data from general industry surveys of non-financial services companies and of financial services companies, which included members of our Comparator Group, and research data gathered from several different sources, including general surveys of the marketplace and through retained compensation consultants including Towers Perrin.

HUSI's 2007 compensation program generally provided executives with the opportunity to earn a base salary that was targeted near the median of the market. We believe this represented a competitive base salary for meeting general business objectives. Total compensation, which includes incentive awards, was also targeted to be in the 50th percentile if HUSI and the executive met established performance goals, with the possibility of reaching the 75th percentile based on HUSI's, HSBC's and the executive's performance. This provided greater incentive to achieve higher performance standards and the specific compensation strategy established by REMCO. The level of compensation paid to an executive from year to year will differ based on performance. This year-to-year difference stems mainly from HUSI's and/or an individual business unit's performance results and, for individuals eligible for performance-based equity awards, awards may vary based upon HSBC's performance results. Compensation levels will also increase or decrease based on the executive's individual performance and level of responsibility.

### ***Global Banking and Markets***

The philosophies underlying the compensation programs employed in the Global Banking and Markets businesses are consistent with the philosophy described above for HUSI generally, but there are some specific variations in the compensation methodologies that are employed.

The overall approach for these businesses involves a carefully managed approach to tracking of compensation expense throughout the year in relation to business performance and planned overall expenditure on staff costs. This is combined with a year-end pay review process that takes careful account of market pay methods, levels and trends, as well as the actual levels of business and individual performance that are achieved. The year-end pay review process is itself subject to review and approval by HSBC senior management and endorsement by REMCO.

The approach to regular bonus accrual is agreed with the Head of Global Banking and Markets and the Group Finance Director, and updated at intervals to reflect changes in the competitive market. This agreement covers factors such as the proportion of pre-tax profit that may be allocated to the bonus pool for each business, taking into account aspects such as the maturity and complexity of each business and also considering any appropriate geographical variations. Annual operating plans for each business cover monthly accrual of the planned bonus amounts. Development of these accruals against the agreed parameters is reviewed at intervals during each year with the Group Finance Director.

At year end, the compensation levels within each business reflect individual contribution, business unit performance and the competitive pay market. In addition, compensation within the Global Banking and Markets businesses also reflects the overall (i.e., global) results of the respective business. Base salary and incentive compensation (bonus) are sized within the context of a total compensation package that is intended to be appropriately market competitive, but these businesses apply a much less formulaic approach to the use of comparative market data than is typical in some other parts of HUSI and HSBC. Compensation proposals are based upon careful benchmarking of individual executives in the correct competitive context, making use of independently compiled studies of market pay levels, methods and trends. These studies are conducted by external advisors with in-depth knowledge of the business areas concerned and they allow careful verification against market of the compensation levels and methodologies for executives in these businesses. In light of this information, senior management carefully considers and interprets the performance of each business, and of Global Banking and Markets globally, relative to the performance of key competitors. Individual performance is assessed relative to performance in a market context to ensure that each executive is correctly positioned against market. Global Banking and Markets targets appropriate groups of competitors for each business so that the total compensation for each executive can be correctly positioned within the overall market range, ensuring a high degree of differentiation towards the very best performers. Senior management also uses market data in a similar way when designing appropriate recruitment and retention initiatives.

The compensation programs within the Global Banking and Markets businesses are designed to support the successful recruitment, development and retention of high performing executive talent and to provide incentive to those executives to maximize the performance of their respective businesses. Within the context of the total compensation package, performance-related adjustments emphasize variable pay (i.e., discretionary bonus awards) over fixed pay (i.e., base salary). As described above, bonus awards are differentiated significantly towards the very best performers and careful attention is also paid to those executives whose retention is regarded as critical to the business. For those executives receiving large bonus awards, a significant portion of the award is paid in the form of Restricted Shares that vest over three years provided the individual remains employed with HSBC, thus encouraging retention of the best performers. The proportion of bonus that is deferred varies to some extent between specific businesses but the typical approach is to apply a “tax table” so that increasing proportions of a bonus will be deferred above clearly defined hurdles. The maximum proportion of bonus to be deferred within Global Banking and Markets is normally 50 percent. The proportion of bonus to be deferred and the related vesting periods are positioned against competitive market practice using information provided by the external advisors referenced above.

### ***Repricing of Stock Options and Timing of Option Grants***

For HSBC discretionary option plans, the exercise price of awards made in 2003 and 2004 was the higher of the average market value for HSBC ordinary shares on the five business days preceding the grant date or the market value on the date of the grant.

HSBC also offers employees a plan in which options to acquire HSBC ordinary shares are awarded when an employee commits to contribute up to 250 GBP (or the equivalent) each month for one, three or five years. At the end of the term, the accumulated amount, plus interest, may be used to purchase shares under the option, if the employee chooses to do so. The exercise price for such options is the average market value of HSBC ordinary shares on the five business days preceding the date of the invitation to participate, less a 15 to 20 percent discount (depending on the term).

HUSI does not, and our parent, HSBC, does not, reprice stock option grants. In addition, neither HUSI nor HSBC has ever engaged in the practice known as “back-dating” of stock option grants, nor have we attempted to time the granting of historical stock options in order to gain a lower exercise price.

### ***Dilution from Equity-Based Compensation***

While dilution is not a primary factor in determining award amounts, there are limits to the number of shares that can be issued under HSBC equity-based compensation programs. These limits were established by vote of HSBC's shareholders in 2005.

### ***Perquisites***

HUSI's philosophy is to provide perquisites that are intended to help executives be more productive and efficient or to protect HUSI and its executives from certain business risks and potential threats. Our review of competitive market data indicates that the perquisites provided to executives are reasonable and within market practice. See the Summary Compensation Table below for further information on perquisites awarded to HUSI executives.

### ***Retirement Benefits***

HNAH offers a pension retirement plan in which HUSI executives may participate that provides a benefit equal to that provided to all eligible employees of HUSI with like dates of hire. However, both qualified and non-qualified defined benefit plans are maintained so that this level of pension benefit can be continued without regard to certain Internal Revenue Service limits. Executives and certain other highly compensated employees can elect to participate in a non-qualified deferred compensation plan, where such employees can elect to defer the receipt of earned compensation to a future date. We also maintain a qualified 401(k) plan with company matching contributions. Ms. Derickson and Ms. Burak, as former executives of HSBC Finance Corporation, also participate in a non-qualified deferred compensation plan that provides executives and certain other highly compensated employees with a benefit measured by the company matching contribution that could not be allocated to the 401(k) plan because of certain Internal Revenue Service limits. As international managers, Mr. Lawrence and Mr. Dew are accruing pension benefits under a foreign-based defined benefit plan that includes member contributions. Additional information concerning this plan is contained below in this 2007 CD&A in the table entitled Pension Benefits. HUSI does not pay any above-market or preferential interest in connection with deferred amounts.

### ***Employment Contracts and Severance Protection***

There are no employment agreements between HUSI and its executive officers. Prior to her departure in February 2007, Ms. Derickson had an employment agreement with HSBC Finance Corporation, pursuant to which she was to serve as President and Chief Executive Officer of HUSI until March 28, 2008. However, upon Ms. Derickson's resignation, the employment agreement was terminated and replaced with a separation agreement, the terms of which are described under Compensation of Officers Reported in the Summary Compensation Table below.

### ***Accounting Considerations***

HUSI adopted the fair value method of accounting under Statement of Financial Accounting Standards No. 123 (revised 2004), "Share Based Payment" (SFAS 123(R)) effective January 1, 2006. SFAS 123(R) applies to all equity instruments granted to employees beginning January 1, 2006 and does not apply to awards granted in prior periods before the effective date, except to the extent that prior periods' awards are modified, repurchased or cancelled after the required effective date. Prior to 2006, HUSI adopted the fair value method of accounting prospectively in 2002 for all new equity instruments granted to employees as provided under Statement of Financial Accounting Standards No. 148, "Accounting for Stock-Based Compensation - Transition and Disclosure (an amendment of FASB Statement No. 123)." The Board of Directors believes that this treatment reflects greater accuracy and transparency of the cost of these incentives and promotes better corporate governance.

## ***Tax Considerations***

Limitations on the deductibility of compensation paid to executive officers under Section 162(m) of the Internal Revenue Code are not applicable to HUSI, as it is not a public corporation as defined by Section 162(m). As such, all compensation to our executive officers is deductible for federal income tax purposes, unless there are excess golden parachute payments under Section 4999 of the Internal Revenue Code following a change in control.

## ***Elements of Compensation***

The primary elements of executive compensation are base salary, annual non-equity performance-based awards, and long-term equity-based incentives. In limited circumstances, discretionary bonuses may also be awarded. While the base salary is generally fixed and not subject to fluctuation, the size of the cash incentive and amount of equity compensation an individual receives is discretionary. HSBC conducts an internal comparison of its executives globally, and then compares business performance relative to the market. In addition, executives are eligible to receive company funded retirement benefits that are offered to employees at all levels who meet the eligibility requirements. Perquisites are not a significant component of compensation. As discussed above in the section entitled *Oversight of Compensation Decisions*, in establishing executive compensation packages for 2007, other than for Messrs. Lawrence, Mattia and McKenna and Ms. Derickson, the Compensation Committee provided advisory recommendations to HSBC's Group General Manager of Human Resources for submission to the HSBC CEO, the HSBC CEO either approved the awards or further recommended final remuneration under each element of compensation to REMCO and REMCO endorsed the awards. The HSBC CEO based his decision on what he considered was an appropriate balance between performance-based compensation and other forms of compensation, the level of responsibility and individual contribution of the executive and competitive practice in the marketplace for executives from companies of similar industry, size and complexity as HUSI.

HSBC's philosophy is to focus on total compensation versus the individual elements of pay. HSBC has adopted a market-driven orientation that strives to leverage variable pay to motivate outstanding business results. We have implemented a process that aids in determining final total individual pay based on an evaluation of business performance against goals, individual performance, and a comparison against the marketplace. Individual total compensation for each of our executives is targeted at the 50<sup>th</sup> percentile, and adjusted upward or downward based on performance.

Within the Global Banking and Markets businesses, the allocation of compensation between base salary and incentive compensation, as well as between long-term and short-term incentives, is recommended by senior management and reviewed and approved by the Head of Global Banking and Markets and, if appropriate, the HSBC CEO, and, if appropriate, endorsed by REMCO. As further described below, short-term incentive awards include cash awards under each business's discretionary bonus program. Long-term incentives include the deferral of a portion of discretionary bonus awards through HSBC equity-based awards. In establishing executive compensation packages, remuneration under each element is based on what is believed to be an appropriate balance between performance-based compensation and other forms of compensation, the level of responsibility and individual contribution of the executive, business unit performance and overall Global Banking and Markets results.

## ***Base Salary***

Base salary is reviewed annually and increases, if any, are based on individual performance and market position. When establishing base salaries for executives, consideration is given to compensation paid for similar positions at companies included in compensation surveys and HUSI's Comparator Group, targeting the 50<sup>th</sup> percentile, which, when combined with significant performance-based compensation opportunities, enables HUSI to attract and retain high performing executives. In addition, other factors such as individual and corporate performance, potential for future advancement, specific job responsibilities, length of time in current position, individual pay history, and comparison to comparable internal positions (internal equity) influences the final base salary recommendations for individual executives.

Within the Global Banking and Markets businesses, annual salary increases must be accommodated within the annual operating plan for the business globally. Accordingly, salary increases proposed by senior management are prioritized towards high performing employees and those who have demonstrated rapid development. Proposals for salary increases are justified against performance and with reference to local market rates, where available. While individual performance is assessed relative to performance in a market context to ensure that the executive is correctly positioned within the market range, the Global Banking and Markets businesses generally do not apply formulaic rates in determining compensation, but rely more on the discretion and judgment of senior management in the context of performance relative to key competitors of that business.

### *Annual Performance-Based Awards*

Annual non-equity performance-based awards are paid in cash upon satisfaction of individual, business unit, corporate financial and operational goals. Superior performance is encouraged by placing a significant part of the executive's total compensation at risk. In the event certain quantitative or qualitative performance goals are not met, annual non-equity performance awards may be less than the maximum permitted.

Performance goals are set based on prior year's performance, expectations for the upcoming year, HUSI's annual business plan, HSBC's business strategies, and objectives related to building value for HSBC shareholders. This is consistent with the strategy of targeting individual total compensation for each of HUSI's executives at the 50th percentile, and adjusting it upward or downward based on the factors mentioned above.

In support of the pay-for-performance philosophy, HUSI has an annual non-equity performance-based award program entitled the Management Incentive Program. The Management Incentive Program is an annual cash incentive plan that uses quantitative and qualitative goals to motivate HUSI employees who have a significant role in the corporation and do not participate in another incentive compensation plan. The quantitative objectives may include meeting designated financial performance targets for the company and/or the executive's respective business unit. Qualitative objectives may include key strategic business initiatives or projects for the executive's respective business unit. The qualitative objective goals may also include cross-business initiatives that create revenue, leverage talent across businesses and share and support execution of "best practices" and/or adopt another business' "best practice." Historically, award opportunity and payouts were determined as a percentage of base salary and based on comparison to other internal comparable positions (internal equity) and external market practices. In 2007, HUSI began to move away from compensation based on specific objectives defined within the Management Incentive Program and towards more discretionary and performance-based pay. Accordingly, while quantitative and qualitative objectives may have provided some guidance with respect to 2007 compensation, discretion played a much more prominent role in establishing compensation packages for HUSI's senior executives than in previous years. This is reflected in the discussions of 2007 compensation packages for the executive officers listed in the Summary Compensation Table below. Cash incentive awards under the Management Incentive Program are paid in February of the year following the measurement year.

Within the Global Banking and Markets businesses, all regular employees are eligible for consideration for a discretionary bonus award. Final bonus recommendations are determined after full year results are available and are evaluated within the context of the performance of each business unit, including, where relevant, economic profit at the regional and global levels and compensation proposals for all business units within Global Banking and Markets. In conjunction with an assessment of the executive's individual performance, senior management may consult market surveys to assist in identifying both market pay levels and factors influencing pay (i.e., product, market, length of service, etc.). However, as is the case with other components of compensation, more reliance is placed on the discretion and judgment of senior management in the context of performance relative to key competitors than on a mechanical application of market rates.

### *Long-term Incentives*

Long-term incentive compensation is awarded through grants of HSBC equity instruments. The purpose of equity-based incentives is to help HSBC attract and retain outstanding employees and to promote the growth and success of HUSI's business over a period of time by aligning the financial interests of these employees with those of HSBC's shareholders.

Historically, equity incentives were awarded through stock options and restricted share grants. Prior to 2005, options on HSBC ordinary shares were granted to certain executives and restricted shares to others. Awarded options have an exercise price equal to the greater of the average market value of HSBC ordinary shares on the five business days prior to the grant of the option and the market value of HSBC ordinary shares on the grant date. Options without a performance condition typically vest in three, four or five equal installments, subject to continued employment, and expire ten years from the grant date. However, certain options awarded to key executives had a "total shareholder return" performance vesting condition and only vest if and when the condition is satisfied. No stock options were granted to executive officers in 2005, 2006 or 2007 as HSBC shifted to Restricted Share and Performance Share grants for equity-based compensation.

Awarding restricted shares is another form of long-term incentive compensation utilized to compensate and provide incentive to our employees. When restricted shares are granted to an executive officer, the underlying shares are held in a trust for the benefit of the employee and are released only after the defined vesting conditions are met at the end of the holding period. While in such trust, dividend equivalents are paid on all underlying shares of restricted stock at the same rate paid to ordinary shareholders. The dividend equivalents are paid in the form of additional shares for awards made after 2004 and in cash for all prior awards.

There are two types of long-term incentive share awards used by HSBC: (i) those with a time vesting condition awarded to recognize significant contributions to HUSI ("Restricted Shares") and (ii) those with time and corporate performance-based vesting conditions ("Performance Shares"). Restricted Shares are awarded to key executives as part of the annual pay review process in recognition of past performance and to further motivate and retain executives. Restricted Share awards comprise a number of shares to which the employee will become entitled, normally after three years, subject to the individual remaining in employment. The level of 2007 grants to most HSBC Group General Managers and other senior executives reflect the fact that these awards do not carry the uncertainty of performance conditions for future vesting. The amount granted is based on general guidelines endorsed by REMCO addressing individual performance, goal achievement and potential for growth as part of an individual executive's total compensation package. In March 2007, certain HUSI executives received Restricted Share awards for 2006 performance. In January 2008, certain HUSI executives were awarded Restricted Shares for 2007 performance. No Performance Shares were awarded to HUSI executive officers for 2007 performance.

Performance Shares, which were awarded in 2005 and 2006 to key executives, were awarded based on achievement of defined levels of future performance of HSBC. Performance Shares were divided into two equal parts subject to distinct performance conditions measured over a three year period. A total shareholder return award, which accounts for 50 percent of each Performance Share award, will vest in whole or in part (based on a sliding scale of 0 percent to 100 percent) depending upon how the growth in HSBC's share value, plus declared dividends, compares to the average shareholder return of a defined competitor group comprised of 28 major banking institutions including: ABN AMRO Holding N.V., Banco Bilbao Vizcaya Argentaria, S.A., Banco Santander Central Hispano S.A., Bank of America Corporation, The Bank of New York Mellon Company, Inc., Barclays PLC, BNP Paribas S.A., Citigroup, Inc., Credit Agricole SA, Credit Suisse Group, Deutsche Bank AG, HBOS plc, JP Morgan Chase, Lloyds TSB Group plc, Mitsubishi Tokyo Financial Group Inc., Mizuho Financial Group Inc., Morgan Stanley, National Australia Bank Limited, Royal Bank of Canada, The Royal Bank of Scotland Group plc, Société Générale, Standard Chartered PLC, UBS AG, Unicredito Italiano, US Bancorp, Wachovia Corporation, Wells Fargo & Company and Westpac Banking Corporation.

The earnings per share award accounts for 50 percent of each Performance Share award and is measured using a defined formula based on HSBC's earnings per share growth over the three-year period as compared to the base-year earnings per share, which is earnings per share for the year prior to the year the Performance Shares are granted. None of the earnings per share Performance Shares will vest unless a minimum earnings per share is reached at the end of three years.

