

BASE PROSPECTUS SUPPLEMENT



HSBC Bank plc

(A company incorporated with limited liability in England with registered number 14259)

as Issuer

This base prospectus supplement (the "**Base Prospectus Supplement**") is supplemental to and must be read in conjunction with (i) the base prospectus dated 19 June 2012 relating to the Programme for the Issuance of Notes and Warrants (the "**NWP Base Prospectus**") and the supplements thereto dated 28 June 2012, 7 August 2012, 27 November 2012 and 20 December 2012 and (ii) the Base Prospectus dated 25 May 2012 relating to the Debt Issuance Programme ("**DIP Base Prospectus**") and the supplements thereto dated 28 June 2012, 7 August 2012, 27 November 2012 and 20 December 2012 (the NWP Base Prospectus and the DIP Base Prospectus together being hereafter referred to as the "**Base Prospectuses**") prepared by HSBC Bank plc (the "**Bank**") in connection with the applications made for Notes, Warrants or Certificates to be admitted to listing on the Official List of the Financial Services Authority (in its capacity as competent authority for the purposes of Part VI of the Financial Services and Markets Act 2000) and to trading on the Regulated Market of the London Stock Exchange plc.

This Base Prospectus Supplement constitutes a supplement for the purposes of Directive 2003/71/EC, as amended (the "**Prospectus Directive**") and a supplementary prospectus for the purposes of section 87G of the Financial Services and Markets Act 2000, as amended (the "**FSMA**"). Terms defined in any of the Base Prospectuses shall have the same meaning when used in this Base Prospectus Supplement.

To the extent that there is any inconsistency between any statement in this Base Prospectus Supplement and any other statement in, or incorporated by reference in, any of the Base Prospectuses, the statements in this Base Prospectus Supplement will prevail.

The purpose of this Base Prospectus Supplement is to disclose the following:

- (i) On 4 March 2013, the Bank published its annual report and accounts for the year ended 31 December 2012 (the "**Annual Report and Accounts**") in the form annexed hereto. Any document incorporated by reference into the Annual Report and Accounts does not form part of this Base Prospectus Supplement.
- (ii) Amendments to the Summary Notes of the Base Prospectuses relating to: the board of directors of the Bank, to reflect the current members thereof; the financial information relating to the Bank, to reflect the figures set out in the Annual Report and Accounts; and the summary of risk factors, so as to provide further information on changes to the UK regulatory structure, settlements made with government agencies in the US and UK, LIBOR investigations and PPI/interest rate product redress.

1. The revised Summary Note set out in the NWP Base Prospectus shall read as follows:

HSBC Bank plc (the "**Bank**" or the "**Issuer**") is a public limited company registered in England and Wales under registration number 14259. The liability of its members is limited. It has its registered and head office at 8 Canada Square, London, E14 5HQ, United Kingdom; telephone number +44 20 7991 8888. The Issuer was constituted by Deed of Settlement on 15 August 1836, registered under the Companies Act 1862 as an unlimited company and re-registered under the Companies Acts 1948 to 1980 as a public limited company.

The Issuer is a wholly owned subsidiary of HSBC Holdings plc ("**HSBC Holdings**").

The directors of the Issuer are J W Leng (Chairman), B Robertson (Chief Executive), P Antika, Dame Denise Holt, S W Leathes, Dame Mary Marsh, R E S Martin, A R D Monro-Davies, T B Moulouguet, P M Shawyer, A P Simoes and J F Trueman. The members of the Executive Committee are B Robertson

(Chairman), J Beunardeau, J P Casey, R J H Gray, M J Haythorne, N Hinshelwood, A S Ramsay, P J Reid, T de Roux, A Schmitz, M D Sheridan, A P Simoes, M Smith, M Spurling and M Watkinson.

The articles of association of the Issuer are dated 20 October 2010.

The auditors of the Issuer are KPMG Audit Plc Chartered Accountants of 15 Canada Square, London, E14 5GL, United Kingdom.

The Issuer and its subsidiaries form a UK-based group (the "**Group**") providing a comprehensive range of banking and related financial services. The Group divides its activities into four business segments: UK Retail Banking; Continental Europe Retail Banking; Global Banking and Markets and Global Private Banking. The Issuer is HSBC Holdings's principal operating subsidiary undertaking in Europe.

During 2012 the Group employed, on average, 74,190 persons.

As at 31 December 2012, the Group had total assets of £815,481 million, loans and advances to customers and banks of £314,971 million, total customer accounts and deposits by banks of £364,457 million and total equity of £32,200 million. For the year ended 31 December 2012, the Group's operating profit was £1,007 million on total operating income of £15,407 million. The Issuer had a total capital ratio of 17.3 per cent. and a tier 1 capital ratio of 12.4 per cent. as at 31 December 2012.

The articles of association of the Issuer, as well as its historical financial information, reports and other documents are available for inspection at the registered office of the Issuer.

There has been no material adverse change in the prospects of the Issuer since 31 December 2012.

Summary of risk factors

There are a number of factors which could cause the Bank's actual results to differ, in some instances materially, from those anticipated. The factors set out below should not be regarded as a complete and comprehensive statement of all potential risks and uncertainties which face the Bank's businesses.

Current economic and market conditions may adversely affect the Bank's results: The Bank's earnings are affected by global and local economic and market conditions. Following the global financial crisis in 2007, a difficult economic climate remains with continued pressures on household and corporate finances. These adverse economic conditions continue to create a challenging operating environment for the Bank.

The Bank has exposure to the ongoing economic crisis in the eurozone: The sovereign debt crisis that erupted in 2010 extended through 2012. Concern regarding the financial position of several economies which spread from peripheral eurozone countries to include certain core eurozone countries, continued to be widespread. The Bank is exposed to financial institutions and central banks in the core European countries which may be affected by any sovereign or currency crisis.

Liquidity, or ready access to funds, is essential to the Bank's business: The Bank's ability to borrow on a secured or unsecured basis and the cost of so doing can be affected by a number of factors. If the Bank is unable to raise funds its liquidity position could be adversely affected and the Bank might be unable to meet deposit withdrawals or obligations under committed financing facilities, to fund new investments and to repay borrowings as they mature.

The Bank is subject to political and economic risks in the countries in which it operates: The Bank operates through an international network of subsidiaries and is subject to the risk of loss from unfavourable political developments, currency fluctuations, social instability and changes in government policies.

The Bank has significant exposure to counterparty risk both within the financial sector and to other risk concentrations: The Bank's ability to engage in routine transactions to fund its operations and manage its risks could be adversely affected by the actions and commercial soundness of other financial institutions. Financial institutions are necessarily interdependent because of trading, clearing, counterparty or other relationships.

The Bank is subject to legal and compliance risks, which may have an adverse effect on the Bank: Legal and compliance risks arise from a variety of sources and require the Bank to deal appropriately with

potential conflicts of interest, legal and regulatory requirements, ethical issues, anti-money laundering laws or regulations, privacy laws, information security policies, sales and trading practices and the conduct of its associated companies.

Operational risks are inherent in the Bank's business: The Bank is exposed to many types of operational risks, including fraudulent or other criminal activities, breakdowns in processes or procedures, systems failure or non-availability and disruption of its business arising from events that are wholly or partially beyond its control. Notwithstanding anything in this risk factor, this risk factor should not be taken as implying that either the Bank or the Group will be unable to comply with its obligations as a company with securities admitted to the Official List or as a supervised firm regulated by the Financial Services Authority.

The Bank is subject to tax-related risks in the countries in which it operates, which could have an adverse effect on its operating results: The Bank is subject to the substance and interpretation of tax laws in all countries in which it operates, the risk associated with changes in tax law or in the interpretation of tax law, the risk of changes in tax rates and the risk of consequences arising from failure to comply with procedures required by tax authorities.

The Bank's operations are highly dependent on its information technology systems: The reliability and security of the Bank's information and technology infrastructure and the Bank's customer databases are crucial to maintaining the service availability of banking applications and processes and to protecting the HSBC brand. Critical system failure, prolonged loss of service or a material breach of security could cause long-term damage to the Bank's business and brand.

The Bank faces a number of challenges in regulation and supervision: The Bank is subject to ongoing regulation and associated regulatory risks, including the implementation risk thereof. In addition there are a number of regulatory changes which are likely to have an effect on the activities of the Group; including those proposed under Basel III and/or the Capital Requirements Directive IV and those proposed to give effect to the recommendations of the UK Independent Commission on Banking ("ICB"), and the reform of the UK financial services regulatory structure. The proposals relating to capital and liquidity will result in increased capital and liquidity requirements and could have a material effect on the Group's future financial condition or results of its operations. The legislation implementing the ICB proposals may affect the manner in which the Group conducts its activities and structures itself, with the potential to both increase the costs of doing business and curtail the types of business carried out, with the risk of decreased profitability as a result.

Regulatory investigations

HSBC Holdings has entered into agreements with US and UK government agencies to comply with certain forward-looking obligations with respect to anti-money laundering and sanctions requirements over a five-year term. If HSBC Holdings fails to comply with the terms of such agreements, the FSA could take action against the Bank, including but not limited to, revocation of the Bank's licence. In addition, the Group continues to be subject to a number of other regulatory proceedings into certain past submissions made by panel banks in connection with the setting of London interbank offered rates and other benchmark interest and foreign exchange rates.

Remediation

The Group has established customer redress programmes in relation to the possible mis-selling of Payment Protection Insurance policies and interest rate products sold to small businesses. There remains a high degree of uncertainty as to the eventual costs of redress for these matters.

Summary of provisions relating to the Notes and Warrants

Notes and Warrants will be issued in Series which may comprise one or more Tranches issued on different issue dates.

The terms and conditions applicable to each Tranche are set out under "*Terms and Conditions of the Notes*" or "*Terms and Conditions of the Warrants*" as appropriate, as completed by the relevant Final Terms.

The Issuer may, subject to compliance with relevant laws, issue Notes and Warrants denominated in any currency. There is no limit on the maximum amount of Notes and Warrants outstanding at any time. Notes will be in registered form or in uncertificated registered form, without interest coupons, or in bearer form, with or without interest coupons. Warrants will be in book-entry form represented by a global Warrant, in registered form or in uncertificated registered form

The aggregate principal amount, interest rate or interest calculation, issue price, denomination, maturity date and other terms and conditions with respect to a Series of Notes, to the extent not contained in this Base Prospectus, will be set forth in the applicable Final Terms. Notes may be redeemable at par or at such other redemption amount as is set out in the relevant Final Terms or by the delivery of securities or other property. If so specified in the relevant Final Terms, Notes may be redeemed prior to their stated maturity at the option of the Issuer and/or the Noteholders in such circumstances and at such redemption amount as set out in the relevant Final Terms. The Issuer has the option to redeem Notes early for taxation reasons. Early redemption may reduce the return on investment provided by a Note compared to the return that would have been achieved had the Note been redeemed at maturity.

If the Calculation Agent determines that the Issuer's performance of obligations under any Notes and/or Warrants has become unlawful or impractical in whole or in part for any reason, the Issuer may redeem or cancel such Notes and/or Warrants and, subject to the relevant Final Terms, pay the holders of such Notes and/or Warrants an amount equal to the fair market value of such Notes and/or Warrants notwithstanding such illegality less the cost to the Issuer of unwinding any related hedging arrangements, all as determined by the Issuer and/or the Calculation Agent (as applicable) in its sole and absolute discretion.

The aggregate amount, type, style, issue price, currency, expiry date and other terms and conditions with respect to a Series of Warrants, to the extent not contained in this Base Prospectus, will be set forth in the applicable Final Terms. Warrants give the holder certain rights, including the right to receive a cash amount from the Issuer or the right to receive delivery of securities or other property against payment of a specified sum. Warrants create options exercisable by the Warrantholder, but there is no obligation upon such Warrantholder to exercise his Warrant or any obligation upon the Issuer to pay any amount in respect of unexercised Warrants.

Notes and Warrants issued under the Programme will be unsecured and unsubordinated obligations of the Issuer. Events of default applicable to the Notes are limited to non-payment (subject to a grace period) of principal or interest and winding-up of the Issuer. The Notes will not have the benefit of negative pledge or cross-default provisions (in respect of events of default). There are no events of default applicable to the Warrants.

Payments of principal and interest in respect of Notes will be made without deduction for or on account of United Kingdom withholding taxes, except as required by law. Warrantholders will be liable for and/or subject to any taxes, including withholding tax, payable in respect of the Warrants.

The Notes and Warrants permit the substitution of an affiliate of the Issuer as principal debtor in respect of the Notes and Warrants.

The terms and conditions of the Notes may be modified by resolution of Noteholders. Modifications to the terms and conditions of the Notes and the Warrants may be made without the consent of any Noteholders or any Warrantholders, as the case may be, where the Issuer determines that the modification is not materially prejudicial to the interests of the Noteholders or the Warrantholders, as the case may be, or to correct an inconsistency with the termsheet relating to the relevant Notes or Warrants.

Notes and Warrants issued pursuant to the Programme may include:

- (1) Equity-Linked Notes and Warrants, which include:
 - (a) Equity-Linked Notes and Cash Equity Notes;
 - (b) Index-Linked Notes; and
 - (c) Security Warrants, Security Basket Warrants, Index Warrants and Index Basket Warrants;
- (2) Preference Share-Linked Notes;

- (3) Market Access Notes and Warrants;
- (4) Commodity/Commodity Index-Linked Notes;
- (5) Interest Rate-Linked Notes and Warrants;
- (6) Inflation Rate-Linked Notes and Warrants;
- (7) Currency-Linked Notes and Warrants; and
- (8) Credit-Linked Notes.

In some cases, Notes and Warrants may carry the risk of a total or partial loss of principal.

In "*Subscription and Sale of Notes*" and "*Sale and Purchase of Warrants*", the Base Prospectus describes certain legal restrictions on the offer, distribution or sale of Notes and Warrants in a number of jurisdictions including the United Kingdom and the United States. Persons into whose possession the Base Prospectus or any Notes or Warrants come must inform themselves about, and observe, any such restrictions.

Application has been made to admit Notes and Warrants issued under the Programme to the Official List of the UK Listing Authority and to trading on the Regulated Market of the London Stock Exchange. However, Notes and Warrants may also be unlisted or admitted to listing, trading and/or quotation by other stock exchanges, listing authorities and/or quotation systems as specified in the applicable Final Terms. Whether or not any Notes and Warrants are admitted to listing, trading or quotation, there may be no active trading market for the Notes or Warrants.

Unless otherwise specified in the applicable Final Terms, Notes and Warrants will be accepted for clearing through one or more clearing systems, including CREST, DTC, Euroclear Bank and/or Clearstream, Luxembourg. In relation to Notes and Warrants which are held through a clearing system, investors will have to rely on such clearing system's procedures for transfer, payment and communications with the Issuer, including the exercise of any Warrants.

In respect of Notes and Warrants issued under the Programme and unless otherwise specified in the relevant Final Terms, the Dealer will be HSBC Bank plc and the CREST Registrar will be Computershare Investor Services plc. The Calculation Agent will be HSBC Bank plc or HSBC France (as specified in the relevant Final Terms). The Principal Paying Agent, the Principal Warrant Agent and the Registrar will be HSBC Bank plc. In respect of Notes and Warrants issued in the United States under Rule 144A, the Registrar and Transfer Agent will be HSBC Bank USA, N.A.

Upon request, certain documents relating to the Programme, the Notes and the Warrants will be available, during usual business hours on any weekday, for inspection at the offices of the Issuer, the Paying Agents and the Warrant Agents.

2. The revised Summary Note set out in the DIP Base Prospectus shall read as follows:

HSBC Bank plc (the "**Bank**" or the "**Issuer**") is a public limited company registered in England and Wales under registration number 14259. The liability of its members is limited. It has its registered and head office at 8 Canada Square, London, E14 5HQ, United Kingdom; telephone number +44 20 7991 8888. The Issuer was constituted by Deed of Settlement on 15 August 1836, registered under the Companies Act 1862 as an unlimited company and re-registered under the Companies Acts 1948 to 1980 as a public limited company.

The Issuer is a wholly owned subsidiary of HSBC Holdings plc ("**HSBC Holdings**").

The directors of the Issuer are J W Leng (Chairman), B Robertson (Chief Executive), P Antika, Dame Denise Holt, S W Leathes, Dame Mary Marsh, R E S Martin, A R D Monro-Davies, T B Moulouguet, P M Shawyer, A P Simoes and J F Trueman. The members of the Executive Committee are B Robertson (Chairman), J Beunardeau, J P Casey, R J H Gray, M J Haythorne, N Hinshelwood, A S Ramsay, P J Reid, T de Roux, A Schmitz, M D Sheridan, A P Simoes, M Smith, M Spurling and M Watkinson.

The articles of association of the Issuer are dated 20 October 2010.

The auditors of the Issuer are KPMG Audit Plc Chartered Accountants of 15 Canada Square, London, E14 5GL, United Kingdom.

The Issuer and its subsidiaries form a UK-based group (the "**Group**") providing a comprehensive range of banking and related financial services. The Group divides its activities into four business segments: UK Retail Banking; Continental Europe Retail Banking; Global Banking and Markets and Global Private Banking. The Issuer is HSBC Holdings's principal operating subsidiary undertaking in Europe.

During 2012 the Group employed, on average, 74,190 persons.

As at 31 December 2012, the Group had total assets of £815,481 million, loans and advances to customers and banks of £314,971 million, total customer accounts and deposits by banks of £364,457 million and total equity of £32,200 million. For the year ended 31 December 2012, the Group's operating profit was £1,007 million on total operating income of £15,407 million. The Issuer had a total capital ratio of 17.3 per cent. and a tier 1 capital ratio of 12.4 per cent. as at 31 December 2012.

The articles of association of the Issuer, as well as its historical financial information, reports and other documents, are available for inspection at the registered office of the Issuer.

There has been no material adverse change in the prospects of the Issuer since 31 December 2012.

Summary of risk factors

There are a number of factors which could cause the Bank's actual results to differ, in some instances materially, from those anticipated. The factors set out below should not be regarded as a complete and comprehensive statement of all potential risks and uncertainties which face the Bank's businesses.

Current economic and market conditions may adversely affect the Bank's results: The Bank's earnings are affected by global and local economic and market conditions. Following the global financial crisis in 2007, a difficult economic climate remains with continued pressures on household and corporate finances. These adverse economic conditions continue to create a challenging operating environment for the Bank.

The Bank has exposure to the ongoing economic crisis in the eurozone: The sovereign debt crisis that erupted in 2010 extended through 2012. Concern regarding the financial position of several economies which spread from peripheral eurozone countries to include certain core eurozone countries, continued to be widespread. The Bank is exposed to financial institutions and central banks in the core European countries which may be affected by any sovereign or currency crisis.

Liquidity, or ready access to funds, is essential to the Bank's business: The Bank's ability to borrow on a secured or unsecured basis and the cost of so doing can be affected by a number of factors. If the Bank is unable to raise funds its liquidity position could be adversely affected and the Bank might be unable to meet deposit withdrawals or obligations under committed financing facilities, to fund new investments and to repay borrowings as they mature.

The Bank is subject to political and economic risks in the countries in which it operates: The Bank operates through an international network of subsidiaries and is subject to the risk of loss from unfavourable political developments, currency fluctuations, social instability and changes in government policies.

The Bank has significant exposure to counterparty risk both within the financial sector and to other risk concentrations: The Bank's ability to engage in routine transactions to fund its operations and manage its risks could be adversely affected by the actions and commercial soundness of other financial institutions. Financial institutions are necessarily interdependent because of trading, clearing, counterparty or other relationships.

The Bank is subject to legal and compliance risks, which may have an adverse effect on the Bank: Legal and compliance risks arise from a variety of sources and require the Bank to deal appropriately with potential conflicts of interest, legal and regulatory requirements, ethical issues, anti-money laundering laws or regulations, privacy laws, information security policies, sales and trading practices and the conduct of its associated companies.

Operational risks are inherent in the Bank's business: The Bank is exposed to many types of operational risks, including fraudulent or other criminal activities, breakdowns in processes or procedures, systems failure or non-availability and disruption of its business arising from events that are wholly or partially beyond its control. Notwithstanding anything in this risk factor, this risk factor should not be taken as implying that either the Bank or the Group will be unable to comply with its obligations as a company with securities admitted to the Official List or as a supervised firm regulated by the Financial Services Authority.

The Bank is subject to tax-related risks in the countries in which it operates, which could have an adverse effect on its operating results: The Bank is subject to the substance and interpretation of tax laws in all countries in which it operates, the risk associated with changes in tax law or in the interpretation of tax law, the risk of changes in tax rates and the risk of consequences arising from failure to comply with procedures required by tax authorities.

The Bank's operations are highly dependent on its information technology systems: The reliability and security of the Bank's information and technology infrastructure and the Bank's customer databases are crucial to maintaining the service availability of banking applications and processes and to protecting the HSBC brand. Critical system failure, prolonged loss of service or a material breach of security could cause long-term damage to the Bank's business and brand.

The Bank faces a number of challenges in regulation and supervision: The Bank is subject to ongoing regulation and associated regulatory risks, including the implementation risk thereof. In addition there are a number of regulatory changes which are likely to have an effect on the activities of the Group; including those proposed under Basel III and/or the Capital Requirements Directive IV and those proposed to give effect to the recommendations of the UK Independent Commission on Banking ("**ICB**"), and the reform of the UK financial services regulatory structure. The proposals relating to capital and liquidity will result in increased capital and liquidity requirements and could have a material effect on the Group's future financial condition or results of its operations. The legislation implementing the ICB proposals may affect the manner in which the Group conducts its activities and structures itself, with the potential to both increase the costs of doing business and curtail the types of business carried out, with the risk of decreased profitability as a result.

Regulatory investigations

HSBC Holdings has entered into agreements with US and UK government agencies to comply with certain forward-looking obligations with respect to anti-money laundering and sanctions requirements over a five-year term. If HSBC Holdings fails to comply with the terms of such agreements, the FSA could take action against the Bank, including but not limited to, revocation of the Bank's licence. In addition, the Group continues to be subject to a number of other regulatory proceedings into certain past submissions made by panel banks in connection with the setting of London interbank offered rates and other benchmark interest and foreign exchange rates.

Remediation

The Group has established customer redress programmes in relation to the possible mis-selling of Payment Protection Insurance policies and interest rate products sold to small businesses. There remains a high degree of uncertainty as to the eventual costs of redress for these matters.

Summary of provisions relating to the Notes

Notes will be issued in Series. Each Series may comprise one or more Tranches issued on different dates. The Notes of each Series will be subject to identical terms or terms which are identical except for the issue date, the amount of the first payment of interest and/or the denominations. The Notes of each Tranche will all be subject to identical terms in all respects save that a Tranche may comprise Notes of different denominations. Unless otherwise specified in the relevant Final Terms, the net proceeds of the issue of each Series of Notes issued by the Bank will be used in the conduct of the business of the Bank.

The terms and conditions applicable to each Tranche will be those set out in this Base Prospectus under "*Terms and Conditions of the Notes*" as completed by the relevant Final Terms. The Notes, as well as the related Trust Deed and Agency Agreement are all governed by English law.

Subject to compliance with relevant laws, Notes may be denominated in any currency. There is no maximum aggregate principal amount of Notes outstanding at any time. The Notes may be issued in registered or bearer form. The aggregate principal amount, any interest rate or interest calculation, the issue price, the denomination, the maturity and any other terms and conditions with respect to a Series of Notes will be established at the time of issuance and, to the extent not contained in the Base Prospectus, set forth in the Final Terms relating to that Series of Notes. If so specified in the relevant Final Terms, Notes may have no maturity date.

Notes may be redeemable at par or at such other redemption amount (detailed in a formula or otherwise) as may be set out in the relevant Final Terms.

If so set out in the relevant Final Terms, Notes may be redeemed prior to their stated maturity at the option of the Issuer and/or the Holders (as defined herein) of such Notes subject to all applicable legal and regulatory requirements (including, in the case of Notes that are part of the regulatory capital of the Bank, indication from its prudential regulator that it does not object). Notes will be redeemable at the option of the Issuer prior to their stated maturity for taxation reasons. If so specified in the relevant Final Terms, Notes may also be redeemed at the option of the Issuer if there are certain changes in the applicable regulatory capital requirements. The amount payable on redemption may be fixed or variable, as set out in the relevant Final Terms.

The Notes will be unsecured and may be subordinated or unsubordinated obligations of the Issuer. The events of default applicable to the Notes are limited to non-payment (subject to a grace period) of principal or interest and winding up of the Bank. Subordinated Notes (as defined herein) will rank after depositors and other ordinary, or senior, creditors of the Bank. Undated Subordinated Notes (as defined herein) will rank as if they were preference shares of the Bank and therefore behind even Subordinated Notes. The Bank's obligation to make any payment of principal or interest in respect of Undated Subordinated Notes is conditional upon the Bank being able to make such payment and remain Solvent (as defined in the Trust Deed) immediately thereafter. If so specified in the relevant Final Terms, principal and interest in respect of Subordinated Notes may be deferred in certain circumstances. Interest on Undated Subordinated Notes may be deferred by the Bank for any reason. The Notes will not have the benefit of a negative pledge or cross-default provisions.

Notes redeemable prior to maturity may be redeemed at par or at such other redemption amount as may be specified in the relevant Final Terms. Early redemption may reduce the return on investment provided by a Note compared to the return that would have been achieved had the Note been redeemed at maturity. Early redemption may be effected at a time when the Holders may not be able to reinvest the redemption proceeds at rates that would produce a comparable return to that which would have been achieved had the Notes been redeemed at maturity.

Unless otherwise set out in the relevant Final Terms, payments of principal and interest in respect of Notes will be made without withholding or deduction for or on account of United Kingdom taxes, except as may be required by law, in which case additional amounts will be paid subject as mentioned in "*Terms and Conditions of the Notes*".

The Notes permit the substitution of an affiliate of the Bank as principal debtor in respect of the Notes, subject to a guarantee of the Bank. Modifications to the terms and conditions of the Notes may be made by resolution of Noteholders. Accordingly, modifications may be made to which not all Noteholders agree.

Notes issued under the Programme may be linked to one or more underlying variables. Any such Notes may entail significant risks not associated with a similar investment in fixed or floating rate debt securities, including a return that may be significantly less than the return available on an investment in fixed rate notes or floating rate notes. In some cases, Notes may also carry the risk of a total or partial loss of principal.

The Notes may be offered for sale only (i) in the United States to qualified institutional buyers (as defined in Rule 144A under the Securities Act) pursuant to Rule 144A or (ii) outside the United States to non-U.S. persons in reliance on and in accordance with Regulation S under the Securities Act and in accordance with applicable laws. The Notes include notes in bearer form that are subject to U.S. tax law requirements. Subject to certain exceptions, Notes in bearer form may not be offered, sold or delivered within the United States or to U.S. persons. There are also other restrictions on the sale of Notes and the

distribution of offering material relating to them in a number of other jurisdictions including the United Kingdom.

Application has been made to admit Notes issued under the Programme to the Official List of the UK Listing Authority and to trading on the Regulated Market or the Professional Securities Market of the London Stock Exchange. However, Notes may also be issued under the Programme on an unlisted basis or be admitted to listing, trading and/or quotation by other stock exchanges, listing authorities and/or quotation systems. The Final Terms applicable to any Notes will specify whether such Notes are to be admitted to listing, trading and/or quotation by any stock exchange, listing authority and/or quotation system or are to be unlisted. Whether or not any Notes are admitted to listing, trading or quotation, there may be no active trading market for the Notes.

Unless otherwise specified in the relevant Final Terms, Notes will be accepted for clearing through one or more clearing systems and will be represented by Global Notes. These systems may include, in the United States, the systems operated by DTC and, outside the United States, the systems operated by Euroclear and Clearstream, Luxembourg. Global Notes will be held by or on behalf of the relevant clearing system and, therefore, investors will have to rely on the clearing system procedures for transfer, payment and communications with the Issuer.

In respect of Notes issued under the Programme, unless otherwise specified in the relevant Final Terms: the Dealer will be HSBC Bank plc; the Trustee will be The Law Debenture Trust Corporation p.l.c.; and the Principal Paying Agent, the Agent Bank and, if applicable, the Registrar will be HSBC Bank plc or HSBC Bank USA, National Association.

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Save as disclosed in this Base Prospectus Supplement and in any prior supplements to any of the Base Prospectuses, no significant new factor, material mistake or inaccuracy relating to information included in the Base Prospectuses has arisen since the publication of the Base Prospectuses.

In circumstances where Article 16(2) of the Prospectus Directive (as implemented in the United Kingdom by Section 87Q(4) of the FSMA) applies, investors who have agreed to purchase or subscribe for any Notes, Warrants or Certificates (as the case may be) prior to the publication of this Base Prospectus Supplement may have the right to withdraw their acceptance. Investors wishing to exercise any such right should do so by giving notice in writing to the person from whom they agreed to purchase or subscribe for such Notes, Warrants or Certificates no later than the second working day following the date of publication of this Base Prospectus Supplement, which is the final date for the exercise of such right to withdraw.

The Bank accepts responsibility for the information contained in this Base Prospectus Supplement. To the best of the knowledge and belief of the Bank (which has taken all reasonable care to ensure that such is the case) the information contained in this Base Prospectus Supplement is in accordance with the facts and does not omit anything likely to affect the import of such information.

15 March 2013

ANNEX A

HSBC Bank plc Annual Report and Accounts 2012

Annual Reports and Accounts 2012

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Presentation of Information

This document comprises the *Annual Report and Accounts 2012* for HSBC Bank plc ('the bank') and its subsidiaries (together 'the group'). It contains the Report of the Directors and Financial Statements, together with the Independent Auditor's Report, as required by the UK Companies Act 2006. References to 'HSBC' or 'the Group' within this document mean HSBC Holdings plc together with its subsidiaries.

In November 2012, the group sold HSBC Private Banking Holdings (Suisse) SA to HSBC Holdings plc, with the exception of HSBC Private Bank (UK) Limited which remains as part of the group. The consolidated statement of comprehensive income has been re-presented to show the discontinued operation separately from continuing operations.

Cautionary Statement Regarding Forward-Looking Statements

This *Annual Report* contains certain forward-looking statements with respect to the financial condition, results of operations and business of the group.

