

KNIGHT VINKE



Stephen Green, Esq.
Executive Chairman
HSBC Holdings plc
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United Kingdom

September 4, 2007

Dear Mr. Green,

Further to the meeting which took place between Knight Vinke Asset Management (KVAM) and Douglas Flint in New York on 12th June this year, we wish to set out our position for the benefit of the Board.

KVAM and its partner, the California Public Employees' Retirement System (CalPERS), as well as several of the largest public pension plans in North America whose funds KVAM manages, have a serious interest in the future of HSBC Holdings plc. We regard our investment in HSBC as a long term investment and together we own 21.9 million shares and call options over a further 13.2 million shares. We wish to engage in a constructive dialogue with the Board and other institutional shareholders of HSBC over the future direction of the Group.

We believe that HSBC is significantly undervalued, perhaps by as much as 40% to 50%. We believe that this is mostly due to the market's uncertainty over whether the strategy being pursued by the Group is appropriate or, indeed, feasible. Steps need to be taken to preserve

and release this value. As part of this process the Board needs to undertake a fundamental review of the Group's strategy in consultation with its shareholders. We are of the view that this process should be led by Simon Robertson, as Senior Non-Executive member of the Board, rather than by you (because of your position as the former Group Chief Executive). The process may require reversing decisions which were taken in the past and shareholders will wish this process to be conducted impartially. We intend to play a role in this process and KVAM has hired a leading firm of management consultants to assist us in evaluating alternatives.

We have set out below some of the fundamental issues that we think the Board should address as part of its review process.

Corporate Governance Issues

Good corporate governance is a matter of the greatest importance for KVAM and for CalPERS. In our view it is the bedrock on which successful performance is built. Whilst we recognise and appreciate the value of your experience with HSBC, we believe that, at this point in time, it would be best for the Group that the Chairman be a non-executive, and recommend that this be implemented by the next Annual General Meeting.

At the most recent AGM, a number of shareholders argued that the method of calculation used by the Remuneration Committee to determine the award of Performance Shares under The HSBC Share Plan was not in accordance with the relevant shareholder resolution. We reserve judgment on this but, having looked at the resolution and the explanation in the Annual Reports since 2004, have concluded that the language is unclear and possibly misleading.

Whether or not the dissenting shareholders were correct, it seems to us that the debate at the AGM has highlighted the fact that the incentive arrangements do not properly align the interests of shareholders and senior management. We note, for example, the following:

- Performance Shares up to a maximum value of 7 times annual salary may be awarded subject to achieving targets in terms of total shareholder return (TSR) and earnings per share (EPS) over a three year period, of which 30% (i.e., approximately 2 times annual salary) vests for very modest performance.

- **30% of the TSR portion** vests if only median performance is achieved compared to a group of 29 banks¹ including itself (i.e. if HSBC ranks 14th out of the 29).

Although the peer group is said to comprise “the largest banks in the world measured in terms of market capitalisation”, it does not include any of the Chinese banks, three of which are among the top ten in the world. It also no longer includes any of the listed banks in Hong Kong, nor any in Taiwan, Singapore, Brazil, India, Korea or Malaysia, almost all of which outperformed HSBC in TSR terms over the past few years.

- **30% of the EPS portion** vests if the “incremental EPS over the performance period” is 24% (and all of it vests if HSBC’s “incremental EPS over the performance period” is 52% or more). The above-mentioned dissenting shareholders have pointed out that the term “incremental EPS over the performance period” is somewhat unorthodox because it is defined as the addition of the growth rates for each of the three years **relative to the base year** (and not the previous year). As shown in the example below, *this could result in the maximum payout being made even if there were to be absolutely no net increase in EPS over the three year period.*

	Base year	Year 1	Year 2	Year 3	Total
EPS	100	126	126	100	
Percentage change		+26%	+0%	-21%	0%
“Incremental EPS” (over base)		+26%	+26%	0%	+52%

It is important that the Board consider carefully the alignment of shareholder and management interests and propose changes in the incentive arrangements if necessary.