REMCO maintains discretion to determine that a Performance Share award will not vest unless satisfied that HSBC's financial performance has shown sustained improvement since the date of the award. REMCO may also waive, amend or relax performance conditions if it believes the performance conditions have become unfair or impractical and believes it appropriate to do so. Due to the probability of one or both of the performance conditions not being met in part or in full, grants of Performance Shares are for a greater number of shares than Restricted Share grants. The expected value of Performance Shares is equal to 44 percent of the face value.

Within the Global Banking and Markets businesses, a portion of each discretionary bonus award is paid in Restricted Shares. The minimum deferral threshold, or the portion of each bonus award paid in Restricted Shares, and vesting schedules may vary by business unit within the parameters set by Global Banking and Markets for their businesses.

#### ***Compensation of Officers Reported in the Summary Compensation Table***

Below is a summary of the factors that affected the compensation earned in 2007 by the executive officers listed in the *Summary Compensation Table*. In determining compensation for each of our executives, management, the Compensation Committee and the HSBC CEO evaluated competitive levels of compensation for executives managing operations or functions of similar size and complexity and the importance of retaining executives with the required strategic, leadership and financial skills to ensure HUSI's continued growth and success and their potential for assumption of additional responsibilities. The HSBC CEO then forwarded his recommendations to REMCO and REMCO endorsed the final awards.

#### ***Compensation of Paul J. Lawrence, Chief Executive Officer***

Mr. Lawrence has served as President and Chief Executive Officer of HUSI and HBUS since February 21, 2007. He has also served as Head of Global Banking and Markets, North America since October 2006.

Mr. Lawrence participates in general benefits available to executives of HUSI and HBUS and certain additional benefits available to HSBC's international staff executives. Compensation packages for international staff executives are compared as a total package, consisting of base salary, a cash incentive award, stock awards and perquisites, against the Comparator Group as well as internal peers on a global basis and are awarded on a discretionary basis. In addition, in determining Mr. Lawrence's total compensation, the HSBC CEO considered his individual performance measured against HUSI and HBUS's annual operating plan, the performance of HUSI and HBUS and Mr. Lawrence's leadership of HUSI and HBUS through a very difficult U.S. business environment. For 2007, Mr. Lawrence's goals included implementing the annual operating plan of HUSI, improving collaboration across the HSBC North America business entities, achieving a targeted net income goal, executing cost containment initiatives to achieve a profit before tax target, managing reputational risk and developing talent and creating strong talent pools and succession plans. Mr. Lawrence's cash compensation for 2007 was determined by REMCO on the recommendation of the HSBC CEO who consulted with HSBC Human Resources executives. As with all HUSI executives, REMCO has authority over Mr. Lawrence's equity-based awards. The Compensation Committee did not review or make recommendations with respect to Mr. Lawrence's compensation for 2007.

Mr. Lawrence's base salary for 2007 was \$642,986. In determining Mr. Lawrence's base salary for 2007, the HSBC CEO reviewed the salary levels of Mr. Lawrence's internal peers of equivalent experience level on a global basis. In accordance with the HSBC reward strategy where the focus is on using variable compensation to reward performance, Mr. Lawrence's base salary was positioned around the 50<sup>th</sup> percentile of the market rate. No salary adjustment was made on Mr. Lawrence's appointment as President and Chief Executive Officer of HUSI and HBUS.

In March 2007, the HSBC CEO proposed and REMCO endorsed an award to Mr. Lawrence of Restricted Shares with a grant date value of \$434,324 and Restricted Shares with a grant date value of \$400,000. The awards were made in recognition of Mr. Lawrence's 2006 performance. In January 2008, the HSBC CEO proposed and REMCO endorsed an award to Mr. Lawrence of Restricted Shares with a grant date value of \$1,461,243. The January 2008 discretionary award, which is granted in March 2008, was made in recognition of Mr. Lawrence's 2007 performance and reflects the HSBC CEO's view of the value of Mr. Lawrence's long-term contribution to and leadership within HSBC, including HUSI and the Global Banking and Markets business in North America, and HSBC's desire to retain Mr. Lawrence and to motivate and reward his outstanding performance. The 2008 Restricted Share award is also consistent with maintaining Mr. Lawrence's total compensation at a competitive market pay level in respect of his performance and long-term value to the HSBC Group. The awards are each subject to a three-year vesting schedule.

In January 2008, the HSBC CEO proposed and REMCO endorsed a discretionary bonus award to Mr. Lawrence of \$1,555,243. The HSBC CEO proposed the award in recognition of Mr. Lawrence's performance in his role as President and Chief Executive Officer of HUSI and HBUS. In considering Mr. Lawrence's bonus award, the HSBC CEO considered Mr. Lawrence's personal contribution to the achievement of the business objectives of HUSI and HBUS, as described above. In addition, the award recognizes his contribution across other Group businesses. The discretionary bonus award was considered as part of the overall assessment of Mr. Lawrence's total compensation, which was based on his 2007 performance and benchmarked against HUSI and HBUS's Comparator Group.

In conformance with HSBC's total compensation philosophy, Mr. Lawrence also received perquisites relating to housing, education, travel and tax equalization, that were significant when compared to other compensation received by other executive officers within HUSI and HBUS. These amounts are consistent, however, with perquisites paid to similarly-placed HSBC international staff executives, who are subject to appointment to HSBC locations globally as deemed appropriate by HSBC senior management. The additional perquisites and benefits available to HSBC international staff executives, as described below in the Summary Compensation Table, are intended to compensate executives for the significant cost and expense incurred in connection with global postings.

#### ***Compensation of Sandra L. Derickson, Former Chief Executive Officer***

On February 20, 2007, Ms. Derickson resigned as the President and Chief Executive Officer of HUSI. Until that time, she participated in the same programs and generally received compensation based on the same factors as the other executive officers. Ms. Derickson had an employment agreement with HSBC Finance Corporation pursuant to which she was to serve as President and Chief Executive Officer of HUSI until March 28, 2008. However, upon Ms. Derickson's resignation, the employment agreement was terminated and replaced with a separation agreement entered into on February 20, 2007 between Ms. Derickson and HSBC Finance Corporation. The Compensation Committee did not review or make recommendations with respect to Ms. Derickson's compensation for 2007.

Pursuant to the separation agreement, Ms. Derickson received \$18,846, representing all base salary earned but unpaid as of February 20, 2007, and \$19,295 in respect of vacation earned but not taken prior to her departure. In addition, Ms. Derickson was entitled to receive \$1,300,500 on the first day of September 2007, reflecting, in substantial part, a bonus to the 2006 executive bonus pool to which she was entitled in accordance with the terms of her employment agreement but did not receive. In addition, Ms. Derickson continues to receive her base salary, at a rate of \$700,000 per annum through March 28, 2008. On January 2, 2008 she received payments for guaranteed bonuses in the amounts of \$1,275,000 for the period January 1, 2007 through December 31, 2007 and \$318,750 for the period January 1, 2008 through March 28, 2008. Ms. Derickson is also to receive interest on all payments to which she is entitled to but has not received at a rate of seven percent from the date they would be due until the date each such payment is made.



Pursuant to the separation agreement, Ms. Derickson was entitled to the payment of premiums for medical and dental insurance, continued coverage in HSBC Finance Corporation's life insurance plan and allowances for umbrella liability insurance, automobile and financial counseling until the earlier of such time as Ms. Derickson becomes eligible to participate in similar plans or policies of another employer and March 28, 2008. All options to purchase shares granted to Ms. Derickson prior to November 20, 2002 pursuant to the Household International 1996 Long-Term Executive Incentive Compensation Plan are fully vested and remain exercisable for the full ten-year and one-day term. All options to purchase shares granted on and after November 20, 2002 pursuant to the 1996 plan are fully vested and exercisable for the full ten-year and one-day term.

Ms. Derickson's separation agreement included a non-competition provision for the five-month period following her departure. In addition, the agreement contained a non-solicitation provision that stated that, subject to some exceptions, during the one-year period starting February 20, 2007, Ms. Derickson would not directly or indirectly induce any employee of HUSI or its affiliates to terminate employment with any such entity, and would not, directly or indirectly, hire, employ or offer employment or assist in hiring, employing or offering employment, to any person who is or was employed by HUSI or an affiliate.

#### ***Compensation of Gerard Mattia, Chief Financial Officer***

Mr. Mattia has served as Senior Executive Vice President and Chief Financial Officer of HUSI and HBUS since March 2007. He has also served as Chief Financial Officer of Global Banking and Markets, North America since September 2004. As a result, his compensation package was considered and approved by both the HUSI CEO and the Head of Global Banking and Markets. The Compensation Committee did not review or make recommendations with respect to Mr. Mattia's compensation for 2007.

Mr. Mattia participates in general benefits available to executives of HUSI and HBUS. Mr. Mattia's total compensation in 2007 was \$1,655,000. In recommending Mr. Mattia's 2007 compensation package, HUSI Human Resources executives and Global Banking and Markets senior management considered the performance of HUSI and HBUS as well as the Global Banking and Markets businesses locally and globally and their judgment of competitive compensation levels within the relevant markets. The recommendation also reflected senior management's view of Mr. Mattia's contribution to the business in 2007, his fundamental role in supporting both the Global Banking and Markets businesses in North America and HUSI and HBUS generally, and the desire to retain Mr. Mattia within HSBC. The Head of Global Banking and Markets and the HUSI CEO agreed with senior management's recommendation and approved Mr. Mattia's total compensation package.

As described above, the allocation of compensation between base salary and incentive compensation within Global Banking and Markets, as well as between long-term and short-term incentives, is recommended by senior management in its discretion and reviewed and approved by the HSBC CEO. Mr. Mattia's 2007 compensation package was also reviewed and approved by the HUSI CEO after consultation with HUSI Human Resources executives. For 2007, Mr. Mattia's compensation package consisted of \$255,000, or approximately 15 percent of his total compensation, in base salary and \$1,400,000, or approximately 85 percent, as a discretionary bonus award. Of the discretionary bonus award, Mr. Mattia received \$910,000 in cash and the balance will be deferred through a grant of Restricted Shares in March 2008 with a grant date value of \$490,000. The Restricted Share award is also consistent with maintaining Mr. Mattia's total compensation at a competitive market pay level in respect of his performance and long-term value to the HSBC Group. The Restricted Share award is subject to a three-year vesting schedule.

Other compensation paid to Mr. Mattia, including the perquisites described below in the *Summary Compensation Table*, is consistent with perquisites paid to similarly-placed executive officers within and outside of HSBC.

### ***Compensation of John J. McKenna, Former Chief Financial Officer***

Mr. McKenna served as Senior Executive Vice President and Chief Financial Officer of HUSI and HBUS from October 2005 to March 2007. In March 2007, Mr. Mattia succeeded Mr. McKenna as Chief Financial Officer of HUSI and HBUS. In October 2007, Mr. McKenna accepted a position as chief financial officer of an HSBC affiliate in Australia. Prior to that date, Mr. McKenna participated in general benefits available to executives of HUSI and HBUS. Mr. McKenna's base salary for 2006 was \$325,040. In determining his base salary for 2007, the HUSI CEO reviewed competitive compensation levels and found Mr. McKenna's base salary to be slightly below the 50<sup>th</sup> percentile among similarly-placed executives in salary survey data as well as internal peers on a global basis. In keeping with the HSBC reward strategy of maintaining executive base salaries in the 50<sup>th</sup> percentile, a recommendation was made to the HUSI CEO and Chief Executive Officer of HNAH and Mr. McKenna's base salary was increased by five percent to \$341,303.

In February 2007, the HUSI CEO, in consultation with the Chief Executive Officer of HNAH and HUSI Human Resources executives, approved an award to Mr. McKenna of Restricted Shares with a grant date value of \$350,000. In 2008, a share award was not recommended for Mr. McKenna. The award is subject to a three-year vesting schedule.

In January 2008, the HUSI CEO proposed a discretionary bonus award to Mr. McKenna of \$162,726. The discretionary bonus award was considered as part of the overall assessment of Mr. McKenna's total compensation, which was based on his 2007 performance and benchmarked against HUSI's Comparator Group.

Other compensation paid to Mr. McKenna, including the perquisites described below in the *Summary Compensation Table*, is consistent with perquisites paid to similarly-placed executive officers within and outside of HSBC.

### ***Compensation of Janet L. Burak, Senior Executive Vice President & General Counsel***

Ms. Burak has served as Senior Executive Vice President & General Counsel of HUSI and HBUS since April 2004. She also served as Secretary of HUSI and HBUS from April 2004 to September 1, 2007. In addition to her role as General Counsel, Ms. Burak was assigned the additional responsibility for the North American compliance function on July 1, 2007. She was appointed Senior Executive Vice President & General Counsel of HNAH, HUSI and HBUS's North American parent, as of December 1, 2007.

Ms. Burak participates in general benefits available to executives of HUSI and HBUS. Ms. Burak's 2007 compensation was determined as a total compensation package and included base salary, a cash incentive award, stock awards and perquisites. In determining Ms. Burak's total compensation for 2007, the Compensation Committee considered the performance of HUSI and Ms. Burak's individual performance and contributions to the North American businesses in 2007, which included, among others, efforts towards the development of a "best practices" approach to regulatory management and corporate governance processes, significant contributions in addressing the various challenges to the North American operations arising out of general market and economic developments during the second half of 2007, process and structure improvements in the North American compliance function, and overall leadership in the further development of the performance and consultative skills of the North American legal function. The HUSI CEO determined Ms. Burak's equity-based awards, which recommendation was approved by the HSBC CEO and endorsed by REMCO.

Ms. Burak's base salary for 2006 was \$400,208. In determining Ms. Burak's base salary for 2007, the Compensation Committee reviewed competitive compensation levels and found Ms. Burak's base salary to be slightly below the 50<sup>th</sup> percentile among similarly-placed executives in salary survey data as well as internal peers on a global basis. In keeping with the HSBC reward strategy of maintaining executive base salaries in the 50<sup>th</sup> percentile, a recommendation was made to the HSBC CEO and Ms. Burak's base salary was increased by five percent to \$420,218. Her base salary was increased to \$500,000 on July 1, 2007 in consideration of her additional responsibilities with respect to the North American compliance function and further increased to \$550,000 on December 1, 2007 in consideration of her additional responsibilities as General Counsel of HNAH.

In March 2007, the HSBC CEO, upon the recommendation of the Compensation Committee in consultation with HUSI Human Resources executives, proposed and REMCO endorsed an award to Ms. Burak of Restricted Shares with a grant date value of \$500,000. The award was made in recognition of Ms. Burak's 2006 performance. In March 2008, the HSBC CEO, upon the recommendation of the Compensation Committee, proposed and REMCO endorsed an award to Ms. Burak of Restricted Shares with a grant date value of \$600,000. The March 2008 award was made in recognition of Ms. Burak's 2007 performance and reflects the HUSI CEO's and the HSBC CEO's view of the value of Ms. Burak's long-term contribution to HSBC, including the North American operations, and HSBC's desire to retain Ms. Burak and to motivate and reward her outstanding performance. The 2008 Restricted Share award is also consistent with maintaining Ms. Burak's total compensation at a competitive market pay level in respect of her performance and long-term value to the HSBC Group. The awards are each subject to a three-year vesting schedule.

In January 2008, the Compensation Committee, upon the recommendation of the HUSI CEO, proposed, and the HSBC CEO approved, a discretionary bonus award to Ms. Burak of \$800,000. The HUSI CEO recommended the award in recognition of Ms. Burak's personal contributions to the North American businesses. The discretionary bonus award was considered as part of the overall assessment of Ms. Burak's total compensation, which was based on her 2007 performance, as described above, and benchmarked against HUSI's Comparator Group.

Other compensation paid to Ms. Burak, including the perquisites described below in the *Summary Compensation Table*, is consistent with perquisites paid to similarly-placed executive officers within and outside of HSBC.

#### ***Compensation of David Dew, Senior Executive Vice President – Chief Operating Officer***

Mr. Dew has served as Senior Executive Vice President and Chief Operating Officer of HUSI and HBUS since March 2007. He served as Chief Administrative Officer of HUSI and HBUS from February to March 2007 and as Senior Executive Vice President, Audit for HSBC North America Inc. (HNAI) from January 2006 to February 2007.

Mr. Dew participates in general benefits available to executives of HUSI and HBUS and certain additional benefits available to HSBC's international staff executives. Compensation packages for international staff executives are compared as a total package, consisting of base salary, a cash incentive award, stock awards and perquisites, against the Comparator Group as well as internal peers on a global basis and are awarded on a discretionary basis. In determining Mr. Dew's total compensation for 2007, the HUSI CEO and the HSBC CEO considered the performance of HUSI and Mr. Dew's individual performance and contributions in implementing HUSI's 2007 annual operating plan, which included, among others, implementing a more integrated operational infrastructure across customer groups and support functions, implementing cost containment initiatives to support achievement of established profit before tax targets, pursuing greater transparency and enhanced accountability for senior executives within the support functions while maintaining positive working relationships with functional executives, and efforts supporting collaboration across the HSBC North America business entities and customer groups. The HUSI CEO determined Mr. Dew's equity-based awards, which recommendation was approved by the HSBC CEO and endorsed by REMCO.

Mr. Dew's base salary for 2007 was \$554,338. In determining Mr. Dew's base salary for 2007, the HUSI CEO reviewed the salary levels of Mr. Dew's internal peers of equivalent experience level on a global basis. In accordance with the HSBC reward strategy where the focus is on using variable compensation to reward performance, Mr. Dew's base salary was positioned around the 50<sup>th</sup> percentile of the market rate. No salary adjustment was made on Mr. Dew's appointment as Chief Operating Officer of HUSI and HBUS.

In March 2007, the HSBC CEO, upon the recommendation of the HUSI CEO, proposed and REMCO endorsed an award to Mr. Dew of Restricted Shares with a grant date value of \$98,710. The award was made in recognition of Mr. Dew's 2006 performance. In January 2008, the HSBC CEO, upon the recommendation of the HUSI CEO, proposed and REMCO endorsed an award to Mr. Dew of Restricted Shares with a grant date value of \$250,000. The January 2008 award was made in recognition of Mr. Dew's 2007 performance and reflects the HUSI CEO and the HSBC CEO's view of the value of Mr. Dew's long-term contribution to HSBC, including HUSI and HBUS, and HSBC's desire to retain Mr. Dew and to motivate and reward his outstanding performance. The 2008 Restricted Share award is also consistent with maintaining Mr. Dew's total compensation at a competitive market pay level in respect of his performance and long-term value to the HSBC Group. The awards are each subject to a three-year vesting schedule.