Statements that are not historical facts, including statements about the group's beliefs and expectations, are forward-looking statements. Words such as 'expects', 'anticipates', 'intends', 'plans', 'believes', 'seeks', 'estimates', 'potential' and 'reasonably possible', variations of these words and similar expressions are intended to identify forward-looking statements. These statements are based on current plans, estimates and projections, and therefore undue reliance should not be placed on them. Forward-looking statements speak only as of the date they are made. HSBC Bank plc makes no commitment to revise or update any forward-looking statements to reflect events or circumstances occurring or existing after the date of any forward-looking statement.

Forward-looking statements involve inherent risks and uncertainties. Readers are cautioned that a number of factors could cause actual results to differ, in some instances materially, from those anticipated or implied in any forward-looking statement.

Financial Highlights of the group

	2012	2011	2010
For the year (£m)			
Profit on ordinary activities before tax ¹	1,004	3,111	4,011
Total operating income	15,407	16,205	18,099
Net operating income before loan impairment charges and other credit risk provisions	12,488	14,023	15,076
Profit attributable to shareholders of the parent company	2,384	2,329	2,959
At year-end (£m)			
Total equity attributable to shareholders of the parent company	31,675	31,090	31,825
Risk weighted assets	193,402	227,679	201,720
Loans and advances to customers (net of impairment allowances)	282,685	288,014	285,218
Customer accounts	324,886	346,129	344,123
Capital ratios² (%)			
Core Tier 1 ratio	11.4	9.1	10.5
Tier 1 ratio	12.4	10.0	11.4
Total capital ratio	17.3	14.4	16.1
Performance ratios (%)			
Return on average invested capital (on underlying basis) ³	6.2	4.7	8.7
Return on average shareholders' funds (equity) of the parent company ⁴	3.5	7.4	9.9
Post-tax return on average total assets	0.1	0.2	0.3
Pre-tax return on average risk-weighted assets	0.5	1.5	2.0
Credit coverage ratios (%)			
Loan impairment charges as a percentage of total operating income	8.1	7.5	9.0
Loan impairment charges as a percentage of average gross customer advances	0.5	0.4	0.7
Efficiency and revenue mix ratios (%)			
Cost efficiency ratio ⁵	82.0	66.2	60.5
As a percentage of total operating income:			
- net interest income	44.8	44.6	42.5
- net fee income	24.5	24.1	22.3
- net trading income	11.9	9.5	11.7
Financial ratios (%)			
Ratio of customer advances to customer accounts	87.0	83.2	82.9
Average total shareholders' equity to average total assets	3.4	3.3	3.4

1 Excludes gain on sale of £1,265 million of HSBC Private Banking Holdings (Suisse) SA to HSBC Holdings plc.

2 The group's capital ratios have been impacted by the implementation of CRDIII requirements (commonly known as Basel 2.5) as of 31 December 2011.

3 The return on average invested capital measures the return made in the business, enabling management to benchmark the group against competitors. This ratio is defined as profit attributable to shareholders of the parent company divided by average invested capital. Average invested capital is measured as average total shareholders' equity after:

- deducting the average balance of the group's revaluation surplus relating to property held for own use. This reserve was generated when determining the deemed carrying cost of such properties on transition to IFRSs and will run down over time as the properties are sold;
- deducting average preference shares and other equity instruments issued by HSBC Bank plc (as defined in Note 37 'Called up share capital and other equity instruments'); and
- deducting average reserves for unrealised gains/ (losses) on effective cash flow hedges and available-for-sale securities.

4 The return on average total shareholders' equity is defined as profit attributable to shareholders of the parent company divided by the average total shareholders' equity.

5 The cost efficiency ratio is defined as total operating expenses divided by net operating income before loan impairment charges and other credit risk provisions.

The financial highlights are influenced by changes in the group structure over the three years.

Products and Services

Retail Banking and Wealth Management

The group's Retail Banking and Wealth Management business takes deposits and provides transactional banking services to enable customers to manage their day to day finances and save for the future.

The group selectively offers credit facilities to assist customers in their short or longer-term borrowing requirements; and provides financial advisory, broking, insurance and investment services to help them manage and protect their financial futures.

The products are designed to meet the needs of specific customer segments, which may include a range of different services and delivery channels.

Typically, products offered to customers include:

- *liability-driven services*: deposits and account services;
- *asset-driven services*: credit and lending, both secured and unsecured; and
- *fee-driven and other services*: financial advisory, broking, life insurance manufacturing and asset management.

Commercial Banking

The group's Commercial Banking business is segmented into Corporate, to serve both corporate and mid-market companies with more sophisticated financial needs, and Business Banking, to serve small and medium-sized enterprises ('SMEs'). This allows the group to provide continuous support to companies as they grow both domestically and internationally and ensures a clear focus on internationally aspirant customers.

The group places particular emphasis on international connectivity to meet the needs of its business customers. HSBC aims to be recognised as the leading international trade and business bank by focussing on faster-growing markets, repositioning towards international business and enhancing collaboration across the Group. This will be underpinned by reducing complexity and operational risk and driving efficiency gains through adopting a global operating model.

- **HSBC Premier**: provides preferential banking services and global recognition to mass affluent customers and their immediate families with a dedicated relationship manager, specialist wealth advice and tailored solutions. Customers can access emergency travel assistance, priority telephone banking and an online 'global view' of their Premier accounts around the world.
- **HSBC Advance**: provides a range of preferential products and services to simplify the banking needs of customers and to help them manage and plan their money to achieve their financial goals and ambitions.
- **Wealth solutions and financial planning**: a financial planning process designed around individual customer needs to help clients to protect, grow and manage their wealth through investment and wealth insurance products manufactured by in-house partners (Global Asset Management, Global Markets and HSBC Insurance) and by selected third party providers.
- **Payroll & Employee Packages**: provides various products and services for customers who choose to pay their salaries into an HSBC account.
- **Basic Banking**: the group increasingly provides globally standardised but locally delivered, reliable, easy to understand, good value banking product platforms and globally set service standards.

Customers can interact with the bank through four principal channels: branches, self-service terminals, telephone service centres and digital (internet and mobile).

- **Credit and Lending**: the group offers a broad range of domestic and cross-border financing, including overdrafts, corporate cards, term loans and syndicated, leveraged acquisition and project finance. Asset finance is also offered in selected countries.
- **International trade and receivables finance**: the group provides the services and finance its clients need throughout the trade cycle including: letters of credit; collections; guarantees; receivables finance; supply chain solutions; commodity and structured finance; and risk distribution. HSBC is supporting the development of renminbi ('RMB') as a trade currency, with RMB capabilities in more than 50 markets.
- **Payments and cash management**: HSBC is a leading provider of domestic and cross-border payments, collections, liquidity management and account services offering local, regional and global solutions delivered via e-enabled platforms designed to address the needs of the group's clients current and future.
- **Insurance and Investments**: Commercial Banking offers business and financial protection, trade insurance, employee benefits, corporate wealth management and a variety of other commercial risk insurance products in selected countries.
- **Global Banking and Markets**: Commercial Banking customers represent a key base for Global Banking and Markets products and services, including foreign exchange and interest rate products, together with capital raising on debt and equity markets and advisory services.

Products and Services (continued)

Global Banking and Markets

Global Banking and Markets provides tailored financial solutions to major government, corporate and institutional clients and private investors worldwide. Managed as a global business, Global Banking and Markets operates a long-term relationship management approach to build a full understanding of clients' financial requirements. Sector-focused client service teams comprising relationship managers and product specialists develop financial solutions to meet individual client needs.

Global Banking and Markets is managed as two principal business lines: Global Markets and Global Banking. This structure allows the group to focus on relationships and sectors that best fit HSBC's footprint and facilitates seamless delivery of its products and services to clients.

Global Private Banking

Global Private Banking provides investment management and trustee solutions to high net worth individuals and their families. Global Private Banking aims to meet the needs of its clients by providing excellent customer service, leveraging the HSBC's global footprint and offering a comprehensive suite of solutions

Drawing on the strength of the HSBC Group and the most suitable products from the marketplace, Global Private Banking works with its clients to provide solutions to grow, manage and preserve wealth for today and for the future.

- **Global Markets** operations consist of treasury and capital markets services. Products include foreign exchange; currency, interest rate, bond, credit, equity and other derivatives; government and non-government fixed income and money market instruments; precious metals and exchange-traded futures; equity services; distribution of capital markets instruments; and securities services, including custody and clearing services and funds administration to both domestic and cross-border investors.
- **Global Banking** offers financing, advisory and transaction services. Products include:
 - Capital raising, advisory services, bilateral and syndicated lending, leveraged and acquisition finance, structured and product finance, lease finance and non-retail deposit taking;
 - International, regional and domestic payments and cash management services; and trade services for large corporate clients.

- **Private Banking** services comprise multicurrency and fiduciary deposits, account services, and credit and specialist lending. Global Private Banking also leverages HSBC's universal banking capabilities to offer products and services such as credit cards, internet banking, and corporate and investment banking solutions.
- **Investment Management** comprises advisory and discretionary investment services, as well as brokerage across asset classes. This includes a complete range of investment vehicles, portfolio management, security services and alternatives.
- **Private Trust Solutions** comprise trusts and estate planning, designed to protect wealth and preserve it for future generations through structures tailored to meet the individual needs of each client.

Report of the Directors: Business Review

Introduction

2012 was once again dominated by the ongoing impact of the eurozone sovereign debt crisis. This together with a weak UK economy and the return of the eurozone to recession made for a challenging operating environment in most European countries. A resilient underlying performance, across all business segments, was more than offset by the cost of UK customer redress provisions and the adverse movements in the fair value of own debt attributable to credit spreads.

HSBC's financial strength, premium customer base and ability to leverage its global network ensured that the group remained strong and profitable.

HSBC Bank plc maintained its well-funded balance sheet and strong capital position.

Results for 2012

The consolidated profit for the year attributable to the shareholders of the bank was £2,384 million.

Interim dividends of £200 million (in lieu of a final dividend in respect of the previous financial year), £575 million and £2 billion were paid on the ordinary share capital during the year.

A third interim dividend in lieu of a final dividend of £1,400 million in respect of 2012 was declared after 31 December 2012, payable on 6 March 2013.

Further information about the results is given in the consolidated income statement on page 95.

Principal activities

HSBC's purpose is to offer a comprehensive range of banking and related financial services. The group divides its activities into four business segments: UK Retail Banking; Continental Europe Retail Banking; Global Banking and Markets; and Global Private Banking.

As at 31 December 2012, the bank had 1,178 branches in the United Kingdom and 13 located in the Isle of Man and the Channel Islands. The bank had further branches in Belgium, the Czech Republic, France, Greece, the Hong Kong Special Administrative Region, Ireland, Israel, Italy, Netherlands, South Africa, Spain and Switzerland.

The bank's subsidiaries have banks, branches and offices in Armenia, the Channel Islands, France, Germany, Greece, Hong Kong Special Administrative Region, Ireland, Kazakhstan, Luxembourg, Malta, Poland, Russia, South Africa, Switzerland and Turkey.

HSBC Values and Global Standards

In line with HSBC's ambition to be the world's leading international bank, HSBC aspires to lead the industry in standards of conduct. As international markets become

more interconnected and complex and as threats to the global financial system grow, the group is further strengthening the policies and practices which govern how and with whom it does business.

The role of HSBC Values is fundamental to the group's culture in the context of the financial services sector and the wider economy. This is particularly important in the light of developments and changes in regulatory policy, investor confidence and society's view of the role of banks. HSBC expects its executives and employees to act with courageous integrity by being:

- dependable and doing the right thing;
- open to different ideas and cultures; and
- connected with customers, communities, regulators and each other.

The Group continues to enhance its values-led culture by embedding HSBC Values into how it conducts its business and in the selection, assessment, recognition and learning provided to staff.

Like any business, HSBC greatly values its reputation. HSBC's success over the years is due in no small part to its reputation for trustworthiness and integrity. HSBC is committed to adopting and enforcing the highest compliance standards across the group. Doing this will help HSBC to achieve three key objectives:

- strengthen its capabilities to combat the ongoing threat of financial crime;
- make consistent – and therefore simplify – how high standards are monitored and enforced; and
- ensure that the group consistently applies HSBC Values so as to serve positively the customers and societies who entrust their financial needs to HSBC.

Under the supervision of a Global Standards Steering Committee, established by HSBC, the Group are strengthening policies in a number of important areas, described below.

Financial crime filter: In 2012, HSBC introduced a sixth filter against which all existing and prospective clients and businesses will be screened. This filter will analyse all new and existing business to limit activity and client acquisition in jurisdictions with a high risk of financial crime. It means the group may stop writing business altogether in some jurisdictions, and significantly restrict its activities in others.

Tax transparency: The Group is strengthening its policies and controls to ensure that HSBC's services are not used by clients seeking to evade their tax obligations.

Sanctions: The Group has expanded its application of financial sanctions to ensure that the most demanding standards are enforced for all currencies and in all jurisdictions. Through application of these standards, HSBC screens clients and all cross-border payments to

Report of the Directors: Business Review (continued)

prevent the use of HSBC's banking services for the benefit of blacklisted countries, companies and individuals.

Customer due diligence: The Group is applying a globally consistent approach to the knowledge needed to accept or retain a customer relationship. When any customer or potential customer is considered an unacceptable reputational risk – or otherwise does not meet HSBC's standards – that determination will be applied globally.

Affiliates' due diligence: HSBC is building a single central repository holding all required due diligence information on each of its affiliates in order to facilitate seamlessly cross-border transactions on behalf of its clients.

Bearer shares: Shares not registered to any owner, but beneficially owned by the person who has physical possession of the share certificates, carry inherent risks relating to money laundering and tax evasion. HSBC has set out minimum, highly restrictive standards, applicable in all markets, for dealing with customers who utilise bearer shares.

Business segments

The group has four reportable business segments which reflect the basis on which senior management review operating activities, allocate capital, and assess performance.

The main business activities of the group's business segments are summarised below with further details provided on page 2.

UK Retail Banking

Within the UK, the retail banking segment comprises two Global Businesses; Retail Banking and Wealth Management and Commercial Banking. Retail Banking and Wealth Management provide a range of services to UK personal customers through a variety of distribution channels under various brands including HSBC, first direct, M&S Bank and partnership cardTM. Commercial Banking provides a wide range of products and services to commercial organisations, from sole proprietors to quoted companies.

Continental Europe Retail Banking

Continental Europe Retail Banking comprises two Global Businesses: Retail Banking and Wealth Management and Commercial Banking, providing a similar range of services as UK Retail Banking to local and expatriate individual customers and internationally minded companies. The main Continental European Retail Banking operations are in France, Germany, Turkey and Malta.

Global Banking and Markets

Global Banking and Markets provides tailored financial

solutions to major government, corporate and institutional clients and private investors worldwide. The business is managed as two principal business lines: Global Banking and Global Markets. This structure allows the group to focus on relationships and sectors that best fit the Group's footprint and facilitates seamless delivery of HSBC's products and services to clients.

Global Private Banking

Global Private Banking provides banking, investment and planning services to high net worth clients and their families.

Strategic direction

HSBC's strategic direction is aligned to two long-term trends:

Financial flows – the world economy is becoming ever more connected. Growth in world trade and cross-border capital flows continues to outstrip growth in average gross domestic product. Financial flows between countries and regions are highly concentrated, and over the next decade the Group expects 35 markets to generate 90 per cent of world trade growth with a similar degree of concentration in cross-border capital flows.

Economic development – HSBC expects economies currently deemed 'emerging' to have increased five-fold in size by 2050, benefiting from demographics and urbanisation, by which time they will be larger than the developed world. By then, it is expected 19 of the 30 largest economies will be markets that are currently described as emerging.

HSBC is one of the few truly international banks. The Group's advantages lie in the extent to which its network corresponds with markets relevant to international financial flows, its access and exposure to high growth markets and businesses, and its strong balance sheet, which helps to generate a resilient stream of earnings.

Based on these long-term trends and its competitive position the Group strategy has two parts:

Network of businesses connecting the world – HSBC is well positioned to capture the growing international financial flows. The Group's global reach and range of services puts HSBC in a strong position to serve corporate clients as they grow from small enterprises into large and international corporates. Access to local retail funding and the Group's suite of international products allows HSBC to offer distinctive solutions to these clients.

Wealth management and retail with local scale – social mobility and wealth creation in the faster-growing markets in which HSBC is positioned will generate demand for financial services which will be met through the Wealth Management and Global Private Banking businesses. The Group will only invest in retail

Report of the Directors: Business Review (continued)

businesses in markets where it can achieve critical mass.

In Europe the group's strategy is to be the leading international bank connecting Europe with the rest of the world and capturing the region's wealth opportunity. The group will develop a strategy for each of the four Global Businesses while focusing on increasing capital and cost efficiency.

The primary focus of the group's capital deployment will be the UK, one of HSBC's two home markets, and the priority growth markets of Germany, France and Turkey.

In addition, the group will continue to address the fragmentation of the business by rationalising its portfolio and exiting underperforming businesses using the six filters to guide strategic actions. In 2012, a sixth filter was added to the existing five strategic evaluation criteria used to assess HSBC's business (international connectivity, economic development, profitability, cost efficiency and liquidity).

The results of this continuous review determine whether the group invests in, turns around, continues with or exits businesses. The group is also focusing on improving cost efficiency through implementation of consistent business models, re-engineering of operational processes and streamlining IT. These sustainable cost savings are intended to facilitate self-funded growth in key markets and investment in new products, processes and technology, and provide a buffer against regulatory and inflationary headwinds.

Retail Banking and Wealth Management will focus on selected markets where the group has scale and growth opportunities. Investment will be focused on the UK, France, Turkey and Malta, growing the group's wealth management franchise and targeting the mass affluent market.

Commercial Banking will be to drive international and intra-Group connectivity leveraging the group's strong European footprint. Investment will be focused on increasing the group's share, both regional and global, of foreign direct investment and trade-flows. The continuing investment in product platforms within the Payments and Cash Management and Group Trade and Receivables Finance businesses will further enhance the group's international product offerings and capabilities.

Global Banking and Markets will build on its core strengths, develop new capabilities and leverage connectivity. Through the selective build out from the hubs in London and Paris the group will optimise its market coverage. Selective investments in systems, such as Payments and Cash Management, which will provide seamless global liquidity solutions across Europe and internationally.

Global Private Banking will look to optimise market coverage, invest in the core domestic businesses, and

create synergies across Europe for clients in developed and faster growing markets.

UK Retail Banking

The UK Retail Banking and Wealth Management business continues to build its position as a leading provider of financial services to mass affluent customers in the UK through the Premier and Advance branded propositions. This will be achieved through:

- the delivery of superior service and investing in digital capabilities, facilitating investment from sustainable cost savings;
- continued focus on high value customer acquisition and quality mortgage origination;
- leveraging the Group's global scale and international capabilities; and
- the further development of wealth management and insurance capabilities, innovating new product propositions and increasing customer penetration.

The UK Commercial Banking strategy is to be the leading international trade and business bank, using the Group's geographical network together with product expertise in payments, trade receivables finance and foreign exchange to actively support customers who are trading and investing across borders. Delivery of this strategy will be achieved through:

- focusing on faster-growing markets while connecting revenue and investment flows with developed markets;
- enhanced collaboration with Global Banking and Markets, providing capital market access and a wider range of sophisticated risk management and liquidity products to the growing mid-market Corporates;
- capturing growth in international small and medium-sized enterprises; and
- driving efficiency gains through adopting a global operating model that delivers efficiencies by sharing systems and best practice, including customer experience, training and product offerings, and selectively applying a direct banking model.

Continental Europe Retail Banking

In Continental Europe, investment is being redirected towards markets with strong group connectivity. The key objective is to provide relationship-driven services to selected internationally minded and emerging market clients.

The Continental Europe Retail Banking and Wealth Management strategy builds on its strength in mass affluent markets by providing relevant, efficient and sustainable propositions to Premier and Advance customers in selected markets across the region.

Report of the Directors: Business Review (continued)

In Commercial Banking, the strategy is to strengthen HSBC's position as the leading international trade and business bank, underpinned by focusing on driving returns across the region, collaborating with Global Banking and Markets to capture market opportunities and by driving efficiency gains.

Global Banking and Markets

Global Banking and Markets continues to pursue its well established 'emerging markets-led and financing-focused' strategy, with the objective of being a leading wholesale bank. This strategy has evolved to include a greater emphasis on connectivity, leveraging the Group's extensive distribution network. The business focuses on four strategic imperatives:

- reinforce client coverage and client-led solutions for major government, corporate and institutional clients;
- continue to invest selectively in the business to support the delivery of an integrated suite of products and services;
- enhance collaboration with other global businesses, particularly Commercial Banking, to appropriately service the needs of the international client base; and
- focus on business re-engineering to optimise operational efficiency and reduce costs.

Global Private Banking

Global Private Banking works with high net worth clients to manage and preserve their wealth while connecting them to global opportunities through:

- a focused business model that serves client needs with an enhanced system platform and improved risk and compliance standards;
- close collaboration with other Global Businesses, particularly to access Commercial Banking's wealth creating entrepreneur client base; and
- focused investment on the most developed and faster-growing wealth markets, where the business can leverage the Group's client franchise and its strong local and international products and services.

Key Performance Indicators

The Board of Directors monitors the group's progress against its strategic objectives on a regular basis. Progress is assessed by comparison with the group strategy, operating plan targets and historical performance.

Management remains focused on improving the group's capital deployment to support the achievement of its return targets, guided by its six filter analysis. Since 2011, the group has announced a number of closures and disposals as a result of using this analysis and will continue to evaluate businesses during 2013 using this methodology.

From time to time the group reviews its key performance indicators ('KPIs') in light of its strategic objectives and may adopt new or refined measures to better align the KPIs to HSBC's strategic objectives.

Employee engagement has, in the past, been monitored through annual Global People Surveys. In 2012, quarterly Pulse Surveys were introduced, and the Global People Surveys scheduled biannually. The next Global People Survey will be in 2013. As the Pulse Surveys were not designed to report employee engagement information comparable with that demanded from the Global People Surveys, this KPI has not been disclosed in 2012.

Financial KPIs

	2012	2011	2010
	%	%	%
Risk adjusted revenue growth	(9.3)	(5.5)	7.6
Cost efficiency	82.0	66.2	60.5
Pre-tax return on average risk-weighted assets	0.5	1.5	2.0
Core tier 1 capital	11.4	9.1	10.5
Advances to core funding ratio ...	104.2	91.2	95.7

Risk-adjusted revenue growth is measured as the percentage change in reported net operating income after loan impairment and other credit risk charges since last year. The group seeks to deliver consistent growth in risk-adjusted revenues.

Outcome: Reported risk-adjusted revenue decreased primarily due to the adverse fair value movement on own debt attributable to credit spreads.

Cost efficiency is measured as total operating expenses divided by net operating income before loan impairment and other credit risk provisions.

Outcome: The cost efficiency ratio was outside the target range principally due to higher costs, most notably from customer redress programmes and lower income from the adverse fair value movements on own debt attributable to credit spreads.

Return on risk-weighted assets is measured as pre-tax profit divided by average risk-weighted assets. The group targets a return in the medium term of between 1.8 and 2.0 per cent.

Outcome: The return on average risk-weighted assets was below the target range.

Core tier 1 capital comprises shareholders' equity and related non-controlling interests less regulatory deductions and adjustments. The group seeks to maintain a strong capital base to support the development of its business and meet regulatory capital requirements at all times.

Outcome: The increase in core tier 1 capital to 11.4 per cent primarily reflected the impact of the disposal of HSBC Private Banking Holdings (Suisse) SA on reducing both capital deductions and risk-weighted assets.

Report of the Directors: Business Review (continued)

Advances to core funding ratio comprises loans and advances to customers as a percentage of the total core customer deposits and term funding with a remaining term to maturity in excess of one year. The lower the percentage, the stronger the funding position.

Outcome: The advances to core funding ratio remained within approved limits.

Brand perception

HSBC monitors the strength of its brand through an index of brand measures (Brand Health Index), derived through market research from independent agencies, benchmarked against competitors.

The HSBC brand retained the number one ranking in the UK and France. In Turkey, progress has been made although the brand health index is still below target in this key market.

Customer recommendation

In Retail Banking and Wealth Management, customer satisfaction is measured through a third party metric, the Customer Recommendation Index ('CRI').

The CRI remains strong in the UK and France.

Commercial Banking uses a third party 'Client Engagement' survey, which was notably ahead of competition for Corporates in the UK and Germany, in line in France and marginally below in Turkey. For Business Banking clients, the CRI was ahead of competitors in the UK and France.

Awards

HSBC was recognised in several industry awards throughout 2012. A small selection of those follows:

- 'Most Innovative Investment Bank of the Year' – 'The Banker' Investment Banking Awards 2012
- 'Best Global Emerging Markets Bank' and 'Best Global Emerging Markets Debt House' – Euromoney Awards for Excellence 2012
- 'Best Overall Trade Finance Bank EMEA' and 'Best Export Finance Arranger EMEA' - Trade Finance Magazine Awards for Excellence 2012
- 'Best Risk Advisor in Western Europe' – Euromoney Awards for Excellence 2012
- 'Best Debt House in Turkey' – Euromoney Awards for Excellence 2012

- 'Best Bank Mortgage Provider' – Moneyfacts Awards 2012
- 'Most Trusted Mortgage Provider' – (first direct) Moneywise Customer Service Awards 2012
- 'Best Service from a Business Bank' – Business Moneyfacts Awards 2012
- 'Best Bank for FX for Corporates' – FX Week
- 'Bank of the Year' – Financial Times The Banker (HSBC Malta)

Economy

The UK economy remained weak in 2012, with little growth in underlying activity. Preliminary data showed that the level of real Gross Domestic Product contracted by 0.3 per cent in the fourth quarter, as economic activity fell back after a boost related to the Olympic Games. Despite the lacklustre economy, the labour market remained fairly resilient, with the unemployment rate in the three months to November falling to 7.8 per cent from 8.4 per cent in the same period in 2011. In response to the stagnating economy, the Bank of England ('BoE') increased the size of its Asset Purchase Facility to £375bn and launched a new scheme, called Funding for Lending, aimed at increasing the supply of credit. Although the Consumer Prices Index inflation fell during the first half of the year it remained above the BoE's 2 per cent target. In the fourth quarter, it returned to 2.7 per cent, partly due to an increase in university tuition fees.

The eurozone returned to recession in 2012. The initial resilience in France and Germany was more than offset by deepening contractions in the periphery, where domestic demand was dragged down by austerity and private sector deleveraging. Inflation slowed from 2.7 per cent at the end of 2011 to 2.2 per cent in 2012. The European Central Bank ('ECB') cut the refi rate by 0.25 per cent to 0.75 per cent in July. The sovereign crisis heightened in the first half of 2012 but the beginnings of a roadmap for future integration of the economic and monetary union, additional support for Greece and, most importantly, the ECB's commitment to saving the euro through its Outright Monetary Transactions bond-buying programme succeeded in lowering peripheral government bond spreads to their lowest level since March 2012.

Report of the Directors: Business Review (continued)

Financial summary

Summary consolidated income statement

	2012 £m	2011 £m	2010 £m
Net interest income	6,904	7,223	7,694
Net fee income	3,781	3,900	4,040
Trading income	1,834	1,536	2,117
Net income from financial instruments designated at fair value	118	433	276
Gains less losses from financial investments	336	292	537
Net earned insurance premiums	2,286	2,580	2,635
Other operating income	148	241	800
Total operating income	15,407	16,205	18,099
Net insurance claims incurred and movement in liabilities to policyholders	(2,919)	(2,182)	(3,023)
Net operating income before impairments and provisions	12,488	14,023	15,076
Loan impairment charges and other credit risk provisions	(1,245)	(1,623)	(1,951)
Net operating income	11,243	12,400	13,125
Total operating expenses ¹	(10,236)	(9,288)	(9,119)
Operating profit	1,007	3,112	4,006
Share of profit in associates and joint ventures	(3)	(1)	5
Profit before tax	1,004	3,111	4,011
Tax credit/(expense)	156	(734)	(996)
Profit for the year before discontinued operations	1,160	2,377	3,015
Gain on sale of discontinued operations ²	1,265	–	–
Profit for the year	2,425	2,377	3,015
Profit attributable to shareholders of the parent company	2,384	2,329	2,959
Profit attributable to non-controlling interests	41	48	56

¹ Total operating expenses include £1,379 million of provisions relating to customer redress programmes in 2012, compared to £507 million in 2011, other provisions including £84 million for vacant space and impairment on associated assets, operational losses of £65 million resulting from closed account balances of dissolved companies, restructuring costs of £193 million in 2012 compared to £237 million in 2011 and an accounting gain in the UK of £360 million resulting from legislative change in the inflation measure used to calculate the indexation of certain pension liabilities in May 2011.

² On the sale of HSBC Private Banking Holdings (Suisse) SA, the associated foreign exchange revaluation reserve of £1,258 million was recycled through the income statement, together with a gain on disposal of £7 million.

Review of business performance

2012 compared with 2011

HSBC Bank plc and its subsidiary undertakings reported profit before tax of £1,004 million, 68 per cent lower than 2011. This was primarily due to adverse fair value movements on own debt attributable to credit spreads of £1,055 million, compared with favourable movements of £832 million in 2011 and provisions for UK customer redress programmes of £1,379 million, which compared with £507 million in 2011. This was partly offset by favourable Global Banking and Markets revenues, notably in the Rates and Credit businesses as spreads on eurozone bonds tightened and investor sentiment improved. Impairment charges also fell due to lower credit risk provisions in Global Banking and Markets notably in the legacy credit portfolio, and improved delinquency rates in UK Retail due to the continued improvement in the quality of these portfolios with a higher proportion of secured lending.

Excluding the fair value movement on own debt and customer redress provisions, profit before tax was 23 per cent higher than in 2011.

During the year, the group continued to make progress in reshaping the business in Europe. The

disposal of non-core businesses has simplified the European portfolio, allowing the group to concentrate resources on businesses where sustainable profits and growth can be delivered and risks managed effectively. During 2012, business exits from Hungary, Georgia, Slovakia, Retail Banking and Wealth Management in Russia and Poland, and the disposals of Property Vision in the UK, insurance and reinsurance businesses in Ireland, and the retail equities brokerage in Greece were completed.

In November 2012, in line with HSBC's strategy, which includes simplifying the management of the Group, the legal ownership of HSBC Private Banking Holdings (Suisse) SA, the principal holding company for the Group's Global Private Banking entities, was transferred to HSBC Holdings plc. The ownership of HSBC Private Bank (UK) Limited and a limited number of other private banking businesses remain with HSBC Bank plc.