We also believe that the Board should be restructured so as better to reflect the future direction of the Group (both functionally and geographically), with greater responsibility and

¹ ABN AMRO, BBVA, Banco Santander Central Hispano, Bank of America, Bank of New York, Barclays, BNP Paribas, Citigroup, Credit Agricole, Credit Suisse, Deutsche Bank, HBOS, JP Morgan Chase, Lloyds TSB, Mitsubishi Tokyo Financial, Mizuho Financial, Morgan Stanley, National Australia Bank, Royal Bank of Canada, RBS, Societe Generale, Standard Chartered, UBS, UniCredito Italiano, US Bancorp, Wacovia, Wells Fargo, Westpac (2006 Annual Report, page 282).

autonomy being given to the Board's non-executive members. In view of the Group's stated strategy of focusing on the emerging markets, we feel that the current Board is excessively weighted towards those whose primary experience has been in Europe and North America.

Stock Price Performance and Group Strategy

The fact which troubled us most following KVAM's meeting in June was our feeling that there appeared to be little sense of concern within management about the performance of the Group – almost to the point of complacency – and a fundamental lack of ambition.

With respect to KVAM's observation that HSBC's stock price performance has been a disappointment to shareholders, the response we were given mirrors that which was published in a recent Dow Jones article,² (reportedly based on interviews with HSBC management):

“HSBC's performance has to be judged over a longer period, especially since 2004, when the U.S. Federal Reserve started raising interest rates. Measured against similar banks over that period, HSBC's share performance doesn't look bad. It outperformed Royal Bank of Scotland, Citigroup and Bank of America in the last three years” .

What the article fails to mention is that, whilst HSBC's returns amounted to 9.7% p.a. since the end of June 2004 (when interest rates started rising), over the same period of time the FTSE100 rose by 18.1% p.a. and the MSCI Financials Index (expressed in sterling) rose by 15.7% p.a.

It is worth pointing out that in terms of total shareholder return, since the end of June 2004 (i.e. the period referred to in the Dow Jones article), HSBC has significantly underperformed almost all of its selected peers. It ranked 22nd out of the previously-mentioned 29 stocks. The three other banks mentioned in the article (i.e. RBS, Bank of America and Citigroup) came in 20th, 27th, and 29th, respectively.

Although there are many reasons for HSBC's underperformance, our initial analysis suggests that the primary factors include the following:

- Migration of the Group's centre of gravity from Hong Kong to Europe and the United States, coinciding with China's emergence as the world's most dynamic economy.

² “HSBC Needs a Better Board, Not a Break-Up”, Dow Jones, 13 June, 2007.

We note that since 2002, 77% of all new assets added by the Group (i.e., approximately \$850 billion) were located in Europe and North America compared to only 16% in Hong Kong and Rest of Asia, where returns have been higher. As of today, 74% of the Group's managing directors and general managers are based in Europe and the United States, compared to only 18% in Asia.

- Acquisitions in areas such as French commercial banking (CCF) and U.S. sub-prime (Household) where the Group has no real competitive advantage and/or lacks scale.
- Poorly executed attempts at building a major investment banking and capital markets business which have ended in failure and resulted in vast amounts of capital being deployed at very low rates of return; and
- More generally, the perception that HSBC lacks focus and that the "world's local bank" is seeking to be all things to all people.

All of these issues suggest to us that there is a problem within the Group with respect to capital allocation decisions.

Sub-Prime Exposure

During the meeting with Douglas Flint one of the key points raised by KVAM concerned HSBC's continuing exposure to the U.S. sub-prime market, which we felt was likely to depress HSBC's share price and distract management for a considerable period of time.

You said at the recent AGM that it could take two to three years to resolve the problems in the US sub-prime business. In the light of that comment KVAM suggested that HSBC should consider spinning off or selling the sub-prime portfolio as an alternative to attempting to fix the problems. As you will remember, the full extent of the sub-prime crisis had not yet become apparent to the market at the time these discussions were held and we believe that a sale or spin-off of the portfolio was certainly feasible at that time. The response we were given was that "this is a business that we like" and "the portfolio could be sold if this was what the Group wanted to do", which clearly signalled to us that the portfolio had been adequately provisioned and that the situation was under control.

In retrospect, we were right to be concerned. The problem has escalated with substantial additional provisions at mid-year plus unexpected (and as yet unquantifiable) indirect exposure via back-up lines of credit to the asset backed commercial paper (ABCP) market.