In January 2008, the HUSI CEO recommended, and the HSBC CEO approved, a discretionary bonus award to Mr. Dew of \$550,000. The HUSI CEO proposed the award in recognition of Mr. Dew's performance in his role as Chief Operating Officer of HUSI and HBUS. In considering Mr. Dew's discretionary bonus award, the HUSI CEO considered Mr. Dew's personal contribution to the achievement of the business objectives of HUSI and HBUS. The discretionary bonus award was considered as part of the overall assessment of Mr. Dew's total compensation, which was based on his 2007 performance, as described above, and benchmarked against HUSI's Comparator Group.

In conformance with HSBC's total compensation philosophy, Mr. Dew also received perquisites relating to housing, education, travel and tax equalization, that were significant when compared to other compensation received by other executive officers within HUSI. These amounts are consistent, however, with perquisites paid to similarly-placed HSBC international staff executives, who are subject to appointment to HSBC locations globally as deemed appropriate by HSBC senior management. The additional perquisites and benefits available to HSBC international staff executives, as described below in the *Summary Compensation Table*, are intended to compensate executives for the significant cost and expense incurred in connection with global postings.

#### ***Compensation of Kevin Newman, Senior Executive Vice President – Personal Financial Services***

Mr. Newman has served as Group General Manager and Senior Executive Vice President, Personal Financial Services since December 2006. Prior to that, he served as Senior Executive Vice President, Personal Financial Services from September 2005 to October 2006 and as Executive Vice President, Personal Financial Services from December 2003 to September 2005. Mr. Newman was named a Group General Manager in April 2005.

Mr. Newman participates in general benefits available to executives of HUSI and HBUS. Mr. Newman's 2007 compensation was determined as a total compensation package and included base salary, a cash incentive award, stock awards and perquisites. In determining Mr. Newman's total compensation for 2007, the Compensation Committee considered the performance of HUSI and Mr. Newman's individual performance and contributions to the Personal Financial Services business in 2007, which included, among others, efforts in connection with the re-launch of the Premier proposition, both locally and globally, leadership of HSBC Direct, improvements to the Wealth Management and Small Business operations, improved efficiencies and performance of the branch network and reduced average time to profitability of new branches, and overall leadership of the Personal Financial Services business in 2007 as it made considerable progress in building core capabilities. The HUSI CEO determined Mr. Newman's equity-based awards, which recommendation was approved by the HSBC CEO and endorsed by REMCO.

Mr. Newman's base salary for 2006 was \$500,000. In determining Mr. Newman's base salary for 2007, the Compensation Committee reviewed competitive compensation levels and found Mr. Newman's base salary to be slightly below the 50th percentile among similarly-placed executives in salary survey data as well as internal peers on a global basis. In keeping with the HSBC reward strategy of maintaining executive base salaries in the 50th percentile, the Compensation Committee recommended a base salary increase of four percent to \$520,000, which recommendation was approved by the HSBC CEO and endorsed by REMCO.

In March 2007, the HSBC CEO, upon the recommendation of the Compensation Committee, proposed and REMCO endorsed an award to Mr. Newman of Restricted Shares with a grant date value of \$748,000. The award was made in recognition of Mr. Newman's 2006 performance. In January 2008, the HSBC CEO, upon the recommendation of the Compensation Committee, proposed and REMCO endorsed an award to Mr. Newman of Restricted Shares with a grant date value of \$1,000,000. The January 2008 award was made in recognition of Mr. Newman's 2007 performance and reflects REMCO and the HSBC CEO's view of the value of Mr. Newman's long-term contribution to HSBC, including HUSI and HBUS, and HSBC's desire to retain Mr. Newman and to motivate and reward his outstanding performance. The 2008 Restricted Share award is also consistent with maintaining Mr. Newman's total compensation at a competitive market pay level in respect of his performance and long-term value to the HSBC Group. The awards are each subject to a three-year vesting schedule.

In January 2008, the HSBC CEO, upon the recommendation of the Compensation Committee, proposed, and REMCO endorsed, a discretionary bonus award to Mr. Newman of \$1,000,000. The HSBC CEO recommended the award in recognition of Mr. Newman's personal contributions to the Group's PFS franchise and leadership in pursuit of the achievement of PFS business objectives in North America. The discretionary bonus award was considered as part of the overall assessment of Mr. Newman's total compensation, which was based on his 2007 performance, as described above, and benchmarked against HUSI's Comparator Group.

Other compensation paid to Mr. Newman, including the perquisites described below in the *Summary Compensation Table*, is consistent with perquisites paid to similarly-placed executive officers within and outside of HSBC.

#### ***Compensation Committee Interlocks and Insider Participation***

The primary purpose of the Compensation Committee is to assist the Board of Directors in discharging its responsibilities related to the compensation of the Chief Executive Officer, other officers of HUSI holding a title of executive vice president and above and such other officers as may be designated by the Board of Directors. The Compensation Committee is comprised of the following directors: Dr. Frances D. Fergusson (Chair), Donald K. Boswell and James L. Morice. All members of the Compensation Committee are independent directors under HUSI's Corporate Governance Standards. Additional information with regard to the Compensation Committee, including a description of the committee's responsibilities under its charter, is contained in the section of this Form 10-K entitled *Item 10. Directors, Executive Officers and Corporate Governance – Corporate Governance*.

#### ***Compensation Committee Report***

We, the Human Resources & Compensation Committee of the Board of Directors of HSBC USA Inc., have reviewed and discussed the Compensation Discussion and Analysis ("2007 CD&A") set forth above with management and, based on such review and discussion, have recommended to the Board of Directors that the 2007 CD&A be included in this Annual Report on Form 10-K.

Human Resources & Compensation Committee  
Dr. Frances D. Fergusson (Chair)  
Donald K. Boswell  
James L. Morice

The following tables and narrative text discuss the compensation awarded to, earned by or paid to (i) Mr. Paul J. Lawrence, who has served as HUSI's Chief Executive Officer since February 21, 2007, (ii) Ms. Sandra L. Derickson, who served as HUSI's Chief Executive Officer from January 1, 2007 to February 20, 2007 and who served as Chief Executive Officer-Designate from September 1, 2006 to December 31, 2006, (iii) Mr. Gerard Mattia, who has served as HUSI's Chief Financial Officer since March 27, 2007, (iv) Mr. John J. McKenna who served as HUSI's Chief Financial Officer during 2006 and from January 1, 2007 to March 26, 2007, and (v) the next three most highly compensated executive officers (other than the chief executive officer and chief financial officer) who were serving as executive officers as of December 31, 2007.

### Summary Compensation Table

| Name and principal position  | Year | Salary     | Bonus (2)    | Stock Awards (3) | Option Awards (4) | Non-Equity Incentive Plan Compensation (5) | Change in Pension Value and Nonqualified Deferred Compensation Earnings (6) | All Other Compensation (7) | Total        |
|--|------|------------|--------------|------------------|-------------------|--|---|----------------------------|--------------|
| <b>Paul J. Lawrence</b><br>President and<br>Chief Executive Officer                                | 2007 | \$ 642,986 | \$ 1,555,243 | \$ 508,634       | \$ -              | \$ -                                       | \$ 502,728  | \$ 847,730                 | \$ 4,057,321 |
| <b>Sandra L. Derickson (1)</b><br>Former President and<br>Chief Executive Officer                  | 2007 | 102,308    | -            | -                | -                 | -  | 110,899   | 3,720,131                  | 3,933,338    |
|  | 2006 | 233,333    | -            | -                | -                 | -  | 63,386  | 192,632                    | 489,351      |
| <b>Gerard Mattia</b><br>Senior Executive<br>Vice President and<br>Chief Financial Officer          | 2007 | 255,000    | 910,000      | 232,027          | -                 | -  | 8,287   | 15,245                     | 1,420,559    |
| <b>John J. McKenna</b><br>Former Senior Executive<br>Vice President and<br>Chief Financial Officer | 2007 | 325,676    | -            | 306,177          | -                 | 162,726                                    | 78,661  | 64,413                     | 937,653      |
|  | 2006 | 321,196    | -            | 222,114          | -                 | 381,934                                    | 92,238  | 16,685                     | 1,034,167    |
| <b>Kevin Newman</b><br>Senior Executive Vice<br>President, Personal<br>Financial Services          | 2007 | 516,928    | -            | 674,092          | -                 | 1,000,000                                  | 231,145   | 18,810                     | 2,440,975    |
| <b>David Dew (8)</b><br>Senior Executive<br>Vice President and<br>Chief Operating Officer          | 2007 | 554,338    | 550,000      | 180,161          | -                 | -  | 532,279   | 647,307                    | 2,464,085    |
| <b>Janet L. Burak</b><br>Senior Executive<br>Vice President and<br>General Counsel                 | 2007 | 431,287    | -            | 333,317          | -                 | 800,000                                    | 383,822   | 74,253                     | 2,022,679    |
|  | 2006 | 395,176    | -            | 415,346          | -                 | 736,383                                    | 368,753   | 92,597                     | 2,008,255    |

- (1) Sandra L. Derickson resigned as President and Chief Executive Officer on February 20, 2007. The amount shown for Ms. Derickson is the pro rata portion of her annual base salary of \$700,000.
- (2) The amount disclosed for Messrs. Lawrence, Mattia and Dew represent the discretionary cash bonus relating to 2007 performance but paid in February 2008.
- (3) Reflects the amounts of compensation expense amortized in 2007 for accounting purposes under FAS 123R for outstanding restricted stock grants made in the years 2003 through 2007. A portion of the expense reflected for Messrs. Lawrence, Newman and Dew relates to Performance Shares granted in 2005 and 2006 that will vest in whole or in part three years from the date of grant if all or some of the performance conditions are met, as follows: 50 percent of the award is subject to a total shareholder return measure ("TSR") and will vest in whole or in part (based on a sliding scale of 0 to 100 percent) depending upon how the growth in HSBC's share value, plus declared dividends, compares to the average shareholder return of a defined competitor group, which for 2006 grants was comprised of 28 major banking institutions, including ABN AMRO Holding N.V., Banco Bilbao Vizcaya Argentaria, S.A., Banco Santander Central Hispano S.A., Bank of America Corporation, The Bank of New York Mellon Company, Inc., Barclays PLC, BNP Paribas S.A., Citigroup, Inc., Credit Agricole SA, Credit Suisse Group, Deutsche Bank AG, HBOS plc, JP Morgan Chase, Lloyds TSB Group plc, Mitsubishi Tokyo Financial Group Inc., Mizuho Financial Group Inc., Morgan Stanley, National Australia Bank Limited, Royal Bank of Canada, The Royal Bank of Scotland Group plc, Société Générale, Standard Chartered PLC, UBS AG, Unicredito Italiano, US Bancorp, Wachovia Corporation, Wells Fargo & Company and Westpac Banking Corporation. The remaining 50 percent of the award is subject to

satisfaction of an earnings per share measure (“EPS”) and may vest based on an incremental EPS percentage in accordance with a defined formula. If the aggregate incremental EPS is less than 24 percent, the EPS portion will be forfeited. If it is 52 percent or more, the EPS component will vest in full. We have reduced the amount of expense related to the Performance Shares that would have been recorded by 50 percent due to the probability of a 0 percent vest on the TSR portion and a 100 percent vest on the EPS portion for both years 2005 and 2006. HUSI records expense over the three-year period based on the fair value, which is 100 percent of the face value on the date of the award. The remaining grants are non-performance-based awards and are subject to various time vesting conditions as disclosed in the footnotes to the *Outstanding Equity Awards at Fiscal Year End Table* and will be released as long as the named executive officer is still in the employ of HUSI at the time of vesting. HUSI records expense based on the fair value over the vesting period, which is 100 percent of the face value on the date of the award. Dividend equivalents, in the form of cash or additional shares, are paid on all underlying shares of restricted stock at the same rate as paid to ordinary share shareholders.

- (4) The current philosophy of HSBC and HUSI, including within the Global Banking and Markets businesses, is to reward executive officers with awards of restricted shares rather than stock options.
- (5) The amounts disclosed for Messrs. McKenna and Newman and Ms. Burak represent the incentive bonus earned in 2007 but paid in February 2008 under the Management Incentive Program.
- (6) The HSBC-North America (U.S.) Retirement Income Plan (“RIP”), the Household Supplemental Retirement Income Plan (“SRIP”), the HSBC Bank Supplemental Plans (“Excess Plans”), and the HSBC International Staff Retirement Benefit Scheme (Jersey) (“ISRBS”) are described under *Savings and Pension Plans* on page 195.

Increase in values by plan for each participant are: Ms. Derickson – \$5,941 (RIP), \$44,756 (SRIP); Mr. Mattia – \$4,914 (RIP); Mr. McKenna – \$39,552 (RIP), \$39,109 (BEP); Mr. Newman – \$37,316(RIP), \$60,807 (SRIP); Ms. Burak – \$23,805 (RIP), \$350,856 (SRIP); and Mr. Lawrence – \$502,728, and Mr. Dew – \$532,279 (ISRBS, net of mandatory 2007 contribution).

- (7) Components of All Other Compensation are disclosed in the aggregate. All Other Compensation includes perquisites and other personal benefits received by each named executive officer, such as financial planning services, physical exams, club initiation fees, expatriate benefits and car allowances, to the extent such perquisites and other personal benefits exceeded \$10,000 in 2007. The following itemizes perquisites and other benefits for each named executive officer who received perquisites and other benefits in excess of \$10,000: *Executive Tax Services* for Mr. Lawrence was \$804, for Mr. Dew was \$787 and for Ms. Derickson was \$6,228. The following executives received physical exams at the cost listed next to each of their names: Mr. Lawrence \$9,868, Ms. Derickson \$14,277, Mr. McKenna \$541, and Ms. Burak \$11,816. *Car allowance* for Mr. McKenna was \$1,062 in 2007. *Club Dues and Membership fees* for Mr. Dew were \$770. Ms. Derickson received *Executive Umbrella Liability Coverage* at a cost of \$1,750 for 2007. In 2007, Messrs. Lawrence and Dew received \$288,681 and \$277,232, respectively, for *Housing Allowances*, and, Mr. Dew also received reimbursement on his foreign utilities expenses in the amount of \$2,253. In 2007, Mr. Lawrence had \$156,779 in *Children’s Education Allowance*. In 2007, Mr. Dew received \$13,770 representing a *Relocation Allowance*. Ms. Burak received \$8,462 as additional compensation for vacation earned, not taken, and sold back to the company. Messrs. Lawrence and Dew received \$63,371 and \$29,050, respectively, in *Executive Travel Allowance*, \$34,872 and \$18,588, respectively, in *Loan Subsidy* and Mr. Dew received \$7,484 of *Additional Income*. Messrs. Lawrence and Dew received expat benefits at a cost to the company of \$293,355 and \$246,115, respectively. Mr. Dew also received a miscellaneous reimbursement of \$1,009, plus \$50,249 in tax gross ups. Mr. McKenna received an expat premium of \$14,418 and cost of living adjustment of \$968, plus tax equalization payments totaling \$31,683.

In addition, under the terms of her separation agreement, Ms. Derickson received the balance of her salary for 2007 in the amount of \$597,692, pay for vacation earned but not taken in the amount of \$19,295, \$1,300,500 reflecting a bonus to cover 2006, a guaranteed bonus of \$1,275,000 for 2007, \$175,000 covering salary to be received in 2008 along with a prorated 2008 bonus of \$318,750.

The total in the All Other Compensation column includes life insurance premiums paid by HUSI in 2007 for the benefit of executives, as follows: Ms. Derickson, \$2,868; Mr. Mattia, \$1,745; Mr. McKenna, \$2,241; Mr. Newman, \$5,310; and Ms. Burak, \$5,175. All Other Compensation also includes HUSI’s contribution for the named executive officer’s participation in the HSBC-North America (U.S.) Tax Reduction Investment Plan (“TRIP”) in 2007, as follows: Ms. Derickson had a \$6,696 contribution; and Messrs. McKenna, Mattia and Newman and Ms. Burak each had a \$13,500 contribution. In addition, Ms. Derickson and Ms. Burak each had a company contribution in the Supplemental Tax Reduction Investment Plan (“STRIP”) of \$2,075 and \$35,301, respectively, in 2007. TRIP and STRIP are described under *Savings and Pension Plans – Deferred Compensation Plans* on page 199.

- (8) David Dew was named to his position effective as of March 26, 2007, transferred from HSBC plc, and his salary is prorated for his time in position.