Progress continues to be made in aligning the businesses in country to their respective global business operating models. This is planned to reduce complexity and lower costs in a sustainable way. Total restructuring costs of £193 million were incurred as a result of organisational effectiveness and other initiatives which

Report of the Directors: Business Review (continued)

delivered sustainable cost savings of approximately £451 million.

Retail Banking and Wealth Management continued to make progress in delivering against strategy. In the UK, there was growth in mortgage balances resulting from the success of competitive offers and marketing campaigns. Changes were made to the structure of the UK wealth management business and its products were enhanced to meet new regulatory requirements. The expansion of the business continued in Turkey, notably in personal lending and cards, while in France there was strong growth in both mortgage and deposit balances.

Commercial Banking continued to invest in the UK, increasing the number of International Relationship Managers and launching an International Small and Medium Enterprise ('SME') Fund to support UK businesses that trade, or aspire to trade, internationally. Dedicated 'China Desks', which aim to provide local support to Chinese companies as they look to expand their international businesses, were established in the UK, France and Germany. Growth in Payments and Cash Management revenues reflected higher transaction volumes from new mandates and investments in new products. In line with the strategy, the Business Banking segment continued its focus of attracting and servicing international SMEs. In the UK sales of interest rate protection products to customers in the Business Banking segment were withdrawn.

Global Banking and Markets continued to develop cross-product capabilities in the growing renminbi market. In the first half of 2012, the group issued the first international renminbi bond outside of Mainland China and Hong Kong. Since then a number of significant transactions, supported by collaboration with other regional teams, has reinforced HSBC's position as the leading house for international renminbi issuance. In the Foreign Exchange business, the focus remained on enhancing product offerings in e-FX platforms to a broader client base. In Payments and Cash Management, the business won a number of mandates and implemented the Global Liquidity Solutions proposition to provide advanced liquidity management functionality for clients. Global Banking and Markets continues to actively manage down the legacy credit exposures using a clear economic framework for making disposal decisions.

In 2012, Global Private Banking repositioned its business model and target client base to focus on selected priority markets. Building on existing product strengths and leveraging Group capabilities the business will focus on meeting the needs of higher net worth international and domestic customers. This will provide clients with globally consistent products and services while improving co-ordination of marketing and servicing activity.

The following items are significant in a comparison of 2012's results to 2011:

- provisions of £1,379 million in 2012 and £507 million in 2011. In 2012, this included £938 million estimated redress for the possible mis-selling of PPI policies and £375 million in relation to the possible mis-selling of interest rate protection products, of which £168 million relates to the estimated redress payable to customers;
- other provisions including £84 million for vacant space and impairment on associated assets;
- operational losses of £65 million resulting from closed account balances of dissolved companies;
- operating expenses of £193 million in 2012 in relation to restructuring, compared to £237 million in 2011; and
- an accounting gain of £360 million resulting from legislative change in the inflation measure used to calculate the defined benefit obligation in the UK for deferred pensions recognised in 2011.

Net interest income decreased by £319 million or 4 per cent. Balance Sheet Management revenues declined as yield curves continued to flatten and interest rates remained low. The redeployment of liquidity from disposals of available-for-sale debt securities to relatively lower yielding central bank placements also contributed to the decline.

In UK Retail net interest income was higher primarily due to the strong growth in average residential mortgage balances and improved margins. This was partially offset by ongoing deposit spread compression reflecting the low interest rate environment and strong competition.

Net interest income declined in France due to lower deposit spreads. This was partly offset by an increase in Turkey due to growth in average personal lending and credit card balances due to business expansion and improved lending margins in Commercial Banking.

Net interest income decreased in Global Private Banking reflecting the impact of the inclusion of only 10 months in 2012, following the transfer of the majority of the segment to HSBC Holdings plc, compared to a full year in 2011. The redeployment of liquidity from higher yielding debt securities which had matured to relatively lower yielding securities also contributed to the decline, as the business selectively managed exposures to eurozone sovereign debt.

Net fee income declined by £119 million or 3 per cent mainly due to a fall in brokerage fees in Global Private Banking following the transfer of the majority of the business segment to HSBC Holdings plc at the beginning of November 2012. In UK Retail, new mandates earned in Payments and Cash Management and higher transaction volumes in Global Trade and Receivables Finance resulted in higher levels of net fee income. Higher net fees income in Continental Europe

Report of the Directors: Business Review (continued)

Retail reflected lower levels of insurance fees payable and increased levels of cards fees income in Turkey. The growth in Global Banking & Markets fees reflected increased client demand for debt capital financing.

Trading income increased by £298 million or 19 per cent primarily due to significantly higher Rates and Credit revenues as spreads tightened and investor sentiment improved following stimuli by central banks. This was despite significant adverse fair value movements in Rates, including a charge from own credit spreads on structured liabilities as spreads tightened which compared with a gain reported in 2011. In addition, there was a net charge of £196 million as the result of a change in estimation methodology in respect of credit valuation adjustments on derivative assets and debit valuation adjustments on derivative liabilities. Foreign Exchange income was also stronger as a result of robust client flows.

Foreign exchange losses were reported on trading assets held as economic hedges of foreign currency debt designated at fair value, which are offset in *'Net income from financial instruments designated at fair value'*.

Net income from financial instruments designated at fair value decreased by £315 million or 73 per cent in 2012. Excluding the adverse fair value movements due to the change in credit spreads on own debt held at fair value, net income from financial instruments designated at fair value was £ 1,173 million in 2012 compared with a net expense of £399 million in 2011. This reflected favourable foreign exchange movements on foreign currency debt designated at fair value issued as part of the bank's overall funding strategy, with an offset reported in *'Trading income'*. In addition, net investment gains were recognised on the fair value of assets held to meet liabilities under insurance and investment contracts as market conditions improved, compared with net investment losses in 2011. The corresponding movement in liabilities to customers is recorded under *'Net insurance claims incurred and movement in liabilities to policyholders'* to the extent that these investment gains or losses were attributed to policyholders holding unit-linked insurance policies and insurance or investment contracts with Discretionary Participation Features ('DPF').

Gains less losses from financial investments were £44 million or 15 per cent higher than in 2011 mainly from higher gains on the disposal of available-for-sale debt securities as part of portfolio management activities. This was partly offset by losses on the disposal of legacy assets in Global Banking and Markets in the UK.

Net earned insurance premiums decreased by £294 million or 11 per cent mainly due to lower life insurance sales in Retail Banking and Wealth Management in France as a result of the adverse economic environment and increased competition from other banking products.

The disposal of the insurance and reinsurance businesses in Ireland in 2012 also contributed to the decline.

Other operating income decreased by £93 million or 39 per cent. This included losses on the sale of certain syndicated loans in Global Banking and Markets in the UK.

Net insurance claims incurred and movement in liabilities to policyholders increased by £737 million driven by gains on the fair value of assets held to support policyholder contracts, with a corresponding increase in *'Net income from financial assets designated at fair value'*. This was partly offset by lower reserves established for new business reflecting the decline in premiums in France, together with the run down and subsequent disposal of the insurance and reinsurance businesses in Ireland in 2012.

Loan impairment charges and other credit risk provisions decreased by £378 million or 23 per cent. Global Banking and Markets reported lower credit risk provisions on available-for-sale asset-backed securities driven by an improvement in underlying asset prices, as well as lower charges on Greek sovereign debt. In addition, there was a reduction in loan impairment charges in UK Retail Banking as the business continued to identify and monitor customers facing financial hardship and focused personal lending growth on higher quality assets. This reduction was partly offset by a number of specific impairments in Commercial Banking. The increase in Continental Europe Retail impairment charges was driven by growth in the card and personal lending portfolios in Turkey and higher impairment charges against the commercial banking portfolios in Greece, Spain and Turkey. The lower impairment charge in Group Private Banking reflected the non-recurrence of provisions against Greek debt securities in 2011.

Total operating expenses increased by £948 million or 10 per cent. This included additional provisions of £1,379 million in 2012 in respect of customer redress provisions, primarily in the UK, compared with a charge of £507 million in 2011. These provisions included £938 million for the possible mis-selling of Payment Protection Insurance ('PPI') policies and £375 million in relation to the possible mis-selling of interest rate products in previous years, of which £168 million relates to the estimated redress to be paid to customers.

Costs also rose due to the non-recurrence of a credit of £360 million following a change in the inflation measure used to calculate the defined benefit obligation in the UK for deferred pensions. Restructuring costs of £193 million were £44 million lower than in 2011, as the review initiated in 2011 to improve cost efficiency continued to be implemented and the group completed disposals and exits across Europe.

Excluding these items, costs fell during 2012. Strict cost control and the continued delivery of organisational effectiveness programmes resulted in sustainable cost

Report of the Directors: Business Review (continued)

savings of approximately £451 million. The number of employees (expressed in FTEs) at the end of the 2012 was 7 per cent lower than at the end of 2011. This reflected the planned net reduction of staff numbers across the group from organisational effectiveness initiatives and business disposals.

The savings obtained through the organisational effectiveness programmes and business disposals enabled the group to invest in strategic initiatives including certain business expansion projects and enhance processes and technology capabilities.

Given the UK statutory tax rate of 24.5 per cent, the effective tax rate ('ETR') for HSBC Bank plc would be expected to be at or around this level. In 2012 the ETR would have been approximately 23.3 per cent except for the impact of specific non-recurring items. Adjustments in respect to prior years and non-taxable income on the sale of HSBC Private Banking Holdings (Suisse) SA reduced the 2012 ETR by 16.1 per cent and 14.1 per cent respectively. The adjustment in respect of prior years includes items on which HSBC Holdings plc has agreed to assume the bank's liability as part of a settlement with the UK tax authorities and a tax recovery in respect of European dividends following a recent favourable ruling by the European Court of Justice. The amount of foreign exchange revaluation reserve recycled through the Income Statement, following the sale of HSBC Private Banking Holdings (Suisse) SA, of £1,258 million which is not taxable also reduced ETR. As a result of these one-off items the ETR for the year was a credit of 6.9 per cent.

2011 compared with 2010

Net interest income decreased by £471 million or 6 per cent reflecting the decline in Balance Sheet Management revenues as higher yielding positions matured and opportunities for reinvestment were limited by the prevailing low interest rate environment. This was in addition to a fall in Credit and Lending revenues as a result of lower lending balances. Revenues from the group's legacy credit portfolio also declined due to a reduction in effective yields and lower holdings. The above factors were partly offset by increased spreads on term lending and personal lending in the UK, along with a growth in term balances across the region and mortgages in the UK.

Net fee income decreased by £140 million or 3 per cent as income from management services generated from investment conduits was lower, together with higher intercompany fees payable on intra-group referrals. This was partly offset by higher levels of client activity and growth in assets under management in Group Private Banking.

Trading income decreased by £581 million or 27 per cent primarily due to significantly lower secondary trading revenues in Rates and Credit, as turmoil in eurozone sovereign debt markets escalated, particularly in

the second half of 2011, resulting in trading losses as increased risk aversion and limited client activity led to a significant widening of credit spreads on certain sovereign and corporate bonds. In addition, a sharp reduction in revenues from the group's legacy credit portfolio reflected the non-recurrence of the prior year price appreciation and lower asset holdings.

Lower favourable foreign exchange movements were reported on trading assets held as economic hedges of foreign currency debt designated at fair value. These offset lower adverse movements on foreign currency debt which is reported in '*Net expense from financial instruments designated at fair value*'.

Trading income from structured liabilities included favourable fair value movements in 2011 as credit spreads widened compared with adverse fair value movements in 2010. In the Equities business, revenues rose as investment in platforms improved the group's competitive positioning and helped capture increased client flows. This was coupled with lower losses on portfolio hedges in Global Banking compared with the prior year.

Net income from financial instruments designated at fair value increased by £157 million in 2011, as the change in own credit spread on long term debt resulted in gains of £832 million in 2011 compared with losses of £122 million in 2010. In addition, there were favourable foreign exchange movements on foreign currency debt designated at fair value, issued as part of the overall funding strategy, with an offset reported in '*Trading income*'.

These gains were partly offset by losses on the fair value of assets held to meet liabilities under insurance and investment contracts as equity markets fell, notably in the second half of 2011, compared with gains reported in 2010. To the extent that these losses accrued to policyholders holding unit-linked insurance policies and insurance or investment contracts with Discretionary Participation Features ('DPF'), there was a corresponding decrease in 'Net insurance claims incurred and movement in liabilities to policyholders'.

Gains less losses from financial investments were £292 million compared to £537 million in 2010, as a deterioration in market confidence resulted in fewer disposal opportunities and lower gains from the disposal of private equity investments. This was partly offset by gains on certain securitised debt portfolios in 2011.

Net earned insurance premiums decreased by £55 million or 2 per cent driven by the non-renewal and transfer to third parties of certain contracts in the group's Irish reinsurance business, and the run-off and sale of the legacy motor business in the UK. This was partly countered by increased revenues from targeted sales campaigns in Retail Banking and Wealth Management, notably for investment contracts with Discretionary

Report of the Directors: Business Review (continued)

Participation Features ('DPF') in France and unit-linked products in the UK.

Other operating income decreased by £559 million mainly due to the disposal of Rail Finance business and the £125 million gain on the sale and leaseback of the group's Paris headquarters both in 2010. A net decrease in the present value of in-force ('PVIF') long-term insurance business reflected the impact from experience and assumption updates. This was partially offset by a one-off gain recognised upon the refinement of the calculation of the PVIF asset and strong sales of insurance products notably in France.

Net insurance claims incurred and movement in liabilities to policyholders decreased by £841 million in 2011. Investment losses, which contrasted with investment gains in 2010, led to a lower increase in the movement in liabilities to policyholders. Further, the non-renewal and transfer to third parties of certain contracts in the Irish reinsurance business and the sale of the legacy motor book in the UK also resulted in a decrease in net insurance claims incurred and movement in liabilities to policyholders. Partly offsetting this, were reserves established for new business written, consistent with the increase in net earned insurance premiums.

Loan impairment charges and other credit risk provisions decreased by £328 million or 17 per cent. Loan impairment charges in UK Retail were significantly lower than in 2010 driven by improved delinquencies across both the secured and unsecured lending portfolios due to improved collections and the low interest environment. In Continental Europe Retail, impairments increased slightly, with a provision on the insurance assets portfolio due to the depressed financial markets and higher provisions on a small number of Commercial Banking exposures in Greece. Global Banking and Markets recorded a charge of £90 million on available-for-sale Greek sovereign debt now judged to be impaired, however this was partly offset by lower charges on asset-backed securities as the impact of losses in the underlying

collateral pools generated lower charges on asset-backed securities. In addition, impairments of £55 million were included in Global Private Banking in relation to specific charges in the UK and Channel Islands, as well as a provision on Greek available-for-sale debt securities.

Total operating expenses increased by £169 million or 2 per cent. This included provisions of £507 million relating to UK customer redress programmes, including a charge in respect of the possible mis-selling of Payment Protection Insurance (PPI) in previous years, and restructuring provisions across the region of £237 million. This was partly offset by a credit of £360 million resulting from a legislative change in the inflation measure used to calculate the defined benefit obligation in the UK for deferred pensions. 2010 included one-off payroll and bonus taxes of £218 million in the UK and France. Operating expenses also rose due to investment in strategic initiatives including the development of Prime Services and equity market capabilities and the expansion of the Rates and Foreign Exchange e-commerce platforms. In addition, the strengthening of the Swiss franc, which accounts for a significant proportion of the Group Private Banking cost base, also led to a rise in expenses. Global Banking and Markets continued to invest in strategic initiatives including the development of Prime Services and equity market capabilities and the expansion of the Rates and Foreign Exchange e-commerce platforms. Performance-related awards, however, were substantially lower than in the prior year, reflecting the decline in net operating income, although this was mostly offset by higher amortisation charges for previous years' performance shares and accelerated expense recognition for current year deferred bonus awards.

The effective tax rate was 23.6 per cent (2010: 24.8 per cent). This is lower than the UK statutory tax rate of 26.5 per cent (2010: 28 per cent). The main driver of the lower effective tax rate is the effect of non-taxable income.

Report of the Directors: Business Review (continued)

Review of business position

Summary consolidated balance sheet¹

	2012 £m	2011 £m	2010 £m
Total assets	815,481	827,970	798,494
Cash and balances at central banks	51,613	56,460	24,495
Trading assets	161,516	126,598	159,552
Financial assets designated at fair value	15,387	15,332	15,467
Derivative assets	177,808	176,993	129,158
Loans and advances to banks	32,286	44,603	57,027
Loans and advances to customers	282,685	288,014	285,218
Financial investments	71,265	93,112	102,086
Other	22,921	26,858	25,491
Total liabilities	783,281	796,366	766,137
Deposits by banks	39,571	41,032	48,287
Customer accounts	324,886	346,129	344,123
Trading liabilities	122,896	119,211	132,360
Financial liabilities designated at fair value	32,918	31,992	27,935
Derivative liabilities	181,095	178,121	129,204
Debt securities in issue	40,358	42,688	48,119
Liabilities under insurance contracts issued	17,913	16,347	17,116
Other	23,644	20,846	18,993
Total equity	32,200	31,604	32,357
Total shareholders' equity	31,675	31,090	31,825
Non-controlling interests	525	514	532

Summary of key balances on a continuing operations basis²

	2012 £m	2011 £m	2010 £m
Total assets	815,481	780,598	752,863
Of which:			
Cash and balances at central banks	51,613	50,023	24,071
Loans and advances to customers	282,685	273,271	271,532
Financial investments	71,265	75,421	77,374
Total liabilities	783,281	756,081	727,871
Of which:			
Customer accounts	324,886	296,900	296,759

¹ Reported balances as at 31 December.

² Excludes the HSBC Private Banking Holdings (Suisse) SA key balances from the 2011 and 2010 comparatives.

Movements in 2012

Total reported assets were £815 billion, 2 per cent lower than at 31 December 2011.

Excluding the effect of the transfer of HSBC Private Banking Holdings (Suisse) SA to HSBC Holdings plc, total assets increased by 4 per cent.

The following commentaries are after adjusting for the impact of the transfer of HSBC Private Banking Holdings (Suisse) SA.

The group maintained a strong and liquid balance sheet with the ratio of customer advances to customer accounts at 87.0 per cent (2011: 83.2 per cent).

The group's reported core tier 1 ratio stood at 11.4 per cent (2011: 9.1 per cent).

Assets

Cash and balances at central banks rose by 3 per cent as a greater portion of the surplus liquidity was placed with central banks, reflecting both the group's conservative risk profile and growth in customer deposits.

Trading assets increased by 28 per cent. At the end of 2011, as eurozone debt concerns dominated the global economy, the group reduced its holdings of debt and equity securities and did not replace maturities in the reverse repo book. In 2012, client activity increased from these subdued levels and resulted in a rise in reverse repo and securities borrowing balances, together with higher holdings of equity securities.

Financial assets designated at fair value were in line with 2011.

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Derivative assets were broadly in line with December 2011 levels. The downward movements in yield curves of major currencies led to a rise in the fair value of interest rate contracts. This was offset by a decline in the fair value of credit derivative contracts as spreads tightened, and reduced fair values of foreign exchange derivatives.

Loans and advances to banks declined by 21 per cent, driven by a reduction in reverse repo balances in Europe.

Loans and advances to customers increased by 3 per cent. Residential mortgage balances continued to grow strongly, reflecting the success of marketing campaigns and competitive pricing in the UK. In addition, an increase in lending to corporate customers, the result of demand for credit from SMEs in the UK, and higher levels of corporate overdraft balances which did not meet netting criteria also contributed to the in the UK. Lending to Global Banking and Markets customers declined as a result of the disposal of selected positions as exposure to certain sectors was reduced, together with a small number of large repayments. Reverse repos balances also declined.

Financial investments declined by 6 per cent as part of the group's redeployment of liquidity arising following the strategic disposal of government debt securities.

Liabilities

Deposits by banks declined by 15 per cent due to lower placements by, and repo activity with, other financial institutions.

Customer accounts rose by 9 per cent. This was driven by higher Payments and Cash Management

balances and a rise in deposits in the UK reflecting the success of deposit gathering campaigns. The increase in current accounts, in the UK, was also attributable to the rise in overdrafts which did not meet netting criteria, with a corresponding rise reported in loans and advances to customers.

Trading liabilities grew by 3 per cent, largely due to a decrease in the number of repos that were eligible for netting.

Derivative liabilities increased by 2 per cent. The derivative businesses are managed within market risk limits and, as a consequence, the increase in the value of '*Derivative liabilities*' broadly matched that of '*Derivative assets*'.

Debt securities in issue fell by 12 per cent as maturing bonds and certificates of deposit were not replaced. This was compounded by paydowns of commercial paper during the period.

Liabilities under insurance contracts increased by 10 per cent. The increase was driven mainly by reserves established for new business premiums written in France, together with an increase in equity markets, which resulted in an increase in the fair value of assets held to support unit-linked and investment and insurance contracts with DPF.

Equity

Total shareholders' equity rose by 2 per cent, mainly due to the favourable movement on the available-for-sale reserve from a negative balance of £2,020 million at 31 December 2011 to a negative balance of £266 million at 31 December 2012, reflecting an improvement in the fair value of these assets.

Report of the Directors: Business Review (continued)

Performance and Business Review

Profit on ordinary activities before tax

	2012 £m Reported	2011 £m Reported	2010 £m Reported
UK Retail Banking	806	1,547	1,321
Continental Europe Retail Banking	376	314	374
Global Banking and Markets	642	(94)	1,816
Private Banking	480	528	616
Other/Intersegment ¹	(1,300)	816	(116)
	1,004	3,111	4,011

HSBC Bank plc and its subsidiary undertakings reported a profit before tax of £1,004 million, £2,107 million or 68 per cent lower than 2011.

Global Banking and Markets reported a £736 million increase in profit before tax compared to 2011, along with higher profit in Continental Europe Retail Banking. UK Retail Banking and Global Private Banking both recorded lower levels of profit than 2011.

The economic environment in the UK and across the eurozone continued to be challenging during the year, however the group continued to support its personal and commercial customers manage their financial challenges and plan for the future.

UK Retail Banking

	2012 £m	2011 £m	2010 £m
Net interest income.....	3,738	3,602	3,536
Net fee income	1,789	1,776	1,866
Trading income	87	54	10
Other income	100	194	255
Net operating income before impairments and provisions.....	5,714	5,626	5,667
Loan impairment charges and other credit risk provisions.....	(651)	(796)	(1,221)
Net operating income	5,063	4,830	4,446
Total operating expenses.....	(4,260)	(3,282)	(3,128)
Operating profit	803	1,548	1,318
Share of profit in associates and joint ventures.....	3	(1)	3
Profit before tax	806	1,547	1,321

2012 compared with 2011

UK Retail Banking reported a profit before tax of £806 million, 48 per cent lower than 2011. This was primarily due to an increase in provisions recognised in respect of customer remediation programmes, partially offset by lower loan impairment charges and growth in net interest income.

For UK Retail Banking, the following items are significant in a comparison of 2012's results against 2011:

- provisions of £1,144 million in 2012 and £507 million in 2011. In 2012, this included £938 million estimated redress for the possible mis-selling of PPI policies and £168 million in relation to the possible mis-selling of interest rate protection products, of which £74 million relates to the estimated redress payable to customers;
- operational losses of £65 million resulting from closed account balances of dissolved companies;
- restructuring costs of £51 million in 2012 and £43 million in 2011 resulting from business transformation initiatives; and
- an accounting gain of £292 million resulting from legislative change in the inflation measure used to calculate the defined benefit obligation in the UK for deferred pensions recognised in 2011.

Excluding the items above, UK Retail Banking profit before tax was £2,066 million, 14 per cent higher than 2011.

In Retail Banking and Wealth Management, progress continued on delivering the strategy of building long-term sustainable relationships with target customers with particular focus on mortgage lending and wealth management. The share of new UK mortgage lending in 2012 was 12 per cent, which was higher than the 10 per cent share of new lending in the prior year, while maintaining a loan-to-value ratio of 52 per cent. New mortgage lending of £19.5 billion was approved during 2012, compared to the group's original lending commitment of £15 billion, with £5 billion approved for first time buyers.

During the year, the group's Wealth Management products and services were re-designed in accordance with the changes in regulation arising from the Financial Services Authority's Retail Distribution Review, which were introduced on 1 January 2013. The business continues to offer a competitive fee-based financial advice service to Premier customers.

Commercial Banking continued to implement the strategy to become the leading international trade and business bank. In 2012, the business launched an

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International Small and Medium Enterprise ('SME') Fund to support UK businesses that trade, or aspire to trade, internationally. By the end of 2012, the lending through the fund totalled £5.1 billion, exceeding the original target of £4 billion. Total gross new lending to SMEs in the UK rose by 3 per cent to £12.3 billion, and over 80 per cent of small business lending applications received during the year were approved. Revenue from international customers increased and the focus on this client base, together with targeted growth initiatives such as deposit acquisition and regional pricing strategies, led to a rise in Payments and Cash Management and Global Trade and Receivable Finance income.

Financial performance

Net interest income increased by £136 million or 4 per cent primarily due to strong growth in average residential mortgage balances and improved margins in Retail Banking and Wealth Management, along with growth in average customer account and average lending balances in Commercial Banking. This was partially offset by ongoing deposit spread compression reflecting both the low interest rate environment and strong competition for deposits.

Net fee income was broadly in line with 2011.

Trading income increased by £33 million, as a result of bringing the provision of travel money services in-house during 2011.

Other income decreased by £94 million or 48 per cent primarily within Wealth Management due to the impact of the one-off gain arising from the change in methodology used in the recognition of insurance revenues in 2011 and the impact of lower levels of wealth insurance products sold in 2012. Wealth revenues were impacted by structural changes made to the business in anticipation of the changes in regulation arising from the Retail Distribution Review.

Loan impairment charges and other credit risk provisions decreased by £145 million or 18 per cent. In Retail Banking and Wealth Management, loan impairment charges decreased by £184 million or 54 per cent due to lower levels of delinquency across both the secured and unsecured portfolios resulting from the continued focus on improving collections and the high quality of new business booked over the last four years. In Commercial Banking, loan impairment charges increased by £39 million due to customer specific impairments spread across a number of industry sectors. Given the weakened financial state of some commercial and personal customers, a continuation in the positive impairment trend remains sensitive to general economic activity.

Total operating expenses increased by £978 million or 30 per cent. Excluding the customer redress provisions of £1,144 million in 2012 compared with £507 million in 2011, operational losses of £65 million resulting from

closed account balances of dissolved companies, restructuring costs and the £292 million accounting gain arising from changes in indexation of certain pension liabilities recognised in 2011, operating expenses were £24 million or 1 per cent lower than the prior year. Cost reductions were delivered through sustainable cost savings and the re-engineering of business processes that commenced in 2011.

2011 compared with 2010

Overview

The challenging economic environment continued to impact the UK and eurozone economies. The diversification of the group enabled it to continue to support its personal and commercial customers, resulting in a resilient financial performance.

UK Retail Banking reported a profit before tax of £1,547 million compared with £1,321 million in 2010, an increase of 17 per cent. This was primarily due to significantly lower loan impairment charges in both the personal and commercial sectors resulting from continued focus on collections activity, together with the ongoing change in mix of new business towards secured lending. The continuing low interest rate environment in the UK has also allowed many customers to continue to reduce their debt levels.

For UK Retail Banking, the following items are significant in making a comparison of 2011's results against 2010:

- provisions of £507 million in 2011, for customer redress programmes, including the estimated redress in respect of the possible mis-selling of PPI policies; and
- an accounting gain of £292 million resulting from legislative change in the inflation measure used to calculate the defined benefit obligation in the UK for deferred pensions.

In Retail Banking and Wealth Management, further progress was made towards the strategy of building long-term sustainable relationships with Premier customers and growing the value of new investment business. The Wealth Management business continued to develop, with HSBC World Selection assets under management increasing by 21 per cent in the period to total £2.5 billion, and £1.2 billion of assets invested via the Portfolio Investment Management Service since its launch in late 2010. The Global Investment Centre service was successfully launched in November 2011, enabling investors to hold and trade a wide range of funds on-line.

The group's share of new UK residential mortgage lending in 2011 was 10 per cent, above the group's total market share of 6 per cent and its 9 per cent share of new lending achieved in 2010. The average loan to value ratio of this new lending was 53 per cent. The group continued

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to support the UK housing market during 2011, helping over 160,000 customers arrange mortgage finances, including 29,000 first time buyers.

Commercial Banking made further progress in building out its strategy of becoming the leading international trade and business bank, launching a full service renminbi proposition to help customers doing business in China along with developing a “Key Partner Countries” strategy with eight countries to improve customer experience and increase cross border income and activity. The number of international customers grew 19 per cent in 2011, with related international product income up 14 per cent. Trade business revenues increased 18 per cent as the value of import and export transactions grew by 19 per cent and 33 per cent respectively over the prior year.

Commercial Banking also continued to support UK businesses through the economic recovery; with a particular emphasis on those with international aspirations. Commercial Banking grew its deposit base by 10 per cent, and total net lending to UK businesses grew by 6 per cent despite market contraction. New lending to SMEs in the UK grew by 15 per cent, and the bank exceeded its 2011 lending intentions under the Project Merlin agreement with the UK Government in respect of both total and SME facilities.

Commercial Banking continued to strengthen its partnership with Global Banking and Markets, growing its international customer base. Foreign exchange and derivative income particularly deliver strong growth compared with 2010.

Financial performance

Net interest income increased by £66 million or 2 per cent, driven by the growth in mortgage balances, commercial lending and wider asset margins. Despite the continued low base rate environment and strong competition for customer deposits, the group built on its strong deposit base, resulting in income growth compared to 2010.

Net fee income decreased by £90 million or 5 per cent. Of the decrease, £40 million relates to fees previously received from another Group company in respect of the provision of travel money services. In 2011, this business was brought in-house and the revenue was recognised as trading income. Income from Retail Banking and Wealth Management overdraft fees declined due to reduced customer appetite for debt. This was partially offset by a strong Commercial Banking performance following growth in Trade, Receivables Finance and Global Markets business.

Trading income increased by £44million.

Other income decreased by £61 million or 24 per cent due to the impact of winding down of the Insurance Brokers business.

Loan impairment charges and other credit risk provisions decreased by £425 million or 35 per cent. In Retail Banking and Wealth Management, loan impairment charges decreased by £366 million due to lower levels of delinquencies across both the secured and unsecured portfolios as a result of continued focus on improving collections performance and the quality of new business booked. In Commercial Banking loan impairment charges were 12 per cent lower with improvements noted across the majority of industry sectors.