Although we have no doubt that HSBC's balance sheet can withstand all of this (at a cost in terms of the stock price), we ask ourselves what further provisions may be required by the Group's auditors at year end if, for lack of a liquid market, they are unable to satisfy themselves as to the value of the commercial paper being taken onto the balance sheet. We believe that this risk has not yet been properly taken into account by most market participants. We believe HSBC (and all of its competitors who are exposed to the ABCP market in the same way) will not credibly be able to assess the magnitude of any such provisions for at least a month or two.

Group Portfolio

From our point of view, one of the benefits of selling the U.S. sub-prime portfolio (which is now clearly no longer an option on acceptable terms) would have been that the proceeds might then be re-invested in Hong Kong, thereby accelerating the process of moving the Group's centre of gravity back to Asia.

More generally, however, this raises the issue of portfolio composition and whether the Group should not consider selling some of its other business units in Europe and North America in order to redeploy capital in Asia and other emerging markets.

In this context, we would like to make a number of observations:

- First, with the exception of retail banking in Hong Kong, HSBC has failed to achieve a position of true leadership in any of its core markets or businesses -- despite having spent about \$40 billion on acquisitions in Europe and North America over the past 15 years. By way of example, HSBC's non sub-prime US business is a very small regional player within the U.S. market, with little prospect of growing significantly (other than by being consolidated). HSBC's French business also lacks scale within the French market and as a result suffers from very high cost ratios. HSBC's UK business has also had its problems and we believe may have to take further provisions. Furthermore, HSBC has no credible position in the investment banking business and many of the senior employees hired at great expense from competitors have left.
- Secondly, our consultants estimate that the synergies which HSBC has been able to extract from its global banking position amount to only 0.4 to 0.7% of its market capitalisation and are unlikely to increase significantly simply as a result of "joining up the pieces". A large part of the synergies which would normally be derived from

building a global retail business of the kind to which HSBC aspires are revenue synergies coming from the “mass affluent” segment of the market, which is also the segment most influenced by having a strong global brand. Unfortunately, however, neither HSBC’s UK nor its French business -- nor Household, of course -- came with a significant “mass affluent” customer base and therefore offered few if any revenue synergies as a result.

As a consequence, we believe that many investors (and affluent customers) still regard HSBC effectively as a holding company for a collection of disparate and poorly connected businesses which (with the exception of Hong Kong) generally lack scale. The synergies associated with being a “global” retail bank of the kind that HSBC has developed appear to have very little financial value and this is reflected in the lower return that HSBC earns on its equity compared to its local or regional comparable companies. In fact, HSBC’s ROE relative to its chosen peer group has fallen since 1993 and now stands towards the bottom end of the range of its entire peer group.

- Thirdly, we believe that HSBC’s rush for “diversification” may have damaged its core franchise in Hong Kong and compromised its opportunity of being the leading player in China.

Since 2004, HSBC has been losing market share in the Hong Kong retail banking market (in terms of deposits and loans). Obtaining a ringside seat in the emerging Chinese market will require that HSBC be able to deliver world class capital markets services to China’s largest companies: it is estimated that by 2015, over 50% of all Chinese financings will be capital markets issues. In this context, it is of very great concern to us that HSBC has lost a number of its key senior employees in Asia and that, despite having the largest branch network in China amongst the foreign banks, it is not even amongst the top 10 lead managers of IPO’s for mainland Chinese companies³. The truth is that HSBC should have had a strong competitive advantage in China but chose to divert its resources – both human and capital -- to commercial banking in France and U.S. sub-prime lending.

- Finally, we believe that the Board should give serious consideration to buying out the minority shareholders in Hang Seng Bank.

³ See FT Lex column 22nd July 2007 “Underwriting in China”

When KVAM raised this possibility during the June meeting, the response we received was that this would be dilutive and that the synergies would be small. We believe that this is too simplistic an analysis. Whilst it is true that Hang Seng Bank trades at a premium to HSBC, we note that the multiples being offered for parts of ABN AMRO (e.g. LaSalle) are significantly in excess of the multiples at which HSBC as a whole is currently trading. Were HSBC to sell some of the disparate businesses it acquired in the United States, the United Kingdom and/or France (as part of an overall restructuring), there would be no dilution as a result of re-investing the proceeds in Hang Seng Bank. Furthermore, it is much more likely in our opinion that such a restructuring would lead to an overall re-rating of HSBC.