## Grants Of Plan-Based Awards Table

| Name   | Grant Date | Estimated Future Payouts Under<br>Non-Equity Incentive Plan Awards (1) |                      |                 | Estimated Future Payouts Under<br>Equity Incentive Plan Awards (2) |               |                | All Other<br>Stock<br>Awards:<br>Number<br>of Shares<br>of Stock<br>or Units<br>(#) | All Other<br>Option<br>Awards:<br>Number of<br>Securities<br>Underlying<br>Options<br>(#) | Exercise<br>or Base<br>Price of<br>Option<br>Awards<br>(\$/Sh) | Grant Date<br>Fair Value<br>of Stock<br>and Option<br>Awards<br>(\$)(2)(3) |
|--|------------|--|----------------------|-----------------|--|---------------|----------------|---|---|--|--|
|  |            | Threshold<br>(\$)  | Target<br>(\$)       | Maximum<br>(\$) | Threshold<br>(#)   | Target<br>(#) | Maximum<br>(#) |   |   |  |  |
|  |            | <b>Paul J. Lawrence</b><br>President and<br>Chief Executive Officer    | 03/30/07<br>03/05/07 | N/A<br>N/A      | N/A<br>N/A   | N/A<br>N/A    | N/A<br>N/A     |   |   |  |  |
| <b>Sandra L. Derickson</b><br>Former President and<br>Chief Executive Officer                      | N/A        | N/A  | N/A                  | N/A             | N/A  | N/A           | N/A            | N/A   | N/A   | N/A  | N/A  |
| <b>Gerard Mattia</b><br>Senior Executive<br>Vice President and<br>Chief Financial Officer          | 03/05/07   | N/A  | N/A                  | N/A             | N/A  | N/A           | N/A            | 17,953  | N/A   | N/A  | 315,000  |
| <b>John J. McKenna</b><br>Former Senior Executive<br>Vice President and<br>Chief Financial Officer | 03/30/07   | N/A  | 255,977              | 511,955         | N/A  | N/A           | N/A            | 20,022  | N/A   | N/A  | 350,000  |
| <b>Kevin Newman</b><br>Senior Executive Vice<br>President, Personal<br>Financial Services          | 03/30/07   | N/A  | 520,000              | 1,040,000       | N/A  | N/A           | N/A            | 42,791  | N/A   | N/A  | 748,000  |
| <b>David Dew</b><br>Senior Executive Vice<br>President & Chief<br>Operating Officer                | 03/30/07   | N/A  | N/A                  | N/A             | N/A  | N/A           | N/A            | 5,613   | N/A   | N/A  | 98,115   |
| <b>Janet L. Burak</b><br>Senior Executive<br>Vice President and<br>General Counsel                 | 03/30/07   | N/A  | 550,000              | 1,100,000       | N/A  | N/A           | N/A            | 28,603  | N/A   | N/A  | 500,000  |

- (1) Messrs. McKenna and Newman and Ms. Burak participate in the Management Incentive Program. As discussed in the 2007 CD&A, the Management Incentive Program is an annual cash incentive plan that is comprised of both quantitative and qualitative individual, business unit or company objectives that are determined at the beginning of the year with each objective being assigned a target and maximum payout based upon a percentage of base salary. The percentage of target and maximum payout is determined by market data for the position the executive officer holds and will not change unless the executive officer changes into a position that has a different target and maximum payout. Typically, the maximum payout is a 1x, 2x or 3x multiplier of target. Actual awards for the 2007 performance year for Messrs. McKenna and Newman and Ms. Burak were \$162,726, \$1,000,000 and \$800,000, respectively, and were paid in February 2008. These amounts are included in the *Summary Compensation Table* above under "Non-Equity Incentive Plan Compensation".
- (2) The total grant date fair value reflected is based on 100% of the fair market value of the underlying HSBC ordinary shares on March 30, 2007 (the date of grant) of GBP8.25 and converted into U.S. dollars using the GBP exchange rate as of the time of funding the of the grant was 1.96254.
- (3) The total grant date fair value reflected is based on 100% of the fair market value of the underlying HSBC ordinary shares on March 5, 2007 (the date of grant) of GBP8.9079 and converted into U.S. dollars using the GBP exchange rate as of the time of funding the of the grant was 1.9622.



## Outstanding Equity Awards At Fiscal Year-End Table

| Name   | Option Awards   |   |  |                       |                        | Stock Awards  |   |  |   |  |
|--|---|---|--|-----------------------|------------------------|---|---|--|---|--|
|  | Number of Securities Underlying Unexercised Options (#) Exercisable | Number of Securities Underlying Unexercised Options (#) Unexercisable | Equity Incentive Plan Awards: Number of Securities Underlying Unexercised Unearned Options (#) | Option Exercise Price | Option Expiration Date | Number of Shares or Units of Stock That Have Not Vested (#) (1) | Market Value of Shares or Units of Stock that Have Not Vested (\$ (2) | Equity Incentive Plan Awards: Number of Shares, Units or Other Rights That Have Not Vested (#) (1) | Equity Incentive Plan Awards: Market or Payout Value of Unearned Shares, Units or Other Rights That Have Not Vested (\$ (2) |  |
| <b>Paul J. Lawrence</b><br>President and<br>Chief Executive Officer                                |   |   |  |                       |                        | 22,798 (6)  | \$380,904   | 10,706 (3)   | \$178,874   |  |
|  |   |   |  |                       |                        | 24,699 (7)  | 412,666   | 23,734 (4)   | 396,543   |  |
|  |   |   |  |                       |                        |   |   | 30,274 (5)   | 505,812   |  |
| <b>Sandra L. Derickson</b><br>Former President and<br>Chief Executive Officer                      | 133,750 (8)   |   |  | \$21.37               | 11/12/2011             |   |   |  |   |  |
|  | 267,500 (8)   |   |  | \$10.66               | 11/20/2012             |   |   |  |   |  |
|  | 204,000 (8)   |   |  | GBP9.1350             | 11/03/2013             |   |   |  |   |  |
|  |   |   | 102,000 (9)  | GBP8.2830             | 04/30/2014             |   |   |  |   |  |
| <b>Gerard Mattia</b><br>Senior Executive<br>Vice President and<br>Chief Financial Officer          |   |   |  |                       |                        | 4,496 (10)  | 75,118  |  |   |  |
|  |   |   |  |                       |                        | 7,221 (11)  | 120,647   |  |   |  |
|  |   |   |  |                       |                        | 17,953 (15)   | 299,955   |  |   |  |
| <b>John J. McKenna</b><br>Former Senior Executive<br>Vice President and<br>Chief Financial Officer |   |   |  |                       |                        | 9,456 (12)  | 157,989   | 8,280 (3)  | 138,341   |  |
|  |   |   |  |                       |                        | 23,611 (13)   | 394,488   |  |   |  |
|  |   |   |  |                       |                        | 20,022 (7)  | 334,524   |  |   |  |
| <b>Kevin Newman</b><br>Senior Executive Vice<br>President, Personal<br>Financial Services          |   |   |  |                       |                        | 40,358 (12)   | 674,293   | 15,294 (3)   | 255,529   |  |
|  |   |   |  |                       |                        | 35,416 (13)   | 591,723   |  |   |  |
|  |   |   |  |                       |                        | 42,791 (7)  | 714,943   |  |   |  |
| <b>David Dew (16)</b><br>Senior Executive<br>Vice President and<br>Chief Operating Officer         | 5,250 (8)   |   |  | GBP7.46               | 04/03/2010             | 5,613 (7)   | 93,781  | 17,800 (4)   | 297,399   |  |
|  | 5,250 (8)   |   |  | GBP8.71               | 04/23/2011             |   |   | 12,927 (5)   | 215,982   |  |
|  | 7,000 (8)   |   |  | GBP8.41               | 05/07/2012             |   |   |  |   |  |
|  | 7,000 (8)   |   |  | GBP6.91               | 05/02/2013             |   |   |  |   |  |
| <b>Janet L. Burak (16)</b><br>Senior Executive<br>Vice President and<br>General Counsel            | 26,750 (8)  |   |  | \$13.71               | 11/09/2008             | 6,667 (14)  | 111,391   | 20,004 (9)   | 334,223   |  |
|  | 26,750 (8)  |   |  | \$16.96               | 11/08/2009             | 31,678 (12)   | 529,270   |  |   |  |
|  | 26,750 (8)  |   |  | \$18.40               | 11/13/2010             | 29,513 (13)   | 493,097   |  |   |  |
|  |   |   |  |                       |                        | 28,603 (7)  | 477,893   |  |   |  |

- (1) Share amounts do not include additional awards accumulated over the vesting periods.
- (2) The market value of the shares on December 31, 2007 was GBP8.42 and the exchange rate from GBP to U.S. dollars was 1.9843, which equates to a U.S. dollar share price of \$16.7078 per share.
- (3) This award will vest in full on April 2, 2008, if the performance conditions are met.
- (4) This award will vest in full on March 31, 2008, if the performance conditions are met.
- (5) This award will vest in full on March 31, 2009, if the performance conditions are met.
- (6) This award will vest one-third on March 5, 2008, one-third on March 5, 2009, and one-third on March 5, 2010.
- (7) This award will vest in full on March 30, 2010.
- (8) Reflects fully vested options.
- (9) This award will vest, subject to satisfaction of performance conditions, two-thirds on the fourth anniversary of the date of grant, which was April 30, 2004. If the performance conditions are not satisfied on that date, it will be re-tested on the fifth anniversary of the date of grant, and if the performance conditions are met, will vest 100%. If the performance conditions are not met on the fifth anniversary of the date of grant, the options will be forfeited.
- (10) This award will vest in full on March 3, 2008.
- (11) This award will vest in full on February 28, 2008.
- (12) This award will vest in full on March 31, 2008.
- (13) This award will vest in full on March 31, 2009.
- (14) Thirty-three percent of this award vested on October 31, 2006, and thirty-three percent vested on October 31, 2007. Thirty-three percent of the award will vest on October 31, 2008.
- (15) This award will vest one-half on March 5, 2008, one-quarter on February 28, 2009 and one-quarter on February 28, 2010.
- (16) Option awards shown for Mr. Dew and Ms. Burak were awarded prior to joining HUSI.

***Option Exercises and Stock Vested Table***

| Name   | Option Awards                             |                                     | Stock Awards                                 |                                    |
|--|---|-------------------------------------|--|------------------------------------|
|  | Number of Shares Acquired on Exercise (#) | Value Realized on Exercise (\$ (1)) | Number of Shares Acquired on Vesting (#) (2) | Value Realized on Vesting (\$ (1)) |
| <b>Paul J. Lawrence</b><br>President and<br>Chief Executive Officer                                |   |                                     |  |                                    |
| <b>Sandra L. Derickson</b><br>Former President and<br>Chief Executive Officer                      | 107,000 (3)                               | \$ 90,030                           | 483,121 (4)                                  | \$ 8,383,152                       |
| <b>Gerard Mattia</b><br>Senior Executive<br>Vice President and<br>Chief Financial Officer          |   |                                     | 7,537 (5)                                    | 129,662                            |
| <b>John J. McKenna</b><br>Former Senior Executive<br>Vice President and<br>Chief Financial Officer |   |                                     |  |                                    |
| <b>Kevin Newman</b><br>Senior Executive Vice<br>President, Personal<br>Financial Services          |   |                                     | 15,796 (6)                                   | 291,035                            |
| <b>David Dew</b><br>Senior Executive<br>Vice President and<br>Chief Operating Officer              |   |                                     |  |                                    |
| <b>Janet L. Burak</b><br>Senior Executive<br>Vice President and<br>General Counsel                 |   |                                     | 12,018 (7)                                   | 221,746                            |

- (1) Value realized on exercise or vesting uses the GBP fair market value on the date of exercise/release and the exchange rate from GBP to U.S. dollars on the date of settlement.
- (2) Includes the release of additional awards accumulated over the vesting period.
- (3) Includes the exercise of stock options granted on November 13, 2000.
- (4) The amount shown for Ms. Derickson reflects equity awards received while an executive of HSBC Finance Corporation and prior to her appointment as President and Chief Executive Officer of HUSI and includes the release of 141,420 shares granted on April 15, 2003 and 302,481 shares granted on May 25, 2005. The remaining shares reflect the release of additional awards accumulated over the vesting period.
- (5) Includes the release of 7,537 shares granted on March 6, 2006.
- (6) Includes the release of 12,658 shares granted on April 15, 2002. Remaining shares are a release of additional awards accumulated over the vesting period.
- (7) Includes the release of 5,351 shares granted on November 20, 2002 and 6,667 shares granted on November 3, 2003.

## *Pension Benefits*

| <b>Name</b>  | <b>Plan Name (1)</b> | <b>Number of Years Credited Service (#)</b> | <b>Present Value of Accumulated Benefit (\$)</b> | <b>Payments During Last Fiscal Year (\$)</b> |
|--|----------------------|---|--|--|
| <b>Paul J. Lawrence (2)</b><br>President and<br>Chief Executive Officer                                | ISRBS                | 24.9  | \$ 2,347,686                                     | \$ -   |
| <b>Sandra L. Derickson</b><br>Former President and<br>Chief Executive Officer                          | RIP-Account Based    | 7.3   | 36,481   | -  |
|  | SRIP-Account Based   | 7.3   | 240,639  | -  |
| <b>Gerard Mattia</b><br>Senior Executive<br>Vice President and<br>Chief Financial Officer              | RIP-Account Based    | 2.3   | 13,691   | -  |
| <b>John J. McKenna (3)</b><br>Former Senior Executive<br>Vice President and<br>Chief Financial Officer | RIP-HSBC Old         | 21.2  | 300,994  | -  |
|  | Excess-HSBC Old      | 21.2  | 76,356   | -  |
| <b>Kevin Newman</b><br>Senior Executive Vice<br>President, Personal<br>Financial Services              | RIP-HSBC New         | 15.0  | 257,437  | -  |
|  | BEP-HSBC New         | 15.0  | 334,574  | -  |
| <b>David Dew (4)</b><br>Senior Executive<br>Vice President and<br>Chief Operating Officer              | ISRBS                | 29.7  | 3,578,760  | -  |
| <b>Janet L. Burak</b><br>Senior Executive<br>Vice President and<br>General Counsel                     | RIP-Household New    | 15.8  | 304,453  | -  |
|  | SRIP-Household New   | 15.8  | 1,277,889  | -  |

(1) Plan described under Savings and Pension Plans below.

(2) Value of age 53 benefit. Participant is also eligible for an immediate early retirement benefit with a value of \$3,120,916.

(3) Value of age 65 benefit. At age 60, participant would be eligible for unreduced early retirement, and accrued benefit has a present value of \$459,891 (RIP) and \$117,220 (Excess Plan).

(4) Value of age 53 benefit. Participant is also eligible for an immediate early retirement benefit with a value of \$3,809,515.

## *Savings and Pension Plans*

### *Retirement Income Plan (RIP)*

The HSBC-North America (U.S.) Retirement Income Plan (“RIP”) is a non-contributory, defined benefit pension plan for employees of HSBC North America and its U.S. subsidiaries who are at least 21 years of age with one year of service and not part of a collective bargaining unit. Benefits are determined under a number of different formulas that vary based on year of hire and employer.

*Supplemental Retirement Income Plan (SRIP)*  
*HSBC Bank (HBUS) Supplemental Plans (Excess Plans)*

Supplemental Retirement Income Plan (“SRIP”) is a non-qualified retirement plan that is designed to provide benefits that are precluded from being paid to legacy Household employees by the RIP due to legal constraints applicable to all qualified plans. The HBUS Supplemental Benefit Plan and the Benefit Equalization Plan (the “Excess Plans”) are designed to provide benefits that are precluded from being paid to legacy HBUS employees by the defined benefit formula under the Retirement Income Plan (RIP) due to legal constraints applicable to all qualified plans. For example, the maximum amount of compensation during 2007 that can be used to determine a qualified plan benefit is \$225,000 and the maximum annual benefit commencing at age 65 in 2007 is \$180,000. SRIP and Excess Plan benefits are calculated without regard to these limits. The resulting benefit is then reduced by the value of qualified benefits payable by RIP so that there is no duplication of payments. Benefits are paid in a lump sum for retired executives covered by a Household Old, Household New, or Account Based Formula, and in the same manner as elected for the qualified plan for executives covered by a HBUS Old or New Plan Formula.

*Formulas for Calculating Benefits*

**HBUS Old Plan Formula:** Applies to executives who were participants in the HBUS pension plan before January 1, 1989. The normal retirement benefit is the sum of A and B below:

- A. A benefit determined under the HBUS New Plan Formula, provided service for this purpose is limited to 30 years reduced by years of service used in B.
- B. A benefit determined by multiplying (a) by (b) as described below:
  - (a) The gross benefit prior to offset by an integration amount is equal to two percent of average salary multiplied by the first 30 years of service. This gross benefit is then reduced by an integration amount equal to 2/3 of one percent of Social Security multiplied by the first 30 years of service. However, the integration amount cannot reduce the gross benefit by more than 50 percent. Average salary, service, and Social Security for the gross benefit and integration amount are determined as of December 31, 1988.
  - (b) The benefit in (a) is multiplied by a fraction (but not less than one), the numerator of which is average salary at date of retirement and the denominator is average salary on December 31, 1988.

For this purpose, salary includes base wages but excludes bonuses. The formula uses an average of salaries for the 60 highest consecutive months selected from the 120 consecutive months preceding date of retirement. Executives who are at least age 60 with 30 or more years of service are eligible to retire with unreduced benefits. Executives who are at least age 55 with 10 or more years of service may retire before age 65 in which case the benefit is reduced 3/12 of one percent for the first 60 months and 5/12 of one percent for the next 60 months that payment precedes age 65.

**HBUS New Plan Formula:** Applies to executives who were hired prior to January 1, 1997 by HBUS and became participants in the pension plan after December 31, 1988. The normal retirement benefit at age 65 is the sum of (i) 1.55 percent of average salary and (ii) 0.4 percent of average salary in excess of the integration amount. The total of (i) and (ii) is then multiplied by the first 30 years of service. For this purpose, the integration amount is an average of the Social Security taxable wage bases for the 35 year period ending with the year in which full benefits are available; any such wage bases that have to be estimated are based on the current wage base for the year of retirement. Salary includes base wages but excludes bonuses. The formula uses an average of salaries for the 60 highest consecutive months selected from the 120 consecutive months preceding date of retirement. Executives who are at least age 60 with 30 or more years of service are eligible to retire with unreduced benefits. Executives who are at least age 55 with 10 or more years of service may retire before age 65 in which case the benefit is

reduced 3/12 of one percent for the first 60 months and 5/12 of one percent for the next 60 months that payment precedes age 65.

**Household Old Formula:** Applies to executives who were hired prior to January 1, 1990 by Household International. The benefit at age 65 is determined under whichever formula, A or B below, provides the higher amount.

- A. The normal retirement benefit at age 65 is the sum of (i) 51 percent of average salary that does not exceed the integration amount and (ii) 57 percent of average salary in excess of the integration amount. For this purpose, the integration amount is an average of the Social Security taxable wage bases for the 35 year period ending with the year of retirement. The benefit is reduced pro rata for executives who retire with less than 15 years of service. If an executive has more than 30 years of service, the benefit percentages in the formula, (the 51 percent and 57 percent) are increased 1/24 of 1 percentage point for each month of service in excess of 30 years, but not more than 5 percentage points. The benefit percentages are reduced for retirement prior to age 65.
- B. The normal retirement benefit at age 65 is determined under (a) below, limited to a maximum amount determined in (b):
  - (a) 55 percent of average salary, reduced pro rata for less than 15 years of service, and increased 1/24 of 1 percentage point for each month in excess of 30 years, but not more than 5 percentage points; the benefit percentage of 55 percent is reduced for retirement prior to age 65.
  - (b) The amount determined in (a) is reduced as needed so that when added to 50 percent of the primary Social Security benefit, the total does not exceed 65 percent of the average salary. This maximum is applied for payments following the age at which full Social Security benefits are available.

Both formulas use an average of salaries for the 48 highest consecutive months selected from the 120 consecutive months preceding date of retirement; for this purpose, salary includes total base wages and bonuses.

For executives who were participants on January 1, 1978, had attained age 35 and had at least 10 years of employment, the minimum normal retirement benefit is 55 percent of final average salary. For this purpose, salary does not include bonuses and the average is based on 60 consecutive months, rather than 48.