Given the weakened state of some commercial and consumer customers, continuing positive impairment trends remain sensitive to general economic activity, potential impact from the eurozone crisis, interest rates and employment levels and changes in house prices.

Total operating expenses increased by £154 million or 5 per cent. Excluding the accounting gain arising from the change in indexation of certain pension liabilities of £292 million, the provisions for PPI and other customer redress programmes of £507 million, restructuring costs of £43 million, operating expenses were £104 million lower than the prior year. Cost savings were achieved by delivering sustainable long-term reductions in the cost base by re-engineering business processes, funded strategic investment in people and infrastructure to support customers.

Continental Europe Retail Banking

	2012	2011	2010
	£m	£m	£m
Net interest income	1,693	1,775	1,726
Net fee income	790	766	684
Trading income	(29)	(2)	21
Other income	(83)	(90)	14
Net operating income before impairments and provisions	2,371	2,449	2,445
Loan impairment charges and other credit risk provisions	(296)	(212)	(195)
Net operating income	2,075	2,237	2,250
Total operating expenses	(1,698)	(1,923)	(1,876)
Operating profit	377	314	374
Share of profit in associates and joint ventures	(1)	–	–
Profit before tax	376	314	374

2012 compared with 2011

Continental Europe Retail Banking reported a profit of £376 million, 20 per cent higher than 2011.

Retail Banking and Wealth Management benefited from the non-recurrence of the restructuring costs in France in 2011 and the previously announced closures of businesses in Poland, Russia, Georgia, Slovakia and Hungary. This was partially offset by the cost of business expansion in Turkey and the impact from the disposal of the insurance and reinsurance businesses in Ireland. The focus continues to be on simplifying the existing business and continued development in Wealth Management targeting the mass affluent market.

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In Commercial Banking, a number of process and system improvements were rolled out, including the international account opening process, in order to provide a superior cross-border customer service. Commercial Banking continued to focus on its business portfolios in core markets and segments, with controlled exits from certain portfolios, along with the exit of Georgia, Slovakia and Hungary. Payments and Cash Management continued to build a consistent product offering across Europe and has won mandates from both new and existing clients.

For Continental Europe Retail Banking, the following item is significant in making a comparison of 2012's results against 2011:

- restructuring costs of £18 million in 2012 and £120 million in 2011 resulting from business transformation initiatives.

Financial Performance

Net interest income was £82 million or 5 per cent lower than 2011 primarily due to lower deposit spreads in France reflecting the adverse market conditions, partly offset by higher personal lending and mortgage balances in Turkey Retail Banking and Wealth Management due to business expansion, along with improved lending margins in Commercial Banking.

Net fee income was £24 million or 3 per cent higher compared with 2011. Fee income in Retail Banking and Wealth Management was 6 per cent higher as a result of lower levels of commissions paid following the winding down and disposal of the insurance and reinsurance businesses in Ireland, along with the growth of card volumes in Turkey. This was partly offset by lower fees from assets under management in France due to a fall in average client assets from net money outflows.

Other Income increased by £7 million reflecting higher insurance manufacturing revenues in France. This was partly offset by the winding down and the disposal of the insurance and reinsurance businesses in Ireland.

Loan impairment charges and other credit risk provisions were £84 million or 40 per cent higher in 2012. This was primarily driven by balance sheet growth due to the business expansion in Retail Banking and Wealth Management in Turkey, along with higher provisions in Commercial Banking in Greece, Spain and Turkey due to adverse market conditions.

Total operating expenses fell by £225 million or 12 per cent primarily due to lower restructuring costs in 2012 £18 million compared to £120 million incurred in 2011, the completion of business exits and disposals, primarily in Retail Banking and Wealth Management during the period and continued cost saving initiatives.

2011 compared with 2010

Overview

Continental Europe Retail Banking reported a profit of £314 million, 16 per cent lower than 2010, as a strong performance in Commercial Banking was offset by the impact of restructuring costs as the group began to reshape its business portfolio. Based on the Group's strategic approach there were announced closures of retail banking businesses in Poland and Russia and the exit of operations from Georgia.

Following the restructuring of a number of the group's retail banking businesses in 2011, focus has increasingly centred on wealth management with strong emphasis on deepening customer relationships at the core of the group's strategy for the region. In Commercial Banking, progress continued to be made in expanding relationships and aspiring to become the leading international trade and business bank. Enhanced product offerings resulted in an increase in gross revenues from Trade and Receivables Finance and Payments and Cash Management. The number of international customers increased by 19 per cent, while the value of export transactions financed in 2011 increased by 33 per cent.

Commercial Banking also launched a renminbi proposition in a number of European countries to support customers doing business with China. HSBC Group completed a number of landmark transactions in 8 markets. Successful referrals made to other parts of the Group increased by 46 per cent, the majority of those to faster growing markets, underlining the increased connectivity of the Global Commercial Banking business in Continental Europe.

Financial Performance

Net interest income for Retail Banking and Wealth Management was £30 million or 3 per cent lower than 2010. Asset margins were negatively impacted by additional regulatory caps and restrictions on business growth in Turkey while liability margins improved across the region.

In Commercial Banking, net interest income increased by £79 million or 11 per cent compared to 2010, driven by higher asset and deposit volumes. Corporate lending increased in a number of markets including France, Turkey and Germany. Growth in Trade and Receivables Finance advances was four times higher than the overall growth in the lending book. Volume growth was partially offset by a reduction in loan margins as banks defended their market share by reducing rates and customers utilised excess liquidity instead of funding through borrowings.

Net fee income increased by £82 million or 12 per cent compared with 2010. Fee income in Retail Banking and Wealth Management was 16 per cent higher mainly due to growth in Asset Management in Switzerland, and lower levels of commissions paid following the winding

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down of the reinsurance business in Ireland. In Commercial Banking growth was driven by Trade and Receivables Finance and Payments and Cash Management.

Other Income decreased by £104 million following the winding down of the reinsurance business in Ireland.

Loan impairment charges and other credit risk provisions increased by £17 million or 9 per cent in 2011. In Retail Banking and Wealth Management, impairments were in line with 2010 despite a £16 million impairment on Greek available for sale sovereign debt in the insurance assets portfolio.

In Commercial Banking, loan impairment charges increased by £15 million driven by higher provisions in Greece, Turkey, Kazakhstan and Spain.

Total operating expenses increased by £47 million or 3 per cent and include restructuring costs of £120 million. These costs arose as the group began to reshape its business portfolio and exited operations in Georgia, announced the closure of retail businesses in Poland and Russia, and refocused the business in France, Malta, Turkey and Greece. Adjusting for these restructuring costs, total operating expenses decreased by 4 per cent, driven in part by the winding down of the reinsurance business in Ireland.

Global Banking and Markets

	2012	2011	2010
	£m	£m	£m
Net interest income ¹	876	1,323	1,913
Net fee income	616	598	820
Trading income ¹	1,554	1,083	1,711
Other income	973	267	909
Net operating income before impairments and provisions	4,019	3,271	5,353
Loan impairment charges and other credit risk provisions ...	(280)	(543)	(518)
Net operating income	3,739	2,728	4,835
Total operating expenses	(3,093)	(2,822)	(3,021)
Operating profit	646	(94)	1,814
Share of profit in associates and joint ventures	(4)	–	2
Profit before tax	642	(94)	1,816

¹ The bank's Balance Sheet Management business, reported within Global Banking and Markets, provides funding to the trading businesses. To report Global Banking and Markets Trading income on a fully funded basis, Net interest income and Trading income are grossed up to reflect internal funding transactions prior to their elimination in the Inter Segment column (refer to Note 13).

2012 compared with 2011

Overview

Global Banking and Markets reported a profit before tax of £642 million in the period compared with a loss before tax of £94 million in 2011.

Overall, revenues rose by 23 per cent, primarily due to higher trading revenues in Rates and Credit as spreads tightened and investor sentiment improved following stimulus by central banks. Foreign Exchange

performance was stronger as a result of robust client flows, in part due to enhanced collaboration with Commercial Banking. These movements were partly offset by lower revenues in Financing and Equity Capital Markets within Global Banking, and Balance Sheet Management.

For Global Banking and Markets, the following items are significant in making a comparison of 2012's results against 2011:

- a provision of £207 million in 2012, in respect of the possible mis-selling of interest rate protection products, of which £94 million relates to the estimated redress to be paid to customers;
- restructuring costs of £36 million in 2012 and £60 million in 2011 resulting from business transformation initiatives; and
- an accounting gain of £68 million resulting from legislative change in the inflation measure used to calculate the defined benefit obligation in the UK for deferred pensions recognised in 2011.

Financial performance

Net interest income decreased by £447 million or 34 per cent compared to 2011, mainly due to the decline in Balance Sheet Management revenues as yield curves continued to flatten and interest rates remained low, together with a reduction in the available-for-sale debt security portfolio as a result of disposals. Revenues were also lower in Credit and Lending, reported in Global Banking, as clients sought long-term funding from debt capital markets. In the legacy credit portfolio, reported in Global Markets, a reduction in portfolio size resulted in lower effective yields. This was partly offset by higher Payments and Cash Management revenues which increased due to growth in average liability balances and transaction volumes. This reflected new mandates and an increased focus on cross-selling payments and cash management solutions to international customers.

Net fee income increased by £18 million or 3 per cent compared with 2011. Revenues from primary market issuance, mainly within Credit increased as the business enhanced regional coverage and actively captured growth in client demand for debt capital financing. This was partly offset by lower revenues in Financing and Equity Capital Markets in Global Banking, as advisory and underwriting fees declined reflecting the challenging economic environment.

Trading income was £471 million or 43 per cent higher than 2011. Rates trading revenues increased, despite significant adverse fair value movements from own credit spreads on structured liabilities as spreads tightened, compared with a gain reported in 2011, together with a charge of £387 million reported in the fourth quarter as a result of a change in estimation methodology in respect of credit valuation adjustments on derivative assets to reflect evolving market practices.

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Excluding legacy credit, Credit trading revenues increased as credit spreads tightened resulting in gains on corporate bonds. Foreign Exchange performance increased from robust client flows in part due to enhanced collaboration with Commercial Banking, along with increased volumes as the business improved its electronic pricing and distribution capabilities. This was partly offset, however, by lower revenues from less volatile markets in 2012.

Foreign exchange losses were reported on trading assets held as economic hedges of foreign currency debt designated at fair value, with the offset reported in 'Other income'. In addition, trading income benefited by £191 million from the change in estimation methodology for debit valuation adjustments on derivative liabilities.

Other income grew by £706 million mainly due to foreign exchange gains on debt designated at fair value, with the offset reported in 'Trading income', as noted above. Balance Sheet Management reported higher gains on the disposal of available-for-sale debt securities as part of portfolio management activities. This was partly offset by losses on the disposal of legacy assets in Global Banking and Markets in the UK.

Loan impairment charges and other credit risk provisions declined by £263 million or 48 per cent, primarily due to lower impairments on available-for-sale asset-backed securities driven by an improvement in underlying asset prices, along with lower charges on Greek sovereign debt.

Total operating expenses increased by £271 million or 10 per cent. This included a customer redress provision of £207 million relating to interest rate protection products, of which £94 million relates to the estimated redress to be paid to customers. In addition, restructuring costs of £36 million were incurred in 2012 compared with £60 million in 2011, and an accounting gain of £68 million resulting from a change in the inflation measure used to calculate the defined benefit obligation for deferred pensions in the UK was recognised in 2011. Excluding these, expenses increased by £20 million or 1 per cent predominantly driven by higher performance costs which increased relative to revenue growth.

2011 compared with 2010

Overview

Global Banking and Markets reported a loss before tax of £94 million in the period compared with a profit of £1,816 million in 2010, as eurozone uncertainty continued to dominate European market sentiment.

Revenues were markedly lower in 2011 due to significantly lower trading revenues in Credit and Rates as turmoil in eurozone sovereign debt markets escalated, particularly in the second half of 2011. Revenues in Balance Sheet Management and from the legacy credit portfolio also declined. Notwithstanding the difficult trading conditions, there were strong performances in

other lines of business, including Global Banking and Equities.

During the year, there was continued focus on cross-border initiatives to position Global Banking and Markets to leverage trade flows. In addition, Payments and Cash Management enhanced network capabilities which together with innovative liquidity, channel and payables solutions allowed the bank to win substantial business across its Corporate and Financial Institutions business segments.

Financial performance

Net interest income decreased by £590 million or 31 per cent reflecting a decline in Balance Sheet Management revenues driven by the maturity of higher yielding positions, limited opportunities for reinvestment in the prevailing low interest rate environment, and flattening yield curves. Credit and Lending revenues decreased as a result of lower lending balances, while a fall in revenues from the legacy credit portfolio reflected a reduction in effective yields and lower holdings.

Net fee income declined by £222 million or 27 per cent as income for management services generated from the securities investment conduits was lower, together with higher intercompany fees payable on intra-group referrals.

Trading income was £628 million or 37 per cent lower than 2010 primarily due to significantly lower secondary trading revenues in the Rates and Credit businesses as turmoil in eurozone sovereign debt markets resulted in trading losses as increased risk aversion and limited client activity led to a significant widening of credit spreads on certain eurozone sovereign and corporate bonds. In addition, a sharp reduction in revenues from the group's legacy credit portfolio was driven by the non-recurrence of the prior year price appreciation during the year and lower asset holdings.

Trading income from structured liabilities included a favourable fair value movement of £244 million as credit spreads widened compared with a reported loss of £19 million in 2010. Revenues in the Equities business rose as investment in platforms improved competitive positioning and helped capture increased client flows. This was coupled with lower losses on portfolio hedges in Global Banking compared with prior year.

Other income decreased by £642 million or 71 per cent, primarily due to lower gains as deterioration in market confidence resulted in fewer disposal opportunities and lower gains from the disposal of private equity investments.

Loan impairment charges and other credit risk provisions increased by £25 million or 5 per cent reflecting a charge of £90 million in respect of available-for-sale Greek sovereign debt now judged to be impaired. This was partly offset by lower charges on asset-backed securities of £255 million compared to £288 million in

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2010 as the impact of losses arising in the underlying collateral pools generated lower charges on asset-backed securities.

Total operating expenses decreased by £199 million or 7 per cent compared to 2010. Excluding the £208 million charge in 2010 for the one-off UK and French bonus and payroll tax, and a £68 million pension indexation credit in 2011 arising from legislative change, operating expenses were 3 per cent higher. The rise in costs reflected targeted investment and restructuring costs.

The business continued to invest in strategic initiatives including the development of equity market capabilities together with the expansion of e commerce platforms in Foreign Exchange and Rates.

Performance-related awards were substantially lower than in 2010, reflecting the decline in net operating income, although this was mostly offset by higher amortisation for previous years' performance shares and accelerated expense recognition of current year deferred bonus awards.

Global Private Banking

	2012 ¹	2011	2010
	£m	£m	£m
Net interest income	597	750	724
Net fee income	583	700	650
Trading income	254	250	253
Other income	8	22	22
Net operating income before impairments and provisions.....	1,442	1,722	1,649
Loan impairment charges and other credit risk provisions ...	(18)	(72)	(17)
Net operating income	1,424	1,650	1,632
Total operating expenses.....	(943)	(1,122)	(1,016)
Operating profit	481	528	616
Share of profit in associates and joint ventures.....	(1)	–	–
Profit before tax	480	528	616

¹ The results for 2012 include only 10 months of HSBC Private Banking Holdings (Suisse) SA, prior to its sale.

2012 compared with 2011

Overview

Global Private Banking reported profit before tax of £480 million in 2012 compared with £528 million in 2011, a decrease of 9 per cent. The significant item in making a comparison of 2012's results against 2011 is the sale of HSBC Private Banking Holdings (Suisse) SA to HSBC Holdings plc in November 2012.

The results exclude the November and December 2012 results for HSBC Private Banking Holdings (Suisse) SA.

Financial performance

Net interest income decreased by £153 million or 20 per cent against 2011, reflecting the sale of the majority of the business segment. Excluding this impact, net interest income was 10 per cent lower as higher yielding

positions matured, opportunities for reinvestment were limited by lower prevailing yields and the business managed selectively the exposures to eurozone sovereign debt. This was partly offset by a corresponding increase in 'net trading income' through arbitrage opportunities on funding swaps.

Net fee income was lower by £117 million or 17 per cent. The fall reflected the inclusion of fee income for only 10 months. Net fee income was also impacted by a decline in fees from assets under management and account services due to a reduction in average client assets, and in client numbers following a programme to refocus the target client base.

Net trading income increased by £4 million, or 2 per cent. The impact of the sale of HSBC Private Banking Holdings (Suisse) SA was offset by higher volumes of funding swap positions.

Other income decreased by £14 million primarily due to the loss on the sale of Property Vision in 2012 and the non-recurrence of gains realised on HSBC vested shares in 2011.

Loan impairment charges and other credit risk provisions declined by £54 million mainly due to the non-recurrence of the impairment charge in 2011 recorded against Greek available-for-sale debt securities.

Total operating expenses decreased by £179 million or 16 per cent compared to 2011. Excluding the sale, operating expenses were broadly flat, as the reduction resulting from organisational effectiveness initiatives was partially offset by customer redress provisions of £28 million and restructuring costs of £31 million in 2012.

2011 compared with 2010

Overview

Global Private Banking reported profit before tax of £528 million in 2011 compared with £616 million in 2010, a decrease of 14 per cent. Revenue growth driven by net new money inflows and client activity, despite the uncertain economic environment, was more than offset by higher operating expenses and increased impairment charges.

Financial performance

Net interest income increased by £26 million or 4 per cent against 2010 as a result of higher average lending balances and wider spreads following re-pricing activity.

Net fee income increased by £50 million or 8 per cent as a result of higher transaction volumes related to higher market volatility and net new money inflows, in part driven by the recruitment of additional front line staff, particularly in faster growing markets.

Loan impairment charges and other credit risk provisions increased by £55 million due to specific impairment charges against a small number of individual

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customers and impairment charges recorded against Greek available-for-sale debt securities.

Total operating expenses increased by £106 million or 10 per cent compared to 2010, primarily driven by the strengthening of the Swiss Franc, in which a significant portion of the costs are incurred, relative to Sterling. The recruitment of additional front office staff, together with restructuring costs of £14 million, also contributed to the increase.

Other

	2012	2011	2010
	£m	£m	£m
Net interest income	(43)	(93)	(100)
Net fee income	3	60	20
Trading income	(9)	(7)	(8)
Change in credit spread on long-term debt	(1,055)	832	(122)
Other income	119	232	195
Net operating income before impairments and provisions	(985)	1,024	(15)
Loan impairment charges and other credit risk provisions	–	–	–
Net operating (expense)/ income	(985)	1,024	(15)
Total operating expenses	(315)	(208)	(101)
Operating (loss)/ profit	(1,300)	816	(116)
Share of profit in associates and joint ventures	–	–	–
(Loss)/ profit before tax	(1,300)	816	(116)

2012 compared with 2011

The reported loss before tax in Other was £1,300 million, compared to a profit before tax of £816 million in 2011.

Other includes:

- the change in own credit spread on long-term debt which resulted in a loss of £1,055 million in 2012 compared with gains of £832 million in 2011;
- other provisions including £84 million for vacant space and impairment on associated assets; and
- restructuring costs of £57 million in 2012 and £14 million in 2011.

2011 compared with 2010

The reported pre-tax profit in Other was £816 million, compared to a pre-tax loss of £116 million in 2010.

Other includes:

- the change in own credit spread on long-term debt which resulted in a gains of £832 million in 2011 compared with losses of £122 million in 2010;
- the gain of £125 million on the sale and leaseback of the Paris headquarters building in February 2010; and
- other operating income and operating expenses increased as a result of higher intra-group recharges in line with the increase in costs from centralised operational and migrated activities.

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Other information

(Unaudited)

Average balance sheet and net interest income

Average balances are based on daily averages of the group's banking activities with monthly or less frequent averages used elsewhere. Net interest margin numbers are calculated by dividing net interest income as reported in the income statement by the average interest-earning

assets from which interest income is reported within the 'Net interest income' line of the income statement. Interest income and interest expense arising from trading assets and liabilities and the funding thereof is included within 'Net trading income' in the income statement.

Assets

(Unaudited)

	2012			2011			2010		
	Average balance £m	Interest income £m	Yield %	Average balance £m	Interest income £m	Yield %	Average balance £m	Interest income £m	Yield %
Short-term funds and loans and advances to banks.....	107,080	876	0.82	86,330	1,102	1.28	76,665	1,111	1.45
Loans and advances to customers	273,522	8,237	3.01	272,379	8,262	3.03	244,544	7,891	3.23
Financial investments.....	84,421	1,557	1.84	100,543	1,979	1.97	97,264	2,101	2.16
Other interest-earning assets	571	4	0.70	578	8	1.38	642	7	1.09
Total interest-earning assets.....	465,594	10,674	2.29	459,830	11,351	2.47	419,115	11,110	2.65
Trading assets.....	125,212	2,313	1.85	154,775	3,026	1.96	138,639	2,492	1.80
Financial assets designated at fair value.....	9,629	150	1.56	9,084	238	2.62	7,558	253	3.35
Impairment provisions.....	(3,488)	–	–	(3,402)	–	–	(4,134)	–	–
Non-interest-earning assets.....	341,851	–	–	341,685	–	–	313,626	–	–
Total assets and interest income.....	938,798	13,137	1.40	961,972	14,615	1.52	874,804	13,855	1.58

Total equity and liabilities

(Unaudited)

	2012			2011			2010		
	Average balance £m	Interest expense £m	Cost %	Average balance £m	Interest expense £m	Cost %	Average balance £m	Interest expense £m	Cost %
Deposits by banks.....	59,534	492	0.83	57,544	729	1.27	62,060	553	0.89
Financial liabilities designated at fair value own debt issued.....	22,077	425	1.93	20,999	396	1.89	14,431	247	1.71
Customer accounts	285,476	2,175	0.76	289,398	2,280	0.79	268,034	1,834	0.68
Debt securities in issue.....	49,967	638	1.28	48,948	672	1.37	54,427	725	1.33
Other interest-bearing liabilities.....	1,226	40	3.26	1,287	51	3.96	1,423	57	4.01
Total interest-bearing liabilities	418,280	3,770	0.90	418,176	4,128	0.99	400,375	3,416	0.85
Trading liabilities	94,356	1,371	1.45	106,364	2,081	1.96	72,690	1,585	2.18
Financial liabilities designated at fair value (excluding own debt issued)	11,207	141	1.26	10,847	187	1.72	10,580	181	1.71
Non-interest bearing current accounts.....	40,045	–	–	39,402	–	–	36,831	–	–
Total equity and other non-interest-bearing liabilities.....	374,910	–	–	387,183	–	–	354,328	–	–
Total equity and liabilities.....	938,798	5,282	0.56	961,972	6,396	0.66	874,804	5,182	0.59

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Net interest margin

(Unaudited)

	2012	2011	2010
	%	%	%
Net interest margin.....	1.48	1.57	1.84

Analysis of changes in net interest income

(Unaudited)

The following table allocates changes in net interest income between volume and rate for 2012 compared to 2011, and for 2011 compared to 2010.

	Increase/(decrease) in 2012 compared with 2011			Increase/(decrease) in 2011 compared with 2010			2010 £m
	2012 £m	Volume £m	Rate £m	2011 £m	Volume £m	Rate £m	
Interest income							
Short-term funds and loans and advances to banks....	876	286	(512)	1,102	140	(149)	1,111
Loans and advances to customers.....	8,237	35	(60)	8,262	899	(528)	7,891
Financial investments.....	1,557	(318)	(104)	1,979	71	(193)	2,101
Interest expense							
Deposits by banks.....	492	137	(374)	729	(40)	216	553
Customer accounts.....	2,175	(31)	(74)	2,280	146	300	1,834
Financial liabilities designated at fair value – own debt issued.....	425	20	9	396	112	37	247
Debt securities in issue.....	638	(85)	51	672	(73)	20	725

Deposits

(Unaudited)

The following table summarises the average amount of bank deposits, customer deposits and certificates of deposit ('CDs') and other money market instruments (which are included within *Debt securities in issue* in the

balance sheet), together with the average interest rates paid thereon for each of the past three years. The Other category includes securities sold under agreements to repurchase.

	2012		2011		2010	
	Average balance £m	Average rate %	Average balance £m	Average rate %	Average balance £m	Average rate %
Deposits by banks	64,896		66,759		80,944	
Demand and other – non-interest bearing.....	4,427	–	4,791	–	4,360	–
Demand – interest bearing.....	5,637	0.4	10,396	0.7	8,913	0.6
Time.....	15,381	1.5	12,542	2.2	18,310	0.9
Other.....	39,451	1.1	39,030	1.3	49,361	0.7
Customer accounts	330,182		334,471		296,930	
Demand and other – non-interest bearing.....	45,641	–	49,497	–	43,419	–
Demand – interest bearing.....	160,147	0.4	146,641	0.4	140,666	0.4
Savings.....	38,807	1.8	35,784	1.7	33,514	1.8
Time.....	44,376	1.3	52,069	1.3	49,017	1.1
Other.....	41,211	1.0	50,480	0.8	30,314	0.6
CDs and other money market instruments	20,972	0.5	29,633	0.6	37,006	0.4

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Certificates of deposit and other time deposits

(Unaudited)

At 31 December 2012, the maturity analysis of CDs and other wholesale time deposits, by remaining maturity, was as follows:

	3 months or less £m	After 3 months but within 6 months £m	After 6 months but within 12 months £m	After 12 months £m	Total £m
Certificates of deposit.....	8,789	2,901	538	–	12,228
Time deposits					
- banks	24,059	1,199	313	5,655	31,226
- customers.....	31,429	5,486	3,898	1,995	42,808

Contractual obligations

(Unaudited)

The table below provides details of selected known contractual obligations of the group as at 31 December 2012.

	Payments due by period			
	Total £m	Less than 1 year £m	1-5 years £m	More than 5 years £m
Long-term debt obligations.....	70,628	25,145	27,778	17,705
Term deposits and certificates of deposit.....	86,262	78,612	7,182	468
Capital (finance) lease obligations.....	151	7	39	105
Operating lease obligations.....	1,622	158	537	927
Purchase obligations.....	3	3	–	–
Short positions in debt securities and equity shares.....	25,162	16,888	3,685	4,589
Current tax liability	122	122	–	–
Pension/healthcare obligation	4,440	179	1,841	2,420
	188,390	121,114	41,062	26,214

Report of the Directors: Risk

Challenges and Uncertainties

(Unaudited)

Macro-economic and geopolitical

Eurozone – risk of sovereign and counterparty defaults

There is still some risk of one or more countries leaving the euro, although the situation improved in 2012. Even if the eurozone does not split, the currency will remain very vulnerable to market perception. Banks in some countries remain fragile and the rest of the European banking industry could be affected through exposure to the weakest countries. Banks are therefore expected to continue to deleverage. In the current context of low growth due to austerity measures, this could further aggravate the economic crisis and could push European countries into a vicious circle of economic crisis and sovereign difficulties. Although the group's exposure to the peripheral eurozone countries is relatively limited, the group is exposed to counterparties in the core European countries which could be affected by any sovereign or currency crisis. The group's eurozone exposures are described in more detail on pages 34 to 38.

Potential impacts on the group include:

- The group could incur significant losses stemming from the exit of one or more countries from the eurozone and the redenomination of their currencies.
- The exposures to European banks may come under stress, heightening the potential for credit and market risk losses, if the sovereign debt and banking system crisis in the region increases the need to recapitalise parts of the sector.
- In the event of contagion from stress in the peripheral eurozone sovereign and financial sectors, the group's ability to borrow from other financial institutions or to engage in funding transactions may be adversely affected by market dislocation and tightening liquidity.
- A sovereign default without the co-ordinated intervention to protect the rest of the eurozone. This could trigger banking defaults in companies with which the group does business and have a knock-on effect on the global banking system. The group actively managed the risk of sovereign defaults during 2012 by reducing exposures and other measures.
- In seeking to manage and mitigate this risk, the group has prepared and tested detailed operational contingency plans to deal with such a scenario.

Increased geopolitical risk in certain regions

The group is subject to geopolitical risks in the countries in which it operates.

The group's results are subject to the risk of loss from unfavourable political developments, currency

fluctuations, social instability and changes in government policies on matters such as expropriation, authorisations, international ownership, interest-rate caps, foreign exchange transferability and tax in the jurisdictions in which it operates.

In mitigation, the group has increased its monitoring of the geopolitical and macro-economic outlook, in particular in countries where there are material exposures. The internal credit risk rating of sovereign counterparties takes these factors into account and drives the appetite for conducting business in those countries. Where necessary, country limits and exposures are adjusted to reflect this appetite and mitigate these risks as appropriate.

Macro-prudential and regulatory risks

Financial service providers face increasingly stringent and costly regulatory and supervisory requirements, particularly in the areas of capital and liquidity management, conduct of business, operational structures and the integrity of financial services delivery. Increased government intervention and control over financial institutions, together with measures to reduce systemic risk, may significantly alter the competitive landscape. These measures may be introduced as formal requirements in a super-equivalent manner and to differing timetables across regulatory regimes.

Regulatory developments affecting the business model and group profitability

Several regulatory changes are likely to affect the group's activities. These changes include (i) the implementation of the 'Basel III' measures through national regulations and, in the EU, through CRD IV and the designation of the Group by the Financial Stability Board as a global systemically important bank; (ii) proposed legislation in the UK to give effect to the recommendations of the Independent Commission on Banking ('ICB') in relation to 'ring-fencing' of the UK retail banking from wholesale banking activities, and in France and, in the EU, considerations following the Liikanen Group recommendations; (iii) changes in the capital regime for the operation of capital markets with increasing standardisation, central clearing, reporting and margin requirements; (iv) requirements flowing from arrangements for the recovery and resolution of the bank and its main operating entities; and (v) changing standards for the conduct of business. There is also continued risk of further changes to regulation relating to remuneration and other taxes.

Potential impacts on the group include:

- Proposed changes relating to capital and liquidity requirements, remuneration and/or taxes could increase the group's cost of doing business, reducing future profitability.
- Proposed changes in regulations for derivatives and central counterparties, the UK ICB ring-fencing proposals, recovery and resolution plans and the

Report of the Directors: Risk (continued)

Foreign Account Tax Compliance Act ('FATCA') may affect the manner in which the group conducts activities and structures itself. This has the potential both to increase the costs of doing business and curtail the types of business the group can carry out, with the risk of decreased profitability as a result. Due to the fact that the development and implementation of many of these various regulations are in their early stages, it is not possible to estimate the effect, if any, on the group's operations.

