

Asia ex-Japan

Paul Sheehan

Hong Kong (852) 2848 8580
paul.sheehan@asia.ing.com

HSBC Goes Sub-Prime

5 HK/HSBC LN

Hold

Maintained

Is this a Household accident?

We are revising our forecasts for HSBC's new Household International subsidiary, increasing 2004-05F net income by 5-9%. Although HSBC's EPS has been increased by the transaction, we see little strategic value. Maintain HOLD.

The network effect. With the acquisition of Household, HSBC gains access to over 1,400 new branches in the US and Canada, which it hopes can be used to cross-sell other products and bolster fee income.

Downmarket customers. However, HI's customer base of sub-prime borrowers is less creditworthy and generally of a less wealthy demographic than HSBC's existing premium clientele. This should limit cross-selling opportunities and could potentially tarnish HSBC's franchise.

Low-multiple business. Sub-prime lending is a low-multiple business as a standalone, and HSBC does not have a track record of running such a franchise to draw upon. With charge-offs rising, we are wary of assigning HSBC's existing earnings multiple to the HI income stream.

Earnings forecasts

Yr to Dec	01	02	03F	04F
Core income (US\$m)	6,208	7,590	9,803	10,986
Core EPS (US\$)	0.66	0.80	0.92	1.03
Core EPS growth (%)	-19.5	20.6	14.3	12.1
Net profit (US\$m)	4,992	6,239	7,745	8,976
EPS (US\$)	0.53	0.66	0.72	0.84
EPS growth (%)	-23.4	23.3	9.9	15.9
DPS (US\$)	0.48	0.53	0.56	0.60
Yield (%)	4.0	4.4	4.7	5.0

Source: Company data, ING estimates

719p/HK\$93.25

27/6/03

Target price: 12 months

652p/HK\$84

Financial data

	FY02	FY03F
ROA (%)	0.86	0.96
Core ROA (%)	1.04	1.21
ROE (%)	11.91	11.17
Core ROE (%)	14.48	14.14
BVPS (US\$)	5.53	6.47
Adj BVPS (US\$)	3.39	4.32

Share data

Market cap (US\$m)	128,079
No of shares (m)	10,713
Free float (%)	100
52-week hi/lo (HK\$)	97.0-78.8

Price performance (%)

	Absolute	Relative to HSI
3m	14.1	5.2
6m	8.1	5.9
12m	5.7	13.8

Price chart



Source: Bloomberg

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Executive summary

Growth at a good price.

HSBC's acquisition of HI is overwhelmingly likely to be accretive from an earnings standpoint, with the purchase price equivalent to 9.7x depressed 2002 reported net income versus HSBC's own 18x multiple on 2002 earnings. In addition, the mere act of purchase creates growth, which we believe to be a key factor in HSBC's share premium and the high value placed on the company by investors.

Where's the synergy?

However, this is not in and of itself a sufficient rationale for the transaction, as HSBC trades at a substantial premium to virtually all major global financial services companies, and could thus show potential accretion from any M&A within the industry. Therefore, the key question from an investor's standpoint should be what is the benefit to owning these two companies together rather than separately?

We see weak evidence so far that there is indeed such a benefit, with our rationale developing as follows:

Changing business may reduce earnings.

Household's future earning power may be impaired. Although the HSBC-HI transaction appears earnings-accretive on a historical basis, we believe that HI will no longer generate a revenue stream as strong as that which it had in the past. This is mainly due to HI's legal need to change its lending practices and reduce certain fees, which are seen as excessive. In addition, we expect that HSBC will need to dramatically increase oversight of HI's branches and employees from a compliance and audit standpoint – this is not an insignificant earnings driver.

Different customers.

Household's customer is not the HSBC customer. Although HI's management claims that only one-third of the company's borrowers are sub-prime, the customer base as a whole skews downmarket. Although this is not per se an issue for us – a well-run sub-prime business can be a cash cow – it is curious that HSBC would branch out in this direction, particularly as its existing customers are quite different. In almost every market, HSBC has positioned itself as a premium bank, not quite a private bank, but definitely above average in customer demographics. The US franchise (primarily the old Republic and Safra banks) is no exception.

We do not see much intersection between the existing customer base and the new HI one, meaning that cross-selling opportunities will be limited. Management's contention that the addition of HI will enable the bank to serve customers that it has previously turned away is unusual (these customers were supposedly passed over because of their poor credit quality), as is the expectation that some of HI's better clients will graduate to HSBC services over time as their quality improves. As the businesses will of necessity operate independently, it is not evident to us that HSBC will have much of an advantage retaining HI's better customers, as they move up in quality and seek more comprehensive services.

Depending on sub-prime.

A leveraged risk on the US consumer may not be timely. Although HSBC's own US economic forecast is bearish, calling for only 2% growth in 2003 as well as rising unemployment, the success of the HI acquisition (at least over the next three years) is highly dependent upon the very sensitive sub-prime customer remaining healthy. We are much less sanguine about the advisability of taking additional exposure to the most highly-levered segment of the population at this point in the cycle, although in fairness it must be said that HSBC management should indeed be planning well beyond the current economic cycle.

Maintain HOLD.

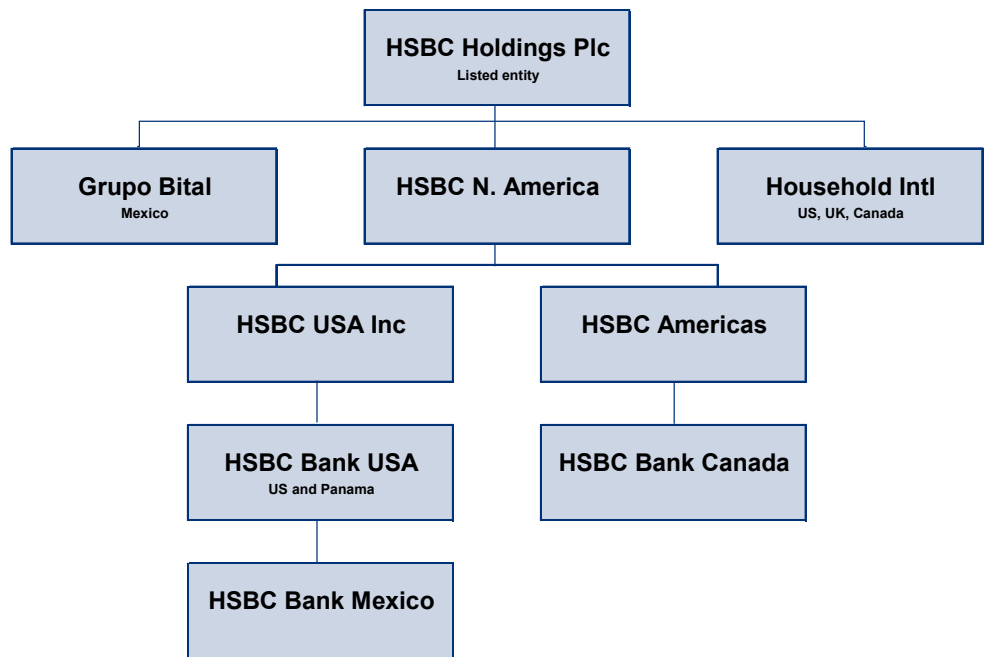
We have raised our price target and earnings slightly, with fair value moving from 647p to 652p (HK\$ target moves up to HK\$84 due to US\$ weakening). We maintain our HOLD rating on HSBC shares.

Transaction and structure

HSBC completed its acquisition of Household International at the end of March 2003, issuing 14.8% new shares in payment for a 100% stake in the company.

Household will be merged into the existing US and Canadian operations of HSBC, with the combined North American operations to be overseen by former HI head, William F. Aldinger, who will become Chairman of the US bank and a member of the HSBC main board later in the year. Although Mr. Aldinger has signed a multi-year contract extension to remain with the group, it is possible that he could become embroiled in the scandal that continues to surround Household's lending and disclosure practices.

Fig 1 Simplified HSBC Americas structure



Note: Some intermediate holding companies omitted.

Source: Company data, FFIEC

Household analysis

Products and offerings

Household offers a variety of consumer finance products to its customer base in the US, Canada and the UK. The company's loans are primarily mortgage and home equity loans (43%) and outstanding credit card receivables (32%), although auto lending and unsecured personal loans are also significant contributors to the overall business.

Fig 2 Household loan book by product (US\$m)

	YE02		YE98	
	Balances	% of total	Balances	% of total
Mortgage and HELOAN	46,275	43.0	22,486	35.2
Auto finance	7,442	6.9	1,765	2.8
MasterCard/Visa	18,953	17.6	16,611	26.0
Private label credit cards	14,917	13.9	10,378	16.2
Personal loans	19,446	18.1	11,971	18.7
Commercial and other	463	0.4	697	1.1

Source: Company data, ING

Real estate lending

HI has re-emphasised its real estate lending business over the past two years, as rising consumer delinquencies have led management to prioritise origination of these less-risky loans. HI finances both first and second purchase money mortgages, and also offers home equity loans and lines of credit to existing homeowners.