Executives who are at least age 50 with 15 years of service or at least age 55 with 10 years of service may retire before age 65, in which case the benefits are reduced.

**Household New Formula:** Applies to executives who were hired after December 31, 1989, but prior to January 1, 2000, by Household International. The normal retirement benefit at age 65 is the sum of (i) 51 percent of average salary that does not exceed the integration amount and (ii) 57 percent of average salary in excess of the integration amount. For this purpose, salaries include total base wages and bonuses and are averaged over the 48 highest consecutive months selected from the 120 consecutive months preceding date of retirement. The integration amount is an average of the Social Security taxable wage bases for the 35 year period ending with the year of retirement. The benefit is reduced pro rata for executives who retire with less than 30 years of service. If an executive has more than 30 years of service, the percentages in the formula, (the 51 percent and 57 percent) are increased 1/24 of 1 percentage point for each month of service in excess of 30 years, but not more than 5 percentage points. Executives who are at least age 55 with 10 or more years of service may retire before age 65 in which case the benefit percentages (51 percent and 57 percent) are reduced.

**Account Based Formula:** Applies to executives who were hired by Household International after December 31, 1999. It also applies to executives who were hired by HBUS after December 31, 1996 and became participants in the Retirement Income Plan on January 1, 2005, or were hired by HSBC after March 28, 2003. The formula provides for a notional account that accumulates two percent of annual salary for each calendar year of employment. For this purpose, salary includes total base wages and bonuses. At the end of each calendar year, interest is credited on the notional account using the value of the account at the beginning of the year. The interest rate is based on the lesser of average yields for 10-year and 30-year Treasury bonds during September of the preceding calendar year. The notional account is payable at termination of employment for any reason after three years of service although payment may be deferred to age 65.

**Provisions Applicable to All U.S. Formulas:** The amount of salary used to determine benefits is subject to an annual maximum that varies by calendar year. The limit for 2007 is \$225,000. The limit for years after 2007 will increase from time-to-time as specified by IRS regulations. Benefits are payable as a life annuity, or for married participants, a reduced life annuity with 50 percent continued to a surviving spouse. Participants (with spousal consent, if married) may choose from a variety of other optional forms of payment, which are all designed to be equivalent in value if paid over an average lifetime. Retired executives covered by a Household Old, Household New or Account Based Formula may elect a lump sum form of payment (spousal consent is needed for married executives).

#### *HSBC International Staff Retirement Benefits Scheme*

The HSBC International Staff Retirement Benefits Scheme (Jersey) (“ISRBS”) is a defined benefit plan maintained for certain international managers. Each member during his service must contribute five percent of his salary to the plan but each member who has completed 20 years of service or who enters the senior management or general management sections during his service shall contribute 6 2/3 percent of his salary. In addition, a member may make voluntary contributions, but the total of voluntary and mandatory contributions cannot exceed 15 percent of his total compensation. Upon leaving service, the value of the member’s voluntary contribution fund, if any, shall be commuted for a retirement benefit.

The annual pension payable at normal retirement is 1/480 of the member’s final salary for each completed month in the executive section, 1.25/480 of his final salary for each completed month in the senior management section, and 1.50/480 of his final salary for each completed month in the general management section. A member’s normal retirement date is the first day of the month coincident with or next following his 53<sup>rd</sup> birthday. Payments may be deferred or suspended but not beyond age 75.

If a member leaves before normal retirement with at least 15 years of service, he will receive a pension which is reduced by 0.25 percent for each complete month by which termination precedes normal retirement. If he terminates with at least 5 years of service, he will receive an immediate lump sum equivalent of his reduced pension.

#### *Present Value of Accumulated Benefits*

For the Account Based formula: The value of the notional account balances currently available on December 31, 2007.

For other formulas: The present value of the benefit payable at assumed retirement using interest and mortality assumptions consistent with those used for financial reporting purposes under SFAS 87 with respect to the company’s audited financial statements for the period ending December 31, 2007. However, no discount has been assumed for separation prior to retirement due to death, disability or termination of employment. Further, the amount of the benefit so valued is the portion of the benefit at assumed retirement that has accrued in proportion to service earned on December 31, 2007.

## *Deferred Compensation Plans*

**Tax Reduction Investment Plan** HNAH maintains the HSBC-North America (U.S.) Tax Reduction Investment Plan (“TRIP”), which is a deferred profit-sharing and savings plan for its eligible employees. With certain exceptions, a U.S. employee who has been employed for 30 days and who is not part of a collective bargaining unit may contribute into TRIP, on a pre-tax and after-tax basis, up to 40 percent (15 percent if highly compensated) of the participant’s cash compensation (subject to a maximum annual pre-tax contribution by a participant of \$15,500, as adjusted for cost of living increases, and certain other limitations imposed by the Internal Revenue Code) and invest such contributions in separate equity or income funds.

If the employee has been employed for at least one year, HUSI contributes three percent of compensation on behalf of each participant who contributes one percent and matches any additional participant contributions up to four percent of compensation. However, matching contributions will not exceed six percent of a participant’s compensation if the participant contributes four percent or more of compensation. The plan provides for immediate vesting of all contributions. With certain exceptions, a participant’s after-tax contributions which have not been matched by us can be withdrawn at any time. Both our matching contributions made prior to 1999 and the participant’s after-tax contributions which have been matched may be withdrawn after five years of participation in the plan. A participant’s pre-tax contributions and our matching contributions after 1998 may not be withdrawn except for an immediate financial hardship, upon termination of employment, or after attaining age 59 1/2. Participants may borrow from their TRIP accounts under certain circumstances.

**Supplemental Tax Reduction Investment Plan** HNAH also maintains the Supplemental Tax Reduction Investment Plan (“STRIP”), which is an unfunded plan for eligible employees of HUSI and its participating subsidiaries who are legacy Household employees and whose participation in TRIP is limited by the Internal Revenue Code. Only matching contributions required to be made by us pursuant to the basic TRIP formula are invested in STRIP through a credit to a bookkeeping account maintained by us which deems such contributions to be invested in equity or income funds selected by the participant.

**Non-Qualified Deferred Compensation Plan** HNAH maintains a Non-Qualified Deferred Compensation Plan for the highly compensated employees in the organization, including executives of HUSI. The named executive officers are eligible to contribute up to 80 percent of their salary and/or cash bonus compensation in any plan year. Participants are required to make an irrevocable election with regard to an amount or percentage of compensation to be deferred and the timing and manner of future payout. Two types of distributions are permitted under the plan, either a scheduled in-service withdrawal which must be scheduled at least 2 years after the end of the plan year in which the deferral is made, or payment upon termination of employment. For either the scheduled in-service withdrawal or payment upon termination, the participant may elect either a lump sum payment or if the participant has made at least \$25,000 of contributions and has over 10 years of service, he may request installment payments over 10 years. Due to the unfunded nature of the plan, participant elections are deemed investments whose gains or losses are calculated by reference to actual earnings of the investment choices. In order to provide the participants with the maximum amount of protection under an unfunded plan, a Rabbi Trust has been established where the participant contributions are segregated from the general assets of HUSI. The Investment Committee for the plan endeavors to invest the contributions in a manner consistent with the participant’s deemed elections reducing the likelihood of an underfunded plan.

***Nonqualified Defined Contribution and Other Nonqualified Deferred Compensation Plans***

| Name   | Nonqualified<br>Deferred<br>Compensation<br>Plan (1) |           | Supplemental<br>Tax Reduction<br>Investment<br>Plan (2) |        | Aggregate<br>Earnings in 2007 | Aggregate<br>Withdrawals/<br>Distributions | Aggregate<br>Balance at<br>12/31/2007 |           |
|--|--|-----------|---|--------|-------------------------------|--|---------------------------------------|-----------|
|  | Executive<br>Contributions in<br>2007                |           | HUSI<br>Contributions in<br>2007                        |        |                               |  |                                       |           |
| <b>Paul J. Lawrence</b><br>President and<br>Chief Executive Officer                                | \$   | N/A       | \$  | N/A    | \$                            | N/A  | \$                                    | N/A       |
| <b>Sandra L. Derickson</b><br>Former President and<br>Chief Executive Officer                      |  | 14,942    |   | 2,075  | 60,202                        | -  |                                       | 2,660,290 |
| <b>Gerard Mattia</b><br>Senior Executive<br>Vice President and<br>Chief Financial Officer          |  | 36,000    |   | -      | 3,373                         | -  |                                       | 76,179    |
| <b>John J. McKenna</b><br>Former Senior Executive<br>Vice President and<br>Chief Financial Officer |  | N/A       |   | N/A    | N/A                           | N/A  |                                       | N/A       |
| <b>Kevin Newman</b><br>Senior Executive Vice<br>President, Personal<br>Financial Services          |  | 1,566,900 |   | N/A    | 133,022                       | -  |                                       | 2,803,094 |
| <b>David Dew</b><br>Senior Executive<br>Vice President and<br>Chief Operating Officer              |  | N/A       |   | N/A    | N/A                           | N/A  |                                       | N/A       |
| <b>Janet L. Burak</b><br>Senior Executive<br>Vice President and<br>General Counsel                 |  | 59,901    |   | 35,301 | 9,161                         | -  |                                       | 774,019   |

- (1) The Nonqualified Deferred Compensation Plan is described under *Savings and Pension Plans* on page 199.
- (2) The Supplemental Tax Reduction Investment Plan (STRIP) is described under *Savings and Pension Plans* on page 199. Company contributions are invested in STRIP through a credit to a bookkeeping account, which deems such contributions to be invested in equity or income mutual funds selected by the participant. For this purpose, compensation includes amounts that would be compensation but for the fact they were deferred under the terms of the HSBC North America Non-Qualified Deferred Compensation Plan. Distributions are made in a lump sum upon termination of employment. These figures are also included in the "Change in Pension Value and Nonqualified Deferred Compensation Earnings" column of the *Summary Compensation Table* on page 190.



## Potential Payments Upon Termination Or Change-In-Control

The following tables describe the payments that HUSI would be required to make as of December 31, 2007 to Mr. Lawrence, Mr. McKenna, Mr. Mattia, Mr. Newman, Mr. Dew and Ms. Burak as a result of their termination, retirement, disability or death or a change in control of the company as of that date. The specific circumstances that would trigger such payments are identified in the tables. The amounts and terms of such payments are defined by HSBC's employment and severance policies, and the particular terms of any equity-based awards.

### Paul J. Lawrence

| Executive Benefits and Payments Upon Termination | Voluntary Termination | Disability    | Normal Retirement | Involuntary Not for Cause Termination | For Cause Termination | Voluntary for Good Reason Termination | Death           | Change in Control Termination |
|--|-----------------------|---------------|-------------------|---------------------------------------|-----------------------|---------------------------------------|-----------------|-------------------------------|
| <b>Cash Compensation</b>                         |                       |               |                   |                                       |                       |                                       |                 |                               |
| Base Salary                                      | -                     | -             | -                 | -                                     | -                     | -                                     | -               | -                             |
| Short Term Incentive                             | -                     | -             | -                 | \$1,555,243 (1)                       | -                     | -                                     | -               | -                             |
| <b>Long Term Incentive</b>                       |                       |               |                   |                                       |                       |                                       |                 |                               |
| Performance Shares                               | -                     | \$926,999 (2) | \$926,999 (2)     | 926,999 (2)                           | -                     | \$926,999 (2)                         | \$1,220,118 (3) | \$926,999 (2)                 |
| Stock Options: Unvested and Accelerated          | -                     | -             | -                 | -                                     | -                     | -                                     | -               | -                             |
| Restricted Stock: Unvested and Accelerated       | -                     | 216,273 (4)   | 216,273 (4)       | 216,273 (4)                           | -                     | 216,273 (4)                           | 820,634 (5)     | 216,273 (4)                   |

- (1) Assumes a termination date of December 31, 2007, and represents the 2007 bonus awarded but not paid until 2008.
- (2) Assumes performance conditions have been met. This amount represents accelerated vesting of a pro-rata portion of the outstanding restricted shares assuming a termination date of December 31, 2007, and are calculated using the closing price of HSBC ordinary shares and exchange rate on December 31, 2007.
- (3) Performance conditions would be waived. This amount represents a full vesting of the outstanding restricted shares assuming a termination date of December 31, 2007, and are calculated using the closing price of HSBC ordinary shares and exchange rate on December 31, 2007.
- (4) This amount represents accelerated vesting of a pro-rata portion of the outstanding restricted shares assuming a termination date of December 31, 2007, and are calculated using the closing price of HSBC ordinary shares and exchange rate on December 31, 2007.
- (5) This amount represents a full vesting of the outstanding restricted shares assuming a termination date of December 31, 2007, and are calculated using the closing price of HSBC ordinary shares and exchange rate on December 31, 2007.

### John J. McKenna

| Executive Benefits and Payments Upon Termination | Voluntary Termination | Disability    | Normal Retirement | Involuntary Not for Cause Termination | For Cause Termination | Voluntary for Good Reason Termination | Death         | Change in Control Termination |
|--|-----------------------|---------------|-------------------|---------------------------------------|-----------------------|---------------------------------------|---------------|-------------------------------|
| <b>Cash Compensation</b>                         |                       |               |                   |                                       |                       |                                       |               |                               |
| Base Salary                                      | -                     | -             | -                 | \$275,668 (1)                         | -                     | -                                     | -             | -                             |
| Short Term Incentive                             | -                     | -             | -                 | 162,726 (1)                           | -                     | -                                     | -             | -                             |
| <b>Long Term Incentive</b>                       |                       |               |                   |                                       |                       |                                       |               |                               |
| Performance Shares                               | -                     | \$169,451 (2) | \$169,451 (2)     | 169,451 (2)                           | -                     | \$169,451 (2)                         | \$169,451 (3) | \$169,451 (2)                 |
| Restricted Stock: Unvested and Accelerated       | -                     | 458,572 (4)   | 458,572 (4)       | 496,869 (4)                           | -                     | 496,869 (4)                           | 946,915 (3)   | 496,869 (4)                   |

- (1) Under the terms of the HSBC Severance Policy, Mr. McKenna would receive 42 weeks of his current salary upon separation from the company and a pro-rata amount of his earned bonus. The figures above represent the bonus payment earned in 2007 assuming a termination date of December 31, 2007.
- (2) The figures above represent accelerated vesting of 100 percent of the outstanding Performance Shares assuming "good leaver" status is granted by REMCO, a termination date of December 31, 2007 and that the performance test has been passed using the month end prior to exit date as the performance period. The amount has been calculated using the closing price of HSBC ordinary shares and exchange rate on December 31, 2007. If the performance test is not passed, 100 percent of the award remains outstanding and the performance condition is re-tested on the third, fourth and fifth anniversary of the award date. If the performance condition is not passed by the fifth anniversary, the shares are forfeited.
- (3) The figures above represent a full vest of the outstanding shares assuming a termination date of December 31, 2007, and are calculated using the closing price of HSBC ordinary shares and exchange rate on December 31, 2007.
- (4) The figures represent a pro-rata portion of the outstanding restricted share awards based on the number of months elapsed between the date of grant and date of termination assuming a termination date of December 31, 2007, and are calculated using the closing price of HSBC ordinary shares and exchange rate on December 31, 2007.

## Gerard Mattia

| Executive Benefits and Payments Upon Termination | Voluntary Termination | Disability    | Normal Retirement | Involuntary Not for Cause Termination | For Cause Termination | Voluntary for Good Reason Termination | Death         | Change in Control Termination |
|--|-----------------------|---------------|-------------------|---------------------------------------|-----------------------|---------------------------------------|---------------|-------------------------------|
| <b>Cash Compensation</b>                         |                       |               |                   |                                       |                       |                                       |               |                               |
| Base Salary                                      | -                     | -             | -                 | \$127,500 (1)                         | -                     | -                                     | -             | -                             |
| Short Term Incentive                             | -                     | -             | -                 | 910,000 (1)                           | -                     | -                                     | -             | -                             |
| <b>Long Term Incentive</b>                       |                       |               |                   |                                       |                       |                                       |               |                               |
| Restricted Stock: Unvested and Accelerated       | -                     | \$251,964 (2) | \$251,964 (2)     | 251,964 (2)                           | -                     | \$251,964 (2)                         | \$533,377 (3) | \$251,964 (2)                 |

- (1) Under the terms of the HSBC Severance Policy, Mr. Mattia would receive 26 weeks of his current salary upon separation from the company and a pro-rata amount of his earned bonus. The Short Term Incentive amount represents the bonus payment earned in 2007 assuming a termination date of December 31, 2007.
- (2) The figures represent a pro-rata portion of the outstanding restricted share awards based on the number of months elapsed between the date of grant and date of termination assuming a termination date of December 31, 2007, and are calculated using the closing price of HSBC ordinary shares and exchange rate on December 31, 2007.
- (3) The figures above represent a full vest of the outstanding restricted shares assuming a termination date of December 31, 2007, and are calculated using the closing price of HSBC ordinary shares and exchange rate on December 31, 2007.

## Kevin Newman

| Executive Benefits and Payments Upon Termination | Voluntary Termination | Disability     | Normal Retirement | Involuntary Not for Cause Termination | For Cause Termination | Voluntary for Good Reason Termination | Death          | Change in Control Termination |
|--|-----------------------|----------------|-------------------|---------------------------------------|-----------------------|---------------------------------------|----------------|-------------------------------|
| <b>Cash Compensation</b>                         |                       |                |                   |                                       |                       |                                       |                |                               |
| Base Salary                                      | -                     | -              | -                 | \$ 280,000 (1)                        | -                     | -                                     | -              | -                             |
| Short Term Incentive                             | -                     | -              | -                 | 1,000,000 (1)                         | -                     | -                                     | -              | -                             |
| <b>Long Term Incentive</b>                       |                       |                |                   |                                       |                       |                                       |                |                               |
| Performance Shares                               | -                     | \$ 312,994 (2) | \$ 312,994 (2)    | 312,994 (2)                           | -                     | \$ 312,994 (2)                        | \$ 312,994 (3) | \$ 312,994 (2)                |
| Restricted Stock: Unvested and Accelerated       | -                     | 1,238,833 (4)  | 1,238,833 (4)     | 1,238,833 (4)                         | -                     | 1,238,833 (4)                         | 2,110,663 (3)  | 1,238,833 (4)                 |

- (1) Under the terms of the HSBC Severance Policy, Mr. Newman would receive 28 weeks of his current salary upon separation from the company. The Short Term Incentive amount is based on an assumed termination date of December 31, 2007, and represents the 2007 bonus awarded but not paid until 2008.
- (2) The figures above represent accelerated vesting of 100 percent of the outstanding Performance Shares assuming "good leaver" status is granted by REMCO, a termination date of December 31, 2007 and that the performance test has been passed using the month end prior to exit date as the performance period. The amount has been calculated using the closing price of HSBC ordinary shares and exchange rate on December 31, 2007. If the performance test is not passed, 100 percent of the award remains outstanding and the performance condition is re-tested on the third, fourth and fifth anniversary of the award date. If the performance condition is not passed by the fifth anniversary, the shares are forfeited.
- (3) The figures above represent a full vest of the outstanding shares assuming a termination date of December 31, 2007, and are calculated using the closing price of HSBC ordinary shares and exchange rate on December 31, 2007.
- (4) The figures represent a pro-rata portion of the outstanding restricted share awards based on the number of months elapsed between the date of grant and date of termination assuming a termination date of December 31, 2007, and are calculated using the closing price of HSBC ordinary shares and exchange rate on December 31, 2007.