- The group is closely engaged with the governments and regulators in the countries in which the group operates to help ensure that the new requirements are properly considered and can be implemented in an effective manner. The group is also ensuring that the capital and liquidity plans take into account the potential effects of the changes. Capital allocation and liquidity management disciplines have been expanded to incorporate future increased capital and liquidity requirements and drive appropriate risk management and mitigating actions.

Regulatory investigations

Financial service providers are at risk of regulatory sanctions or fines related to conduct of business and financial crime. The incidence of regulatory proceedings and other adversarial proceedings against financial service firms is increasing.

In December 2012, HSBC, the bank's parent company, entered into agreements to achieve a resolution with US and UK government agencies that have investigated HSBC's conduct related to inadequate compliance with anti-money laundering ('AML'), US Bank Secrecy Act ('BSA') and sanctions laws. This was as a result of investigations by the US Department of Justice ('DoJ'), the Federal Reserve, the Office of the Comptroller of the Currency and the US Department of Treasury's Financial Crimes Enforcement Network in connection with AML/BSA compliance in various parts of the HSBC Group. As part of the resolution, HSBC and HSBC Bank USA, N.A. entered into a deferred prosecution agreement (the 'DPA') with the DoJ, the United States Attorney's Office for the Eastern District of New York, and the United States Attorney's Office for the Northern District of West Virginia, and a DPA with the New York County District Attorney, and consented to a cease and desist order with the Federal Reserve.

HSBC also entered into an undertaking with the FSA to comply with certain forward-looking obligations with respect to anti-money laundering and sanctions requirements over a five-year term. Under these agreements, HSBC will continue to cooperate fully with US and UK regulatory and law enforcement authorities and take further action to strengthen its compliance policies and procedures. Over the five-year term of the agreements with the DoJ and FSA, a 'skilled person' under section 166 of the Financial Services and Markets

Act (FSMA) (also known as an independent monitor) will evaluate HSBC's progress in fully implementing these and other measures it recommends, and will produce regular assessments of the effectiveness of HSBC's compliance function. If HSBC fulfils all of the requirements imposed by the DPA and other agreements, the DOJ's charges against it will be dismissed at the end of the five-year period.

The above agreements cover the activities of all the entities in the HSBC Group, including the bank and its subsidiaries.

The FSA requested the bank, as the FSA authorised and approved entity in the UK, to apply for a variation of its banking permission to ensure that HSBC complies with these undertakings. If HSBC fails to comply with the terms of the DPA, the FSA could take action against the bank including, but not limited to, revocation of the bank's license.

In relation to the DPA, the Group has committed to take or continue to adhere to a number of remedial measures. Breach of the DPA at any time during its term may allow the DoJ or the New York County District Attorney's Office to prosecute HSBC in relation to the matters which are subject to the DPA.

Steps to address many of the requirements of the DPA have either already been taken or are under way. These include simplifying the Group's control structure, strengthening the governance structure with new leadership appointments, revising key policies and establishing bodies to implement single global standards shaped by the highest or most effective anti-money laundering standards available in any location where the Group operates, as well as substantially increasing spending and staffing in the anti-money laundering and regulatory compliance areas over the past few years.

Additionally, the Group continues to be subject to a number of other regulatory proceedings, including investigations and reviews by various regulators and competition and enforcement authorities around the world including in the UK, the US, Canada, the EU, Switzerland and Asia, who are conducting investigations and reviews related to certain past submissions made by panel banks and the process for making submissions in connection with the setting of London interbank offered rates ('Libor'), European interbank offered rates ('Euribor') and other benchmark interest and foreign exchange rates. As certain HSBC entities are members of such panels, HSBC and/or its subsidiaries have been the subject of regulatory demands for information and are cooperating with those investigations and reviews.

Implementation risks of regulatory change

The extensive programme of regulatory change carries significant implementation risks for authorities and industry participants alike.

Report of the Directors: Risk (continued)

- *Disparities in implementation:* Many official measures are proposals in development and negotiation, and have not yet been enacted into regional and national legislation. Linked to this, some regulators are adopting or considering changes in applying existing rules relating to capital requirements. These processes could result in differing, fragmented and overlapping implementation around the world, leading to risks of regulatory arbitrage, a far from level competitive playing-field and increased compliance costs.
- *Timetable and market expectations:* While the Basel Committee has announced the timetable for its core proposals in Basel III, it remains uncertain how these and other measures will play out in practice. Meanwhile, market expectations will exert pressure on institutions to assess and effect compliance well in advance of official timetables.
- *Wider economic impact and unforeseen consequences:* While the conclusions of official and industry studies have diverged, the measures proposed will clearly impact on financial and economic activity in ways that cannot yet be clearly foreseen. For example, higher capital requirements may seriously restrict the availability of funds for lending to support economic recovery.

Business operations, governance and control

Challenges to achieving the group's strategy in a downturn

The external environment remains challenging and the structural changes which the financial sector is going through are creating obstacles to the achievement of strategic objectives. This, combined with the prolonged global macroeconomic slowdown, could affect the achievement of the strategic targets for the group as a whole and its global businesses.

Potential impacts on the group include:

- The downturn may put pressure on the group's ability to earn returns on its invested capital in excess of its cost of equity while operating within the overall parameters of its risk appetite.
- Through key strategic initiatives, which have heightened the focus on capital allocation and cost efficiency, the group is actively seeking to manage and mitigate this risk.

Remediation

There continues to be a heightened focus on the activities of banks, with particular attention on the possible mis-selling of Payment Protection Insurance ('PPI') policies and interest rate products sold to small businesses, most notably in the UK. This has led to significant financial costs as well as reputational loss across the banking sector. The group has established customer redress

programmes and has recognised substantial provisions for the cost of reimbursing customers.

To mitigate the risks of similar financial and reputational losses in the future, the group has implemented additional controls and training, and has reviewed its product offering. Furthermore, the group is continuing to work closely with regulators and other stakeholders to implement consistent standards in the group's dealings with its customers.

Internet crime and fraud

With the ever-growing acceptance and demand by consumers to use internet and mobile services, the group is naturally exposed to fraudulent and criminal activities via these channels. Internet crime could result in financial loss, and/or the compromise of customer data and sensitive information. Along with internet fraud, the overall threat of external fraud may increase during adverse economic conditions, particularly in retail and commercial banking.

The group also faces breakdowns in processes or procedures and systems failure or unavailability and is subject to the risk of disruption to group's business arising from events that are wholly or partially beyond group's control, such as internet crime and acts of terrorism.

Potential impacts on the group include:

- Internet crime and fraud may give rise to losses in service to customers and/or economic loss to the group. The same threats equally apply when the group relies on external suppliers or vendors to provide services to the group and its customers.
- The group has increased the defences through enhanced monitoring and has implemented additional controls, such as two-factor authentication, to mitigate the possibility of losses from fraud risks. The group continually assesses these threats as they evolve and adapts controls to mitigate them.

Social media risk

Social media networks ('SMN's) have expanded rapidly in terms of customer demographic and geographical reach and their scale and profile now represents a significant potential reputational risk to the group's organisation, given that these networks can be used as powerful broadcasting tools which can reach large numbers of people in a very short time frame.

Potential impacts on the group include:

- SMNs can be used to exacerbate the effect of customer complaints and service failures, and provide a means for employees to publicise confidential information. SMNs present significant risks to the group's reputation and brand.

Report of the Directors: Risk (continued)

- To reduce exposure to these risks, a group presence has been created in several of the larger SMNs in order to provide an official point of contact for customers and stakeholders. Monitoring has also been implemented to protect the brand and to understand general sentiment towards the group and, in some cases, specific products and initiatives.

Level of change creating operational complexity and heightened operational risk

There are many drivers of change across the group and the banking industry including new banking regulations, the increased globalisation of the economy and business activities, new products and delivery channels, and organisational change.

Operational complexity has the potential to heighten all types of operational risk across the group's activities. These risks include process errors, systems failures and fraud. Complexity can also increase operational costs.

The implementation of the group's strategy to simplify the business involves the withdrawal from certain markets, which presents disposal risks which must be carefully managed. Implementing organisational changes to support the group's strategy also requires close management oversight.

Potential impacts on the group are as follows:

- The implementation of HSBC's strategy has involved the re-organisation and clarification of management accountabilities. There is consequently a risk that issues are missed during the transition. This change activity is being monitored through a comprehensive review programme and robust governance arrangements.
- Critical systems failure and a prolonged loss of service availability could cause serious damage to the ability to serve clients, breach regulations under which the group operates and cause long-term damage to the business, reputation and brand. Systems and controls could be degraded as a result of organisational effectiveness initiatives unless there is strong governance and an oversight framework to monitor the risk and control environment. The group seeks to ensure that the critical systems infrastructure, including IT services, essential buildings, offshore processes and key vendors, is constantly monitored and properly resourced to mitigate against systems failures.
- The group pro-actively reviews relevant external events and the impact such events may have on its systems. Following the systems outage at a major UK bank in 2012, the group assessed its own exposure to similar risks and implemented appropriate steps in mitigation. The group has a strong focus on industry best practices. The group includes rigorous testing and review of all planned updates to the systems environment. All changes are

risk-assessed, and appropriate mitigating controls are required for any planned changes classified as high risk. During periods of heightened risk, comprehensive change embargoes are imposed to minimise the risk of customers being affected. The group also assesses the systems scheduling tools. There are controls in place to manage inter-dependencies, report exceptions and alert to file data corruption. These additional controls assure that the effect of any similar product failure would be limited. In addition, a continuity test of a similar problem within the major datacentres in the UK was conducted in the second half of 2012.

- The potential effects of disposal risks include regulatory breaches, industrial action, loss of key personnel and interruption to systems and processes during business transformation, and they can have both financial and reputational implications. Steps taken to manage these risks proactively include a close dialogue with regulators and customers and the involvement of HR, legal, compliance and other functional experts.

Information security risk

The security of the group's information and technology infrastructure is crucial for maintaining the banking applications and processes while protecting customers and the HSBC brand.

Potential impacts on the group are as follows:

- Financial loss and reputational damage which could adversely affect customer and investor confidence. Loss of customer data would also result in regulatory breaches which would result in fines and penalties being incurred.
- The group has invested significantly in addressing this risk through increased staff training to raise awareness of requirements and enhanced multi-layered controls protecting information and technical infrastructure.

Model risk

More stringent regulatory requirements governing the development, parameters applied to and controls around models used for measuring risk can give rise to changes, including increases in capital requirements. Furthermore, the changing external economic and legislative environment and changes in customer behaviour can lead to the assumptions the group has made in models becoming invalid.

These model risks can result in a potentially increased and volatile capital requirement. The group continues to address these risks through enhanced model development, independent review and model oversight to ensure the models remain fit for purpose.

Report of the Directors: Risk (continued)

Regulation and Supervision

(Unaudited)

The regulation and supervision of financial institutions continues to undergo significant change in response to the global financial crisis.

Basel III

In December 2010, the Basel Committee issued two documents: 'A global regulatory framework for more resilient banks and banking systems' and 'International framework for liquidity risk measurement, standards and monitoring', which together are commonly referred to as 'Basel III'. In June 2011, the Basel Committee issued a revision to the former document setting out the finalised capital treatment for counterparty credit risk in bilateral trades.

The Basel III rules set out the minimum common equity tier 1 ('CET1') ratio requirement of 4.5 per cent and an additional capital conservation buffer requirement of 2.5 per cent, to be phased in sequentially from 1 January 2013, becoming fully effective on 1 January 2019. Any additional countercyclical capital buffer requirements will also be phased in, starting in 2016 to a proposed maximum level of 2.5 per cent effective on 1 January 2019, although individual jurisdictions may choose to implement larger countercyclical capital buffers. The leverage ratio is subject to a supervisory monitoring period which commenced on 1 January 2011, and a parallel run period which will last from 1 January 2013 until 1 January 2017. Further calibration of the leverage ratio will be carried out in the first half of 2017 with a view to migrating to a Pillar 1 requirement from 1 January 2018.

In addition to the criteria detailed in the Basel III proposals, the Basel Committee issued further minimum requirements in January 2011 to ensure that all classes of capital instruments fully absorb losses at the point of non-viability before taxpayers are exposed to loss. Instruments issued on or after 1 January 2013 may only be included in regulatory capital if the new requirements are satisfied. The capital treatment of securities issued prior to this date will be phased out over a 10-year period commencing on 1 January 2013.

CRD IV

In July 2011, the European Commission published proposals for a new Regulation and Directive, known collectively as CRD IV, to give effect to the Basel III framework in the EU.

The CRD IV rule changes introduce a revised definition of regulatory capital, primarily focused on common equity tier 1 ('CET1') capital as the predominant form of going concern capital, with a greater quantum to be held by banks. There are increased capital deductions and new regulatory adjustments affecting this higher tier of capital. The new rules also introduce increased RWA

requirements, mainly for Counterparty Credit Risk ('CCR').

The most significant impact on CET1 capital is the proposed deduction of equity holdings in banks, financial institutions and insurance entities resulting from a reallocation of current deductions to this higher tier of capital and new rules for calculating the amounts to be deducted.

The regulatory treatment applied to immaterial unconsolidated investments in banks, financial institutions and insurance entities does not recognise netting of long and short positions where the short position is less than one year residual maturity that are nevertheless hedged from a market risk perspective.

The rules are currently in draft and subject to ongoing negotiation. If finalised in their current form, the holdings of such positions would generate a disproportionate capital cost. However, a range of actions from adjustments to hedging, curtailment and/or closure of the relevant equities business could be applied to mitigate the capital deduction.

The most significant impact on RWAs is a new capital charge to cover risk of mark to market losses on expected counterparty risk, referred to as a regulatory CVA risk capital charge, calculated on a full range of OTC (i.e. non-exchange traded) derivative counterparties. Other changes will impose increases in the asset value correlation multiplier for financial counterparties, additional requirements for collateralised counterparties, margin period of risk and new requirements for exposures to central clearing counterparties resulting in a higher CCR charge.

CRD IV is not yet in law and its provisions are subject to ongoing negotiation and amendment. In addition, formal Implementation Technical Standards ('ITSs') due for issue by the European Banking Authority ('EBA') are still to be drafted and finalised, leaving the CRD IV rules subject to significant interpretation.

During 2012, the EBA issued a number of consultations on the draft ITSs including:

- In August 2012 the EBA published revised reporting requirements to harmonise prudential regulatory and financial reporting (commonly known as COREP and FINREP). The EBA will deliver final COREP and FINREP reporting requirements when the final text of the CRD IV is adopted by European legislators.
- On 13 November 2012 the EBA issued a draft regulatory technical standard on prudent valuation. The regulatory basis of prudent value differs from the accounting basis for calculating fair values of financial instruments under IAS 39. It is proposed that when the accounting value is greater than the regulatory value the difference, referred to as an

Report of the Directors: Risk (continued)

additional valuation adjustment ('AVA'), should be deducted from CET1.

Further consultative documents are expected during 2013.

The CRD IV legislation is in draft and remains subject to agreement by the European Parliament, Council and Commission. As such, the finalised CRD IV rules could result in materially different impacts on CET1 and RWAs.

UK regulatory reform

The UK financial services regulatory structure is currently in the process of substantial reform. Legislation has been passed to abolish the FSA and establish three new regulatory bodies from 1 April 2013.

These three bodies will comprise the Financial Policy Committee ('FPC') of the Bank of England, the Prudential Regulation Authority ('PRA') and the Financial Conduct Authority ('FCA'). The FPC will not directly supervise firms, being responsible for macro-prudential regulation and considering systemic risk affecting economic and financial stability. The PRA and the FCA will inherit the majority of the FSA's existing functions as the micro-prudential supervisors. The bank will be a 'dual-regulated' firm, subject to prudential regulation by the PRA and to conduct regulation by the FCA. These reforms will endow the new regulatory bodies with additional powers.

In the case of the FPC, its January 2013 Draft Policy Statement, 'The Financial Policy Committee's power to supplement capital requirements', states that it will have two main objectives: the first is to make recommendations, and the second is a power to direct the FCA and the PRA to adjust specific macroprudential tools, namely the countercyclical capital buffer ('CCB') and sectoral capital requirements ('SCRs'). The UK Government is proposing to make the FPC responsible for setting the CCB, a Basel III global requirement applied to certain financial institutions in the UK. The CCB is a macroprudential tool at the disposal of national authorities that can be deployed to protect the banking sector from future potential losses when the FPC judges that threats to financial stability have arisen in the UK which increase system-wide risk. Should a CCB be required, it is expected to be set in the range of 0-2.5 per cent.

It is also planned to give the FPC 'direction power' over SCRs. The SCR tool is more targeted and would allow the FPC to change capital requirements above minimum regulatory standards on exposures to three broad sectors judged to pose a risk to the system as a whole (residential property, including mortgages; commercial property; and other parts of the financial sector), as well as more granular sub-sectors (for example, to mortgages with high loan to value or loan to income ratios at origination). This will include both

banking book and trading book exposures and be irrespective of the domicile of the ultimate borrower.

The CCB and SCR tools are stated as broad tools designed to reduce the likelihood and severity of financial crises, the primary purpose being to tackle cyclical risks. Both tools provide the FPC with means to increase the amount of capital that banks must have when threats to financial stability are judged to be emerging. The amount of capital add-ons for SCR has not yet been quantified.

Other regulatory proposals

In 2013 the FSA will introduce new industry-wide capital measures such as a requirement to floor all sovereign loss given defaults ('LGD's) at 45 per cent and the imposition of a stringent supervisory slotting approach for the group's UK commercial real estate portfolio. Furthermore, the FSA has informed the group of a framework which will be used when assessing wholesale portfolios with a low number of defaults. This framework will impose LGD and exposure at default ('EAD') floors based on the foundation approach for portfolios with less than 20 events of default (per country).

Potential effect of regulatory proposals on the group's capital requirements

The group's approach to managing its capital position has been to ensure the group exceeds current regulatory requirements and is well placed to meet expected regulatory requirements arising from the future implementation of CRD IV.

Structural banking reform

In September 2011, the Independent Commission on Banking ('ICB') recommended measures on capital requirements for UK banking groups. In June 2012, the UK Government published its consultation, 'Banking reform: delivering stability and supporting a sustainable economy', which set out its detailed proposals for implementing the recommendations, such as ring fencing and bail-in debt, of the ICB. In October 2012 the UK Government published draft primary legislation which was presented to the UK's Parliamentary Commission on Banking Standards for pre-legislative scrutiny. The UK Government is now considering whether the original proposal should be adjusted in light of the findings. The Government intends to enact the legislation by the end of this Parliament in 2015 and to have reforms in place by 2019.

In October 2012, the Liikanen Report delivered its recommendations to the EC to reform the structure of the European banking sector. This also recommends ring-fencing focused on isolating trading activities (as opposed to deposits in the ICB) and, in principle, additional bail-in debt.

The group continues to monitor these developments.

Report of the Directors: Risk (continued)

Outlook

(Unaudited)

The bank expects global growth to stay around 2.0 per cent in 2013, in line with the modest growth seen in 2012. Developed countries will continue to face weak growth on the back of structural constraints such as debt deleveraging and weak labour markets but emerging market growth is expected to accelerate over the course of the year.

The Eurozone growth outlook remains very weak. There are some positive signs: structural reforms mean labour markets are becoming less rigid and more competitive while the stabilisation in financial markets since the ECB's commitment to do "whatever it takes" to preserve the euro has fed through into an improvement in monetary conditions and business confidence, but significant headwinds remain. Deleveraging, austerity and rising unemployment are set to continue, so growth will depend on external demand, particularly in the periphery. An upturn in the world trade cycle should provide some relief in 2013, particularly in Germany where we expect real GDP to recover gradually from the sharp contraction in the final quarter of 2012 and to grow by 0.6 per cent in 2013. Despite this, the Eurozone is expected to contract by a further 0.2 per cent in 2013 after the 0.5 per cent drop in GDP in 2012. For most of the Eurozone low growth or ongoing recession, combined with the low inflation that arises from the need to regain competitiveness, implies government debt projections in the periphery in particular will continue to be revised up.

The bank expects UK GDP to rise by 1.1 per cent in 2013, a pick up in growth from a flat economy in 2012. Inflation is likely to continue to outpace wage growth, squeezing real terms incomes and limiting the ability of consumers to drive strong growth. Domestic demand will also be restrained by the ongoing fiscal consolidation while weakness in the Eurozone, the UK's main trading partner, means export growth is unlikely to provide major support to growth.

Managing Risk

(Unaudited)

All the group's activities involve, to varying degrees, the analysis, evaluation, acceptance and management of risks or combinations of risks.

An established risk governance framework and ownership structure ensures oversight of and accountability for, the effective management of risk. The group's risk management framework fosters the continuous monitoring of the risk environment and an integrated evaluation of risks and their interactions. Integral to the group's risk management framework are risk appetite, stress testing and the identification of emerging risks.

The group's risk management framework is designed to provide appropriate risk monitoring and assessment. The bank's Risk Committee focuses on risk governance and provides a strong forward-looking view of risks and their mitigation.

The Risk Committee is a sub-committee of the Board and has responsibility for oversight and advice to the Board on, inter alia, the Bank's risk appetite, tolerance and strategy, systems of risk management, internal control and compliance. Additionally, the Risk Committee focus on the alignment of the reward structures and the maintenance and development of a supportive culture, in relation to the management of risk, appropriately embedded through procedures, training and leadership actions.

In carrying out its responsibilities, the Risk Committee is closely supported by the Chief Risk Officer, the Chief Financial Officer, the Head of Internal Audit and the Head of Compliance, together with other business functions on risks within their respective areas of responsibility.

Risk culture

All staff are required to identify, assess and manage risk within the scope of their assigned responsibilities. Global standards set the tone from the top and are central to the group's approach to balancing risk and reward. Personal accountability is reinforced by HSBC Values, with staff expected to act with courageous integrity in conducting their duties.

Staff are supported by a disclosure line which enables them to raise concerns in a confidential manner. The group also have in place a suite of mandatory training to ensure a clear and consistent attitude is communicated to staff; mandatory training not only focuses on the technical aspects of risk but also on the group's attitude towards risk and the behaviours expected by its policies.

The risk culture is reinforced by the group's approach to remuneration; individual awards are based on the achievement of both financial and non-financial (relating to HSBC values) objectives which are aligned to the global strategy.

Risk profile

Risks are assumed by the global businesses in accordance with their risk appetite and managed at global business and regional levels. All risks are identified through the group's risk map process which sets out the group's risk profile in relation to key risk categories in the regional and global businesses. Risks are regularly assessed through the group's risk appetite framework, stress testing process and in terms of emerging risks.

Credit, market and operational risk are measured using the Basel II Pillar 1 framework for regulatory capital through the allocation of risk-weighted assets.

Report of the Directors: Risk (continued)

Other risks are also measured through the group's economic capital model under Pillar 2.

Risk appetite

The Group's risk appetite is set out in the Group's Risk Appetite Statement, which describes the types and levels of risk that the group is prepared to accept in executing its strategy. This is approved by the HSBC Board on the advice of the Risk Committee, and is a key component of the risk management framework. It is central to the annual planning process, in which global businesses, geographical regions and functions are required to articulate their risk appetite statements. These are aligned with Group strategy, and provide a risk profile of each global business, region or function in the context of the individual risk categories discussed.

Stress testing

The group's stress testing and scenario analysis programme is central to the monitoring of top and emerging risks. A range of Group stress-testing scenarios including, but not limited to, severe global economic downturn, country, sector and counterparty failures and a variety of projected major operational risk events are conducted. The outcomes of the stress testing are used to assess the potential demand for regulatory capital under the various scenarios.

In the course of 2012, we examined several scenarios reflecting potential developments in the eurozone and more widely. The group explored the potential first and second order impact from a range of eurozone scenarios. These scenarios increase in severity from an orderly Greek exit, to a scenario comprising default of several peripheral eurozone countries with potential risk of further deterioration. The results of these two scenarios demonstrated that the group would remain satisfactorily capitalised under both scenarios after taking account of assumed management actions.

Areas of special interest

The group determines areas of special interest based on events which have taken place in the current or recent reporting periods and warrant particular attention.

Exposure to countries in the eurozone

(Unaudited)

For the purpose of this disclosure, eurozone countries are members of the EU and part of the euro single currency bloc. The peripheral eurozone countries are those that exhibited levels of market volatility that exceeded other eurozone countries, demonstrating fiscal or political uncertainty which may persist through the first half of 2013. The eurozone countries considered as peripheral for these disclosures are Greece, Ireland, Italy, Portugal and Spain.

In 2012, in spite of improvements through austerity and structural reforms, the peripheral eurozone countries

continued to exhibit a high ratio of sovereign debt to GDP or short to medium-term maturity concentration of their liabilities.

At 31 December 2012, the group's net exposure to the peripheral eurozone countries was £16.0 billion including a net exposure to sovereign, agencies and banks of £6.1 billion. During the year the group continued to reduce its overall net exposure to sovereigns, agencies and banks of peripheral eurozone countries. In addition, it continued to actively reduce exposures to counterparties domiciled in other eurozone countries that had exposures to sovereigns and/or banks in peripheral eurozone countries of sufficient size to threaten their on-going viability in the event of an unfavourable conclusion to the current crisis.

The group's businesses in peripheral eurozone countries are funded from a mix of local deposits, local wholesale funding and intra-group loans extended from HSBC operations with surplus funds. Intra-group funding carries the risk that a member country might exit the eurozone and redenominate its national currency, which could result in a significant currency devaluation. A description of risks relating to currency redenomination in the event of the exit of a eurozone member is provided on page 37.

Risk management and contingency planning

(Unaudited)

The group has an established framework for dealing with counterparty and systemic crisis situations which is complimented by regular specific stress testing and scenario planning. The framework functions both at pre- and in-crisis situations and ensures that the group has detailed operational plans in case an adverse scenario materialises. The framework was deployed in 2011 and has continued to operate throughout 2012 to ensure that pre-crisis preparation remains apposite and robust.

While the main focus of preparation continues to be Greece and Spain, as the eurozone situation developed in 2012 the group has also considered additional scenarios including contagion risk to non-eurozone countries or the exit of a higher impact eurozone member. Management action includes the operation of a Eurozone Major Incident Group which meets regularly, complemented by a regional eurozone contingency plan covering all businesses and functions. The plan has been tested and considers payments, legal, client account, internal and external communication and regulatory and compliance issues associated with eurozone breakup.

The tables in this section summarise the group's exposure to selected eurozone countries, including:

- governments and central banks along with quasi-government agencies;
- banks; and
- other financial institutions and corporates.

Report of the Directors: Risk (continued)

Exposures to banks, other financial institutions and corporates are based upon the counterparty's country of domicile.

Credit default swaps and off-balance sheet items

(Unaudited)

Credit default swaps ('CDSs') were transacted with banks with investment grade credit ratings, and would pay out in the event of the default of the referenced security and certain other credit events. CDS contracts disclosed in the tables below were principally entered into for customer facilitation with banks and financial institutions where their terms are typically drawn up in accordance with the guidance set out in the 2003 ISDA Credit Derivatives Definitions and the July 2009 Supplement. The credit events that trigger the payout of CDSs may differ as they are based on the terms of each

agreement between the counterparties. Such credit events normally include bankruptcy, payment default on a reference asset or assets, restructuring and repudiation or moratoria.

Off-balance sheet exposures mainly relate to the group's commitments to lend and the amounts shown in the tables represent the amounts that could be drawn down by the counterparties. In some instances limitations are imposed on a counterparty's ability to draw down on a facility. These limitations are governed by the legal documentation which differs from counterparty to counterparty. In the majority of cases the group is bound to fulfil commitments made to third parties.

The group has no significant net open positions in the credit default swap contracts of any of the peripheral eurozone countries.

Exposure to peripheral eurozone countries

On- and off-balance sheet exposure

(Audited)

	At 31 December 2012					
	Greece £bn	Ireland £bn	Italy £bn	Portugal £bn	Spain £bn	Total £bn
<i>On-balance sheet exposure</i>						
Total						
Held for trading	0.4	1.4	1.2	0.1	1.4	4.5
Not held for trading	2.2	3.0	2.3	0.4	3.6	11.5
	2.6	4.4	3.5	0.5	5.0	16.0
Sovereigns & agencies						
Held for trading	–	0.1	0.8	0.1	0.3	1.3
Not held for trading	0.1	–	0.8	0.1	0.2	1.2
	0.1	0.1	1.6	0.2	0.5	2.5
Banks						
Held for trading	0.4	0.9	0.4	–	1.1	2.8
Not held for trading	–	–	0.3	0.2	0.3	0.8
	0.4	0.9	0.7	0.2	1.4	3.6
Other financial institutions & corporates						
Held for trading	–	0.4	–	–	–	0.4
Not held for trading	2.1	3.0	1.2	0.1	3.1	9.5
	2.1	3.4	1.2	0.1	3.1	9.9
<i>Off-balance sheet exposure</i>						
Other financial institutions & corporates						
Commitments	0.1	0.5	1.0	0.1	1.4	3.1
Other	0.3	–	0.5	–	0.3	1.1
	0.4	0.5	1.5	0.1	1.7	4.2

Report of the Directors: Risk (continued)

	At 31 December 2011					
	Greece £bn	Ireland £bn	Italy £bn	Portugal £bn	Spain £bn	Total £bn
<i>On-balance sheet exposure</i>						
Total						
Held for trading	0.5	0.8	1.4	0.4	1.5	4.6
Not held for trading	2.8	2.3	2.8	0.4	5.0	13.3
	<u>3.3</u>	<u>3.1</u>	<u>4.2</u>	<u>0.8</u>	<u>6.5</u>	<u>17.9</u>
Sovereigns & agencies						
Held for trading	0.2	0.1	0.9	0.3	0.1	1.6
Not held for trading	0.1	0.1	0.6	–	0.7	1.5
	<u>0.3</u>	<u>0.2</u>	<u>1.5</u>	<u>0.3</u>	<u>0.8</u>	<u>3.1</u>
Banks						
Held for trading	0.3	0.5	0.4	0.1	1.3	2.6
Not held for trading	0.2	0.5	0.7	0.3	0.6	2.3
	<u>0.5</u>	<u>1.0</u>	<u>1.1</u>	<u>0.4</u>	<u>1.9</u>	<u>4.9</u>
Other financial institutions & corporates						
Held for trading	–	0.2	0.1	–	0.1	0.4
Not held for trading	2.5	1.7	1.5	0.1	3.7	9.5
	<u>2.5</u>	<u>1.9</u>	<u>1.6</u>	<u>0.1</u>	<u>3.8</u>	<u>9.9</u>
<i>Off-balance sheet exposure</i>						
Other financial institutions & corporates						
Commitments	0.4	0.1	0.1	–	0.2	0.8
Other.....	0.5	–	0.5	–	–	1.0
	<u>0.9</u>	<u>0.1</u>	<u>0.6</u>	<u>–</u>	<u>0.2</u>	<u>1.8</u>

At 31 December 2012, the group's total on-balance sheet exposure to *Greece* was £2.6 billion, £0.7 billion lower than at the end of 2011. A major part of the current exposure relates to Greek shipping companies. The group believes this industry is less sensitive to the Greek economy as it is mainly dependent on international trade.