Although secured lending is meant to be more, well, *secure*, charge-offs on real estate lending have more than doubled since 3Q01 to 1.12% in 1Q03. Likewise, delinquencies have risen over the same period, albeit by only 50%.

Fig 3 Real estate loan products

Product	Loan amount (US\$)	APR (%)
Residential First Mortgages	10,000-400,000	8.19-8.69
Mortgage Refinance Loans	10,000-400,000	8.19-8.69
Personal loans for homeowners	5,000-35,000	17.39-17.89
Home Equity loans	10,000-150,000	9.19-9.69

Source: Company data, ING

In addition to originating loans through HI's branch network, the company also purchases or funds loans sourced by several hundred independent mortgage brokers through its Decision One Mortgage subsidiary. We estimate that this channel accounts for 35-40% of HI's outstanding mortgage portfolio, with the relatively recent purchase of Decision One (in 1999) indicating that its share of new originations may be higher. We view this as a major contributing factor in the increasing share of mortgage lending in Household's portfolio, along with the purchase of a portfolio of US\$4bn in loans during 2000.

Note that it is more difficult for Household to ensure that its affiliates meet proper standards for lending practices; given the company's legal troubles, we believe that there will be some pressure to either rein in this business or improve its oversight, with concomitant pressure on revenues or expenses respectively.

Credit cards

Household is the eighth-largest issuer of credit cards in the US with approximately 20m customer accounts, roughly the same relative position the company has held since 1995. HI's main products in the credit card sector are the GM Card, a co-branded card which allows clients to earn discounts on General Motors cars, the AFL-CIO Union Plus card, which is marketed to union members, and the Household Bank card, which is no longer actively marketed. In addition to these Mastercard and VISA products, the company issues private-label credit cards for retailers including Best Buy, Costco, Microsoft, CompUSA, and Sony.

Fig 4 US credit card issuance rankings

30/6/2002

1	Citigroup
2	MBNA
3	First USA
4	Chase Manhattan
5	Capital One
6	Providian
7	Bank of America
8	Household International
9	FleetBoston
10	Direct Merchants Bank

Source: Company data, ING

Network

Household has a widespread network of over 1,300 branches in 45 of the 50 states in the US, as well as over 100 in Canada and 224 branches in the United Kingdom. In addition, the company sources loans through 4,500 auto dealers and 14,000 tax preparation outlets (representing largely 9,900 H&R Block and 546 Jackson Hewitt locations).

As shown in the following charts, Household's branch network is widespread and covers almost every major US population centre, a great advantage.

By comparison, HSBC's 442 US branches are almost all located in the state of New York, products of the group's acquisition of Marine Midland Bank and Republic Bank. Within New York, most offices are either in the metro New York City area (old Republic Bank territory) or in Buffalo and Rochester (the former Marine Midland network). The company also has approximately 120 offices in Canada.

Fig 5 HSBC-USA existing branch network

State	Branches
CA	4
FL	8
NY	426
PA	2
WA*	1
OR*	1

* Branches of HSBC Bank Canada

Source: Company data, FFIEC, ING

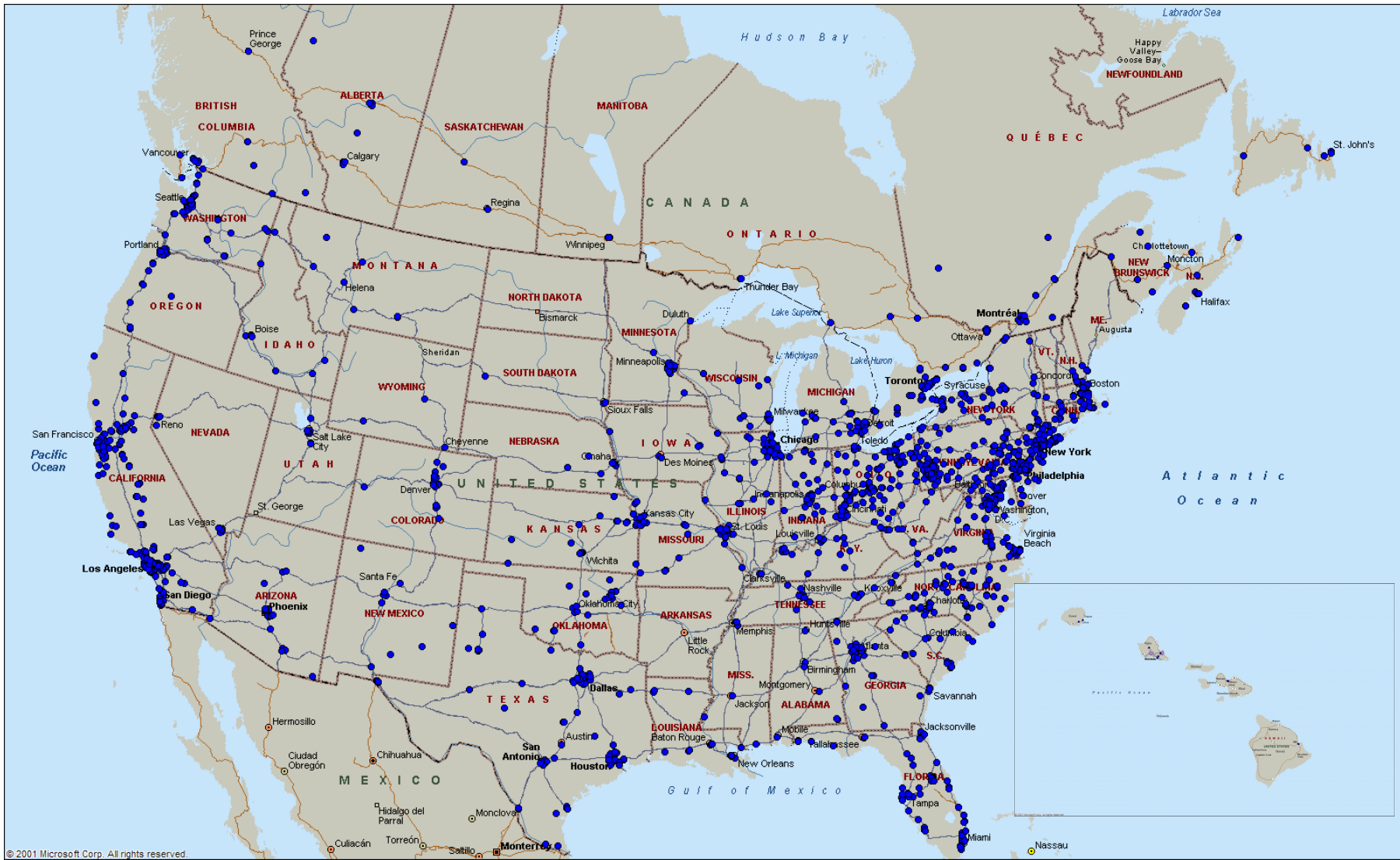
The Household acquisition will extend HSBC's distribution network for its financial products; however, it should be noted that the Household offices are in many cases not up to the standards of traditional bank branches, and cater to a far different clientele.

One potential use of this branch network will be remittances. Recall that HSBC purchased Mexico's fourth-largest bank, Banco Bital, in December.

We have previously stated that we believe both Citi (through subsidiary Banamex) and BofA (through its 25%-owned affiliate, Santander Serfin) have better ability to get value out of their Mexican franchises than does the existing HSBC USA platform, as they are already concentrated in the key California market (Citi will add 335 branches in the state through its acquisition of Golden State Bancorp, while BofA has 948 branches and is #1 in terms of deposit market share). California's large population of Mexican immigrants generates an increasing amount of cross-border financial activity, including a very lucrative remittance business with volume reported at US\$9.3bn annually.

In contrast, HSBC's existing banking customers are concentrated in the Northeast (only four California offices) and have fewer connections with Mexico. However, HSBC's pending acquisition of Household International will change its profile quite significantly, adding at least 86 branches in California and over 70 in Texas, another state with large economic ties to Mexico. Here as well, however, BofA pulls ahead, with 455 branches and 12% deposit market share (#2).