## David Dew

| Executive Benefits and Payments Upon Termination | Voluntary Termination | Disability    | Normal Retirement | Involuntary Not for Cause Termination | For Cause Termination | Voluntary for Good Reason Termination | Death         | Change in Control Termination |
|--|-----------------------|---------------|-------------------|---------------------------------------|-----------------------|---------------------------------------|---------------|-------------------------------|
| <b>Cash Compensation</b>                         |                       |               |                   |                                       |                       |                                       |               |                               |
| Base Salary                                      | -                     | -             | -                 | -                                     | -                     | -                                     | -             | -                             |
| Short Term Incentive                             | -                     | -             | -                 | \$550,000 (1)                         | -                     | -                                     | -             | -                             |
| <b>Long Term Incentive</b>                       |                       |               |                   |                                       |                       |                                       |               |                               |
| Performance Shares                               | -                     | \$423,892 (2) | \$423,892 (2)     | 423,892 (2)                           | -                     | \$423,892 (2)                         | \$567,285 (3) | \$423,892 (2)                 |
| Restricted Stock: Unvested and Accelerated       | -                     | 23,888 (4)    | 23,888 (4)        | 23,888 (4)                            | -                     | 23,888 (4)                            | 95,552 (3)    | 23,888 (4)                    |

- (1) The Short Term Incentive amount is based on an assumed termination date of December 31, 2007, and represents the 2007 bonus awarded but not paid until 2008.
- (2) The figures above represent accelerated vesting of 100 percent of the outstanding Performance Shares assuming “good leaver” status is granted by REMCO, a termination date of December 31, 2007 and that the performance test has been passed using the month end prior to exit date as the performance period. The amount has been calculated using the closing price of HSBC ordinary shares and exchange rate on December 31, 2007. If the performance test is not passed, 100 percent of the award remains outstanding and the performance condition is re-tested on the third, fourth and fifth anniversary of the award date. If the performance condition is not passed by the fifth anniversary, the shares are forfeited.
- (3) The figures above represent a full vest of the outstanding shares assuming a termination date of December 31, 2007, and are calculated using the closing price of HSBC ordinary shares and exchange rate on December 31, 2007.
- (4) The figures represent a pro-rata portion of the outstanding restricted share awards based on the number of months elapsed between the date of grant and date of termination assuming a termination date of December 31, 2007, and are calculated using the closing price of HSBC ordinary shares and exchange rate on December 31, 2007.

## Janet L. Burak

| Executive Benefits and Payments Upon Termination | Voluntary Termination | Disability    | Normal Retirement | Involuntary Not for Cause Termination | For Cause Termination | Voluntary for Good Reason Termination | Death          | Change in Control Termination |
|--|-----------------------|---------------|-------------------|---------------------------------------|-----------------------|---------------------------------------|----------------|-------------------------------|
| <b>Cash Compensation</b>                         |                       |               |                   |                                       |                       |                                       |                |                               |
| Base Salary                                      | -                     | -             | -                 | \$ 275,000 (1)                        | -                     | -                                     | -              | -                             |
| Short Term Incentive                             | -                     | -             | -                 | 800,000 (1)                           | -                     | -                                     | -              | -                             |
| <b>Long Term Incentive</b>                       |                       |               |                   |                                       |                       |                                       |                |                               |
| Performance Shares                               | -                     | \$334,223 (2) | \$334,223 (2)     | 334,223 (2)                           | -                     | \$334,223 (2)                         | \$ 334,223 (3) | \$334,223 (2)                 |
| Restricted Stock: Unvested and Accelerated       | -                     | 968,983 (4)   | 968,983 (4)       | 968,983 (4)                           | -                     | 968,983 (4)                           | 1,602,378 (5)  | 968,983 (4)                   |

- (1) Under the terms of the HSBC Severance Policy, Ms. Burak would receive 26 weeks of her current salary upon separation from HUSI and a pro-rata amount of her bonus. The figure above represents the bonus payment earned in 2007 assuming a termination date of December 31, 2007.
- (2) The figures above represent a full vest of the Performance Shares, assuming “good leaver” status is granted by REMCO, a termination date of December 31, 2007, and 100 percent of the performance condition being met on the fourth anniversary of the date of grant. If the performance condition is not passed on the fourth anniversary, the award is subject to a re-test provision on the fifth anniversary of the date of grant. If the performance condition is not passed on the fifth anniversary, the award is forfeited. The amount is calculated using the closing price of HSBC ordinary shares and exchange rate on December 31, 2007.
- (3) Performance conditions would be waived. The figure above represents a full vest of the Performance Shares that would vest three years from the date of grant assuming a termination date of December 31, 2007, and is calculated using the closing price of HSBC ordinary shares and exchange rate on December 31, 2007.
- (4) The figures above represent a pro-rata portion of the outstanding restricted share awards based on the number of months elapsed between date of grant and date of termination, assuming a termination date of December 31, 2007 and assuming “good leaver” status is granted by REMCO. The figures are calculated using the closing price of HSBC ordinary shares and exchange rate on December 31, 2007.
- (5) The figure above represents a full vest of the outstanding shares assuming a termination date of December 31, 2007, and is calculated using the closing price of HSBC ordinary shares and exchange rate on December 31, 2007.

The following table and narrative text discusses the compensation awarded to, earned by or paid to our Directors in 2007.

### *Director Compensation*

| Name                  | Fees<br>Earned or<br>Paid in<br>Cash<br>(\$)(1) | Stock<br>Awards<br>(\$)(2) | Option<br>Awards<br>(\$)(3) | Non-Equity<br>Incentive Plan<br>Compensation<br>(\$)(4) | Change in<br>Pension Value<br>And<br>Nonqualified<br>Deferred<br>Compensation<br>Earnings (\$)(5) | All Other<br>Compensation<br>(\$)(6) | Total<br>(\$) |
|-----------------------|---|----------------------------|-----------------------------|---|---|--------------------------------------|---------------|
|                       |   |                            |                             |   |   |                                      |               |
| Salvatore H. Alfiero  | \$105,000                                       | -                          | -                           | -   | \$237,500   | -                                    | \$342,500     |
| Donald K. Boswell     | 85,000  | -                          | -                           | -   | -   | \$4,000                              | 89,000        |
| James H. Cleave       | 85,000  | -                          | -                           | -   | -   | -                                    | 85,000        |
| Frances D. Fergusson  | 90,000  | -                          | -                           | -   | 269,309   | -                                    | 359,309       |
| Michael F. Geoghegan  | -   | -                          | -                           | -   | -   | -                                    | -             |
| Stuart T. Gulliver    | -   | -                          | -                           | -   | -   | -                                    | -             |
| Richard A. Jalkut     | 120,000   | -                          | -                           | -   | 250,000   | -                                    | 370,000       |
| Peter Kimmelman       | 85,000  | -                          | -                           | -   | -   | -                                    | 85,000        |
| Paul J. Lawrence      | -   | -                          | -                           | -   | -   | -                                    | -             |
| Charles G. Meyer, Jr. | 90,000  | -                          | -                           | -   | -   | -                                    | 90,000        |
| James L. Morice       | 85,000  | -                          | -                           | -   | -   | -                                    | 85,000        |

- (1) The Directors' fee schedule was revised effective January 1, 2007 (in response to the Nominating & Governance Committee's recommendation that the compensation structure be reevaluated). In 2007, the non-management Directors of HUSI received an annual cash retainer of \$75,000 for their services on the boards of HUSI and HBUS (with the exception of Mr. Jalkut, who as Lead Director and Chair of the Executive Committee, received a retainer of \$100,000). In addition to the Board retainer, Mr. Cleave, Mr. Jalkut and Mr. Kimmelman each received an additional \$10,000 for their membership in the Audit Committee, Mr. Alfiero received an additional \$25,000 as Chair of the Audit Committee, Mr. Meyer received an additional \$10,000 as Chair of the Fiduciary Committee, Dr. Fergusson received an additional \$10,000 as Chair of the Human Resources & Compensation Committee, Mr. Jalkut received an additional \$10,000 as Chair of the Nominating & Governance Committee. In addition, Dr. Fergusson, Mr. Alfiero and Mr. Meyer received an additional \$5,000 each for membership on the Nominating & Governance Committee, and Mr. Boswell and Mr. Morice each received an additional \$10,000 for membership on the Fiduciary and Human Resources & Compensation Committees. Other than as stated above, HUSI does not pay additional compensation for committee membership, or meeting attendance fees to its Directors. Directors who are employees of HUSI or any of its affiliates do not receive any additional compensation related to their Board service. Non-management Directors elected prior to 1999 may elect to participate in the HUSI/HBUS Plan for Deferral of Directors' Fees. Under this plan, they may elect to defer receipt of all or a part of their retainer. The deferred retainers accrue interest on a quarterly basis at the one to two year Employee Extra CD rate in effect on the first business day of each quarter. Upon retirement from the Board, the deferrals plus interest are paid to the Director either in a lump sum or in quarterly or annual installments over a one, five or ten year period. No Director elected to defer receipt of their retainer for 2007.
- (2) HUSI does not grant stock awards to its non-management directors nor do any portions of employee directors' stock awards reflect services related to their Board positions.
- (3) HUSI does not grant stock option awards to its non-management directors.
- (4) HUSI does not award non-equity incentive plan compensation to its non-management directors nor does any portion of the employee directors' non-equity incentive plan compensation reflect compensation for services related to their Board positions.
- (5) The HUSI Directors' Retirement Plan covers non-management directors elected prior to 1998 and excludes those serving as directors at the request of HSBC. Eligible directors with at least five years of service will receive quarterly retirement benefit payments commencing at the later of age 65 or retirement from the Board, and continuing for ten years. The annual amount of the retirement benefit is a percent of the annual retainer in effect at the time of the last Board meeting the director attended. The percentage is 50 percent after five years of service and increases by five percent for each additional year of service to 100 percent upon completion of 15 years of service. If a director who has at least five years of service dies before the retirement benefit has commenced, the director's beneficiary will receive a death benefit calculated as if the director had retired on the date of death. If a retired director dies before receiving retirement benefit payments for the ten year period, the balance of the payments will be continued to the director's beneficiary. The plan is unfunded and payment will be made out of the general funds of HUSI or HBUS.
- (6) Mr. Boswell also serves on the Western Region Board for which he received \$4,000 during 2007. Non-management directors are offered, on terms that are not more favorable than those available to the general public, a MasterCard/Visa credit card issued by one of our subsidiaries with a credit limit of \$15,000. HUSI guarantees the repayment of amounts charged on each card. Under HUSI's Matching Gift Program, HUSI matches charitable gifts to qualified organizations (subject to a maximum of \$10,000 per year), with a double match for the first \$500 donated to higher education institutions (both public and private) and eligible non-profit organizations which promote neighborhood revitalization or economic development for low and moderate income populations. Each current independent Director may ask us to contribute up to \$10,000 annually to charities of the Director's choice which qualify under our philanthropic program.

## ***Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters***

### ***Security Ownership of Certain Beneficial Owners***

HSBC USA Inc.'s common stock is 100 percent owned by HSBC North America Inc. ("HNAI"). HNAI is an indirect wholly owned subsidiary of HSBC.

### ***Security Ownership by Management***

The following table lists the beneficial ownership, as of January 31, 2008, of HSBC ordinary shares or interests in HSBC ordinary shares and HSBC's American Depositary Shares, Series A, by each director and the executive officers named in the *Summary Compensation Table* on page 190, individually, and the directors and executive officers as a group. Each of the individuals listed below and all directors and executive officers as a group own less than one percent of the HSBC ordinary shares. No director or executive officer of HUSI owned any of HUSI's outstanding series of preferred stock at January 31, 2008.

|  | <b>Number of<br/>HSBC<br/>Ordinary<br/>Shares<br/>Beneficially<br/>Owned (1) (2)</b> | <b>HSBC Ordinary<br/>Shares That<br/>May Be Acquired<br/>Within 60 Days<br/>By Exercise of<br/>Options (3)</b> | <b>HSBC<br/>Restricted<br/>Shares<br/>Released<br/>Within 60<br/>Days (4)</b> | <b>Number of<br/>HSBC Ordinary<br/>Share<br/>Equivalents (5)</b> | <b>Total HSBC<br/>Ordinary<br/>Shares</b> | <b>HSBC<br/>Holdings plc<br/>American<br/>Depositary<br/>Shares,<br/>Series A (6)</b> |
|--|--|--|---|--|---|---|
| <b>Directors</b>                                       |  |  |   |  |   |   |
| Salvatore H. Alfiero                                   | 309,000  | -  | -   | -  | 309,000                                   | 450,000   |
| Donald K. Boswell                                      | 220  | -  | -   | -  | 220                                       | -   |
| James H. Cleave  | 227,080  | -  | -   | -  | 227,080                                   | -   |
| Dr. Frances D. Fergusson                               | 100  | -  | -   | -  | 100                                       | -   |
| Michael F. Geoghegan                                   | 386,946  | -  | 1,135,652   | -  | 1,522,598                                 | -   |
| Stuart T. Gulliver                                     | 2,022,961  | -  | 1,168,396   | -  | 3,191,357                                 | -   |
| Paul J. Lawrence                                       | 200  | -  | -   | -  | 200                                       | -   |
| Richard A. Jalkut                                      | 250  | -  | -   | -  | 250                                       | -   |
| Peter Kimmelman  | 5,540  | -  | -   | -  | 5,540                                     | -   |
| Charles G. Meyer, Jr.                                  | 170  | -  | -   | -  | 170                                       | -   |
| James L. Morice  | 1,500  | -  | -   | -  | 1,500                                     | -   |
| <b>Named Executive Officers</b>                        |  |  |   |  |   |   |
| Paul J. Lawrence                                       | 200  | -  | -   | -  | 200                                       | -   |
| Sandra L. Derickson                                    | 44,895   | 605,250  | -   | 27,079   | 677,224                                   | -   |
| Gerard Mattia  | 4,990  | -  | 19,288  | -  | 24,278                                    | -   |
| John J. McKenna  | 3,000  | -  | -   | 1,550  | 4,550                                     | -   |
| Janet L. Burak   | 21,667   | 80,250   | 35,654  | 234  | 137,805                                   | -   |
| David Dew  | 15,429   | 24,500   | -   | -  | 39,929                                    | -   |
| Kevin Newman   | -  | -  | 55,652  | -  | 55,652                                    | -   |
| <b>All directors and executive officers as a group</b> | <b>3,077,739</b>   | <b>732,500</b>   | <b>2,480,955</b>  | <b>29,481</b>  | <b>6,320,675</b>                          | <b>450,000</b>  |

- Directors and executive officers have sole voting and investment power over the shares listed above, except as follows. The number of ordinary shares held by spouses, children and charitable or family foundations for which a director or executive officer does not have voting and investment power and beneficial ownership of which is denied is as follows: Mr. Kimmelman, 1,822; and directors and executive officers as a group, 1,822.
- Some of the shares included in the table above were held in American Depositary Shares, each of which represents five HSBC ordinary shares.
- Represents the number of ordinary shares that may be acquired by HUSI's directors and executive officers through April 1, 2008 pursuant to the exercise of stock options.
- Represents the number of ordinary shares that may be acquired by HUSI's directors and executive officers through April 1, 2008 pursuant to the satisfaction of certain conditions.

- (5) Represents the number of ordinary share equivalents owned by executive officers under HSBC-North America (U.S.) Tax Reduction Investment Plan and HSBC-North America Employee Non-Qualified Deferred Compensation Plan. Some of the shares included in the table above were held in American Depositary Shares, each of which represents five HSBC ordinary shares.
- (6) Each depositary share represents one-fortieth of a share of HSBC's 6.20% Non-Cumulative Dollar Preference Shares, Series A.

### ***Item 13. Certain Relationships and Related Transactions, and Director Independence***

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#### ***Transactions with Related Persons***

During the fiscal year ended December 31, 2007, HUSI was not a participant in any transaction, and there is currently no proposed transaction, in which the amount involved exceeded or will exceed \$120,000, and in which a director or an executive officer, or a member of the immediate family of a director or an executive officer, had or will have a direct or indirect material interest, other than the agreement with Ms. Derickson described in *Item 11. Executive Compensation - Compensation Discussion and Analysis - Compensation of Officers Reported in the Summary Compensation Table*. During 2007, HBUS provided loans to certain directors and executive officers of HUSI and its subsidiaries in the ordinary course of business. Such loans were provided on substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable loans with persons not related to HUSI and do not involve more than the normal risk of collectibility or present other unfavorable features.

HUSI maintains a written Policy for the Review, Approval or Ratification of Transactions with Related Persons, which provides that any "Transaction with a Related Person" must be reviewed and approved or ratified in accordance with specified procedures. The term "Transaction with a Related Person" includes any transaction, arrangement or relationship, or series of similar transactions, arrangements or relationships, in which (1) the aggregate dollar amount involved will or may be expected to exceed \$120,000 in any calendar year, (2) HUSI or any of its subsidiaries is, or is proposed to be, a participant, and (3) a director or an executive officer, or a member of the immediate family of a director or an executive officer, has or will have a direct or indirect material interest (other than solely as a result of being a director or a less than 10 percent beneficial owner of another entity). The following are specifically excluded from the definition of Transaction with a Related Person:

- compensation paid to directors and executive officers reportable under rules and regulations promulgated by the Securities and Exchange Commission;
- transactions with other companies if the only relationship of the director, executive officer or family member to the other company is as an employee (other than an executive officer), director or beneficial owner of less than 10 percent of such other company's equity securities;
- charitable contributions, grants or endowments by HUSI or any of its subsidiaries to charitable organizations, foundations or universities if the only relationship of the director, executive officer or family member to the organization, foundation or university is as an employee (other than an executive officer) or a director;
- transactions where the interest of the director, executive officer or family member arises solely from the ownership of HUSI's equity securities and all holders of such securities received or will receive the same benefit on a pro rata basis;
- transactions where the rates or charges involved are determined by competitive bids;
- loans made in the ordinary course of business on substantially the same terms (including interest rates and collateral requirements) as those prevailing at the time for comparable loans with persons not related to HUSI or any of its subsidiaries that do not involve more than the normal risk for collectibility or present other unfavorable features; and
- transactions involving services as a bank depository of funds, transfer agent, registrar, trustee under a trust indenture or similar services.