We believe that a merger with Hang Seng Bank, possibly executed in combination with a transfer of the Group's HQ back to Hong Kong or a relocation of the Group's senior management to Hong Kong, would yield substantial synergies - but could also result in major intangible benefits. The fact that the Chinese authorities have recently blocked HSBC (of all players!) from taking a controlling interest in BoCom suggests that there may be cultural and political issues which need to be addressed. Douglas Flint pointed out to us that the Hang Seng Bank stake could be swapped with another party in exchange for a position elsewhere. Given Hang Seng Bank's superior performance in Hong Kong, we believe that this would be a very dangerous strategy which could result in HSBC weakening its position in Hong Kong. In our view, HSBC needs to demonstrate a much greater commitment to going back to its Chinese roots if it is to realise its true potential.

HSBC's response to calls for greater focus and/or specialisation has been that its shareholders benefit from the "diversification" which comes from having "uncorrelated" earnings streams. As reported by Dow Jones, it has been asserted by HSBC that:

"HSBC shares fare better than peers when systemic risks - macro fundamentals - go against the banking industry. That's possible because its earnings streams from different regions have less correlation with each other. This element is reflected in a stock's low beta and is key for a portfolio manager screening for banking stocks. Standard Chartered outperforms HSBC because the majority of its earnings come from emerging markets. But Standard Chartered is also a riskier stock than HSBC. Standard Chartered's 52-week beta is 1.4, nearly three times that of HSBC. The

return-per-unit-risk advantage would be lost if HSBC were broken up. HSBC Asia would alone be riskier than HSBC as a whole”.⁴

This line of argument is flawed for two main reasons.

First, there is no added value for shareholders from HSBC building a diversified portfolio of banking stocks. Shareholders can construct their own portfolio, selecting the best banks in each area. They can do this faster and at lower cost than HSBC, constructing portfolios on a daily or even hourly basis that conform to their precise requirements. The only benefit that could accrue to shareholders from this strategy would come from creating valuable synergies which outweigh the costs associated with taking control: in the case of the strategy pursued by HSBC, the value of this strategy has yet to be demonstrated. It is striking that none of the banks pursuing a global strategy similar to HSBC's has produced any real stock market outperformance. The Board should, therefore, be prepared to question the validity of this model.

Secondly, the proposition that banking risks are “uncorrelated” geographically and that HSBC is therefore insulated from systemic risks is absolutely untrue. Witness the fact that Germany's banks (and even some Chinese banks) are directly affected by the sub-prime crisis in the United States.

Mr. Flint suggested to KVAM that HSBC's stock had underperformed because, by virtue of its size, HSBC was viewed by the market as a proxy for the banking sector. He suggested that hedge funds had taken to shorting HSBC in order to take long positions in other more focused banking stocks. We do not accept this argument. There are several banking indices to choose from to short the sector.

The sad truth is that HSBC has become the stock to short because it can be counted on to underperform.

Conclusion

In summary, as we noted above, we believe that the Board needs to undertake a fundamental review of the Group's strategy from scratch. It needs to do so with an open mind and to use, as a yardstick for measuring performance, the best, and not the worst, of HSBC's peers.

⁴ “HSBC Needs a Better Board, Not a Break-Up”, Dow Jones, 13 June, 2007.

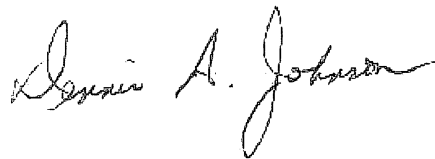
We are sending a copy of this letter to Simon Robertson and other members of the Board and, in view of the possible regulatory issues involved in a restructuring, to the FSA and the Hong Kong Monetary Authority. We look forward to a constructive dialogue with you and your colleagues on the Board.

Yours sincerely,



Eric Knight

Knight Vinke Asset Management LLC



Dennis Johnson

CalPERS - California Public Employees'
Retirement System

cc: Board of Directors

cc: Sir Callum McCarthy, Chairman FSA

cc: Mr. Joseph Yam, Chief Executive, HKMA