Fig 6 Household US and Canada branches



Source: Company data, ING

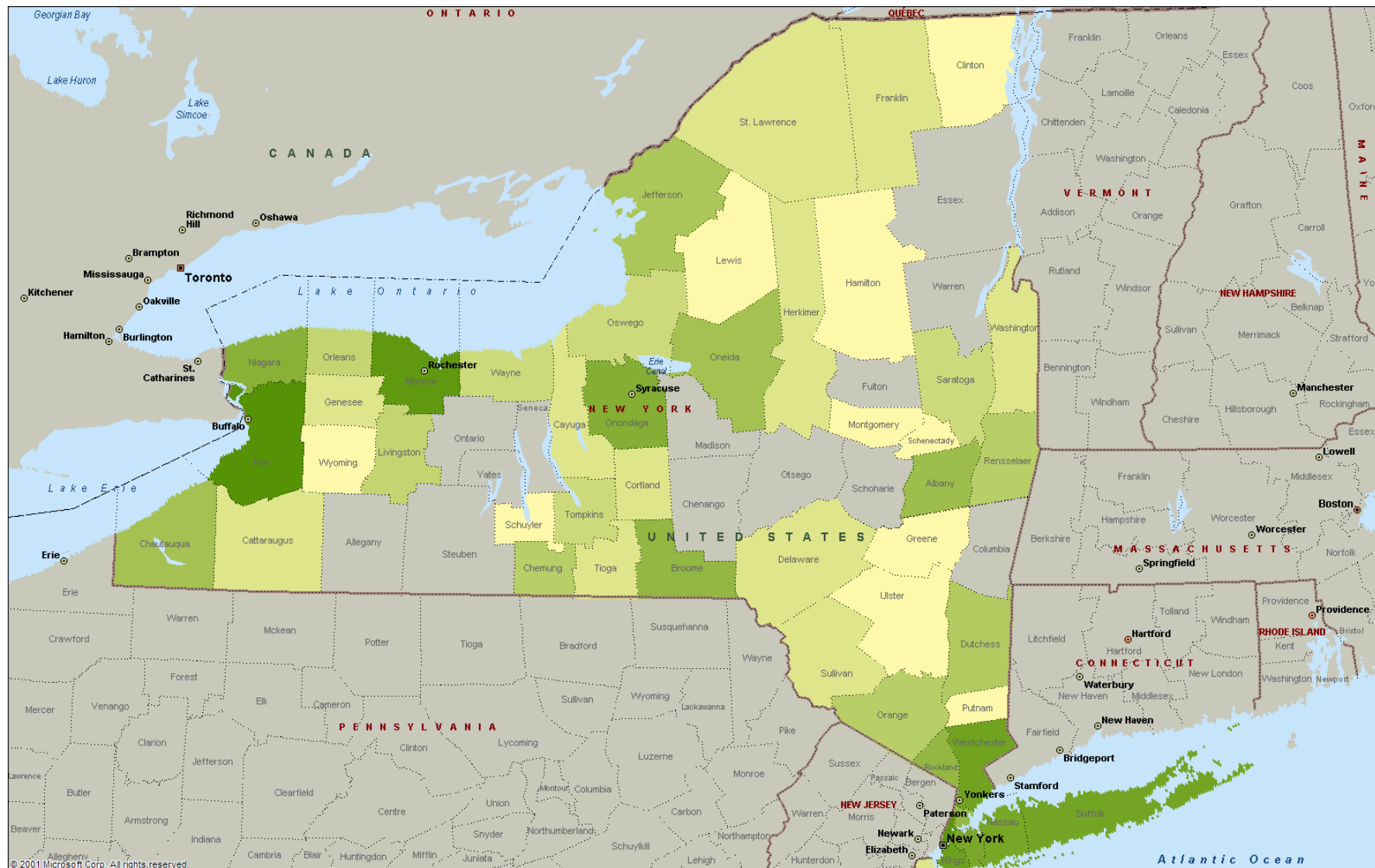
Fig 7 HSBC-USA and HSBC Bank Canada branches



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Source: Company data, ING

Fig 8 HSBC branch concentration: New York state



Source: Company data, ING

Fig 9 HSBC metro New York branch network



Source: Company data, ING

Returns and profitability

Household International has already reported 1Q03 detailed results, the company's last prior to its acquisition by the parent. As HI has debt outstanding, we believe that the company will be obligated to continue filing 10-Q and 10-K reports for the foreseeable future. This is of great benefit to investors, as disclosure has suffered at other companies post their acquisitions by HSBC; in this instance, the mandatory nature of reporting will give us the ability to continue tracking HI on a quarterly basis.

Net income

Household posted net income of US\$255m in the first quarter, down 19% QoQ and 47% YoY on a headline basis. However, a substantial portion of the decrease was due to merger costs of US\$198m during the quarter, which we do not consider part of core earnings. On a core basis, net income declined by 6% YoY and 35% QoQ, to US\$453m.

Fig 10 Key earnings components: 1997-2002

(US\$m)	97	98	99	00	01	02
Net interest income	2,979	3,291	3,937	4,887	5,941	6,774
Non-interest income	3,041	2,885	2,670	3,010	3,651	4,342
Non-interest expenses	2,982	2,740	2,621	3,123	3,718	4,233
Loan loss provisions	1,493	1,517	1,716	2,117	2,913	3,732
Core income	923	1,320	1,419	1,621	1,833	2,398
Net income	923	509	1,419	1,621	1,833	1,495
EPS (US\$)	1.90	1.05	3.03	3.44	4.01	3.15

Source: Company data, ING

Fig 11 Key earnings components: 4Q01-1Q03

(US\$m)	4Q01	1Q02	2Q02	3Q02	4Q02	1Q03
Net interest income	1,645	1,635	1,658	1,743	1,739	1,714
Non-interest income	979	1,093	987	1,101	1,162	1,159
Non-interest expenses	948	1,048	1,039	1,047	1,099	1,209
Loan loss provisions	829	923	851	973	985	1,010
Core income	526	483	492	730	694	454
Net income	526	483	492	205	316	255
EPS (US\$)	1.15	1.06	1.08	0.45	0.67	NM

Source: Company data, ING

For the full-year 2002, HI earned US\$1.50bn, an 18% fall from FY01. However, this figure is heavily skewed by special charges taken during the year, including US\$525m for legal settlement costs in Household's predatory lending case and US\$378m for the loss on sale of the company's thrift subsidiary and associated assets. On a core basis, profits of US\$2.40bn were 31% ahead of the prior period.

Returns

Household's returns on assets and equity have been consistently good on a core basis, with the company averaging above 2.4% ROAA from 1996–2002. Return on equity has been just over 19% for the same period.

HI's return on common equity declined sharply in 1Q03 after an initial softness in FY02; however, the 1Q03 performance was primarily due to the increase in book equity occasioned by merger accounting. HSBC has elected to revalue the assets and liabilities of HI on purchase, resulting in a US\$7.7bn increase in goodwill and fair value adjustments during the quarter, and a US\$5.4bn increase in total book equity. Had

these adjustments not been made, we estimate that actual and core ROE for the quarter would have been 11.0% and 19.5%, respectively.

Fig 12 Key earnings ratios: 1997-2002 (%)

	97	98	99	00	01	02
ROA	2.42	1.02	2.50	2.36	2.21	1.60
Core ROA	2.42	2.65	2.50	2.36	2.21	2.57
ROE	20.26	8.21	22.40	22.52	23.21	17.52
Core ROE	20.26	21.29	22.40	22.52	23.21	28.11
NIM	8.69	7.36	7.63	7.73	7.70	7.71
Cost/income	49.55	44.37	39.67	39.55	38.76	38.08
Overheads	8.70	6.13	5.08	4.94	4.82	4.82
Effective tax rate	29.94	22.34	30.87	32.71	32.78	22.06

Source: Company data, ING

Fig 13 Key earnings ratios: 4Q01-1Q03 (%)

	4Q01	1Q02	2Q02	3Q02	4Q02	1Q03
ROA	2.42	2.16	2.11	0.83	1.27	1.00
Core ROA	2.42	2.16	2.11	2.95	2.79	1.77
ROE	28.72	27.36	26.39	11.02	16.40	13.02
Core ROE	28.72	27.36	26.39	39.29	36.02	23.13
NIM	8.10	7.81	7.59	7.55	7.47	7.34
Cost/income	36.13	38.41	39.29	36.83	37.88	42.08
Overheads	4.67	5.00	4.75	4.54	4.72	5.18
Effective tax rate	33.25	33.63	33.11	9.84	13.44	28.53

Source: Company data, ING

Because of the distortions from balance sheet revisions and changes in gearing, return on average assets is a better proxy for the health of the underlying business. On a core basis, ROAA declined to 1.77% in 1Q03 from 2.16% in the corresponding period of 2002. Although this is still quite strong when compared with the HSBC group level core ROE of 1.04% for 2002 (est 1.18% for 2003), HI has been lagging behind top-tier peers in the US, such as MBNA and Capital One Financial.

Securitised assets increase book returns

Although we believe that book ROAA is a useful ratio for understanding HI's business, a complete assessment must take into account the effect of securitisation and off-balance-sheet items on the company's results. Therefore, in addition to traditional core ROAA, we also track core return on average managed assets, which shows a similar progression.

Fig 14 Return on managed assets (US\$m)

	96	97	98	99	00	01	02
Total book assets	29,595	46,817	52,893	60,749	76,706	88,911	97,861
Est managed assets	29,595	71,296	72,595	80,188	96,956	109,859	122,794
Core income	522	923	1,320	1,419	1,621	1,833	2,398
Core ROAA (actual) (%)	1.77	2.42	2.65	2.50	2.36	2.21	2.57
Core ROAA (managed) (%)	1.77	1.83	1.83	1.86	1.83	1.77	2.06

Source: Company data, ING

Returns vs competition

Household's returns on assets and equity lag behind those of the premier companies in the sector, including (as standalone consumer finance companies) MBNA and Capital One. HI does come in more strongly than its listed sub-prime peers Providian and Metris (parent of Direct Merchants Bank). However, the track record of these companies over the past few years should be a cautionary illustration of the downside of the lower end of the US consumer market.