The policy requires each director and executive officer to notify the Office of the General Counsel in writing of any Transaction with a Related Person in which the director, executive officer or an immediate family member has or will have an interest and to provide specified details of the transaction. The Office of the General Counsel, through the Corporate Secretary, will deliver a copy of the notice to the Chair of the Nominating & Governance Committee of the Board of Directors. The Nominating & Governance Committee will review the material facts of each proposed Transaction with a Related Person at each regularly scheduled committee meeting and approve, ratify or disapprove the transaction.

The vote of a majority of disinterested members of the Nominating & Governance Committee is required for the approval or ratification of any Transaction with a Related Person. The Nominating & Governance Committee may approve or ratify a Transaction with a Related Person if the committee determines, in its business judgment, based on the review of all available information, that the transaction is fair and reasonable to, and consistent with the best interests of, HUSI and its subsidiaries. In making this determination, the Nominating & Governance Committee will consider, among other things, (i) the business purpose of the transaction, (ii) whether the transaction is entered into on an arms-length basis and on terms no less favorable than terms generally available to an unaffiliated third-party under the same or similar circumstances, (iii) whether the interest of the director, executive officer or family member in the transaction is material and (iv) whether the transaction would violate any provision of the HSBC North America Holdings Inc. Statement of Business Principles and Code of Ethics, the HSBC USA Inc. Code of Ethics for Senior Financial Officers or the HSBC USA Inc. Corporate Governance Standards, as applicable.

In any case where the Nominating & Governance Committee determines not to approve or ratify a Transaction with a Related Person, the matter will be referred to the Office of the General Counsel for review and consultation regarding the appropriate disposition of such transaction including, but not limited to, termination of the transaction, rescission of the transaction or modification of the transaction in a manner that would permit it to be ratified and approved.

***Director Independence***

The HSBC USA Inc. Corporate Governance Standards, together with the charters of the committees of the Board of Directors, provide the framework for HUSI’s corporate governance. Director independence is defined in HUSI’s Corporate Governance Standards, which are based upon the rules of the New York Stock Exchange. The Corporate Governance Standards are incorporated by reference to Exhibit 99(i) of this Form 10-K and are available upon written request made to HSBC USA Inc., 452 Fifth Avenue, New York, New York 10018, Attention: Corporate Secretary.

According to HUSI’s Corporate Governance Standards, a majority of the members of the Board of Directors must be independent. The composition requirement for each committee of the Board of Directors is as follows:

| <u>Committee</u>                         | <u>Independence/ Member Requirements</u>                             |
|--|--|
| Audit Committee                          | Chair and all voting members   |
| Fiduciary Committee                      | Chair and all voting members   |
| Human Resources & Compensation Committee | Chair and a majority of members                                      |
| Nominating & Governance Committee        | Chair and all voting members   |
| Executive Committee                      | Chair and all voting members, other than the Chief Executive Officer |

Messrs. Alfiero, Boswell, Cleave, Jalkut, Kimmelman, Meyer and Morice and Dr. Fergusson are considered to be independent directors. Mr. Geoghegan currently serves as Group Chief Executive Officer; Mr. Lawrence currently serves as President and Chief Executive Officer of HUSI and HBUS; and Mr. Gulliver currently serves as HSBC Managing Director and Head of Global Banking and Markets. Because of the positions held by Messrs. Geoghegan, Lawrence and Gulliver, they are not considered to be independent directors.

During a portion of 2007, Sandra L. Derickson and Siddharth N. (Bobby) Mehta served as directors of HUSI and HBUS. Ms. Derickson also served as President and Chief Executive Officer of HUSI and HBUS for part of 2007 and Mr. Mehta served as Chief Executive Officer of HSBC Finance Corporation, another principal subsidiary of HNAH, for part of 2007. Because of the positions held by Ms. Derickson and Mr. Mehta, they were not considered to be independent directors.

See *Item 10. Directors, Executive Officers and Corporate Governance – Corporate Governance* for more information about HUSI’s Board of Directors and its committees.

***Item 14. Principal Accounting Fees and Services***

Fees billed to HUSI by its auditing firm, KPMG LLP, were as follows.

| <b>Year Ended December 31</b>   | <b>2007</b>     | <b>2006</b>     |
|---|-----------------|-----------------|
| <b>(in thousands)</b>   |                 |                 |
| Audit fees:   |                 |                 |
| Auditing of financial statements, quarterly reviews, statutory audits, preparation of comfort letters, consents and review of registration statements .....   | \$ 5,981        | \$ 5,522        |
| Audit related fees:   |                 |                 |
| Employee benefit plan audits, due diligence assistance, internal control review assistance, and certain attestation services .....                            | 769             | 467             |
| Tax fees:   |                 |                 |
| Tax related research, general tax services in connection with transactions and legislation, and assistance with preparation of certain required filings ..... | <u>22</u>       | <u>34</u>       |
| Total KPMG LLP fees .....   | <u>\$ 6,772</u> | <u>\$ 6,023</u> |

***Audit Committee Pre-approval Policies and Procedures***

It is the practice of the Audit Committee of HUSI’s Board of Directors to approve the annual audit fees, including those covering audit services beyond HUSI’s financial statements, before any audit procedures are undertaken. Prior to 2003, management had the implicit pre-approval of the Audit Committee to engage KPMG LLP, or any other professional service firm, to perform tax and other services. Any such services provided by KPMG LLP were reported to the Audit Committee after the fact. Beginning in 2003, the Audit Committee assumed responsibility for pre-approving all auditing services and permitted non-auditing services, including the related fees and terms thereof.



## PART IV

### ***Item 15. Exhibits and Financial Statement Schedules and Reports on Form 8-K***

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**(a) (1) Financial Statements**

HSBC USA Inc.:

- Consolidated Balance Sheet
- Consolidated Statement of Income
- Consolidated Statement of Changes in Shareholders' Equity
- Consolidated Statement of Cash Flows

HSBC Bank USA, National Association:

- Consolidated Balance Sheet
- Notes to Financial Statements

**(2) Not applicable**

**(3) Not applicable**

**(b) Exhibits**

- 3 (i) Articles of Incorporation and amendments and supplements thereto (incorporated by reference to Exhibit 3(a) to HUSI's Annual Report on Form 10-K for the year ended December 31, 1999, filed with the Securities and Exchange Commission on March 30, 2000, Exhibit 3 to HUSI's Quarterly Report on Form 10-Q for the quarter ended September 30, 2000, filed with the Securities and Exchange Commission on November 9, 2000, Exhibits 3.2 and 3.3 to HUSI's Current Report on Form 8-K dated March 30, 2005, filed with the Securities and Exchange Commission on April 4, 2005, Exhibit 3.2 to HUSI's Current Report on Form 8-K dated October 11, 2005 and filed with the Securities and Exchange Commission on October 14, 2005 and Exhibit 3.1 to HUSI's Current Report on Form 8-K dated May 16, 2006, filed with the Securities and Exchange Commission on May 22, 2006).
- 3 (ii) By-Laws (incorporated by reference to Exhibit 3(ii) to HUSI's Annual Report on Form 10-K for the year ended December 31, 2006, filed with the Securities and Exchange Commission on March 5, 2007).
- 4 (i) Senior Indenture, dated as of October 24, 1996, by and between HUSI and Bankers Trust Company, as trustee, as amended and supplemented (incorporated by reference to Exhibits 4.1 and 4.2 to Post-Effective Amendment No. 1 to HUSI's registration statement on Form S-3, Registration No. 333-42421, filed with the Securities and Exchange Commission on April 3, 2002, Exhibit 4.1 to HUSI's Current Report on Form 8-K dated November 21, 2005 and filed with the Securities and Exchange Commission on November 28, 2005).
- 4 (ii) Subordinated Indenture, dated as of October 24, 1996, by and between HUSI and Bankers Trust Company, as trustee, as amended and supplemented (incorporated by reference to Exhibits 4.3, 4.4, 4.5 and 4.6 to Post-Effective Amendment No. 1 to HUSI's registration statement on Form S-3, Registration No. 333-42421, filed with the Securities and Exchange Commission on April 3, 2002).
- 12 Computation of Ratio of Earnings to Fixed Charges and Earnings to Combined Fixed Charges and Preferred Stock Dividends.
- 14 Code of Ethics for Senior Financial Officers (incorporated by reference to Exhibit 14 to HUSI's Annual Report on Form 10-K for the year ended December 31, 2006, filed with the Securities and Exchange Commission on March 5, 2007).

**(b) Exhibits (continued)**

- 18 Letter from Independent Accountant Regarding Change in Accounting Principles (incorporated by reference to Exhibit 18 to HUSI's Quarterly Report on Form 10-Q for the quarter ended September 30, 2006 filed with the Securities and Exchange Commission on November 13, 2006).
- 21 Subsidiaries of HSBC USA Inc.
- 23 Consent of Independent Registered Public Accounting Firm.
- 31.1 Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32 Certification of Chief Executive Officer and Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 99 (i) HSBC USA Inc. Corporate Governance Standards.

## SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

**HSBC USA Inc.**  
Registrant

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/s/ Janet L. Burak

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Janet L. Burak  
Senior Executive Vice President & General Counsel

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed on March 3, 2008 by the following persons on behalf of the registrant and in the capacities indicated:

/s/ Gerard Mattia

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Gerard Mattia  
Senior Executive Vice President and  
Chief Financial Officer  
(Principal Financial Officer)

/s/ Joseph R. Simpson

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Joseph R. Simpson  
Chief Accounting Officer  
(Principal Accounting Officer)

Michael F. Geoghegan\*

Chairman of the Board

Paul J. Lawrence\*

Director, President and Chief Executive Officer

Salvatore H. Alfiero\* Director

Donald K. Boswell\* Director

James H. Cleave\* Director

Frances D. Fergusson\* Director

Stewart T. Gulliver \* Director

Richard A. Jalkut\* Director

Peter Kimmelman\* Director

Charles G. Meyer, Jr.\* Director

James L. Morice\* Director

\* /s/ Janet L. Burak

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Janet L. Burak

Attorney-in-fact

**HSBC USA Inc.**  
**Computation of Ratio of Earnings to Fixed Charges and**  
**Earnings to Combined Fixed Charges and Preferred Stock Dividends**  
(in millions, except ratios)

| Year Ended December 31   | 2007            | 2006            | 2005            | 2004            | 2003            |
|--|-----------------|-----------------|-----------------|-----------------|-----------------|
| Ratios excluding interest on deposits:   |                 |                 |                 |                 |                 |
| Net income .....   | \$ 138          | \$ 1,036        | \$ 976          | \$ 1,258        | \$ 941          |
| Income tax expense .....   | (1)             | 530             | 566             | 718             | 570             |
| Less: Undistributed equity earnings .....  | -               | 34              | 73              | 21              | 6               |
| Fixed charges:   |                 |                 |                 |                 |                 |
| Interest on:   |                 |                 |                 |                 |                 |
| Borrowed funds .....   | 357             | 300             | 270             | 132             | 91              |
| Long-term debt .....   | 1,443           | 1,457           | 1,025           | 380             | 206             |
| One third of rents, net of income from subleases .....   | 29              | 25              | 19              | 19              | 17              |
| Total fixed charges, excluding interest on deposits .....                                      | <u>1,829</u>    | <u>1,782</u>    | <u>1,314</u>    | <u>531</u>      | <u>314</u>      |
| Earnings before taxes and fixed charges,<br>net of undistributed equity earnings .....         | <u>\$ 1,966</u> | <u>\$ 3,314</u> | <u>\$ 2,783</u> | <u>\$ 2,486</u> | <u>\$ 1,819</u> |
| Ratio of earnings to fixed charges .....   | <u>1.07</u>     | <u>1.86</u>     | <u>2.12</u>     | <u>4.68</u>     | <u>5.79</u>     |
| Total preferred stock dividend factor (1) .....  | <u>\$ 99</u>    | <u>\$ 133</u>   | <u>\$ 71</u>    | <u>\$ 36</u>    | <u>\$ 36</u>    |
| Fixed charges, including the preferred stock<br>dividend factor .....                          | <u>\$ 1,928</u> | <u>\$ 1,915</u> | <u>\$ 1,385</u> | <u>\$ 567</u>   | <u>\$ 350</u>   |
| Ratio of earnings to combined fixed charges and<br>preferred stock dividends .....             | <u>1.02</u>     | <u>1.73</u>     | <u>2.01</u>     | <u>4.38</u>     | <u>5.20</u>     |
| Ratios including interest on deposits:   |                 |                 |                 |                 |                 |
| Total fixed charges, excluding interest on deposits .....                                      | \$ 1,829        | \$ 1,782        | \$ 1,314        | \$ 531          | \$ 314          |
| Add: Interest on deposits .....  | 3,840           | 3,113           | 1,771           | 825             | 666             |
| Total fixed charges, including interest on deposits .....                                      | <u>\$ 5,669</u> | <u>\$ 4,895</u> | <u>\$ 3,085</u> | <u>\$ 1,356</u> | <u>\$ 980</u>   |
| Earnings before taxes and fixed charges,<br>net of undistributed equity earnings .....         | \$ 1,966        | \$ 3,314        | \$ 2,783        | \$ 2,486        | \$ 1,819        |
| Add: Interest on deposits .....  | 3,840           | 3,113           | 1,771           | 825             | 666             |
| Total .....  | <u>\$ 5,806</u> | <u>\$ 6,427</u> | <u>\$ 4,554</u> | <u>\$ 3,311</u> | <u>\$ 2,485</u> |
| Ratio of earnings to fixed charges .....   | <u>1.02</u>     | <u>1.31</u>     | <u>1.48</u>     | <u>2.44</u>     | <u>2.54</u>     |
| Fixed charges, including the preferred stock<br>dividend factor .....                          | \$ 1,928        | \$ 1,915        | \$ 1,385        | \$ 567          | \$ 350          |
| Add: Interest on deposits .....  | 3,840           | 3,113           | 1,771           | 825             | 666             |
| Fixed charges, including the preferred stock<br>dividend factor and interest on deposits ..... | <u>\$ 5,768</u> | <u>\$ 5,028</u> | <u>\$ 3,156</u> | <u>\$ 1,392</u> | <u>\$ 1,016</u> |
| Ratio of earnings to combined fixed charges and<br>preferred stock dividends .....             | <u>1.01</u>     | <u>1.28</u>     | <u>1.44</u>     | <u>2.38</u>     | <u>2.45</u>     |

(1) Preferred stock dividends grossed up to their pretax equivalents.

**Subsidiaries of HSBC USA Inc.**

**U.S. Affiliates:**

**Names of Subsidiaries**

**USA or  
US State  
Organized**

|   |            |
|---|------------|
| Delaware Securities Processing Corp.                  | Delaware   |
| Giller Ltd.   | New York   |
| GWML Holdings, Inc.                                   | Delaware   |
| HSBC Bank USA, National Association                   | USA        |
| Capco/Cove, Inc.                                      | New York   |
| Card-Flo #1, Inc.                                     | Delaware   |
| Card-Flo #3, Inc.                                     | Delaware   |
| CBS/Holdings, Inc.                                    | New York   |
| Eagle Rock Holdings, Inc.                             | New York   |
| Ellenville Holdings, Inc.                             | New York   |
| F-Street Holdings, Inc.                               | Delaware   |
| High Meadow Management, Inc.                          | New York   |
| HSBC AFS (USA) LLC                                    | New York   |
| HSBC Business Credit (USA) Inc.                       | Delaware   |
| HSBC Columbia Funding, LLC                            | USA        |
| HSBC Insurance Agency (USA) Inc.                      | New York   |
| HSBC Investment Corporation (Delaware)                | Delaware   |
| HSBC Funding (USA) Inc. V                             | Delaware   |
| HSBC Funding (USA) Inc. VII                           | Delaware   |
| HSBC Private Label Acquisition Corporation (USA)      | Delaware   |
| HSBC Investments (USA) Inc.                           | New York   |
| HSBC Investor PBRS Corporation (Delaware)             | Delaware   |
| HSBC Land Title Holdco (USA) Inc.                     | Delaware   |
| HSBC Land Title Agency (Florida), LLC                 | Florida    |
| HSBC Logan Holdings USA, LLC                          | USA        |
| HSBC Jade Limited Partnership                         | USA        |
| HSBC McKinley Finance, LLC                            | USA        |
| HSBC Whitney Finance, LLC                             | USA        |
| HSBC Mortgage Corporation (USA)                       | Delaware   |
| HSBC Motor Credit (USA) Inc.                          | Delaware   |
| HSBC Overseas Investments Corporation (New York)      | Maryland   |
| HSBC Overseas Corporation (Delaware)                  | Delaware   |
| HSBC International Finance Corporation (Delaware)     | USA        |
| HSBC Private Bank International                       | USA        |
| HSBC International Investments Corporation (Delaware) | Delaware   |
| HSBC Ranier Investments, LLC                          | USA        |
| HSBC Realty Credit Corporation (USA)                  | Delaware   |
| Cabot Park Holdings, Inc.                             | Delaware   |
| HSBC Land Title Agency (USA) LLC                      | New York   |
| MM Mooring #2 Corp.                                   | New York   |
| Northridge Plaza, Inc.                                | Delaware   |
| HSBC Reinsurance (USA) Inc.                           | Vermont    |
| HSBC Retail Credit (USA) Inc.                         | New York   |
| HSBC Services Corporation (USA)                       | New Jersey |
| Katonah Close Corp.                                   | New York   |
| Marine Midland Overseas Corporation                   | USA        |
| Oakwood Holdings, Inc.                                | New York   |
| Property Owner (USA) LLC                              | Delaware   |
| Tower Holding New York Corp.                          | New York   |
| Beachhouse Properties, Inc.                           | New York   |

**Names of Subsidiaries**

Cross Zou Holding Corp.  
Cross-LA Realty, Inc.  
Crossturkey, Inc.  
Sub 1-211, Inc.  
Sub 2-211, Inc.  
Tower Emmons Corp.  
Tower Houma Corp.  
Tower L.I.C. Corp.  
Tower Pierrepont Corp.  
West 56th and 57th Street Corp.  
TPBC Acquisition Corp.  
Trumbull Management, Inc.  
HSBC National Bank USA  
HSBC Trust Company (Delaware), National Association  
HSBC USA Capital Trust I  
HSBC USA Capital Trust II  
HSBC USA Capital Trust III  
HSBC USA Capital Trust V  
HSBC USA Capital Trust VI  
HSBC USA Capital Trust VII  
Marine Midland Mortgage (U.S.A.), Inc.  
One Main Street, Inc.  
R/CLIP Corp.  
Republic New York Securities Corporation  
Republic Overseas Capital Corporation  
Timberlink Settlement Services (USA) Inc.  
Wells Fargo HSBC Trade Bank, N.A.