At 31 December 2012, the group's total on-balance sheet exposure to *Ireland* was £4.4 billion, £1.3 billion higher than at the end of 2011. This increase was in respect of exposures to other financial institutions and corporates. A significant portion of group's exposure related to foreign owned entities incorporated in Ireland.

At 31 December 2012, the group's total on-balance sheet exposure to *Italy* was £3.5 billion £0.7 billion lower than at the end of 2011. The exposure to Italian other financial institutions and corporates mainly comprised large multinational companies and other financial institutions with significant operations outside Italy, which mitigated the risk.

At 31 December 2012, the group's total on-balance sheet exposure to *Portugal* was £0.5 billion, £0.3 billion lower than at the end of 2011. The reduction relates mainly to group's exposure to sovereigns and agencies.

At 31 December 2012, the group's total on-balance sheet exposure to *Spain* was £5.0 billion, £1.5 billion lower than at the end of 2011. The exposure to Spanish other financial institutions and corporates mainly comprised large multinational companies and other financial institutions with significant operations outside Spain, which mitigated the risk. Exposure to the commercial real estate sector in Spain remained insignificant.

The group's sovereign exposures to Ireland, Italy, Portugal and Spain are not considered to be impaired at 31 December 2012 as, despite financial difficulties in these countries, the situation is not severe enough to conclude that loss events have occurred which will have an impact on the future cash flows of these countries' sovereign securities.

Management continues to closely monitor and manage eurozone bank exposures in the peripheral eurozone countries, and is cautious in lending to this sector. The group regularly updates its assessment of higher-risk eurozone banks and adjusts its risk appetite accordingly. Where possible, the group also seeks to play a positive role in maintaining credit and liquidity supply.

As at 31 December 2012, the group's exposure to the banks in Greece, Ireland, Italy, Portugal and Spain was £3.6 billion £1.3 billion lower than at the end of 2011.

The group recognised no impairment in respect of its eurozone bank exposures.

Summary exposure to selected other eurozone countries*(Unaudited)*

At 31 December 2012, the group's exposure to the sovereign and agency debt and banks of Germany, France and Netherlands were £37.4 billion and £26.2 billion respectively. The exposure in the Netherlands predominantly comprises cash placements with the Dutch central bank, which in turn are placed with the ECB. The group's exposure in Germany and France is reflective of the strength of these economies as evidenced by the strong rating and the size of the group's operations.

Report of the Directors: Risk (continued)*On- and off-balance sheet exposure
(Unaudited)*

	At 31 December 2012		
	Germany £bn	France £bn	Netherlands £bn
Total			
On-balance sheet exposure	28.3	57.3	14.2
Off-balance sheet exposure.....	6.8	17.1	2.0
	35.1	74.4	16.2
Sovereigns & agencies			
On-balance sheet exposure	13.8	17.2	6.2
Off-balance sheet exposure.....	–	0.2	–
	13.8	17.4	6.2
Banks			
On-balance sheet exposure	5.9	16.4	1.9
Off-balance sheet exposure.....	0.2	1.6	0.2
	6.1	18.0	2.1
Other financial institutions & corporates			
On-balance sheet exposure	8.6	23.7	6.1
Off-balance sheet exposure.....	6.6	15.3	1.8
	15.2	39.0	7.9

Redenomination risk*(Unaudited)*

As the peripheral eurozone countries continue to exhibit distress, there is a continuing possibility of an exit of a member state from the eurozone. There remains no established legal framework within the European treaties to facilitate such an event. Consequently, it is not possible to predict accurately the course of events and legal consequences that would ensue.

HSBC's current view is that there is a greater risk of HSBC being affected by an exit from the euro of Greece, Italy or Spain than from Ireland or Portugal.

Key risks associated with an exit by a eurozone member include:

- Foreign exchange losses.** Exit by a eurozone country from the euro would probably be accompanied by the passing of new laws establishing a new local currency and providing for a redenomination of euro-denominated assets into that new local currency.
- Devaluation of assets.** The exit of a weaker eurozone country would result in an immediate devaluation of those assets and liabilities where the value of retranslated currency is less than their original euro carrying amount.

It is not possible to predict what the total consequential loss might be as it is uncertain which assets and liabilities would be legally re-denominated or by how much they would be devalued. In order to provide an indication of potential exposure based on balances as at 31 December 2012, the table below identifies assets and liabilities booked in the group's banking operations in Greece, Italy and Spain (described as 'in-country'). These assets and liabilities are predominantly comprised of loans and deposits arising from the group's commercial banking operations in these countries. The net assets represent the group's net funding exposure to those countries which the group considers most likely to be affected by a redenomination event.

Report of the Directors: Risk (continued)*In-country funding exposure as at 31 December 2012
(Unaudited)*

	Denominated in:			Total £bn
	Euros £bn	US Dollars £bn	Other Currencies £bn	
Greece				
In-country assets.....	1.3	0.1	–	1.4
In-country liabilities.....	(1.0)	(0.5)	(0.1)	(1.6)
Net in-country funding.....	0.3	(0.4)	(0.1)	(0.2)
Off balance sheet exposure/hedging.....	(0.2)	0.1	0.2	0.1
Italy				
In-country assets.....	0.6	–	–	0.6
In-country liabilities ¹	(1.2)	–	–	(1.2)
Net in-country funding.....	(0.6)	–	–	(0.6)
Off balance sheet exposure.....	0.5	–	–	0.5
Spain				
In-country assets.....	1.5	0.5	–	2.0
In-country liabilities.....	(1.1)	(0.1)	–	(1.2)
Net in-country funding.....	0.4	0.4	–	0.8
Off balance sheet exposure.....	0.4	0.1	–	0.5

¹ In-country liabilities in Italy include liabilities issued under local law but booked outside the country.

The table also identifies in-country off-balance sheet exposures as these are at risk of redenomination should they give rise to a balance sheet exposure in the future.

It is to be noted that this analysis can only be an indication as it does not include any exposures booked by the group outside the countries at risk which are connected with those countries (see ‘external contracts’ below).

External contracts redenomination risk: Contracts entered into between the group’s businesses based outside a country exiting the euro with in-country counterparties, or with those otherwise closely connected with the relevant country, may be affected by redenomination. The effect remains subject to a high level of uncertainty. Factors such as the country law under which the contract is documented, the group entity involved and the payment mechanism for settlement may all be relevant to this assessment. The consequences for external contracts of a disorderly exit or one sanctioned under EU law may also be very different.

The group has been identifying and monitoring potential redenomination risks and, where possible, taking steps with the potential to mitigate and/or reduce the group’s overall exposure to losses that might arise in the event of a redenomination. It should be emphasised, however, that a euro exit could take the form of a number of different scenarios giving rise to distinct legal consequences which could significantly alter the potential effectiveness of any steps taken, and it is accordingly not possible to predict with certainty how effective particular measures might be until they are tested against the precise circumstances of a redenomination event.

Commercial real estate

(Unaudited)

Exposure to commercial real estate lending is concentrated in the UK, where many regions were negatively affected by weak growth in the economy during 2012. London and the South East, where around 50 per cent of the group’s UK commercial real estate lending is based, continued to exhibit relative strength.

Refinance risk, which is subject to close scrutiny in key commercial real estate markets, is the risk that a loan which is due to be repaid through refinancing over the short term cannot, at maturity, be refinanced on current market terms. Such cases may either lead to the loan being treated as impaired because the borrower’s ability to repay is considered doubtful or, if refinanced within the group, may result in it being treated as a renegotiated loan because of the degree of forbearance required (see page 52 for a description of renegotiated loans). In commercial real estate markets, refinance risk can arise particularly when a loan is serviced exclusively by the property to which it relates, i.e. when the bank does not, or is not able to, place principal reliance on other cash flows available to the borrower. The group monitors the commercial real estate portfolio, assessing those drivers that may indicate potential issues with refinancing. The principal driver is the vintage of the loan, where origination reflected previous market norms which no longer apply in the current market. Examples are higher loan-to-value ratios and/or lower interest cover ratios. The range of refinancing sources in the local market is also an important consideration, with concern increasing where this is restricted to banks and when bank liquidity is limited. In addition, the quality of the underlying fundamentals, such as tenant reliability, ability to let, and

Report of the Directors: Risk (continued)

the condition of the property itself are also important, as they influence property value. In the UK the drivers noted above combine to cause a concern regarding sensitivity to risks of refinancing that warrant enhanced management attention.

At 31 December 2012 the UK had £15.2 billion of commercial real estate loans, of which £4.6 billion is due to be refinanced within the next 12 months. Of this, £1.5 billion is assessed as possessing characteristics that indicate an increased risk of refinancing difficulty. Such cases are monitored closely with £1.2 billion already under special management within the group's Loan Management Units, of which £0.6 billion is already disclosed as impaired with associated specific impairment allowances of £0.3 billion. Where these loans are not considered impaired it is because, while they may possess characteristics that indicate a potential issue with refinancing, there is no evidence indicating that all contractual cash flows will not be recovered or that the loans will need to be refinanced on terms the group would consider below market norms.

The impact of current market conditions on impairment assessments is considered to be particularly relevant over a 12 month horizon. Over a 12 to 24 month horizon, £2.1 billion of UK commercial real estate loans are due to be refinanced. Reviews of more sensitive exposures due between 12 and 24 months have been conducted to ensure that there are no further cases, at present, requiring special management or consideration for impairment.

Interest-only mortgages

(Unaudited)

Interest-only mortgages totalled £30.7 billion, approximately 40 per cent of UK mortgage balances (see table of 'Mortgage lending by product type' on page 43), of which approximately 50 per cent relates to the first direct 'offset' product.

The bank's underwriting criteria for interest-only products is consistent with that for equivalent capital repayment products, and such products continue to be typically originated at conservative loan-to-value ratios. Around a third of interest-only balances relate to first direct 'offset' products where customers are following some form of capital repayment schedule but are able to drawdown further funds within the agreed limit.

The bank manages non-payment risk by ensuring customers have a defined and credible repayment strategy at origination (with affordability assessed on a capital repayment basis) and maintaining regular contact with the customer.

The bank runs contact programmes to ensure it builds an informed relationship with customers whereby they receive the appropriate support in meeting the final repayment of principal, and understand alternative repayment options available. These contact programmes

intensify in the final five years of an interest-only product, and the effectiveness is reviewed by management with enhancements made where appropriate.

The bank monitors specific risk characteristics within the interest-only portfolio, such as current loan-to-value ratio, customer age at expiry, current income levels and credit bureau scores. These factors are assessed both from the context of future credit risk, but also to understand if there are segments of potentially vulnerable customers. There are currently no concentrations within these characteristics that cause the interest-only portfolio to be considered as carrying unduly high credit risk.

Credit risk

(Audited)

Credit risk is the risk of financial loss if a customer or counterparty fails to meet a payment obligation under a contract. It arises principally from direct lending, trade finance and leasing business, but also from off-balance sheet products such as guarantees and credit derivatives, and from the group's holdings of debt and other securities. Of the risks in which the group engages, credit risk generates the largest regulatory capital requirements.

The principal objectives of the group's credit risk management are:

- to maintain across the group a strong culture of responsible lending and a robust risk policy and control framework.
- to both partner and challenge businesses in defining, implementing, and continually re-evaluating the group's risk appetite under actual and scenario conditions; and
- to ensure there is independent, expert scrutiny of credit risks, their costs and mitigation.

Within the bank, the Credit Risk function is headed by the European Chief Risk Officer and reports to the Chief Executive Officer, with a functional reporting line to the Group Chief Risk Officer. Its responsibilities include:

- formulating credit policy. Compliance, subject to approved dispensations, is mandatory for all operating companies which must develop local credit policies consistent with group policies;
- guiding operating companies on the group's appetite for credit risk exposure to specified market sectors, activities and banking products and controlling exposures to certain higher-risk sectors;
- undertaking an independent review and objective assessment of risk. Credit risk assesses all commercial non-bank credit facilities and exposures over designated limits, prior to the facilities being committed to customers or transactions being undertaken;

Report of the Directors: Risk (continued)

- monitoring the performance and management of portfolios across the group;
- controlling exposure to sovereign entities, banks and other financial institutions, as well as debt securities which are not held solely for the purpose of trading;
- setting policy on large credit exposures, ensuring that concentrations of exposure by counterparty, sector or geography do not become excessive in relation to the group's capital base, and remain within internal and regulatory limits;
- maintaining and developing the group's risk rating framework and systems through the Credit Risk Analytics Oversight Committee, which reports to the Risk Management Meeting ('RMM') and oversees risk rating system governance for both wholesale and retail business;
- reporting on retail portfolio performance, high risk portfolios, risk concentrations, large impaired accounts, impairment allowances and stress testing results and recommendations to the group's RMM, the group's Audit Committee and the Board; and
- acting on behalf of the group as the primary interface, for credit-related issues, with the Bank of England, the FSA, local regulators, rating agencies, analysts and counterparts in major banks and non-bank financial institutions.

Credit quality

(Audited)

The group's credit risk rating systems and processes differentiate exposures in order to highlight those with greater risk factors and higher potential severity of loss. In the case of individually significant accounts, risk ratings are reviewed regularly and any amendments are implemented promptly. Within the group's retail business, risk is assessed and managed using a wide range of risk and pricing models to generate portfolio data.

The group's risk rating system facilitates the internal ratings-based ('IRB') approach under Basel II adopted by the Group to support calculation of the minimum credit regulatory capital requirement. For further details, see '*Credit quality of financial instruments*' on page 47.

Special attention is paid to problem exposures in order to accelerate remedial action. Where appropriate, operating companies use specialist units to provide customers with support in order to help them avoid default wherever possible.

The Credit Review and Risk Identification team reviews the robustness and effectiveness of key management, monitoring and control activities.

Periodic risk-based audits of operating companies' credit processes and portfolios are undertaken by the Internal Audit function. Internal Audit discusses with management any risk ratings it considers to be

inappropriate; following which its final recommendations for revised ratings must be adopted.

Impairment Assessment

It is the group's policy that each operating company creates allowances for impaired loans promptly and consistently.

Impairment allowances may be assessed and created either for individually significant accounts or, on a collective basis, for groups of individually significant accounts for which no evidence of impairment has been individually identified or for high-volume groups of homogeneous loans that are not considered individually significant.

When impairment losses occur, the group reduces the carrying amount of loans and advances through the use of an allowance account. When impairment of available-for-sale financial assets and held-to-maturity financial investments occurs, the carrying amount of the asset is reduced directly. For further details on the accounting policy for impairment of available-for-sale debt and equity securities, see accounting policies in Note 2.

Concentrations of credit risk exposure

Concentrations of credit risk arise when a number of counterparties or exposures have comparable economic characteristics, or such counterparties are engaged in similar activities, or operate in the same geographical areas or industry sectors, so that their collective ability to meet contractual obligations is uniformly affected by changes in economic, political or other conditions. The group uses a number of controls and measures to minimise undue concentration of exposure in the group's portfolios across industry, country and customer groups. These include portfolio and counterparty limits, approval and review controls, and stress testing.

Wrong-way risk is an aggravated form of concentration risk that arises when there is a strong correlation between the counterparty's probability of default and the mark-to-market value of the underlying transaction. The group uses a range of procedures to monitor and control wrong-way risk, including requiring entities to obtain prior approval before undertaking wrong-way risk transactions outside pre-agreed guidelines.

Maximum exposure to credit risk

The following table presents the maximum exposure to credit risk from balance sheet and off-balance sheet financial instruments, before taking account of any collateral held or other credit enhancements (where such credit enhancements do not meet offsetting requirements). For financial assets recognised on the balance sheet, the maximum exposure to credit risk equals their carrying amount; for financial guarantees granted, it is the maximum amount that the group would

Report of the Directors: Risk (continued)

have to pay if the guarantees were called upon. For loan commitments and other credit-related commitments that

are irrevocable over the life of the respective facilities, it is generally the full amount of the committed facilities.

Maximum exposure to credit risk
(Audited)

The group

	At 31 December 2012			At 31 December 2011		
	Maximum exposure £m	Offset £m	Exposure to credit risk (net) £m	Maximum exposure £m	Offset £m	Exposure to credit risk (net) £m
Cash and balances at central banks.....	51,613	–	51,613	56,460	–	56,460
Items in the course of collection from other banks..	1,961	–	1,961	1,663	–	1,663
Trading assets	138,624	(10,327)	128,297	114,657	(2,303)	112,354
treasury and other eligible bills.....	2,258	–	2,258	1,301	–	1,301
debt securities	54,576	–	54,576	51,286	–	51,286
loans and advances to banks	32,655	–	32,655	30,335	–	30,335
loans and advances to customers	49,135	(10,327)	38,808	31,735	(2,303)	29,432
Financial assets designated at fair value	7,151	–	7,151	7,856	–	7,856
treasury and other eligible bills.....	–	–	–	5	–	5
debt securities	7,122	–	7,122	7,285	–	7,285
loans and advances to banks	29	–	29	70	–	70
loans and advances to customers	–	–	–	496	–	496
Derivatives ¹	177,808	(141,162)	36,646	176,993	(141,973)	35,020
Loans and advances held at amortised cost ²	314,971	(54,641)	260,330	332,617	(52,881)	279,736
loans and advances to banks	32,286	(1,992)	30,294	44,603	(1,980)	42,623
loans and advances to customers	282,685	(52,649)	230,036	288,014	(50,901)	237,113
Financial investments.....	70,237	–	70,237	91,888	–	91,888
treasury and other similar bills	5,203	–	5,203	6,737	–	6,737
debt securities.....	65,034	–	65,034	85,151	–	85,151
Other assets.....	6,704	–	6,704	8,494	–	8,494
endorsements and acceptances	779	–	779	730	–	730
accrued income and other	5,925	–	5,925	7,764	–	7,764
Financial guarantees	11,660	–	11,660	12,410	–	12,410
Loan commitments and other credit-related commitments	115,725	–	115,725	120,881	–	120,881
	896,454	(206,130)	690,324	923,919	(197,157)	726,762

Report of the Directors: Risk (continued)

Maximum exposure to credit risk (Audited)

The bank

	At 31 December 2012			At 31 December 2011		
	Maximum exposure £m	Offset £m	Exposure to credit risk (net) £m	Maximum exposure £m	Offset £m	Exposure to credit risk (net) £m
Cash and balances at central banks	45,262	–	45,262	44,967	–	44,967
Items in the course of collection from other banks	1,213	–	1,213	908	–	908
Trading assets	115,949	(10,327)	105,622	94,852	(2,303)	92,549
treasury and other eligible bills.....	1,120	–	1,120	709	–	709
debt securities	30,084	–	30,084	27,079	–	27,079
loans and advances to banks	38,258	–	38,258	36,407	–	36,407
loans and advances to customers	46,487	(10,327)	36,160	30,657	(2,303)	28,354
Financial assets designated at fair value	4,373	–	4,373	4,595	–	4,595
debt securities	4,373	–	4,373	4,595	–	4,595
loans and advances to banks	–	–	–	–	–	–
Derivatives ¹	140,340	(88,947)	51,393	145,424	(96,159)	49,265
Loans and advances held at amortised cost ²	242,774	(47,492)	195,282	232,764	(41,163)	191,601
loans and advances to banks	17,207	–	17,207	22,203	–	22,203
loans and advances to customers	225,567	(47,492)	178,075	210,561	(41,163)	169,398
Financial investments	36,116	–	36,116	41,747	–	41,747
treasury and other similar bills.....	4,922	–	4,922	4,106	–	4,106
debt securities.....	31,194	–	31,194	37,641	–	37,641
Other assets.....	4,280	–	4,280	4,460	–	4,460
endorsements and acceptances	525	–	525	393	–	393
accrued income and other	3,755	–	3,755	4,067	–	4,067
Financial guarantees	9,318	–	9,318	8,531	–	8,531
Loan commitments and other credit-related commitments	77,640	–	77,640	81,801	–	81,801
	677,265	(146,766)	530,499	660,049	(139,625)	520,424

1 The derivative offset amount in the 'maximum exposure to credit risk table' relates to exposures where the counterparty has an offsetting derivative exposure with the group, a master netting agreement is in place and the credit risk exposure is managed on a net basis, or the position is specifically collateralised, normally in the form of cash. At 31 December 2012, the total amount of such offsets was £141 billion (2011: £142 billion), of which £122 billion (2011: £124 billion) were offsets under a master netting arrangement, £19 billion (2011: £17 billion) were received in cash and £0.1 billion (2011: £0.2 billion) were other collateral. These amounts do not qualify for net presentation for accounting purposes as settlement may not actually be made on a net basis.

2 The loans and advances offset adjustment primarily relates to customer loans and deposits, and balances arising from repo and reverse repo transactions. The offset relates to balances where there is a legally enforceable right of offset in the event of counterparty default, and where, as a result there is a net exposure for credit risk management purposes. As there is no intention to settle these balances on a net basis under normal circumstances, they do not qualify for net presentation for accounting purposes.

Collateral and other credit enhancements held

Loans and advances held at amortised cost

(Audited)

Although collateral can be an important mitigant of credit risk, it is the group's practice to lend on the basis of the customer's ability to meet their obligations out of their cash flow resources rather than rely on the value of security offered. Depending on the customer's standing and the type of product, facilities may be provided unsecured. For other lending a charge over collateral is obtained and considered in determining the credit decision and pricing. In the event of a default, the group may utilise the collateral as a source of repayment.

Depending on its form, collateral can have a significant financial effect in mitigating exposure to credit risk. The tables below provide a quantification of the value of fixed charges the group holds over a borrower's specific asset (or assets) where the group has a history of enforcing, and are able to enforce, the collateral in satisfying a debt in the event of the borrower failing to meet its contractual obligations, and where the collateral is cash or can be realised by sale in an established market.

The group may also manage its risk by employing other types of collateral and credit risk enhancements, such as second charges, other liens and unsupported

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guarantees, but the valuation of such mitigants is less certain and their financial effect has not been quantified. In particular, loans shown in the tables below as not collateralised may benefit from such credit mitigants.

Consequently, the figures in the tables below only quantify the value of fixed charges held over a specific

asset (or assets) of a borrower where the group have a history of enforcing, and are able to enforce, the collateral in satisfying a debt in the event of a borrower failing to meet their contractual obligations and where the collateral is cash or can be realised in the form of cash by sale in an established market.

Personal Lending

Residential mortgages by level of collateral (Audited)

	At 31 December 2012 £m	At 31 December 2011 £m
Fully collateralised	86,583	81,184
Less than 25% loan to value ('LTV')	6,872	6,392
25% to 50% LTV	22,009	20,410
51% to 75% LTV	37,358	34,008
76% to 90% LTV	16,392	15,448
91% to 100% LTV	3,952	4,926
Partially collateralised		
greater than 100% LTV	1,835	2,116
collateral value	1,587	1,822
Total residential mortgages	88,418	83,300

The above table shows residential mortgage lending including off-balance sheet loan commitments by level of collateral. The collateral included in the table above consists of first charges on real estate.

The loan-to-value ('LTV') ratio is calculated as the gross on-balance sheet carrying amount of the loan and any off-balance sheet loan commitment at the balance sheet date divided by the value of collateral. The value of

collateral is determined using professional valuations and house price indices. The collateral valuation excludes any adjustments for obtaining and selling the collateral. Valuations must be updated on a regular basis and, as a minimum, at intervals of every three years. More frequent re-valuations are conducted where market conditions or portfolio performance are subject to significant change or where a loan is identified and assessed as impaired.

Mortgage lending by product type (Unaudited)

The following table shows the levels of personal mortgage lending products in the various portfolios in the UK and the rest of Europe.

	UK £m	Continental Europe £m
At 31 December 2012		
Total residential mortgage lending	78,514	4,030
Total impairment allowances on residential mortgage lending	(262)	(40)
Interest-only (including endowment) mortgages	30,719	31
Affordability mortgages, including adjustable rate mortgages	1	330
Other	60	-
Total interest-only and affordability mortgages	30,780	361
As a percentage of total mortgage lending	39.2%	9.0%
At 31 December 2011		
Total residential mortgage lending	71,834	6,037
Total impairment allowances on residential mortgage lending	(247)	(38)
Interest-only (including endowment) mortgages	30,283	62
Affordability mortgages, including ARMs	70	320
Other	63	-
Total interest-only and affordability mortgages	30,416	382
As a percentage of total mortgage lending	42.3%	6.3%

Other personal lending

Other personal lending consists primarily of credit cards and personal loans, both of which are generally unsecured.

Report of the Directors: Risk (continued)

Corporate and commercial and financial non-bank lending

(Audited)

Collateral held is analysed separately for commercial real estate and for other corporate and commercial and financial (non-bank) lending. This reflects the differing

nature of collateral held on these portfolios. In each case, the analysis includes off-balance sheet commitments.

Commercial real estate loans and advances by level of collateral (Audited)

	At 31 December 2012	At 31 December 2011
	£m	£m
Rated CRR/EL 1 to 7	20,398	21,557
Uncollateralised	4,374	3,701
Fully collateralised	14,114	15,854
Partially collateralised	1,910	2,002
- collateral value (partially collateralised)	1,720	1,147
Rated CRR/EL 8 to 10	2,271	2,434
Uncollateralised	259	281
Fully collateralised	1,032	912
Partially collateralised	980	1,241
- collateral value (partially collateralised)	581	699
Total commercial real estate loans and advances	22,669	23,991

The collateral included in the table above consists of fixed first charges on real estate.

The value of collateral is determined through a combination of professional and internal valuations and physical inspection. Due to the complexity of collateral valuations for commercial real estate, local valuation policies determine the frequency of review based on local market conditions. Revaluations are sought with greater frequency where as part of the regular credit assessment of the obligors, material concerns arise in relation to the

transaction which may reflect on the underlying value of the collateral, or in circumstances where an obligor's credit quality has declined sufficiently to cause concern that the principal payment source may not fully meet the obligation. The collateral valuations reported exclude any adjustments for obtaining and selling the collateral.

The following table shows corporate, commercial and financial (non-bank) lending including off balance sheet loan commitments by level of collateralisation.

Other corporate, commercial and financial (non-bank) loans and advances by level of collateral rated CRR/EL 8 to 10 only

(Audited)

	At 31 December 2012	At 31 December 2011
	£m	£m
Uncollateralised	2,996	3,578
Fully collateralised	889	1,140
- LTV ratio less than 25%	42	112
- 25% to 50%	115	177
- 51% to 75%	179	379
- 76% to 90%	115	99
- 90% to 100%	438	373
Partially collateralised	836	883
- collateral value	519	360
Total rated CRR/EL 8 to 10	4,721	5,601

The collateral used in the assessment of the above primarily includes first legal charges over real estate and charges over cash in the commercial and industrial sector, and charges over cash and marketable financial instruments in the financial sector. Government sector lending is generally unsecured.

It should be noted that the table above excludes other types of collateral which are commonly taken for corporate and commercial lending such as unsupported

guarantees and floating charges over the assets of a customer's business. While such mitigants have value, often providing rights in insolvency, their assignable value is insufficiently certain and are therefore assigned no value in these disclosures.

As with commercial real estate, the value of real estate collateral included in the table above is determined through professional valuation. The frequency of revaluation is undertaken on a similar basis to

Report of the Directors: Risk (continued)

commercial real estate loans and advances; however, for financing activities in corporate and commercial lending that are not predominantly commercial real estate oriented collateral value is not as strongly correlated to principal repayment performance. Collateral values will generally be refreshed when an obligor's general credit performance deteriorates and it is necessary to assess the likely performance of secondary sources of repayment should reliance upon them prove necessary. For this

reason, the table above reports values only for customers with CRR 8 to 10, reflecting that these loans and advances generally have valuations which are of comparatively recent vintage. For the purposes of the table above, cash is valued at its nominal value and marketable securities at their fair value.

The collateral valuation excludes any adjustments for obtaining and selling the collateral.

Collateral and other credit enhancements obtained

(Audited)

	The group		The bank	
	2012 £m	2011 £m	2012 £m	2011 £m
Nature of assets				
Residential property ¹	33	38	21	26

1 The table presents the carrying amount of collateral and other credit enhancements obtained which are held at the reporting date.

The group obtained assets by taking possession of collateral held as security, or calling upon other credit enhancements. Repossessed properties are made available for sale in orderly fashion, with the proceeds used to reduce or repay the outstanding indebtedness.

If excess funds arise after the debt has been repaid, they are made available either to repay other secured lenders with lower priority or are returned to the customer. The group does not generally occupy the repossessed properties for its business use.

Loans and advances to customers by industry sector

(Audited)

The group

	At 31 December 2012		At 31 December 2011	
	Gross loans and advances to customers £m	Gross loans by industry sector as a % of total gross loans %	Gross loans and advances to customers £m	Gross loans by industry sector as a % of total gross loans %
Personal				
Residential mortgages	82,544	28.87%	77,871	26.73%
Other personal	23,222	8.12%	33,571	11.52%
	105,766	36.99%	111,442	38.25%
Corporate and commercial				
Commercial, industrial and international trade	78,176	27.34%	71,098	24.40%
Commercial real estate	20,504	7.17%	21,034	7.22%
Other property-related	4,580	1.60%	4,908	1.68%
Government	1,481	0.52%	1,977	0.68%
Other commercial	32,283	11.29%	33,498	11.50%
	137,024	47.92%	132,515	45.48%
Financial				
Non-bank financial institutions	40,539	14.18%	43,881	15.06%
Settlement accounts	316	0.11%	440	0.15%
	40,855	14.29%	44,321	15.21%
Other	2,286	0.80%	3,085	1.06%
Total gross loans and advances	285,931	100.00%	291,363	100.00%

Report of the Directors: Risk (continued)*The bank*

	At 31 December 2012		At 31 December 2011	
	Gross loans and advances to customers £m	Gross loans by industry sector as a % of total gross loans %	Gross loans and advances to customers £m	Gross loans by industry sector as a % of total gross loans %
Personal				
Residential mortgages	76,440	33.46%	69,500	32.48%
Other personal	8,939	3.91%	9,276	4.34%
	85,379	37.37%	78,776	36.82%
Corporate and commercial				
Commercial, industrial and international trade	58,363	25.55%	50,103	23.42%
Commercial real estate	12,613	5.52%	12,675	5.92%
Other property-related	2,999	1.31%	3,201	1.50%
Government	987	0.43%	1,594	0.74%
Other commercial	24,798	10.85%	24,858	11.62%
	99,760	43.66%	92,431	43.20%
Financial				
Non-bank financial institutions	41,030	17.95%	39,616	18.52%
Settlement accounts	36	0.02%	41	0.02%
	41,066	17.97%	39,657	18.54%
Other	2,286	1.00%	3,085	1.44%
Total gross loans and advances	228,491	100.00%	213,949	100.00%

Loans and advances to banks*(Audited)*

The following table shows loans and advances to banks including off-balance sheet loan commitments by level of collateral.