Fig 15 Industry comparison: ROA (%)

	96	97	98	99	00	01	02
Household	1.77	2.42	1.02	2.50	2.36	2.21	1.60
Capital One	2.77	2.80	3.34	3.19	2.91	2.73	2.74
MBNA	3.14	3.25	3.30	3.62	3.78	4.03	3.59
Providian	4.01	4.35	5.08	5.10	4.02	0.20	1.19
Metris	8.68	9.22	7.58	-4.12	5.66	5.30	-2.11
Average	4.07	4.41	4.06	2.06	3.75	2.89	1.40

Source: Company data, ING

Fig 16 Industry comparison: Core ROA (%)

	96	97	98	99	00	01	02
Household	1.77	2.42	2.65	2.50	2.36	2.21	2.57
Capital One	2.77	2.80	3.34	3.19	2.91	2.73	2.74
MBNA	3.14	3.25	3.30	3.62	3.78	4.03	3.59
Providian	4.01	4.35	5.08	5.10	4.22	0.82	0.82
Metris	8.68	9.22	8.93	8.19	6.44	6.42	-0.41
Average	4.07	4.41	4.66	4.52	3.94	3.24	1.86

Source: Company data, ING

Fig 17 Industry comparison: ROE (%)

	96	97	98	99	00	01	02
Household	18.53	20.26	8.21	22.40	22.52	23.21	17.52
Capital One	23.18	23.19	25.44	26.07	27.01	24.29	22.64
MBNA	31.96	33.88	35.60	31.09	24.25	23.49	20.90
Providian	38.39	35.52	42.40	51.53	38.74	1.97	10.78
Metris	19.06	24.18	27.58	-23.44	40.02	33.20	-10.44
Average	26.22	27.40	27.85	21.53	30.51	21.23	12.28

Source: Company data, ING

It should be noted for purposes of evaluation of both risk and ROE that Household has run with a slimmer equity base than any of its peers over the past three years. While this is a measure which should also be looked at on an equity/managed receivables basis, we believe that HI's low margin for error is one of the factors that pushed the company to the wall and caused a liquidity crisis during 2002.

Fig 18 Industry comparison: Equity/assets (%)

	96	97	98	99	00	01	02
Household	9.94	13.19	11.76	10.62	10.37	8.82	9.42
Capital One	11.45	12.62	13.49	11.36	10.39	11.79	12.37
MBNA	10.00	9.25	9.27	13.61	17.13	17.16	17.22
Providian	11.10	13.38	11.11	9.29	11.26	9.57	12.80
Metris	48.40	32.68	24.52	14.38	14.00	17.69	24.22
Average	18.18	16.22	14.03	11.85	12.63	13.01	15.21

Source: Company data, ING

Loan portfolio

Household's loan book has changed substantially over the past few years, with the company reducing its historic dependence on credit cards (managed card receivables have fallen to 31% of the book from 42% in 1998) while increasing its real estate lending (loans secured by property have increased from 35% of the book to 44% over the same period).

Fig 19 Household loan book evolution: 1998-1Q03 (US\$m)

	1Q03		YE02		YE01		YE98	
	Balance	% total	Balance	% total	Balance	% total	Balance	% total
Owned receivables	83,438	100	82,562	100	79,875	100	44,206	100
Real estate secured	47,257	57	45,819	55	43,857	55	18,849	43
Auto finance	2,156	3	2,024	2	2,369	3	805	2
MasterCard/Visa	8,453	10	8,947	11	8,141	10	7,180	16
Private label	11,189	13	11,340	14	11,664	15	9,566	22
Personal non-credit card	13,927	17	13,971	17	13,337	17	7,109	16
Commercial and other	457	1	463	1	507	1	697	2
Managed receivables	107,694	100	107,496	100	100,823	100	63,908	100
Real estate secured	47,596	44	46,275	43	44,719	44	22,486	35
Auto finance	7,383	7	7,442	7	6,396	6	1,765	3
MasterCard/Visa	18,394	17	18,953	18	17,395	17	16,611	26
Private label	14,767	14	14,917	14	13,814	14	10,378	16
Personal non-credit card	19,098	18	19,446	18	17,993	18	11,971	19
Commercial and other	457	0	463	0	507	1	697	1

Source: Company data, ING

We attribute this trend both to falling interest rates throughout the period and to rising homeownership rates, particularly in Household's target markets. In our view, there is some causal relationship between these two effects, but we do not believe that low rates alone have increased homeownership – nor do we believe that the macro factors alone explain HI's consistent growth.

Fig 20 30-year fixed mortgage rates



Source: HSH Associates

Fig 21 Housing prices and homeownership

Source: Federal Reserve Board of Governors, ING

The vast majority of HI's property loans are not A-quality traditional mortgages but instead sub-prime paper, home equity loans and revolving lines of credit, and subordinated mortgages, which do not carry the first lien. Because of this, HI is not active in the traditional bank mortgage market, which now consists substantially of conforming loans, which are sold to FNMA and similar entities for packaging into securities. In fact, Household retains ownership of almost all of its originated managed real estate loans – somewhat an oddity in this era.

Loan growth and acquisitions

Auto finance has shown the strongest percentage growth in recent years, albeit off a very low base. Personal lending, including tax refund loans and other speciality products, has also performed well with a CAGR of 11% over the past five years.

Fig 22 Growth in managed receivables (%)

	97	98	99	00	01	02	CAGR
Total	162.4	1.2	12.2	22.1	15.1	6.6	11.2
Real estate secured	362.4	11.2	19.8	36.0	22.1	3.5	18.0
Auto finance	N/M	N/M	72.2	50.1	40.2	16.4	34.8
MasterCard/Visa	123.7	-13.5	-4.9	11.3	-1.1	9.0	-0.3
Private label	104.8	0.0	8.6	6.5	15.1	8.0	7.5
Personal non-credit card	125.7	4.0	16.0	16.9	10.9	8.1	11.1
Commercial and other	2.0	-27.2	16.0	-25.9	-15.3	-8.7	-13.5

Source: Company data, ING

Owned receivables overall grew at a 4.8% (YoY) rate in 1Q03, up slightly from year-end but well below the torrid rate of mid-2002. Managed receivables growth is in line with the FY02 numbers, dropping slightly to 6.4% in 1Q from 6.6% for FY02.

Fig 23 Receivables growth rates (annualised) (%)

	4Q01	1Q02	2Q02	3Q02	4Q02	1Q03
Owned receivables	18.58	15.68	15.86	11.34	3.36	4.83
Real estate secured	24.67	24.37	25.16	18.89	4.47	3.57
Auto finance	28.01	30.93	15.87	-1.03	-14.57	-17.16
MasterCard/Visa	1.09	-6.42	-13.08	-5.26	9.89	21.27
Private label	12.72	4.53	4.81	-1.32	-2.78	4.69
Personal non-credit card	17.73	11.18	15.93	11.55	4.75	5.40
Commercial and other	-15.32	-14.25	-13.40	-11.21	-8.66	-7.00
Managed receivables	15.08	14.49	15.21	12.46	6.62	6.44
Real estate secured	22.06	21.69	22.81	16.96	3.48	2.91
Auto finance	40.15	37.80	33.36	25.07	16.37	11.60
MasterCard/Visa	-1.07	-1.34	-1.51	1.23	8.95	12.51
Private label	15.14	12.18	12.50	10.07	7.98	10.84
Personal non-credit card	10.88	9.68	11.50	10.96	8.08	5.21
Commercial and other	-15.32	-14.25	-13.40	-11.21	-8.66	-7.00

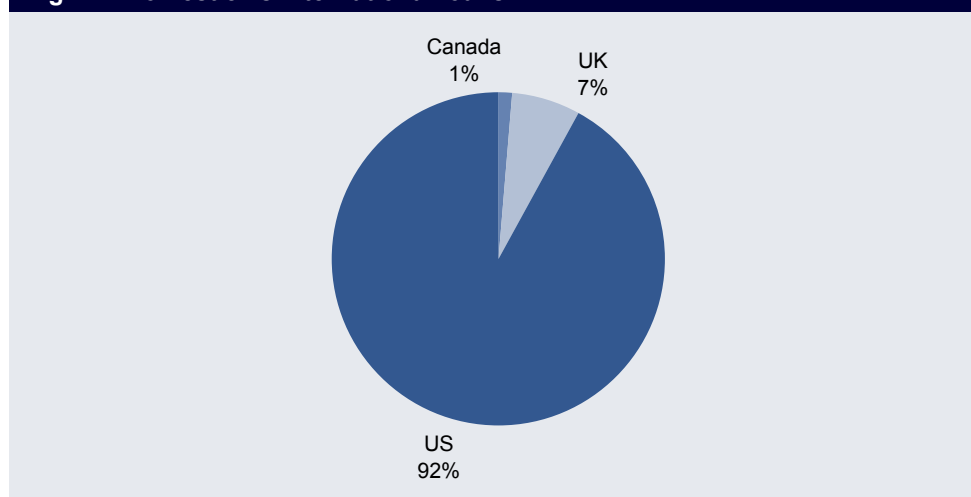
Source: Company data, ING

The private label card business is still adding balances at an 11% YoY rate, while the Mastercard/VISA portfolio is also now showing double-digit growth, after a weak period in late 2001-early 2002.