**Non-U.S. Affiliates:**

**Names of Subsidiaries**

HSBC Investment Holdings (Guernsey) Limited  
HSBC Financial Services (Uruguay) S.A.  
HSBC Tailored Lending Company (Bahamas) Ltd.  
Republic Bullion (Far East) Limited  
HSBC Precious Metals (Australia) Limited  
HSBC Life Insurance (Cayman) Limited  
HSBC Alternative Investments (Guernsey) Limited

**USA or  
US State  
Organized**

New York  
Louisiana  
New York  
Pennsylvania  
Pennsylvania  
New York  
Louisiana  
New York  
New York  
New York  
Florida  
New York  
USA  
USA  
Delaware  
Delaware  
Delaware  
Delaware  
Delaware  
Delaware  
New York  
Florida  
Delaware  
Maryland  
New York  
Delaware  
USA

**Country  
Organized**

United Kingdom  
Montevideo  
Bahamas  
Hong Kong  
New South Wales  
Cayman Islands  
United Kingdom

***Consent of Independent Registered Public Accounting Firm***

The Board of Directors and Shareholders of  
HSBC USA Inc.:

We consent to incorporation by reference in Registration Statements (No. 333-42421, 333-42421-01, 333-42421-02, 333-127603) on Form S-3 of HSBC USA Inc. of our report dated March 3, 2008, relating to the consolidated balance sheets of HSBC USA Inc. and subsidiaries as of December 31, 2007 and 2006, and the related consolidated statements of income, changes in shareholders' equity, and cash flows for each of the years in the three-year period ended December 31, 2007, and the consolidated balance sheets of HSBC Bank USA, National Association and subsidiaries as of December 31, 2007 and 2006, and the effectiveness of internal control over financial reporting as of December 31, 2007, which reports appear in the 2007 HSBC USA Inc. Annual Report on Form 10-K.

/s/ KPMG LLP

New York, New York  
March 3, 2008

*Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002*

I, Paul J. Lawrence, certify that:

1. I have reviewed this annual report on Form 10-K of HSBC USA Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:
  - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - c) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - a) All significant and material weaknesses in the design or operation of internal controls over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls over financial reporting.

Date: March 3, 2008

/s/ Paul J. Lawrence

Paul J. Lawrence  
President and Chief Executive Officer



*Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002*

I, Gerard Mattia, certify that:

1. I have reviewed this annual report on Form 10-K of HSBC USA Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:
  - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - c) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - a) All significant and material weaknesses in the design or operation of internal controls over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls over financial reporting.

Date: March 3, 2008

/s/ Gerard Mattia

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Gerard Mattia  
Senior Executive Vice President and  
Chief Financial Officer

***Certification of Chief Executive Officer and Chief Financial Officer pursuant to  
Section 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. Section 1350)***

Pursuant to section 906 of the Sarbanes-Oxley Act of 2002 (subsections (a) and (b) of section 1350, chapter 63 of title 18, United States Code), each of the undersigned officers of HSBC USA Inc. (HUSI), a Maryland corporation, does hereby certify, to such officer's knowledge, that:

The Annual Report on Form 10-K for the fiscal year ended December 31, 2007 (the Form 10-K) of HUSI fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934 and the information contained in the Form 10-K fairly presents, in all material respects, the financial condition and results of operations of HUSI.

Date: March 3, 2008

/s/ Paul J. Lawrence

Paul J. Lawrence  
President and Chief Executive Officer

Date: March 3, 2008

/s/ Gerard Mattia

Gerard Mattia  
Senior Executive Vice President and  
Chief Financial Officer

**HSBC USA Inc.**  
**HSBC Bank USA, N.A.**  
**HSBC National Bank USA**  
**CORPORATE GOVERNANCE STANDARDS**

The following standards have been approved by the Boards of Directors and, together with the charters of committees of the Boards of Directors, provide the framework for the corporate governance of HSBC USA Inc., HSBC Bank USA, N.A. and HSBC National Bank USA (each referred to herein as “HSBC” or the “Corporation”). These standards will be reviewed by the Boards periodically in order to ensure HSBC maintains “best practices” in corporate governance.

**Role of the Board and Management**

HSBC’s business is conducted by its employees, managers and officers, under the direction of the Chief Executive Officer and the oversight of the Board, to enhance long-term value of the Corporation for its shareholder. The Board has ultimate responsibility for governing the affairs of the Corporation, including the appointment of executive management, approval of business strategy and assessment of major risks facing the Corporation, consistent with its responsibilities to the Corporation’s ultimate parent, HSBC Holdings plc (the “Group”) to ensure that the Corporation’s activities are conducted within the context of the Group’s policies and business strategies. In all actions taken by the Board, the Directors will exercise their business judgment in what they reasonably believe to be in the best interests of the Corporation. In discharging that obligation, Directors may rely on the honesty and integrity of the Corporation’s management and its outside advisors and independent auditors. Management is expected to be loyal to the Corporation, implement approved business strategy, appropriately resolve day-to-day operations issues, keep the Board informed, and maintain and promote high ethical standards while seeking to maximize returns to HSBC in all business dealings.

**Composition and Qualification**

The size of the Board shall consist of the number of Directors established by the Board upon recommendation of the Chief Executive Officer from time to time. The Chief Executive Officer of the Corporation shall be a Director of the Corporation. A majority of the Independent Directors should be active or retired senior executives (or the equivalent) of other large companies, educational institutions, governmental agencies, service providers or non-profit organizations.

Each Director will stand for election by the shareholder every year. HSBC recognizes the benefits of reasonable term limits for Directors. However, HSBC also believes that term limits should not cause the Corporation to lose the increasing benefit of Directors who have been able to develop, over a period of time, insight into the Corporation and its operations. The service of Directors who join the Board after December 31, 2005 will be limited to a maximum of 15 years.

The Corporation also maintains a mandatory retirement policy for Directors (excluding the Chairman and the Chief Executive Officer of the Corporation). Retirement is required as of the annual meeting of the shareholder after the date on which a Director attains the age of 72 or reaches the maximum length of service.

Non-Independent Directors who are senior executive officers of the Corporation are expected to retire from the Board when they retire from the position that entitles such individual to be a Director of the Corporation. With respect to any Director, the Board may delay any retirement from the Board if business conditions or other circumstances, in the opinion of the Board, so warrant such action.

It is anticipated that Independent Directors will offer to resign from the Board whenever there is (i) a major change in their career position or status (unless such change in position or status results from normal retirement), or (ii) a change in status as an "Independent Director". Similarly, it is anticipated that Non-Independent Directors who are not senior executive officers of the Corporation will offer to resign from the Board whenever there is a major change in their career position or status (unless such change in position or status results from normal retirement). The Chairman and the Chair of the Executive Committee shall consult and determine whether to present the offer of resignation to the Board for action. If presented, the Board has complete discretion, after consultation with Group, to either accept or reject such resignation.

Independent Directors shall not be a director, consultant or employee of or to any competitor of the Corporation (i.e., a company that has a business segment offering products or seeking customers that are similar to the products offered or customers served by a business segment of the Corporation). To avoid potential conflicts of interest, interlocking directorships will not be allowed. Interlocking directorships shall be deemed to occur if a senior executive officer of the Corporation (i.e., the Chairman, Chief Executive Officer, President or any direct report to the Chief Executive Officer) serves on the board or as a trustee of the company or institution that employs the Independent Director (i.e., reciprocal directorship).

"Directors Emeriti" will not be elected to the Board. However, former Directors may be invited to special events from time to time.

### **Director Responsibilities**

The Board, representing the best interests of Group and the Corporation, shall:

- provide oversight of the Corporation's compliance with all legal and regulatory obligations;
- approve the corporate mission statement, ethics plan, and affirmative action plan;
- appoint and evaluate, and approve the compensation of, the CEO and other executive management;
- approve a management succession plan;
- review and approve the business planning calendar to insure discussion, input, analysis and decision making;
- review and approve the strategic plan and business plan on a timely basis; receive and discuss periodic updates to these plans;
- oversee management's responsibility to develop systems to insure that the business is conducted in a legal and ethical manner;
- oversee management's responsibility to implement adequate business control systems;
- provide constructive dialogue to management during and between board meetings;
- have the ability to spend the necessary time required to function effectively as a Director;
- develop and maintain a sound understanding of the strategies, business and succession planning of the Corporation;
- carefully study all Board materials and provide active, objective and constructive participation at meetings of the Board and its committees;

- provide assistance in representing HSBC to the world;
- be available to advise and consult on key organizational changes and to counsel on corporate issues;
- develop and maintain a good understanding of global economic issues and trends; and
- seek clarification from experts retained by the Corporation (including employees of the Corporation) to better understand legal, financial or business issues affecting the Corporation.

### **Director Independence**

A majority of the Directors will be independent. Annually, the Board shall determine whether each Director can exercise independent judgment from management. The Board shall use the standards set forth in Appendix A hereto as a foundation for its determinations concerning independence, which are based upon the New York Stock Exchange (NYSE) listing standards.

### **Meetings**

Annually, all Directors shall be provided with a schedule identifying all regularly scheduled Board and committee meetings for the current and the next succeeding year. There will be four regularly scheduled meetings of the Board each year. At the first regularly scheduled meeting of each calendar year, a detailed strategic focus of the Corporation's businesses will be discussed and the Board will approve the annual operating plan and capital expenditure budget. The Board will meet in "retreat" at least once a year to discuss the strategy of the business. Independent Directors shall meet in executive session as required, but no less than once a year. Personal attendance of the Directors at Board and committee meetings is expected. The use of teleconference to facilitate such attendance should be requested by Directors only in extraordinary situations.

The Chairman and the Chief Executive Officer will establish the agenda for each Board meeting. The Chair of a committee in consultation with committee members and senior management will develop the agenda for each committee meeting. Directors are encouraged to suggest, to the Chairman, topics for inclusion on any future agendas.

At every regularly scheduled Board meeting, the Chief Executive Officer or his/her designee shall advise the Board of the operating performance of the Corporation, focusing on important trends, achievements, plans and developments, and how those matters may affect the annual operating plan approved by the Board. Also, at every regularly scheduled Board meeting, the President, Chief Financial Officer, Chief Accounting Officer or Controller shall present the latest available financial detail with respect to the Corporation, focusing on significant variances from the annual operating plan or capital expenditure plan approved by the Board and from prior year/quarter results. Interim meetings will be scheduled to discuss the business on an as required basis.

Information with respect to any Board or committee meeting should be sent to Directors at least five (5) days in advance of the meeting, if possible. Financial statements included in this information should be condensed with commentary focused on important issues, trends or variances, noting the perceived reasons therefore and the opportunities or risks, if any, that may result.

Minutes of all Board and committee meetings shall be sent to all Directors unless it is legally required that such minutes be kept confidential.

## **Committees**

The committee structure of the Board shall be reviewed annually. The Board will have Audit, Human Resources & Compensation, Executive, Fiduciary, and Nominating & Governance Committees. No Director should serve on more than three of the standing committees.

Each standing committee of the Board shall adopt and approve a charter. Each such charter, and any amendments thereto, must be approved by the Board. At least annually, each committee will review the appropriateness of its charter and evaluate and report on its performance to the Board. Other than the Executive Committee, which may act in place of the full Board, no committee shall exercise any power and authority specifically delegated to any other committee of the Board.

The Chairman, in consultation with the Chair of the Executive Committee, shall make recommendations to the Nominating & Governance Committee regarding membership on the committees. The Board will appoint all committee members and the Chair of each committee.

Membership of the Executive Committee shall consist of Independent Directors and the Chief Executive Officer of the Corporation. The Chair of the Executive Committee shall be deemed the "lead director" for the Board and shall perform the duties set forth on Appendix B to these Standards. The Chair of the Executive Committee shall be an "ex officio" member of all other standing committees.

Membership of the Nominating & Governance Committee shall consist of the Lead Director and Chairs of the other committees, provided that such Directors are each Independent Directors.

The Chair of each committee, in consultation with committee members and senior management of the Corporation will determine the frequency and length of the meetings of the committee.

A quorum and the vote required at any committee meeting shall be determined in the same manner as a quorum for a meeting of the Board as set forth in the by-laws of the Corporation.

## **Director Compensation**

Director compensation will be in the form of cash compensation and, as may be appropriate, restricted shares or other equity compensation. The amount of compensation to be paid to Directors will be determined by the Chairman of the Corporation, in consultation with the Nominating & Governance Committee.

## **Access to Senior Management and Independent Advisors**

Directors shall have free and full access to senior management and other employees of the Corporation. Any meetings or contacts that a Director wishes to initiate may be arranged through the Chief Executive Officer or Corporate Secretary or directly by the Director.

The Board and its committees shall have the right at any time to retain independent outside financial, legal or other advisors.

## **Director Orientation and Continuing Education**

The Corporation shall provide a continuing education program for all members of the Board including presentations by senior management on the Corporation's strategic plans, its significant financial, accounting and risk management issues, its compliance programs, its Statement of Business Principles, its management structure and executive officers and its internal and independent auditors. Directors shall be encouraged to participate in approved Director training programs at the expense of the Corporation. New Directors will participate in an organized Director orientation program.

**Succession Planning**

The Chief Executive Officer will report annually to the Human Resources & Compensation Committee and the Board on the plans or programs implemented by the Corporation for management succession and development. Annually, all Independent Directors will meet in a separate session, led by the Chair of the Executive Committee, to review the performance of the Chairman, Chief Executive Officer and President, if any, and senior officers including a discussion of the perceived effectiveness of the processes implemented for management succession and development.

**Annual Evaluation**

Annually, the Board shall perform and discuss a self-evaluation of the Board and each committee. The Nominating and Governance Committee will lead a discussion of the Board evaluation. Each Committee Chair will lead a discussion of the respective committee evaluation.

### **INDEPENDENT DIRECTOR STANDARDS**

The Board shall consider all relevant facts and circumstances in assessing the independence of Directors. As a foundation for such determinations, the Board has established the following guidelines. An Independent Director is a Director who:

- has no personal loans from the Corporation, other than credit cards and charge cards or residential mortgage loans made in the ordinary course of business on substantially the same terms as those prevailing at the time for comparable transactions with non-affiliated persons;
- has not been retained by the Corporation or any of its affiliates in the capacity of an employee or non-employee executive officer within the last three years and is not currently receiving any compensation from the Corporation or any of its affiliates (other than for Board service, deferred compensation for prior service or benefits under a tax-qualified retirement plan);
- has not received more than \$100,000 in direct compensation from the Corporation or any of its affiliates in any year, other than for Board service with the Corporation, benefits under a tax-qualified retirement plan or deferred compensation for prior service, within the last three years;
- has not been affiliated with or employed by an organization (as a partner, employee or 10% or more shareholder) that is an advisor or consultant, including a current or former internal or external auditor, to the Corporation, any of its subsidiaries, any of the senior executives of the Corporation, or any pension, profit sharing or employee benefit plan sponsored by the Corporation within the last three years;
- has not been an employee, partner or executive officer of any significant vendor or customer of the Corporation or any of its subsidiaries, or a pension, profit sharing or employee benefit plan sponsored by the Corporation that makes payments to, or receives payments from the Corporation in an amount that in any fiscal year exceeded the greater of \$1 million, or 2% of such entity's consolidated gross revenues within the last three years;
- has not been an executive officer, director or trustee of a charitable organization in which the Corporation or any of its subsidiaries made contributions in any fiscal year that exceeded the greater of \$1 million, or 2% of the charitable organization's consolidated gross revenues;
- has no interest in any significant transactions or business relationships with the Corporation or its subsidiaries that are required to be disclosed by the rules and regulations of the Securities and Exchange Commission; and
- is not a member of the immediate family of any person described above. Immediate family members are the Director's spouse, parents, children, siblings, mothers and fathers-in-law, sons and daughters-in-law, brothers and sisters-in-law and anyone (other than domestic employees) who share the Director's home.



## Appendix B

### **LEAD DIRECTOR DUTIES**

The duties and responsibilities of the Chair of the Executive Committee (as the Lead Director) shall be as follows:

- 1) The Chair of the Executive Committee shall be informed by, and counsel, the Chairman and Chief Executive Officer on material strategy, policy, and management matters.
- 2) The Chair of the Executive Committee shall be available to advise and counsel the Chief Executive Officer on any matter relating to the Corporation.
- 3) The Chair of the Executive Committee shall offer the Chief Executive Officer counsel as to special interests and concerns of Directors and will act as principal liaison between the Independent Directors and the Chairman.
- 4) In the absence or inability of the Chairman or Chief Executive Officer to act, the Chair of the Executive Committee shall perform those duties of the Chairman pertaining to Board functions.
- 5) The Chair of the Executive Committee shall recommend to the Chairman the retention of consultants or other experts who would report directly to the Board.
- 6) The Chair of the Executive Committee shall advise the Chairman as to the quality, quantity and timeliness of the flow of information from the Corporation that is necessary for the Directors to effectively and responsibly perform their duties.
- 7) The Chair of the Executive Committee shall chair in camera discussions requested by the Independent Directors.
- 8) The Chair of the Executive Committee shall serve as an ex-officio member of each of the committees of the Board.
- 9) The Chair of the Executive Committee shall work with the Chairman and other independent directors to give advice to the Chairman in the development of Board membership.