*Loans and advances to banks by level of collateral**(Audited)*

	At 31 December 2012 £m	At 31 December 2011 £m
Uncollateralised	21,368	17,666
Fully collateralised	15,775	20,353
Partially collateralised	39	94
- collateral value	37	67
Total loans and advances to banks	37,182	38,113

The collateral used in the assessment of the above relates primarily to cash and marketable securities. Loans and advances to banks are however typically unsecured. Certain products such as reverse repurchase and stock borrowing are effectively collateralised and have been included in the table above.

Derivatives*(Audited)*

The International Swaps and Derivatives Association ('ISDA') Master Agreement is the group's preferred agreement for documenting derivatives activity. It provides the contractual framework within which dealing activity across a full range of over-the-counter products is conducted, and contractually binds both parties to apply close-out netting across all outstanding transactions covered by an agreement if either party defaults or other pre-agreed termination events occur. It is common, and the group's preferred practice, for the parties to execute a Credit Support Annex ('CSA') in conjunction with the

ISDA Master Agreement. Under a CSA, collateral is passed between the parties to mitigate the market-contingent counterparty risk inherent in the outstanding positions. The majority of the group's CSAs are with financial institutional clients.

Items in the course of collection from other banks*(Audited)*

Settlement risk arises in any situations where a payment in cash, securities or equities is made with the expectation of a corresponding receipt of cash, securities or equities. Daily settlement limits are established for counterparties to cover the aggregate of transactions with each counterparty on any single day.

The group substantially mitigates settlement risk on many transactions, particularly those involving securities and equities, by settling through assured payment systems, or on a delivery-versus-payment basis.

Report of the Directors: Risk (continued)

Trading assets, financial assets designated at fair value and financial investments

(Audited)

Debt securities, treasury and other eligible bills consist of government, bank or other financial institution issued securities for which either government guarantees are held or no collateral is held.

In addition, debt securities include asset-backed securities ('ABS') and similar instruments which are supported by underlying pools of financial assets. The group also purchases credit default swap gross protection to mitigate its exposure to credit risk.

The majority of the loans and advances held in these financial asset classes are made up of reverse repos and stock borrowing which by their nature are collateralised.

Credit quality

Quality classification	Debt securities and other bills External credit rating	Wholesale lending and derivatives		Retail lending	
		Internal credit rating	Probability of default %	Internal credit rating	Expected loss %
Strong	A- and above	CRR1 to CRR2	0 – 0.169	EL1 to EL2	0 – 0.999
Good	BBB+ to BBB-	CRR3	0.170 – 0.740	EL3	1.000 – 4.999
Satisfactory	BB+ to B+ and unrated	CRR4 to CRR5	0.741 – 4.914	EL4 to EL5	5.000 – 19.999
Sub – standard	B and below	CRR6 to CRR8	4.915 – 99.999	EL6 to EL8	20.000 – 99.999
Impaired	Impaired	CRR9 to CRR10	100	EL9 to EL10	100+ or defaulted ¹

¹ The EL percentage is derived through a combination of PD and LGD and may exceed 100 per cent in circumstances where the LGD is above 100 per cent reflecting the cost of recoveries.

Quality classification definitions

(Audited)

'Strong': Exposures demonstrate a strong capacity to meet financial commitments, with negligible or low probability of default and/or low levels of expected loss. Retail accounts operate within product parameters and only exceptionally show any period of delinquency.

'Good': Exposures require closer monitoring and demonstrate a good capacity to meet financial commitments, with low default risk. Retail accounts typically show only short periods of delinquency, with any losses expected to be minimal following the adoption of recovery processes.

'Satisfactory': Exposures require closer monitoring and demonstrate an average to fair capacity to meet financial commitments, with moderate default risk. Retail accounts typically show only short periods of delinquency, with any losses expected to be minor following the adoption of recovery processes.

'Sub-standard': Exposures require varying degrees of special attention and default risk is of greater concern. Retail portfolio segments show longer delinquency periods of generally up to 90 days past due and/or expected losses are higher due to a reduced ability to mitigate these through security realisation or other recovery processes.

'Impaired': Exposures have been assessed, individually or collectively, as impaired.

Collateral accepted as security that the group is permitted to sell or repledge on reverse repos and stock borrowing is disclosed in Note 36 'Assets charged as security for liabilities and collateral accepted as security for assets'.

Credit quality of financial instruments

(Audited)

The five credit quality classifications defined below each encompass a range of more granular, internal credit rating grades assigned to wholesale and retail lending business, as well as the external rating, attributed by external agencies to debt securities. There is no direct correlation between the internal and external ratings at granular level, except to the extent each falls within a single quality classification.

Risk rating scales

(Audited)

The Customer Risk Rating ('CRR') 10-grade scale above summarises a more granular underlying 23-grade scale of obligor probability of default ('PD'). All distinct HSBC customers are rated using one of these two PD scales, depending on the degree of sophistication of the Basel II approach adopted for the exposure.

The Expected Loss ('EL') 10-grade scale for retail business summarises a more granular underlying EL scale for these customer segments; this combines obligor and facility/product risk factors in a composite measure.

For debt securities and certain other financial instruments, external ratings have been aligned to the five quality classifications. The ratings of Standard and Poor's are cited, with those of other agencies being treated equivalently. Debt securities with short-term issue ratings are reported against the long-term rating of the issuer of those securities. If major rating agencies have different ratings for the same debt securities, a prudent rating selection is made in line with regulatory requirements.

For the purpose of the following disclosure, retail loans which are past due up to 89 days and are not otherwise classified as EL9 or EL10, are not disclosed within the EL grade to which they relate, but are separately classified as past due but not impaired. The following tables set out the group's distribution of financial instruments by measures of credit quality.

Report of the Directors: Risk (continued)

Distribution of financial instruments by credit quality (Audited)

The group

31 December 2012

	Neither past due nor impaired							Total £m
	Strong £m	Medium		Sub- Standard £m	Past due not impaired £m	Impaired £m	Impairment allowances £m	
		Good £m	Satisfactory £m					
Cash and balances at central banks	51,613	-	-	-	-	-	-	51,613
Items in the course of collection from other banks	1,961	-	-	-	-	-	-	1,961
Trading assets	99,766	21,027	17,140	691	-	-	-	138,624
- treasury and other eligible bills	931	797	527	3	-	-	-	2,258
- debt securities	41,991	8,017	4,320	248	-	-	-	54,576
- loans and advances to banks	22,123	5,829	4,269	434	-	-	-	32,655
- loans and advances to customers	34,721	6,384	8,024	6	-	-	-	49,135
Financial assets designated at fair value	2,465	243	4,416	27	-	-	-	7,151
- treasury and other eligible bills	-	-	-	-	-	-	-	-
- debt securities	2,438	243	4,414	27	-	-	-	7,122
- loans and advances to banks	27	-	2	-	-	-	-	29
- loans and advances to customers	-	-	-	-	-	-	-	-
Derivatives	145,481	18,758	12,537	1,032	-	-	-	177,808
Loans and advances held at amortised cost	174,617	66,580	62,145	6,678	1,403	6,818	(3,270)	314,971
- loans and advances to banks	25,104	4,845	2,185	136	-	40	(24)	32,286
- loans and advances to customers	149,513	61,735	59,960	6,542	1,403	6,778	(3,246)	282,685
Financial investments	58,038	4,730	3,956	1,954	-	1,559	-	70,237
- treasury and other eligible bills	4,199	530	474	-	-	-	-	5,203
- debt securities	53,839	4,200	3,482	1,954	-	1,559	-	65,034
Other assets	3,740	353	1,883	707	4	17	-	6,704
- endorsements and acceptances	271	21	487	-	-	-	-	779
- accrued income and other	3,469	332	1,396	707	4	17	-	5,925

Report of the Directors: Risk (continued)

The group

31 December 2011

	Neither past due nor impaired							Total £m
	Strong £m	Medium		Sub- Standard £m	Past due not impaired £m	Impaired £m	Impairment allowances £m	
		Good £m	Satisfactory £m					
Cash and balances at central banks	56,460	–	–	–	–	–	–	56,460
Items in the course of collection from other banks	1,663	–	–	–	–	–	–	1,663
Trading assets	95,586	9,538	8,839	694	–	–	–	114,657
– treasury and other eligible bills	1,205	12	79	5	–	–	–	1,301
– debt securities	45,633	1,769	3,573	311	–	–	–	51,286
– loans and advances to banks	21,108	6,209	2,640	378	–	–	–	30,335
– loans and advances to customers	27,640	1,548	2,547	–	–	–	–	31,735
Financial assets designated at fair value	3,206	119	4,529	2	–	–	–	7,856
– treasury and other eligible bills	5	–	–	–	–	–	–	5
– debt securities	2,669	119	4,495	2	–	–	–	7,285
– loans and advances to banks	36	–	34	–	–	–	–	70
– loans and advances to customers	496	–	–	–	–	–	–	496
Derivatives	147,277	19,776	9,108	832	–	–	–	176,993
Loans and advances held at amortised cost	190,059	66,882	61,372	8,946	1,225	7,514	(3,381)	332,617
– loans and advances to banks	40,747	2,729	1,077	35	–	47	(32)	44,603
– loans and advances to customers	149,312	64,153	60,295	8,911	1,225	7,467	(3,349)	288,014
Financial investments ...	81,868	3,690	3,128	1,776	–	1,426	–	91,888
– treasury and other eligible bills	6,156	485	74	22	–	–	–	6,737
– debt securities	75,712	3,205	3,054	1,754	–	1,426	–	85,151
Other assets	5,313	336	2,456	350	20	19	–	8,494
– endorsements and acceptances	384	15	331	–	–	–	–	730
– accrued income and other	4,929	321	2,125	350	20	19	–	7,764

Report of the Directors: Risk (continued)

The bank

31 December 2012

	Neither past due nor impaired							Total £m
	Strong £m	Medium		Sub- Standard £m	Past due not impaired £m	Impaired £m	Impairment allowances £m	
		Good £m	Satisfactory £m					
Cash and balances at central banks	45,262	–	–	–	–	–	–	45,262
Items in the course of collection from other banks	1,213	–	–	–	–	–	–	1,213
Trading assets	87,801	15,202	12,280	666	–	–	–	115,949
– treasury and other eligible bills	537	65	515	3	–	–	–	1,120
– debt securities	23,704	4,334	1,798	248	–	–	–	30,084
– loans and advances to banks	30,686	4,659	2,504	409	–	–	–	38,258
– loans and advances to customers	32,874	6,144	7,463	6	–	–	–	46,487
Financial assets designated at fair value	–	–	4,373	–	–	–	–	4,373
– debt securities	–	–	4,373	–	–	–	–	4,373
– loans and advances to banks	–	–	–	–	–	–	–	–
Derivatives	112,617	16,419	10,306	998	–	–	–	140,340
Loans and advances held at amortised cost	140,218	46,326	47,277	5,872	615	5,409	(2,943)	242,774
– loans and advances to banks	10,252	2,925	2,329	995	–	725	(19)	17,207
– loans and advances to customers	129,966	43,401	44,948	4,877	615	4,684	(2,924)	225,567
Financial investments	33,955	822	1,059	151	–	129	–	36,116
– treasury and other similar bills	4,177	294	451	–	–	–	–	4,922
– debt securities	29,778	528	608	151	–	129	–	31,194
Other assets	3,242	338	698	2	–	–	–	4,280
– endorsements and acceptances	31	13	481	–	–	–	–	525
– accrued income and other	3,211	325	217	2	–	–	–	3,755

Report of the Directors: Risk (continued)

The bank

31 December 2011

	Neither past due nor impaired							Total £m
	Strong £m	Medium		Sub- Standard £m	Past due not impaired £m	Impaired £m	Impairment allowances £m	
		Good £m	Satisfactory £m					
Cash and balances at central banks	44,967	–	–	–	–	–	–	44,967
Items in the course of collection from other banks	908	–	–	–	–	–	–	908
Trading assets	82,587	6,259	5,362	644	–	–	–	94,852
– treasury and other eligible bills	623	3	79	4	–	–	–	709
– debt securities	24,172	1,310	1,287	310	–	–	–	27,079
– loans and advances to banks	30,751	3,497	1,829	330	–	–	–	36,407
– loans and advances to customers	27,041	1,449	2,167	–	–	–	–	30,657
Financial assets designated at fair value	239	–	4,356	–	–	–	–	4,595
– debt securities	239	–	4,356	–	–	–	–	4,595
– loans and advances to banks	–	–	–	–	–	–	–	–
Derivatives	121,052	16,474	7,108	790	–	–	–	145,424
Loans and advances held at amortised cost	135,742	44,977	41,217	7,663	602	5,977	(3,414)	232,764
– loans and advances to banks	17,464	2,499	818	822	–	626	(26)	22,203
– loans and advances to customers	118,278	42,478	40,399	6,841	602	5,351	(3,388)	210,561
Financial investments ...	40,174	613	607	173	–	180	–	41,747
– treasury and other similar bills	3,722	312	72	–	–	–	–	4,106
– debt securities	36,452	301	535	173	–	180	–	37,641
Other assets	3,596	315	545	4	–	–	–	4,460
– endorsements and acceptances	69	9	315	–	–	–	–	393
– accrued income and other	3,527	306	230	4	–	–	–	4,067

Report of the Directors: Risk (continued)

Past due but not impaired gross financial instruments

Past due but not impaired loans are those for which the customer is in the early stages of delinquency and has failed to make payment, or a partial payment in accordance with the contractual terms of the loan agreement. This is typically where a loan is less than 90 days past due and there are no other indicators of impairment. Further examples of exposures past due but

not impaired include overdue loans fully secured by cash collateral; mortgages that are individually assessed for impairment and that are in arrears more than 90 days, but where the value of collateral is sufficient to repay both the principal debt and all potential interest for at least one year; and short-term trade facilities past due more than 90 days for technical reasons such as delays in documentation, but where there is no concern over the creditworthiness of the counterparty.

Ageing analysis of days past due but not impaired gross financial instruments

(Audited)

The group

	Up to 29 days £m	30-59 days £m	60-89 days £m	90-179 days £m	Over 180 days £m	Total £m
At 31 December 2012						
Loans and advances held at amortised cost	900	331	149	16	7	1,403
Other assets	3	–	–	–	1	4
	903	331	149	16	8	1,407
At 31 December 2011						
Loans and advances held at amortised cost	696	236	266	21	6	1,225
Other assets	6	2	3	4	5	20
	702	238	269	25	11	1,245

The bank

	Up to 29 days £m	30-59 days £m	60-89 days £m	90-179 days £m	Over 180 days £m	Total £m
At 31 December 2012						
Loans and advances held at amortised cost	371	143	101	–	–	615
At 31 December 2011						
Loans and advances held at amortised cost	349	141	96	15	1	602

Forbearance strategies and renegotiated loans

(Audited)

The group may renegotiate the terms and conditions of a loan for a number of reasons which include changing market conditions, customer retention and other reasons not related to the credit condition of a customer. Under certain circumstances, the group may renegotiate the terms and conditions of a loan in response to actual or perceived financial difficulties of a customer; this practice of renegotiation for credit purposes is known as loan forbearance.

A range of forbearance strategies are employed in order to improve the management of customer relationships, maximise collection opportunities and, if possible, avoid default, foreclosure or repossession. The policies and practices are based on criteria which, in the judgement of local management, indicate that repayment is likely to continue.

Forbearance strategies include extended payment terms, a reduction in interest or principal repayments, approved external debt management plans, debt consolidations, the deferral of foreclosure, and other forms of loan modifications and re-ageing. These management policies and practices typically provide the customer with terms and conditions that are more favourable than those provided initially. Such arrangements could include cases where an account is brought up-to-date without full repayment of all arrears.

Loan forbearance is only granted in situations where the customer has showed a willingness to repay the borrowing and is expected to be able to meet the revised obligations.

From this point forward, the group discloses loan forbearance as 'renegotiated loans', which represent payment arrangement concessions granted which the

Report of the Directors: Risk (continued)

group would not normally consider as a result of financial difficulties of a customer.

For retail lending, the group's credit risk management policy sets out restrictions on the number and frequency of renegotiations, the minimum period an account must have been opened before any renegotiation can be considered and the number of qualifying payments that must be received. The application of this policy varies according to the nature of the market, the product and the management of customer relationships through the occurrence of exceptional events.

A loan that has been subject to a change in contractual cash flows as a result of renegotiation for credit purposes will be classified on renegotiation as impaired, unless the delay in payment is insignificant and there are no other indicators of impairment. The loan will remain classified as impaired until it has demonstrated a history of payment performance against the original or revised terms, as appropriate to the circumstances, that is sufficient to demonstrate a significant reduction in the risk of non-payment of future cash flows.

For retail lending the minimum period of payment performance required is dependent on the portfolio, but is typically no less than six months of keeping up to date with scheduled payments. This period of payment

performance is in addition to the receipt of a minimum of two payments within a 60 day period from a customer to initially qualify for the renegotiation. These qualifying payments are required in order to demonstrate that the renegotiated terms are sustainable for the borrower. For corporate and commercial lending, which are individually assessed and where non-monthly payments are more commonly agreed, the history of payment performance will depend on the underlying structure of payments agreed as part of the restructure.

Renegotiated loans are considered when calculating collective impairment allowances, either through management's judgement or by segregation from other parts of the portfolio. Within the retail portfolio, when empirical evidence indicates an increased propensity to default and higher losses on such accounts, the use of roll rate methodology ensures this factor is taken into account when calculating impairment allowances. The carrying amount of loans that have been classified as renegotiated retain this classification until maturity or derecognition. Interest is recorded on renegotiated loans on the basis of the new contractual terms following renegotiation.

The following table shows the group's holdings of renegotiated loans and advances to customers by industry sector and credit quality classification.

Renegotiated loans and advances to customers

(Audited)

	At 31 December 2012				At 31 December 2011 ¹			
	Not past due nor impaired £m	Past due but not impaired £m	Impaired £m	Total £m	Not past due nor impaired £m	Past due but not impaired £m	Impaired £m	Total £m
Retail								
Residential Mortgages	420	131	622	1,173	341	88	624	1,053
Other personal	297	39	82	418	263	47	103	413
Commercial real estate	713	–	1,382	2,095	809	–	1,333	2,142
Corporate and commercial	877	57	1,325	2,259	982	46	1,091	2,119
Financial	5	–	199	204	7	–	303	310
Governments	–	–	–	–	–	–	–	–
Total renegotiated loans and advances to customers	2,312	227	3,610	6,149	2,402	181	3,454	6,037
Impairment allowances:								
Collectively assessed				(15)				(69)
Individually assessed				(1,063)				(1,137)
Total impairment allowance on renegotiated loans				(1,078)				(1,206)

¹ In 2012 the group definition of renegotiated loans was revised, and comparatives have been updated to reflect this change. The revised definition excludes loan modifications that do not affect payment arrangements since, by themselves, such changes do not necessarily indicate credit distress affecting payment capacity.

Impaired loans

(Audited)

Impaired loans and advances are those that meet any of the following criteria:

- loans and advances classified as CRR9, CRR10, EL9 or EL10 (a description of the group's internal credit ratings is provided on page 47;
- retail exposures 90 days or more past due (may be longer for mortgages), unless individually they have been assessed as not impaired; or
- renegotiated loans and advances that have been subject to a change in contractual cash flows as a

Report of the Directors: Risk (continued)

result of a concession which the lender would not otherwise consider, and where it is probable that without the concession the borrower would be unable to meet its contractual payment obligations in full, unless the concession is insignificant and there are no other indicators of impairment. Renegotiated

loans remain classified as impaired until there is sufficient evidence to demonstrate a significant reduction in the risk of non-payment of future cash flows, and there are no other indicators of impairment.

Impaired loans and advances to customers and banks by industry sector*(Audited)*

	Impaired loans and advances at 31 December 2012			Impaired loans and advances at 31 December 2011		
	Individually assessed £m	Collectively assessed £m	Total £m	Individually assessed £m	Collectively assessed £m	Total £m
Banks	40	–	40	47	–	47
Customers	6,131	647	6,778	6,775	692	7,467
Personal	845	618	1,463	1,034	662	1,696
Corporate and commercial	4,941	29	4,970	5,198	30	5,228
Financial	345	–	345	543	–	543
	6,171	647	6,818	6,822	692	7,514

Impairment allowances and charges on loans and advances to customers*(Audited)*

The table below analyses the impairment allowances recognised for impaired loans and advances that are either individually assessed or collectively assessed, and

collective impairment allowances on loans and advances classified as not impaired.

	As at 31 December	
	2012 £m	2011 £m
Gross loans and advances		
Individually assessed impaired loans ¹	6,131	6,775
Collectively assessed ²	279,800	284,588
Impaired loans ¹	647	692
Non-Impaired loans ³	279,153	283,896
Total gross loans and advances	285,931	291,363
Impairment allowances		
Individually assessed	2,327	2,429
Collectively assessed	919	920
Total impairment allowances	3,246	3,349
Individually assessed allowances as a percentage of individually assessed loans and advances	38.0%	35.9%
Collectively assessed allowances as a percentage of collectively assessed loans and advances	0.33%	0.32%

1 Impaired loans and advances are those classified as CRR 9, CRR 10, EL 9 or EL 10 and all retail loans 90 days or more past due.

2 Collectively assessed loans and advances comprise homogeneous groups of loans that are not considered individually significant, and loans subject to individual assessment where no impairment has been identified on an individual basis, but on which a collective impairment allowances has been calculated to reflect losses which have been incurred but not yet identified.

3 Collectively assessed loans and advances not impaired are those classified as CRR1 to CRR8 and EL1 to EL8 but excluding retail loans 90 days past due.

Report of the Directors: Risk (continued)**Impairment allowances on loans and advances to customers and banks by industry sector**

(Audited)

	At 31 December 2012			At 31 December 2011		
	Individually assessed allowances £m	Collectively assessed allowances £m	Total allowances £m	Individually assessed allowances £m	Collectively assessed allowances £m	Total allowances £m
Banks	24	–	24	32	–	32
Customers	2,327	919	3,246	2,429	920	3,349
Personal	296	565	861	351	615	966
Corporate and commercial	1,841	346	2,187	1,804	298	2,102
Financial	190	8	198	274	7	281
	2,351	919	3,270	2,461	920	3,381

Impairment allowances as a percentage of gross loans and advances¹

(Audited)

The group

	At 31 December	
	2012 %	2011 %
<i>Banks</i>		
Individually assessed impairment allowances	0.13	0.13
<i>Customers</i>		
Individually assessed impairment allowances	0.87	0.91
Collectively assessed impairment allowances	0.34	0.34
	1.34	1.38

The bank

	At 31 December	
	2012 %	2011 %
<i>Banks</i>		
Individually assessed impairment allowances	0.13	0.13
<i>Customers</i>		
Individually assessed impairment allowances	1.04	1.35
Collectively assessed impairment allowances	0.27	0.29
	1.44	1.77

¹ Net of reverse repo transactions, settlement accounts and stock borrowings.

Report of the Directors: Risk (continued)

Movement in impairment allowances on loans and advances to customers and banks

(Audited)

The group

	Banks	Customers		Total £m
	Individually assessed £m	Individually assessed £m	Collectively assessed £m	
At 1 January 2012	32	2,429	920	3,381
Amounts written off	(7)	(942)	(526)	(1,475)
Recoveries of loans and advances written off in previous years	–	35	179	214
Charge to income statement	–	875	338	1,213
Disposal of subsidiary	–	(18)	(2)	(20)
Foreign exchange and other movements	(1)	(52)	10	(43)
At 31 December 2012	24	2,327	919	3,270
At 1 January 2011	50	2,248	1,282	3,580
Amounts written off	(10)	(571)	(1,046)	(1,627)
Recoveries of loans and advances written off in previous years	–	19	278	297
Charge to income statement	(7)	794	435	1,222
Foreign exchange and other movements	(1)	(61)	(29)	(91)
At 31 December 2011	32	2,429	920	3,381

The bank

	Banks	Customers		Total £m
	Individually assessed £m	Individually assessed £m	Collectively assessed £m	
At 1 January 2012	26	2,786	602	3,414
Amounts written off	(8)	(820)	(380)	(1,208)
Recoveries of loans and advances written off in previous years	–	35	135	170
Charge to income statement	1	348	231	580
Foreign exchange and other movements	–	(24)	11	(13)
At 31 December 2012	19	2,325	599	2,943
At 1 January 2011	21	2,389	621	3,031
Amounts written off	–	(434)	(523)	(957)
Recoveries of loans and advances written off in previous years	–	20	168	188
Charge to income statement	5	839	336	1,180
Foreign exchange and other movements	–	(28)	–	(28)
At 31 December 2011	26	2,786	602	3,414

Report of the Directors: Risk (continued)

Movement in impairment allowances by industry sector

(Unaudited)

	2012 £m	2011 £m	2010 £m	2009 £m	2008 £m
Impairment allowances at 1 January	3,381	3,580	3,649	2,545	1,796
Amounts written off	(1,475)	(1,627)	(1,824)	(1,580)	(1,150)
Personal	(499)	(996)	(834)	(1,012)	(859)
– residential mortgages	(17)	(15)	(31)	(25)	(2)
– other personal	(482)	(981)	(803)	(987)	(857)
Corporate and commercial	(902)	(612)	(980)	(508)	(280)
– commercial, industrial and international trade	(416)	(345)	(247)	(275)	(200)
– commercial real estate and other property-related	(238)	(165)	(648)	(93)	(42)
– other commercial	(248)	(102)	(85)	(140)	(38)
Financial ¹	(74)	(19)	(10)	(60)	(11)
Recoveries of amounts written off in previous years	214	297	159	170	157
Personal	180	268	136	133	150
– residential mortgages	21	13	19	17	–
– other personal	159	255	117	116	150
Corporate and commercial	32	27	22	32	7
– commercial, industrial and international trade	11	11	11	30	4
– commercial real estate and other property-related	6	5	4	2	3
– other commercial	15	11	7	–	–
Financial ¹	2	2	1	5	–
Charge to income statement	1,213	1,222	1,633	2,619	1,716
Personal	250	415	803	1,130	876
– residential mortgages	(34)	60	99	100	11
– other personal	284	355	704	1,030	865
Corporate and commercial	974	798	709	1,329	749
– commercial, industrial and international trade	420	261	322	543	304
– commercial real estate and other property-related	279	310	232	626	304
– other commercial	275	227	155	160	141
Financial ¹	(11)	9	121	160	91
Governments	–	–	–	–	–
Exchange and other movements	(63)	(91)	(37)	(105)	26
Impairment allowances at 31 December	3,270	3,381	3,580	3,649	2,545
Impairment allowances against banks:					
– individually assessed	24	32	50	57	43
Impairment allowances against customers:					
– individually assessed	2,327	2,429	2,248	2,312	1,380
– collectively assessed	919	920	1,282	1,280	1,122
Impairment allowances at 31 December	3,270	3,381	3,580	3,649	2,545
Impairment allowances against customers as a percentage of loans and advances to customers	%	%	%	%	%
– individually assessed	0.83	0.84	0.78	0.84	0.46
– collectively assessed	0.33	0.32	0.45	0.47	0.38
At 31 December	1.16	1.16	1.23	1.31	0.84

¹ Includes movements in impairment allowances against banks.

Report of the Directors: Risk (continued)**Individually and collectively assessed charge to impairment allowances by industry segment**

(Unaudited)

	2012		
	Individually assessed £m	Collectively assessed £m	Total £m
Banks	–	–	–
Personal	7	243	250
– Residential mortgages	(21)	(13)	(34)
– Other personal	28	256	284
Corporate and commercial	878	96	974
– Commercial, industrial and international trade	401	19	420
– Commercial real estate and other property-related	236	43	279
– Other commercial	241	34	275
Financial	(10)	(1)	(11)
Total charge to income statement	875	338	1,213

	2011		
	Individually assessed £m	Collectively assessed £m	Total £m
Banks	(7)	–	(7)
Personal	66	349	415
– Residential mortgages	38	22	60
– Other personal	28	327	355
Corporate and commercial	712	86	798
– Commercial, industrial and international trade	216	45	261
– Commercial real estate and other property-related	275	34	309
– Other commercial	221	7	228
Financial	16	–	16
Total charge to income statement	787	435	1,222

Net loan impairment charge to the income statement

(Unaudited)

	2012 £m	2011 £m	2010 £m	2009 £m	2008 £m
Individually assessed impairment allowances					
New allowances	1,233	1,042	1,157	1,654	893
Release of allowances no longer required	(323)	(236)	(256)	(167)	(180)
Recoveries of amounts previously written off	(35)	(19)	(22)	(44)	(22)
	875	787	879	1,443	691
Collectively assessed impairment allowances					
New allowances net of allowance required	693	881	1,008	1,445	1,266
Release of allowances no longer required	(176)	(168)	(117)	(143)	(106)
Recoveries of amounts previously written off	(179)	(278)	(137)	(126)	(135)
	338	435	754	1,176	1,025
Total charge for impairment losses	1,213	1,222	1,633	2,619	1,716
Banks	–	(7)	2	35	35
Customers	1,213	1,229	1,631	2,584	1,681
Charge for impairment losses as a percentage of closing gross loans and advances	0.38	0.36	0.47	0.81	0.49
At 31 December	£m	£m	£m	£m	£m
Impaired loans	6,818	7,514	6,783	6,623	3,744
Impairment allowances	3,270	3,381	3,580	3,649	2,545

Charge for impairment losses as a percentage of average gross loans and advances to customers

(Unaudited)

	2012 %	2011 %	2010 %	2009 %	2008 %
Net allowances net of allowances releases	0.53	0.53	0.72	1.11	0.78
Recoveries	(0.08)	(0.10)	(0.06)	(0.07)	(0.07)
Total charge for impairment losses	0.45	0.43	0.66	1.04	0.71
Amount written off net of recoveries	0.46	0.46	0.67	0.63	0.48

Report of the Directors: Risk (continued)

Securitisation exposures and other structured products

(Audited)

Asset-backed securities

During the period a total valuation increase of £2,514 million on available-for-sale assets was recognised in other comprehensive income. This primarily relates to valuation losses on asset-backed securities.