Bear in mind that much of historic growth is non-organic. HI acquired direct competitor Beneficial Finance in 1998, entered the sub-prime auto loan business in a serious way by buying ACC Consumer Finance in 1997, bought the consumer lending operations of Transamerica the same year, and in 1999 purchased both Decision One Mortgage and Renaissance Holdings.

Geographic breakdown

Approximately 92.0% of HI's business is US-based, with an additional 1.4% of managed assets in Canada and the remaining 6.7% in the UK. Household divested its Australian business in the mid-1990s and has no other significant non-US operations. Obviously, now that the company is part of the HSBC group this is expected to change; HSBC management has been clear on its intention to use HI's expertise to help the group engage in consumer finance in Mexico (through GF Bital) and in Asia.

Fig 24 Domestic vs international loans

Source: Company data, ING

We have not made any provision for incremental international businesses in our forecasts, as it is not clear how any joint ventures will be operated. In addition, we are far from convinced that HI has a surfeit of proprietary experience that will help HSBC in these markets, although from a scale perspective both will benefit.

Household makes most of its US loans in California, the Midwest, and the Southeast, with a relatively balanced national credit card portfolio evening out some of the regional skew away from the Northeast and Mid-Atlantic states. Note as per our previously stated analysis, HI has relatively little overlap with HSBC geographically.

Fig 25 Geographic distribution by product (%)

	Northeast	Mid-Atlantic	Southeast	Southwest	Midwest	California	West	Total
Mortgage	7	10	24	11	21	17	10	100
Consumer	12	17	15	8	22	16	10	100
MasterCard/Visa	16	14	12	11	26	14	7	100
Private label cards	9	12	25	16	19	13	6	100
Auto	3	15	29	18	17	14	4	100
Total	10	13	21	12	22	16	8	100

Source: Company data, ING

Rates and margins

Household has managed to maintain its net interest margin within a stable 7.6–7.75% range over the past three fiscal years; however, recent quarterly results have shown a slippage in NIM, which is the driving force behind HI's lower (albeit still quite good) ROA. Robust earning asset growth of 12% YoY in the most recent quarter was only enough to raise net interest income by 5% due to margin contraction; on a consecutive quarter basis, NII was down 1%.

Some seasonality does apply in what is traditionally a weak quarter; however, NIM trends have been steadily down on falling asset yield. This is critical for HI versus its competitors as interest revenues are still the primary driver of the business. HI's non-interest income – mainly securitisation revenues and fees – was 39% of gross revenue in FY02 compared with 67% for Capital One and 77% for MBNA.

Net interest margin shed 12bp over the quarter, and 46bp versus the year-earlier period. We estimate the value of an NIM basis point to HI's net interest income to be US\$9.3m/year; on this basis, the year's compression has lowered NII by US\$429m at the pre-tax level over the next 12 months, an impact of approximately 16% of annualised 1Q03 pre-tax income.

Fig 26 Key net interest margin components: 1997-2002 (%)

	97	98	99	00	01	02
Yield on earning assets	15.62	13.03	13.03	13.96	13.13	12.19
Cost of interest-bearing liabilities	7.77	6.32	5.92	6.76	5.89	4.90
Interest spread	7.86	6.71	7.12	7.20	7.24	7.29
Net interest margin	8.69	7.36	7.63	7.73	7.70	7.71

Source: Company data, ING

Fig 27 Key net interest margin components: 4Q01-1Q03 (%)

	4Q01	1Q02	2Q02	3Q02	4Q02	1Q03
Yield on earning assets	12.98	12.33	12.15	11.95	11.65	11.25
Cost of interest-bearing liabilities	5.29	4.95	4.96	4.73	4.55	4.27
Interest spread	7.69	7.38	7.18	7.22	7.11	6.98
Net interest margin	8.10	7.81	7.59	7.55	7.47	7.34

Source: Company data, ING

Fig 28 Key net interest margin components: chg 4Q01-1Q03 (bp)

	4Q01	1Q02	2Q02	3Q02	4Q02	1Q03
Yield on earning assets	-34	-65	-19	-20	-30	-40
Cost of interest-bearing liabilities	-57	-34	+1	-24	-18	-27
Interest spread	+23	-31	-20	+4	-12	-13
Net interest margin	+18	-29	-22	-4	-8	-12

Source: Company data, ING

It is difficult to determine what portion of the lower margin is due to changes in loan mix; however, we believe that a fall in comparatively high-yielding cards and personal lending balances in 1Q03 will have had an impact. Perhaps more importantly, we believe that Household is being forced to change some of its (hopefully) former predatory lending practices, and that this is having an impact, particularly in the real estate secured portion of the portfolio (now comprising 57% of owned and 44% of managed receivables).

Fig 29 NIM industry comparison (%)

	96	97	98	99	00	01	02
Household	6.15	8.69	7.36	7.63	7.73	7.70	7.71
Capital One	6.86	5.81	8.76	9.95	11.04	8.00	8.97
MBNA	4.77	4.11	3.62	3.83	4.79	4.71	5.02
Provident	10.60	9.78	11.21	11.95	12.37	9.98	5.72
Metris	13.57	19.94	17.81	14.66	14.74	14.80	13.19
Average	8.39	9.67	9.75	9.61	10.13	9.04	8.12

Source: Company data, ING

HSBC funding advantage

HSBC does have a substantial funding advantage over HI in its US operations, where the cost of funds was 2.06% in FY02, versus 4.90% at Household. This in large part represents HSBC-USA's ability to gather low-cost deposits through its bank branches. With a book that is 72% deposits and only 2.6% sub debt, much of HSBC-USA's funding advantage is related to its funding mix rather than its superior credit rating – although we are by no means claiming that the latter has no impact.

Fig 30 HSBC-USA liability funding

Liability breakdown	US\$m	% of total
Interbank borrowings	1,209	1.5
Deposits	59,280	71.8
Subordinated debt	2,109	2.6
Preferred stock and Hybrid capital	500	0.6
Other liabilities	19,431	23.5
Total	82,530	100.0

Source: Company data, ING

Having disposed of its thrift banking operations, HI has minimal deposit-taking capabilities, and as a unit which is separate from the US banks it is not automatically entitled to assume HSBC-USA's powers, nor would HI necessarily welcome the increased regulatory overheads which would come with full operation under a bank charter.

Fig 31 HSBC-USA deposits

Deposit breakdown	US\$m	% of total
Demand deposits	24,530	41.4
Savings deposits	22,705	38.3
Time deposits	12,045	20.3
Total	59,280	100.0

Source: Company data, ING

Given its low LDR of 75%, HSBC-USA could conceivably support some of Household's assets, but doing so via direct lending would invite prompt regulatory scrutiny. Finally, HI's estimated average debt maturity of 4.6 years means that even the availability of low-cost funding will not change the company's returns overnight. Due to these factors, we estimate only a 120bp funding benefit for Household over the next two years – still a very substantial positive.

Asset quality

Asset quality for Household has been becoming worse since the end of 2000. Delinquencies rose by 28%, from 4.20% of managed receivables to 5.36%. On a 12-month lag basis, 60+ day delinquent accounts have risen from 5.13% to 5.71% of managed accounts.

Fig 32 Owned non-performing assets (US\$m)

	1Q01	2Q01	3Q01	4Q01	1Q02	2Q02	3Q02	4Q02	1Q03
Non-accrual receivables	1,803	1,832	1,980	2,028	2,185	2,316	2,485	2,666	2,880
Accruing consumer receivables 90 or more days delinquent	669	744	807	844	839	751	824	861	878
Renegotiated commercial loans	12	12	-	2	1	1	1	1	1
Total non-performing receivables	2,485	2,588	2,786	2,874	3,026	3,068	3,310	3,528	3,760
Real estate owned (ORE)	350	365	363	399	459	457	451	427	445
Total non-performing assets	2,835	2,953	3,149	3,273	3,485	3,525	3,761	3,955	4,205
% of owned receivables + ORE (%)	4.1	4.1	4.1	4.1	4.4	4.2	4.4	4.8	5.0

Source: Company data, ING

Delinquencies can be misleading indicators for a consumer finance company, as bad debts do not tend to stick around for a long time, but are almost always written off within 180 days past due.

What we are really interested in are credit losses, or charge-offs. Proportional charge-offs have risen by 39% since YE00, and are now running at a 4.75% annualised rate on managed loans. Within this book, there is significant variation among the product portfolios, with real estate loans experiencing the lowest charge-offs at 1.12% (up from 0.41% at YE00) and personal non-credit card loans the highest at 9.18%.

Fig 33 Credit cost summary: 1996-2002

BP on average loans	96	97	98	99	00	01	02
Provisions	331.71	475.86	365.99	355.75	353.86	395.69	459.50
Net charge-offs	253.19	239.40	343.77	351.02	294.53	320.81	377.07
Provisions less charge-offs	78.52	236.47	22.22	4.73	59.32	74.87	82.43
Accumulated reserves	393.11	523.39	418.44	364.16	353.02	361.75	410.33

Source: Company data, ING

Fig 34 Credit cost summary: 1Q01-1Q03

BP on average loans	1Q01	2Q01	3Q01	4Q01	1Q02	2Q02	3Q02	4Q02	1Q03
Provisions	103.35	93.50	98.12	106.69	115.76	104.58	116.32	118.17	121.64
Net charge-offs	78.30	80.11	84.54	82.69	88.98	91.46	99.10	93.54	103.51
Provisions less charge-offs	25.04	13.39	13.59	23.99	26.78	13.11	17.21	24.63	18.13
Accumulated reserves	335.24	338.15	336.17	342.60	360.77	366.65	373.85	399.77	419.65

Source: Company data, ING

Restructuring and re-aging

One of our concerns is HI's large portfolio of restructured and re-aged receivables. 16.7% of Household's current loan book is restructured, with almost half of these loans worked out in the last six months alone. As most of these loans have been re-aged (*ie*, they are now reported as performing according to new terms), delinquency figures will tend to understate the number of distressed customers in HI's book.

Fig 35 Restructured loans (managed basis)

	1Q03	4Q02
Percentage of loans:		
Never restructured	83.3	84.4
Restructured:		
– In the last 6 months	7.5	6.5
– In the last 7-12 months	3.6	4.1
– Restructured over 12 months	5.6	5.0
Total restructured	16.7	15.6
Total	100.0	100.0
Percentage of restructured loans by portfolio:		
– Real estate secured	20.0	19.0
– Auto finance	16.9	16.7
– MasterCard/Visa	3.4	3.2
– Private label	9.6	9.7
– Personal non-credit card	25.8	23.0
Total	16.7	15.6

Source: Company data, ING

Note particularly that 20% of Household's real estate loans have been restructured, even though the company shows a very small charge-off rate on these loans, we are concerned that bad borrowers are being rolled along so as not to increase reported losses.

Fig 36 Charge-offs and delinquencies: 4Q95-1Q03

	4Q95	1Q96	2Q96	3Q96	4Q96	1Q97	2Q97	3Q97	4Q97	1Q98	2Q98	3Q98	4Q98	1Q99	2Q99
HI charge-offs (annualised %, net):															
Total managed	2.91	3.24	3.33	3.52	3.59	3.55	3.86	3.98	3.94	4.17	4.26	4.33	4.39	4.37	4.10
Real estate secured						0.75	0.67	0.53	0.62	0.61	0.52	0.72	0.68	0.55	0.64
Auto finance									5.31	5.94	5.18	4.89	5.63	5.45	4.41
MasterCard/Visa	4.26	4.44	4.86	4.71	4.66	4.79	5.66	6.22	5.56	5.78	5.49	5.96	6.61	7.59	7.30
Private label	4.72	4.51	3.82	3.54	3.70	4.16	4.37	4.79	5.19	5.73	6.05	5.33	5.47	5.53	5.57
Personal non-credit card	3.33	3.91	3.58	4.35	4.18	5.09	5.23	5.66	5.85	6.22	7.26	7.50	6.94	6.36	5.61
HI delinquencies (60+ days, %):															
Total managed	3.46	3.60	3.49	3.83	4.15	4.45	4.32	4.62	4.82	4.65	4.65	4.96	4.90	4.81	4.72
Card delinquencies	2.22	2.42	2.05	2.54	2.71	3.13	3.10	3.17	3.05	3.10	3.30	3.73	3.75	3.61	3.11
Private label delinquencies	4.51	4.74	5.04	5.43	5.50	5.52	5.89	6.54	6.75	6.04	6.10	6.55	6.20	6.37	6.62
Other consumer delinquencies	5.60	5.71	5.95	5.79	6.13	6.68	6.77	7.28	8.30	7.72	7.82	8.03	7.94	7.84	8.17
Mortgage delinquencies	3.29	3.28	3.64	3.82	4.13	3.98	3.39	3.59	4.36	3.68	3.55	3.73	3.67	3.54	3.29
	3Q99	4Q99	1Q00	2Q00	3Q00	4Q00	1Q01	2Q01	3Q01	4Q01	1Q02	2Q02	3Q02	4Q02	1Q03
HI charge-offs (annualised %, net):															
Total managed	4.09	3.96	4.00	3.74	3.47	3.41	3.56	3.71	3.74	3.90	4.09	4.26	4.39	4.39	4.75
Real estate secured	0.58	0.54	0.52	0.47	0.41	0.41	0.44	0.48	0.52	0.65	0.65	0.86	1.03	1.11	1.12
Auto finance	4.55	5.43	5.25	4.28	4.45	5.22	5.15	4.47	4.84	6.52	6.70	6.17	5.97	7.62	8.10
MasterCard/Visa	6.15	5.57	5.69	5.57	5.23	5.83	6.27	6.82	6.75	6.69	7.17	7.54	6.81	6.98	7.01
Private label	5.60	5.88	5.65	5.43	5.28	5.06	5.08	5.09	5.13	5.40	5.57	5.38	6.12	5.91	5.91
Personal non-credit card	7.06	6.98	7.41	7.68	7.00	5.92	6.27	6.82	7.00	7.05	7.86	8.56	8.99	7.84	9.18
HI delinquencies (60+ days, %):															
Total managed	4.89	4.66	4.43	4.16	4.21	4.20	4.25	4.27	4.43	4.46	4.63	4.53	4.82	5.24	5.36
Card delinquencies	3.10	2.78	3.06	3.14	3.48	3.49	3.68	3.60	3.91	4.10	4.39	3.90	4.14	4.12	4.57
Private label delinquencies	6.66	5.97	5.94	5.77	5.67	5.48	5.50	5.66	5.88	5.48	5.82	5.85	6.31	6.03	5.77
Other consumer delinquencies	8.57	8.81	8.56	7.92	7.72	7.97	8.37	8.43	8.51	8.87	9.02	9.06	8.89	9.41	9.65
Mortgage delinquencies	3.46	3.27	2.99	2.72	2.77	2.63	2.61	2.63	2.74	2.68	2.93	2.82	3.26	3.94	4.18

Source: Company data, ING

Reserve adequacy

HI maintains credit reserves against both owned receivables and those which are managed by the company with limited recourse. In general, Household's reserves approach our theoretical required reserve value, with the shortfall not material when compared to capital.

In order to calculate required reserves, we apportion loans into the international standard categories of Special Mention, Substandard, Doubtful, and Loss. In Household's case, we assumed that delinquent but still accruing receivables and restructured commercial loans are Substandard, and that non-accrual loans are split between Doubtful (70%) and Loss (30%). In addition, we classify foreclosed property (ORE) and take a general provision of 2% against all performing loans in order to allow for future problems.

Fig 37 Reserve adequacy: 1Q03 owned basis (US\$m)

1Q03 owned	Gross amount	Reserve percentage (%)	Required reserve
Pass	78,800	2	1,576
Special mention		5	-
Substandard	879	20	176
Doubtful	2,632	50	1,316
Loss	1,128	100	1,128
ORE	445	20	89
Excess AIR	NM	20	NM
Total	83,883		4,285
Actual reserves			3,483
Shortfall			801
Actual/required (%)			81
Shortfall/capital (%)			5

Source: Company data, ING

On this basis, we estimate that HI meets 81% of our required figure on an owned-asset basis and 94% on a managed asset basis, with the shortfall at less than 5% of equity in either case.

Fig 38 Reserve adequacy: 1Q03 managed basis (US\$m)

1Q03 managed	Gross amount	Reserve percentage (%)	Required reserve
Pass	101,310	2	2,026
Special mention		5	-
Substandard	879	20	176
Doubtful	3,542	50	1,771
Loss	1,518	100	1,518
ORE	445	20	89
Excess AIR		20	-
Total	107,694		5,580
Actual reserves			5,259
Shortfall			321
Actual/required (%)			94
Shortfall/capital (%)			2

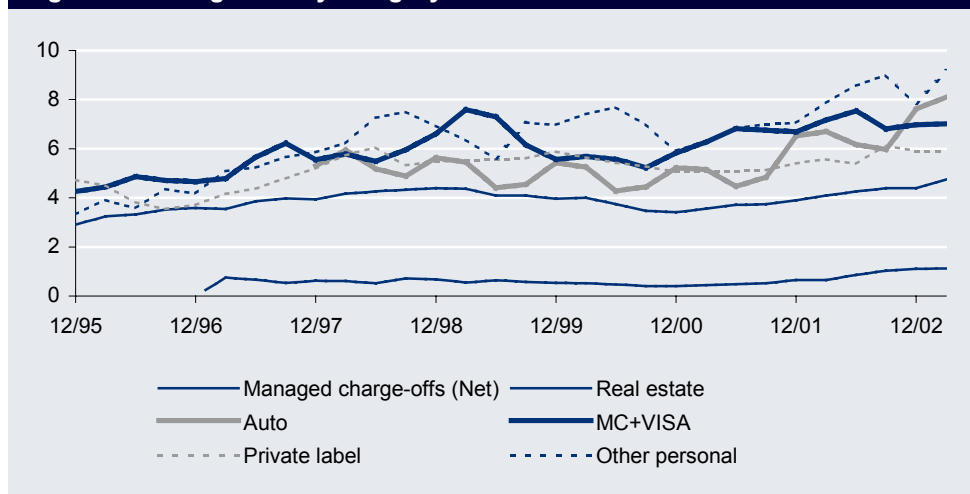
Source: Company data, ING

The US consumer market

What drives losses in US consumer finance?

Our objective in looking at macro data for the consumer market is to find a way of predicting consumer charge-offs. Although we do focus on delinquencies as a measure of where write-offs may be headed, only the actual loss on these loans hits the P&L.

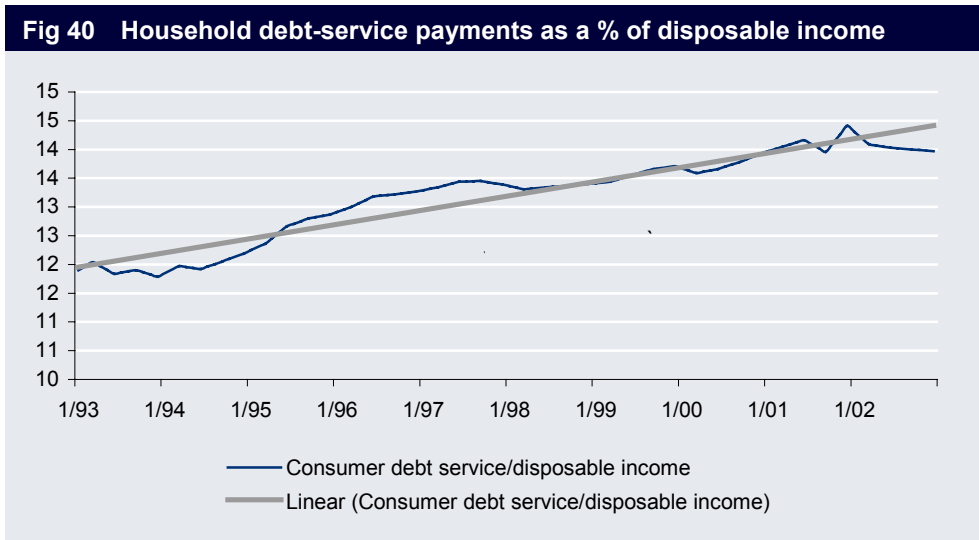
Fig 39 HI charge-offs by category



Source: Company data, ING

We note that some portfolios have perennially high rates of low-level delinquency but remain nonetheless almost untouched by credit losses, while others have customers who default without ever becoming delinquent. This has been most recently and famously the case in Hong Kong, where, despite a 15% charge-off rate, bankers report that 60-70% of their customers who declare bankruptcy (and thus have their accounts immediately charged off in full) are current up until the time a bankruptcy petition is made.

It is frequently asserted that measures of leverage or debt service are the primary driver of consumer default rates, on the not-implausible theory that consumers default in increasing numbers as their debt payments rise with respect to income. Given Household's focus on less-affluent and more strapped borrowers – eg, those with fewer financial options to stave off default – we would expect that any such relationship would be more evident in a review of HI's books than in the general market.



Source: Federal Reserve, ING

Although the asserted relationship between debt service and charge-offs may well hold true for some subset of consumers, our data analysis showed that debt service as a percentage of disposable household income was a weak predictor of total charge-offs for Household over the 1995-1Q03 period, yielding an R-square of only 0.10.

Charge-offs on credit cards and other personal loans were more in tune with the debt service measure than were overall charge-offs, both with R-squares of around 0.50, but this is not especially predictive either.

Fig 41 R-squared table: charge-off predictors 1995-present

	ALL	Cards	Private label	Real estate	Other consumer
Delinquencies	0.86	0.68	0.32	0.17	0.85
Delinquencies (lag basis)	0.38	N/A	N/A	N/A	N/A
Unemployment	0.00	0.00	0.05	0.53	0.00
Change in unemployment (MoM)	0.00	0.02	0.00	0.00	0.01
Change in unemployment (YoY)	0.01	0.28	0.04	0.06	0.17
Unemployment with lag - 3 months	0.00	0.00	0.07	0.62	0.01
Unemployment with lag - 6 months	0.00	0.03	0.11	0.62	0.05
Unemployment with lag - 12 months	0.00	0.22	0.21	0.30	0.21
Household debt service	0.10	0.50	0.25	0.04	0.53
Housing prices	N/A	N/A	N/A	0.05	0.60

Source: Company data, ING

Actual data shows a divergence of default predictors between real estate loans and unsecured consumer lending, primarily credit cards issued under Mastercard and VISA programmes and other consumer loans. Unemployment is a better predictor of defaults on real estate loans, with the best results showing a six-month lag between unemployment rising and charge-offs of loans.

However, unemployment is almost completely uncorrelated with charge-offs on credit card and personal loans, as seen by an R-square near zero for the full 1995-present period – although this rises quite significantly when we look only at the 1999-present period. In addition, losses on these loans are, as we said, driven in part by debt serviceability and tend to rise along with delinquency.

Fig 42 Loan delinquencies vs unemployment



Source: Company data, ING

Legal issues

HI has been beset by legal problems over its lending practices dating back to at least 1998, and the threat of adverse judgement has been one of the key factors affecting the market's more negative view of risk at the company. Most recently, HI was forced to pay US\$484m to a consortium of 47 state attorney generals as part of an agreement to change some of its more questionable operating standards.

Although HI has settled potential state charges against the company, civil liability remains an open issue – and the addition of HSBC as a parent makes HI an even more attractive target for litigation. We strongly believe that HI will have to take additional charges to put these troubles to rest and that the company will make additional changes to its sales practices and compliance to avoid future issues.

What is HI accused of doing?

In broad summary, Household has been accused of 'predatory' lending practices, which include aspects of the following:

- **Hidden terms.** Misleading customers about the terms of loans on offer and/or concealing charges and rates. Customers report that they have agreed to take out or refinance loans at high rates without proper disclosure. Furthermore, HI has reportedly made a practice of using high prepayment penalties to keep customers from refinancing these loans when their true cost is discovered.
- **Excessive fees.** Household has been charging up to 7.5% in up-front fees on real estate loans – far higher than the average origination fee. The charge of excessive fees is frequently coupled with the allegation that these fees were concealed from the borrower until closing.
- **Expensive insurance.** Household and other sub-prime lenders are known for selling single premium credit life insurance alongside (and sometimes as a condition of) their loan products. This insurance is invariably much more expensive than would be the equivalent amount of term life, and if capitalised into the loan up front incurs points and interest throughout the life of the credit facility. Once again, customers allege that HI did not adequately disclose the inclusion and cost of the insurance.
- **Steering.** Generally, steering refers to the practice of guiding customers towards a more expensive (rates and fees) loan than they could qualify for; in other words, prime customers are potentially misled into a sub-prime rate. Note that statistically this phenomenon is especially prevalent in lending to minority customers – one major reason that HI is in trouble over what would otherwise be a pure caveat emptor issue. This is also particularly important, as HI has gone out of its way to emphasise its non-sub prime customer base to investors. Without steering, these customers may be less profitable.

Although HI has not admitted any wrongdoing as part of its settlement, the half-billion dollar payment and (to our way of thinking) clearly unconscionable terms on some of the company's loan book speak for themselves. We believe that a combination of legal liability and stricter HSBC compliance oversight will force a dramatic change in the way in which HI does business.

What has HI agreed to do?

Lowered fees and rates

- **Cap on points.** For the next three years, Household will not charge more than 5% of the total loan amount to establish a loan.
- **Waived prepayment penalties.** Prepayment penalties on existing and future loans will expire 24 months after inception of the loan.
- **No double-dipping.** Household shall not charge fees on any loan refinance within 12 months of the original loan.
- **Insurance revamp.** Household will no longer require consumers to buy credit insurance. In addition, HI had previously stated its intention to stop offering single-premium life insurance altogether.
- **Best rate available.** Household must provide borrowers with the lowest available rate for any loan a consumer applies and is eligible for.

Better disclosure

- **Rate and point disclosure.** Household will clearly disclose a loan's interest rate and will tell consumers how much must be paid in advance to lower the rate.
- **Good faith estimates.** All fees contained in a Good Faith Estimate must be reasonably close to the amount paid at closing. Actual fees should not differ from the estimate by more than 10 percent.

Suitability and appropriateness

- **Net tangible benefit.** No Household loan will be offered to a borrower unless the borrower benefits from the loan.
- **Secured second mortgages.** Household will not make a second loan secured by the same property within 90 days of making the first loan if the loan is a refinance of the property.
- **Balloon payments.** Household will disclose if a "balloon payment" is needed to fully pay off a loan. Household will also disclose the amount of that payment.
- **Independent closer.** Household will use 'independent closers' to complete the loan process. An independent closer may be an employee, but must not report to sales management nor be paid based on loan production.

What is the financial impact?

Whether or not HI agrees that these practices are in fact illegal, we do not believe that HSBC management, once involved in oversight, will allow them to continue. In addition, the settlement detailed above, as well as the threat of further legal actions, make it a virtual certainty that HI will conduct business in a very different manner going forward.

The financial impact of these changes will be divided into three categories:

Direct legal costs

HI has already booked a US\$484m charge for its settlement with the states; we expect addition legal expenses associated with this negotiation will not exceed US\$10m. However, this settlement does not erase HI's civil liability on other suits filed by current and former customers. We believe that numerous class action complaints are filed or pending around the country, and law firms are actively soliciting more potential

plaintiffs. It is almost unimaginable given HI's de facto admission of guilt in the state settlement that there will not be further costs associated with these actions.

The amount is likely, in our opinion, to be material – but is difficult to estimate. Our normal financial tools are not adequate in assessing event risk and the unpredictable nature of the US legal system. What we can do is look to other and somewhat similar cases. The most on-point are those involving competitors Associates First Capital (now part of CitiGroup) and Providian Financial.

Associates elected to settle a national class-action suit for US\$25m simultaneously with its US\$215m FTC settlement (a record at the time). This would indicate that HI faces a proportional liability of US\$50m; however, we can have fairly low confidence in this estimate.

Providian agreed to settle numerous civil class action suits in late 2000 for US\$105m on top of its US\$300m settlement with the OCC and San Francisco District Attorney's office, which would indicate a prospective liability of US\$169m – also a low-confidence estimate.

Bear in mind that all of these legal and settlement costs are expected to be tax-deductible for HI.

Cost of additional compliance

As stated previously, we believe that HSBC will, and should, add substantially to HI's compliance and monitoring infrastructure. Although these costs pale in significance next to the costs of settling lawsuits, they are still non-trivial. We believe that additional personnel and systems for compliance and audit of HI's activities will increase non-interest expense by US\$12-15m per annum.

Reduced revenues

Lower prepayment rates, reduced loan fees, and fewer insurance sales will reduce non-interest income. We estimate that these will affect the real estate book almost entirely – although HI's tax refund loans in the personal loan portfolio have their own issues – and reduce origination fees by an average of 100bp across the board. Based on an average life of seven years, this will reduce fee income by US\$66m per year. Assuming that 10% of insurance written on mortgage loans will not be sold under new guidelines, future revenue is reduced in our model by an additional US\$8m per year.

The downside risk in these figures is for origination volume. If HI's marketing becomes more conservative, or their sales reps spend proportionately more time on documentation and compliance – as they should – or lower fees reduce commissions and incentives, our loan growth estimates could slip.

Projections and forecasts

We project that 2003 will be the nadir of HI's net income, with a bottom line of US\$1.28bn depressed by merger expenses, compliance, and settlement charges. However, consistent loan growth and margin expansion stemming from lower funding costs will kick in by mid-2004, driving 2005 earnings back above their 2001 peak levels.

Lower ROE, as shown here, is a function of the upward revaluation of HI's asset base post acquisition; we believe that HSBC will manage capital on a group-wide basis and so are not intensely concerned with the issue of capital management at HI. That being said, excess capital will be more use to the group inside one of the banking subsidiaries, so that we would not be surprised to see capital outflows from Household once the asset quality situation has stabilised.

Fig 43 HI earnings and forecasts: 2000-2005 (US\$m)

	00	01	02	03F	04F	05F
Net interest income	4,887	5,941	6,774	6,588	7,025	7,645
Non-interest income	3,010	3,651	4,342	4,454	4,362	4,390
Non-interest expenses	3,123	3,718	4,233	5,111	5,424	5,472
Loan loss provisions	2,117	2,913	3,732	3,510	3,400	3,400
Core income	1,621	1,833	2,398	1,517	1,566	1,998
Net income	1,621	1,833	1,495	1,281	1,566	1,998

Source: Company data, ING

Fig 44 HI actual and forecast ratios: 2000-2005 (%)

	00	01	02	03F	04F	05F
ROA	2.36	2.21	1.60	1.29	1.53	1.88
Core ROA	2.36	2.21	2.57	1.53	1.53	1.88
ROE	22.52	23.21	17.52	10.48	10.36	13.37
Core ROE	22.52	23.21	28.11	12.40	10.36	13.37
NIM	7.73	7.70	7.71	7.28	7.81	8.19
Cost/income	39.55	38.76	38.08	46.29	47.63	45.47
Overheads	4.94	4.82	4.82	5.65	6.03	5.86
Effective tax rate	32.71	32.78	22.06	28.14	28.00	28.00

Source: Company data, ING

HSBC Group consolidated forecasts

Fig 45 HSBC group key earnings components: 1997-2004F (US\$m)

	97	98	99	00	01	02	03F	04F
Net interest income	10,944	11,547	11,990	13,723	14,725	15,460	22,048	23,091
Non-interest income	8,332	8,866	9,585	11,176	11,990	11,774	15,785	15,984
Non-interest expenses	10,056	10,994	11,313	13,577	14,605	14,954	19,758	19,964
Loan loss provisions	1,119	2,866	2,244	1,039	3,331	1,752	5,262	4,750
Core income	5,629	4,603	5,644	7,643	6,208	7,590	9,803	10,986
Net income	5,487	4,318	5,408	6,457	4,992	6,239	7,745	8,976
EPS (US\$)	0.66	0.51	0.64	0.70	0.53	0.66	0.72	0.84

Source: Company data, ING

Fig 46 HSBC group key earnings ratios: 1997-2004F (%)

	97	98	99	00	01	02	03F	04F
ROA	1.26	0.90	1.03	1.04	0.73	0.86	0.96	1.02
Core ROA	1.29	0.96	1.07	1.23	0.91	1.04	1.21	1.25
ROE	20.26	15.76	16.19	14.17	10.76	11.91	12.23	13.62
Core ROE	20.79	16.80	16.90	16.77	13.38	14.48	15.48	16.67
NIM	2.87	2.77	2.59	2.52	2.46	2.44	3.11	2.99
Cost/income	52.17	53.86	52.44	54.53	54.67	54.91	52.22	51.09
Overheads	2.63	2.63	2.45	2.49	2.44	2.36	2.79	2.59
Effective tax rate	25.40	27.30	25.42	23.43	22.64	24.07	23.50	23.50

Source: Company data, ING

HSBC valuation

HSBC is currently trading at 18x trailing and 16.4x our 2003 forecast EPS, falling to 14.1x on 2004 earnings. The shares are trading at 2.1x trailing and 1.8x forward book value per share, on a trailing ROE of 11.9%.

Fig 47 HSBC valuation at current price

	01	02	03F	04F
Share price (GBP)	719p			
Share price (HK\$)	93.25			
PER (x)	22.22	18.02	16.40	14.15
Core PER (x)	17.87	14.81	12.96	11.56
PUP (x)	9.16	9.15	7.03	6.65
P/BV (x)	2.39	2.14	1.83	1.77
P/ABV (x)	3.90	3.50	2.74	2.54

Source: Company data, ING

We do believe that HSBC can restore its bottom-line ROE to 14.5% in the near term, translating to a core ROE of approximately 16.0-16.5%. This is not much of an improvement from our previous numbers, save for currency differences. However, risk-free rates and other cost of capital components have declined, raising the value for HSBC.

Fig 48 HSBC valuation methodology

Cost of capital calculation	
Sustainable ROE (%)	14.50
Cost of capital (%)	8.73
Risk-free rate (%)	3.17
Equity risk premium (%)	5.50
Beta	1.01
Target book multiple (x)	1.66
BVPS (YE03F, US\$)	6.47
Implied target price (US\$)	10.8
Implied target price (HK\$)	84
Implied target price (GBP)	652p

Source: Company data, ING

Based on our revised estimates and calculations, we have set our new 12-month price target for HSBC at 652p or HK\$84, up from 647p or HK\$78 previously. We maintain our HOLD recommendation on HSBC shares.

Fig 49 HSBC valuation at target price

	01	02	03F	04F
Share price (GBP)	652p			
Share price (HK\$)	84			
PER (x)	20.15	16.34	14.87	12.83
Core PER (x)	16.20	13.43	11.75	10.49
PUP (x)	8.31	8.30	6.37	6.03
P/BV (x)	2.17	1.95	1.66	1.60
P/ABV (x)	3.54	3.17	2.49	2.30

Source: Company data, ING

ING Financial Markets

AMSTERDAM

Tel: 31 20 563 87 98
Fax: 31 20 563 87 66

LONDON

Tel: 44 20 7767 1000
Fax: 44 20 7767 7777

NEW YORK

Tel: 1 646 424 6000
Fax: 1 646 424 6060

HONG KONG

Tel: 852 2848 8488
Fax: 852 2522 8640

TOKYO

Tel: 813 5210 1500
Fax: 813 5210 1555

Bangkok

Tel: 662 263 2888-9

Jakarta

Tel: 62 21 515 1818

Manila

Tel: 632 840 8888

San Francisco

Tel: 1 415 925 2281

Shanghai

Tel: 86 21 6841 3355

Geneva

Tel: 41 22 818 77 77

Kuala Lumpur

Tel: 603 2166 8803

Paris

Tel: 33 1 56 39 31 41

Seoul

Tel: 822 317 1500

Singapore

Tel: 65 6535 3688

Taipei

Tel: 886 2 2734 7500

Recommendations

In Asia ex-Japan our recommendations are defined as follows:

Buy: At least 10% share price upside is expected over our 12-month view.

Hold: Share price movement of between -10% and +10% is expected on a 12-month view.

Sell: At least 10% share price downside is expected over our 12-month view.

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