The table shows the group's market risk exposure to asset-backed securities (including those carried at fair value through profit and loss and those classified as available-for-sale).

Analysis of asset-backed securities

(Audited)

	31 December 2012				31 December 2011			
	Gross principal ² £m	Gross principal protection ³ £m	Net Principal exposure ^{4,6} £m	Carrying Amount ^{5,6} £m	Gross principal ² £m	Gross principal protection ³ £m	Net Principal exposure ^{4,6} £m	Carrying Amount ^{5,6} £m
High grade ¹	14,237	5,009	9,228	8,347	17,858	4,609	13,249	12,402
Rated C to A	14,235	241	13,995	10,059	16,714	435	16,279	10,536
Not publicly rated	522	–	522	340	788	–	788	261
Total asset-backed securities.....	28,994	5,250	23,745	18,746	35,360	5,044	30,316	23,199

1 High grade assets rated AA or AAA.

2 The gross principal is the redemption amount on maturity or, in the case of an amortising instrument, the sum of the future redemption amounts through the residual life of the security.

3 Gross principal of the underlying instrument that is protected by credit default swaps (CDSs) or by matching liabilities.

4 Net principal exposure is the value of gross principal amount of assets that are not protected by CDSs or by matching liabilities. It includes assets that benefit from monoline protection, except where this protection is purchased with a CDS.

5 Carrying amount of the Net Principal exposure.

6 The asset backed securities are primarily US dollar ('USD') denominated. Principal and carrying amounts are converted into sterling ('GBP') at the prevailing exchange rates at 31 December (2012: 1GBP:USD 1.6163; 2011: 1GBP:USD 1.548).

Included in the above table are securities with a carrying amount of £7,311 million (2011: £7,575 million) held through special purpose entities ('SPEs') that are consolidated by the group. Although the group includes these assets in full on its balance sheet, significant first loss risks are borne by third party investors, through the investors' holdings of capital notes subordinate to the group's holdings. The carrying amount of the capital note liabilities has been decreased by impairment charges of £249 million for the year ended 31 December 2012 (2011: decreased by impairment charges of £202 million).

Special purpose entities

The group enters into certain transactions with customers in the ordinary course of business which involve the establishment of SPEs to facilitate or secure customer transactions.

The group structures that utilise SPEs are authorised centrally when they are established to ensure appropriate purpose and governance. The activities of SPEs administered by the group are closely monitored by senior management.

SPEs are assessed for consolidation in accordance with the accounting policy set out in Note 1(c).

Conduits

The group sponsors and manages two types of conduits: securities investment conduits ('SICs') and multi-seller conduits.

Securities investment conduits

Solitaire, the group's principal SIC, purchases highly rated asset-backed securities ('ABSs') to facilitate tailored investment opportunities. The group's other SICs, Mazarin, Barion and Malachite, evolved from the restructuring of the group's sponsored structured investment vehicles ('SIVs') in 2008.

During the year impairment charges in Mazarin exceeded the carrying value of the capital notes liability and a charge of £76 million (2011: £17 million) was borne by the group. In respect of the SICs, the capital notes held by third parties are expected to absorb the cash losses in the vehicles.

Multi-seller conduits

These vehicles were established for the purpose of providing access to flexible market-based sources of finance for the group's clients.

Money market funds

The group has established and manages a number of money market funds which provide customers with tailored investment opportunities within narrow and well-defined objectives.

Non-money market investment funds

The group has established a large number of non-money market investment funds to enable customers to invest in a range of assets, typically equities and debt securities.

Report of the Directors: Risk (continued)

Securitisations

The group uses SPEs to securitise customer loans and advances it has originated, mainly in order to diversify its sources of funding for asset origination and for capital efficiency purposes. The SPEs are not consolidated when the group is not exposed to the majority of risks and rewards of ownership.

Other

The group also establishes, in the normal course of business for a number of purposes, for example, structured credit transactions for customers to provide finance to public and private sector infrastructure projects, and for asset and structured finance transactions.

Third party sponsored SPEs

Through standby liquidity facility commitments, the group has exposure to third party sponsored SIVs, conduits and securitisations under normal banking arrangements on standard market terms. These exposures are not considered significant to the group's operations.

Additional off-balance sheet arrangements and commitments

Additional off-balance sheet commitments such as financial guarantees, letters of credit and commitments to lend are disclosed in Note 39.

Leveraged finance transactions

Loan commitments in respect of leveraged finance transactions are accounted for as derivatives where it is the group's intention to sell the loan after origination.

Liquidity and funding risk

(Audited)

Liquidity risk is the risk that the group does not have sufficient financial resources to meet its obligations as they fall due, or will have access to such resources only at an excessive cost. This risk arises from mismatches in the timing of cash flows. Funding risk (a form of liquidity risk) arises when the liquidity needed to fund illiquid asset positions cannot be obtained on the expected terms and when required.

The objective of the group's liquidity and funding management framework is to ensure that all foreseeable funding commitments can be met when due, and that access to the wholesale markets is co-ordinated and cost-effective. To this end, the group maintains a diversified funding base comprising core retail and corporate customer deposits and institutional balances. This is augmented with wholesale funding and portfolios of highly liquid assets diversified by currency and maturity which are held to enable the group to respond quickly and smoothly to unforeseen liquidity requirements.

The group requires its operating entities to maintain strong liquidity positions and to manage the liquidity profiles of their assets, liabilities and commitments with

the objective of ensuring that their cash flows are balanced appropriately and that all their anticipated obligations can be met when due.

The group adapts its liquidity and funding risk management framework in response to changes in the mix of business that it undertakes, and to changes in the nature of the markets in which it operates. The group also seeks to continuously evolve and strengthen its liquidity and funding risk management framework.

The group employs a number of measures to monitor liquidity risk. The group also manages its intra-day liquidity positions so that it is able to meet payment and settlement obligations on a timely basis. Payment flows in real time gross settlement systems, expected peak payment flows and large time-critical payments are monitored during the day and the intra-day collateral position is managed so that there is liquidity available to meet payments.

The management of liquidity and funding is primarily undertaken locally in the group's operating entities in compliance with policies and limits set by the RMM. These limits vary according to the depth and liquidity of the market in which the entities operate. It is the group's general policy that each banking entity should manage its liquidity and funding risk on a standalone basis. Exceptions are permitted for certain short-term treasury requirements and start-up operations or for branches which do not have access to local deposit markets. These entities are funded from the group's largest banking operations and within clearly defined internal and regulatory guidelines and limits. The limits place formal restrictions on the transfer of resources between group entities and reflect the range of currencies, markets and time zones within which the group operates.

The group's liquidity and funding management process includes:

- projecting cash flows by major currency under various stress scenarios and considering the level of liquid assets necessary in relation to these;
- monitoring balance sheet liquidity and advances to core funding ratios at both a consolidated and major currency level against internal and regulatory requirements;
- maintaining a diverse range of funding sources with back-up facilities;
- managing the concentration and profile of debt maturities;
- managing contingent liquidity commitment exposures within pre-determined caps;
- maintaining debt financing plans;
- monitoring depositor concentration in order to avoid undue reliance on large individual depositors and ensure a satisfactory overall funding mix; and

Report of the Directors: Risk (continued)

- maintaining liquidity and funding contingency plans. These plans identify early indicators of stress conditions and describe actions to be taken in the event of difficulties arising from systemic or other crises, while minimising adverse long-term implications for the business.

Liquidity and funding in 2012

(Unaudited)

The group retained a strong liquidity position in 2012. The group's loans to customers during 2012 grew by 7 per cent and customer deposits by 11 per cent. In addition, the group maintained good access to wholesale markets.

The management of liquidity risk

(Audited)

The group uses a number of principal measures to manage liquidity risk, as described below.

Inherent Liquidity Risk Categorisation

The group categorises its operating entities into one of three categories to reflect its assessment of their inherent liquidity risk, considering political, economic and regulatory factors within the operating entities' host country, and also factors specific to the entity itself, such as the local footprint, market share, balance sheet strength and control framework. This assessment is used to determine the severity of the liquidity stress that the group expects its operating entities to be able to withstand.

Advances to core funding ratios¹

(Audited)

	At 31 December	
	2012 (%)	2011 (%)
<i>HSBC UK²</i>		
Year end	106.4	99.8
Maximum	106.4	103.4
Minimum	99.8	98.4
Average	103.5	100.8
<i>HSBC France</i>		
Year end	97.3	86.7
Maximum	97.3	107.6
Minimum	81.2	86.7
Average	87.9	101.3
<i>Total of other principal group entities³</i>		
Year end	91.7	82.3
Maximum	92.9	88.8
Minimum	82.3	81.0
Average	87.5	85.6

1 This ratio measures loans and advances to customers as a percentage of the total of core customer deposits and term funding with a remaining term to maturity in excess of one year. The lower the percentage, the stronger the funding position

2 The HSBC UK entity shown comprises three legal entities; HSBC Bank plc (including all overseas branches), Marks and Spencer Financial Services Limited and HSBC Trust Company (UK) Limited, managed as a single operating entity, in line with the application of UK liquidity regulation as agreed with the UK FSA

3 Other principal entities are: HSBC Trinkaus & Burkhart AG, HSBC Bank Malta plc and HSBC Bank A.S. (Turkey)

Report of the Directors: Risk (continued)

Core deposits

The group's internal framework is based on its categorisation of customer deposits into core and non-core. This characterisation takes into account the inherent liquidity risk categorisation of the entity originating the deposit, the nature of the customer and the size and pricing of the deposit.

Projected cash flow scenario analyses

The group uses a number of standard projected cash flow scenarios designed to model both group-specific and market-wide liquidity crises in which the rate and timing of deposit withdrawals and drawdowns on committed lending facilities are varied and the ability to access interbank funding and term debt markets and generate funds from asset portfolios is restricted. The scenarios are modelled by all group banking entities. The appropriateness of the assumptions under each scenario is regularly reviewed. In addition to the group's standard projected cash flow scenarios, individual entities are required to design their own scenarios tailored to reflect specific local market conditions, products and funding bases.

Stressed one-month and three-month coverage ratios¹ (Audited)

	Stressed one-month coverage ratios at 31 December		Stressed three-month coverage ratios at 31 December	
	2012 (%)	2011 (%)	2012 (%)	2011 (%)
<i>HSBC UK</i>				
Year end	114.0	116.2	102.7	101.8
Maximum	117.0	118.1	102.8	101.8
Minimum	107.7	109.4	100.8	99.1
Average	112.4	112.5	101.9	100.4
<i>HSBC France</i>				
Year end	112.0	109.4	103.7	101.5
Maximum	117.7	110.0	108.0	103.5
Minimum	107.0	105.3	101.5	100.6
Average	111.4	107.3	104.6	102.0
<i>Total of other principal group entities</i>				
Year end	113.6	117.5	106.0	107.3
Maximum	118.4	135.7	107.3	119.4
Minimum	105.5	110.6	101.5	103.6
Average	112.4	117.5	104.4	108.4

¹ This ratio measures the liquid assets available to meet net cash outflows over a 30 day/ 90 day period. The higher the percentage, the greater the liquidity.

Liquid assets

(Audited)

The table of the liquid assets shows the estimated liquidity value (before haircuts) of assets categorised as liquid used for the purposes of calculating the three month stressed coverage ratio, as defined under the HSBC Group framework.

Liquid assets are held and managed on a standalone operating entity basis. The vast majority of liquid assets shown are held directly by each operating entity's Balance Sheet Management function, primarily for the

Limits for cumulative net cash flows under stress scenarios are set for each banking entity.

Both ratio and cash flow limits reflect the local market place, the diversity of funding sources available and the concentration risk from large depositors.

Stressed coverage ratios

(Audited)

The stressed coverage ratios tabulated below express stressed cash inflows as a percentage of stressed cash outflows over a one-month and three-month time horizon. Operating entities are required to maintain a ratio of 100 per cent or greater out to three months.

At 31 December 2012, the one-month and three-month stressed coverage ratios for the principal entities shown in the table below were in excess of the 100 per cent target.

In general, customer advances are assumed to be renewed and as a result are not assumed to generate a stressed cash inflow or represent a liquidity resource.

purpose of managing liquidity risk, in line with the Group's liquidity and funding risk management framework.

Liquid assets also include any unencumbered liquid assets held outside Balance Sheet Management for any other purpose. The Group's liquidity risk management framework gives ultimate control of all unencumbered assets and sources of liquidity to Balance Sheet Management.

Report of the Directors: Risk (continued)

Liquid assets (Audited)

	Estimated liquidity value at 31 December	
	2012 £m	2011 £m
HSBC UK		
Level 1	80,712	74,018
Level 2	186	222
Level 3	14,726	–
Non-government assets	–	14,858
	95,624	89,098
HSBC France		
Level 1	14,065	7,252
Level 2	1,567	8
Level 3	452	–
Non-government assets	–	1,167
	16,084	8,427
Total of other principal group entities		
Level 1	7,275	7,760
Level 2	1,269	1,202
Level 3	734	629
Non-government assets	–	–
	9,278	9,591

The Group's liquid asset policy was refined as at 1 January 2012 to apply a more granular classification of liquid assets. These classifications are as follows:

- *Level 1* - Central governments, central banks, supranationals and multilateral development banks;
- *Level 2* – Local and regional governments, public sector entities, secured covered bonds and pass-through ABSs, and gold; and
- *Level 3* – Unsecured non-financial entity securities and equities listed on recognised exchanges and within liquid indices.

The group's contractual exposures as at 31 December monitored under the contingent liquidity risk limit structure (Audited)

	The group	
	2012 £bn	2011 £bn
Conduits		
Client-originated assets ¹		
– total lines	6.3	8.3
– largest individual lines	0.4	0.4
Assets managed by the group	11.2	14.3
Single-issuer liquidity facilities		
– five largest ²	3.7	2.2
– largest market sector ³	6.8	4.9

¹ These exposures relate to consolidated multi-seller conduits, primarily Regency and Bryant Park. These vehicles provide funding to group customers by issuing debt secured by a diversified pool of customer-originated assets. In 2012, a committed line of £0.4 billion was provided to Bryant Park by the bank (transferred from HSBC Bank USA).

² These figures represent the undrawn balance for the five largest committed liquidity facilities provided to customers, other than those facilities to conduits.

³ These figures represent the undrawn balance for the total of all committed liquidity facilities provided to the largest market sector, other than those facilities to conduits.

All assets held within the liquid asset portfolio are unencumbered.

An increase in the level of customer accounts causes a rise in the level of non-core deposits, and therefore the holding of Level 1 liquid assets increases.

Contingent liquidity risk arising from committed lending facilities

(Audited)

The group provides customers with committed facilities, including committed backstop lines to conduit vehicles sponsored by the group and standby facilities to corporate customers. These facilities increase the funding requirements of the group when customers choose to raise drawdown levels above their normal utilisation rates. The liquidity risk consequences of increased levels of drawdown are analysed in the form of projected cash flows under different stress scenarios. The RMM also sets limits for non-cancellable contingent funding commitments by group entity after due consideration of each entity's ability to fund them. The limits are split according to the borrower, the liquidity of the underlying assets and the size of the committed line.

The group-managed asset exposures relate to consolidated securities investment conduits, primarily Solitaire and Mazarin. These vehicles issue debt secured by asset backed-securities which are managed by the group. At 31 December 2012, the commercial paper issued by Solitaire and Mazarin was entirely funded by the group.

In relation to commitment to customers, the table below shows the level of undrawn commitments outstanding in terms of the five largest single facilities and the largest market sector.

Report of the Directors: Risk (continued)

Primary sources of funding

(Audited)

Current accounts and savings deposits payable on demand or at short notice form a significant part of the group's funding, and the group places considerable importance on maintaining their stability. For deposits, stability depends upon preserving depositor confidence in the group's capital strength and liquidity, and on competitive and transparent pricing. The group's liquidity risk framework includes both monitoring depositor concentration to avoid undue reliance on large individual depositors and also limits the concentration of deposits from Global Banking and Markets counterparties. The group also accesses professional markets in order to obtain funding for non-banking subsidiaries that do not accept deposits, to align asset and liability maturities and currencies and to maintain a presence in local money markets.

An analysis of cash flows payable by the group and bank under financial liabilities by remaining contractual maturities at the balance sheet date is included in Note 34 'Maturity analysis of assets and liabilities'.

Funding sources and deployment

(Audited)

The group

	At 31 December			At 31 December	
	2012 £m	2011 ¹ £m		2012 £m	2011 ¹ £m
Sources			Uses		
Customer accounts	324,886	296,900	Loans and advances to customers	282,685	273,271
– repos	12,207	14,898	– reverse repos	16,890	24,214
– cash deposits	312,679	282,002	– loans or other receivables	265,795	249,057
Deposits by banks	39,571	46,825	Loans and advances to banks	32,286	40,654
– repos	6,357	9,348	– reverse repos	13,798	20,278
– cash deposits	33,214	37,477	– loans or other receivables	18,488	20,376
Debt securities issued	40,358	45,990	Assets held for sale	109	75
Liabilities of disposal groups			Trading assets	161,516	126,533
held for sale	–	–	– reverse repos	35,951	22,926
Subordinated liabilities	10,350	9,998	– stock borrowing	6,863	5,210
Financial liabilities designated at fair			– other trading assets	118,702	98,397
value	32,918	31,992	Financial investments	71,265	75,421
Liabilities under insurance			Cash and balances with		
contracts	17,913	16,347	central banks	51,613	50,023
Trading liabilities	122,896	119,621	Net deployment in other		
– repos	40,742	28,962	balance sheet assets and		
– stock lending	3,991	2,241	liabilities	21,618	33,300
– other trading liabilities	78,163	88,418			
Total equity	32,200	31,604			
	621,092	599,277		621,092	599,277

¹ Excludes HSBC Private Banking Holdings (Suisse) SA from the 2011 comparatives

Encumbered and unencumbered assets

(Unaudited)

The objective of this disclosure is to facilitate an understanding of available and unrestricted assets that

The funding sources and uses table, which provides a consolidated view of how the balance sheet is funded, should be read in the light of the group's risk management framework, which requires its operating entities to manage liquidity and funding risk on a stand-alone basis. The table analyses the group balance sheet according to the assets that primarily arise from operating activities and the sources of funding primarily supporting these activities. The assets and liabilities that do not arise from operating activities are presented as a net balancing source or deployment of funds.

In 2012, the level of customer accounts continued to exceed the level of loans and advances to customers. Excluding the impact of repos from customer accounts and reverse repos from loans and advances to customers, the adjusted advances to deposit ratio at 31 December 2012 for the group was 85 per cent (2011: 88 per cent). The positive funding gap was predominantly deployed into liquid assets, cash and balances with central banks and financial investments, as required by the Group's liquidity and funding risk management framework.

could be used to support potential future funding and collateral needs.

An asset is defined as encumbered if it has been pledged as collateral against an existing liability, and as a

Report of the Directors: Risk (continued)

result is no longer available to the group to secure funding, satisfy collateral needs or be sold to reduce the funding requirement.

The disclosure is not designed to identify assets which would be available to meet the claims of creditors or to predict assets that would be available to creditors in the event of a resolution or bankruptcy.

Summary of the group's assets available to support potential future funding and collateral needs (Unaudited)

	2012 £m
Total on-balance sheet assets	815,481
Less:	
– reverse repo/ stock borrowing receivables and derivative assets	(231,044)
– other assets that cannot be pledged as collateral	(99,722)
Total on-balance sheet assets that can support funding and collateral needs	484,715
Add:	
– fair value of collateral received in relation to reverse repo/ stock borrowing that is available to sell or repledge	122,502
– fair value of collateral received in relation to derivatives that is available to sell or repledge	224
Total assets that can support future funding and collateral needs	607,441
Less:	
– on-balance sheet assets pledged	(116,904)
– re-pledging of collateral received in relation to reverse repo/ stock borrowing	(80,072)
– re-pledging of collateral received in relation to derivatives	–
Total assets available to support funding and collateral needs	410,465

Liquidity regulation

(Unaudited)

In December 2010, the Basel Committee on Banking Supervision ('Basel Committee') published the 'International framework for liquidity risk measurement, standards and monitoring'. The framework comprises two liquidity metrics: the liquidity coverage ratio ('LCR') and the net stable funding ratio ('NSFR'). The ratios are subject to an observation period that began in 2011, and are expected to become established standards by 2015 and 2018, respectively. During the observation period, the standards are under review by the Basel Committee. In January 2013, the Basel Committee announced several changes to the calibration of the LCR which included reducing the outflow applied to non-operational non-financial corporate deposits from 75 per cent to 40 per cent and the outflow applied to committed liquidity facilities from 100 per cent to 30 per cent.

A significant level of interpretation is still required in determining how to apply the definitions as currently drafted, in particular, the definition of operational deposits. Uncertainty around LCR also arises from the fact that the implementation of the Basel LCR framework still requires EU endorsement.

Additionally, the final calibration of the NSFR still remains highly uncertain and is expected to remain so, with no announcement on the final NSFR calibration expected from the Basel committee until 2014.

Market risk

(Audited)

Market risk is the risk that movements in market factors, including foreign exchange rates and commodity prices, interest rates, credit spreads and equity prices will reduce the group's income or the value of its portfolios.

The group separates exposures to market risk into trading or non-trading portfolios. Trading portfolios comprise positions arising from market-making, position-taking and others designated as marked-to-market.

Non-trading portfolios including Balance Sheet Management comprise positions that primarily arise from the interest rate management of the group's retail and commercial banking assets and liabilities, financial investments designated as available-for-sale and held-to-maturity, and exposures arising from the group's insurance operations.

For market risk arising in the group's insurance business, refer to page 75.

Monitoring and limiting market risk exposure

(Audited)

The group's objective is to manage and control market risk exposures in order to optimise return on risk while maintaining a market profile consistent with HSBC's status as one of the world's largest banking and financial services organisations.

Report of the Directors: Risk (continued)

The management of market risk is principally undertaken in Global Markets using risk limits approved by the Group Management Board. Limits are set for portfolios, products and risk types, with market liquidity being a primary factor in determining the level of limits set. Group Risk, an independent unit within the Group Management Office, is responsible for HSBC's market risk management policies and measurement techniques. Each major operating entity has an independent market risk management and control function which is responsible for measuring market risk exposures in accordance with the policies defined by Group Risk, and monitoring and reporting these exposures against the prescribed limits on a daily basis.

Each operating entity is required to assess the market risks which arise on each product in the business and to transfer them to either the local Global Markets unit for management, or to separate books managed under the supervision of the local Asset and Liability Management Committee ('ALCO'). The aim is to ensure that all market risks are consolidated within operations which have the necessary skills, tools, management and governance to manage them professionally. In certain cases where the market risks cannot be fully transferred, the group identify the impact of varying scenarios on valuations or on net interest income resulting from any residual risk positions.

The group uses a range of tools to monitor and limit market risk exposures. These include value at risk ('VAR'), sensitivity analysis, stressed VAR and stress testing.

Value at risk ('VAR') and stressed value at risk (Audited)

VAR is a technique that estimates the potential losses on risk positions in the trading portfolio as a result of movements in market rates and prices over a specified time horizon and to a given level of confidence. Stressed VAR is primarily used for Regulatory Capital purposes but is integrated into the risk management process to facilitate efficient capital management and to highlight potentially risky positions based on previous market volatility.

Both VAR and stressed VAR models used by the group are based predominantly on historical simulation. These models derive plausible future scenarios from past series of recorded market rates and prices, taking into account inter-relationships between different markets and rates such as interest rates and foreign exchange rates. The models also incorporate the effect of option features on the underlying exposures.

The historical simulation models used incorporate the following features:

- historical market rates and prices are calculated with reference to foreign exchange rates and commodity

prices, interest rates, equity prices and the associated volatilities;

- potential market movements utilised for VAR are calculated with reference to data from the past two years;
- potential market movements employed for stressed VAR calculations are based on a continuous one-year period of stress for the trading portfolio. The choice of period (March 2008 to February 2009) is based on the assessment at the Group level of the most volatile period in recent history; and
- VAR measures are calculated to a 99 per cent confidence level and use a one-day holding period scaled to ten days, whereas stressed VAR uses a ten-day holding period.

The nature of the VAR models means that an increase in observed market volatility will lead to an increase in VAR without any changes in the underlying positions.

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 the risks offset in one day. This may not fully reflect the market risk arising at times of severe illiquidity, when a one-day holding period may be insufficient to liquidate or hedge all positions fully;
- the use of a 99 per cent confidence level, by definition, does not take into account losses that might occur beyond this level of confidence;
- VAR is calculated on the basis of exposures outstanding at the close of business and therefore does not necessarily reflect intra-day exposures; and
- VAR is unlikely to reflect loss potential on exposures that only arise under significant market movements.

The group's VAR model is designed to capture significant basis risks such as CDS v Bond, asset swap spreads and cross-currency basis. Other basis risks which are not completely covered in VAR, such as the Libor tenor basis, are complemented by Risk-Not-In-VAR ('RNIV') calculations and are integrated into the capital framework. Further, stress testing is also used as one of the market risk tools for managing basis risks.

Sensitivity analysis

(Unaudited)

Sensitivity measures are used to monitor the market risk positions within each risk type, for example, the present

Report of the Directors: Risk (continued)

value of a basis point movement in interest rates for interest rate risk. Sensitivity limits are set for portfolios, products and risk types, with the depth of the market being one of the principal factors in determining the level of limits set.

Stress testing

(Audited)

In recognition of the limitations of VAR, the group augments it with stress testing to evaluate the potential impact on portfolio values of more extreme, although plausible, events or movements in a set of financial variables.

Stress testing is implemented at the legal entity, regional and the overall Group levels. A standard set of scenarios is utilised consistently across all regions within the Group. Scenarios are tailored in order to capture the relevant events or market movements at each level. The risk appetite around potential stress losses for the Group is set and monitored against referral limits.

The process is governed by the 'Stress Testing Review Group' forum which, in conjunction with regional risk management, determines the scenarios to be applied at portfolio and consolidated level, as follows:

- single risk factor stress scenarios that are unlikely to be captured within the VAR models, such as the break of a currency peg;
- technical scenarios consider the largest move in each risk factor, without consideration of any underlying market correlation;
- hypothetical scenarios consider potential macro-economic events, for example the mainland China slowdown and the potential effects of a sovereign debt default, including its wider contagion effects; and
- historical scenarios incorporate historical observations of market movements during previous periods of stress which would not be captured within VAR.

Stress testing results provide senior management with an assessment of the financial effect such events would have on the profit of the bank. Further, reverse stress test scenarios consider scenarios beyond normal business settings and leads to events with contagion and systemic implications.

Stressed VAR and stress testing, together with reverse stress testing and the Gap risk measure (see page

66), provide management with insights regarding the 'tail risk' beyond VAR. HSBC appetite for tail risk is limited and Gap risks are being managed down (see page68).

Trading and non-trading portfolios

(Audited)

The following table provides an overview of the reporting of risks within this section:

Risk type	Portfolio	
	Trading	Non-trading
Foreign exchange and commodity	VAR	VAR ¹
Interest rate	VAR	VAR
Equity	VAR	Sensitivity
Credit spread	VAR	VAR ²

¹ The reporting of commodity risk is consolidated with foreign exchange risk and is not applicable to non-trading portfolios.

² Non-trading credit spread for AFS positions only.

Value at risk of the trading and non-trading portfolios

The VAR, both trading and non-trading, for the group was as follows:

Value at risk

(Audited)

	2012	2011
	£m	£m
At 31 December	88.6	191.3
Average	124.3	161.7
Minimum	75.3	131.4
Maximum	206.8	233.0

The decrease of total VAR during 2012 was driven primarily by the reduced contribution of credit spreads, as a result of subdued volatilities and lower credit spread baselines utilised in the VAR calculations.

Trading portfolios

(Audited)

Risk measurement and control

The group's control of market risk in the trading portfolios is based on a policy of restricting individual operations to trading within a list of permissible instruments authorised for each site by Group Risk, of enforcing rigorous new product approval procedures, and of restricting trading in the more complex derivative products only to offices with appropriate levels of product expertise and robust control systems.

The VAR for such trading activity within Global Markets at 31 December 2012 was £45.3 million (2011: £69.1 million). This is analysed below by risk type:

Report of the Directors: Risk (continued)*Total trading VAR by risk type**(Audited)*

	Foreign exchange and commodity £m	Interest rate £m	Equity £m	Credit £m	Portfolio diversification £m	Total ¹ £m
At 31 December 2012	11.5	22.1	10.8	7.7	(6.8)	45.3
At 31 December 2011	9.5	28.1	4.4	45.4	(18.3)	69.1
Average						
2012	13.0	24.5	6.3	14.8	(14.9)	43.7
2011	9.3	31.4	5.0	30.6	(18.4)	57.9
Minimum						
2012	4.8	17.1	2.0	5.8		28.5
2011	4.4	17.3	1.6	15.1		35.5
Maximum						
2012	29.0	34.6	16.2	46.7		76.1
2011	20.3	45.9	10.7	63.0		84.8

1 The total VAR is non-additive across risk types due to diversification effects.

2 Portfolio diversification is the market risk dispersion effect of holding a portfolio containing different risk types. It represents the reduction in unsystematic market risk that occurs when combining a number of different risk types, for example, interest rate, equity and foreign exchange, together in one portfolio. It is measured as the difference between the sum of the VAR by individual risk type and the combined total VAR. A negative number represents the benefit of portfolio diversification. As the maximum and minimum occur on different days for different risk types, it is not meaningful to calculate a portfolio diversification benefit for these measures

The VAR for trading intent activity at 31 December 2012 was lower than at 31 December 2011 due primarily to the lower contribution of credit spread exposures to sovereigns. This reduction was driven by positions being managed down, together with the utilisation of lower credit spread volatilities and baselines in the VAR calculations.

Stressed value at risk of the trading portfolios

The group stressed VAR of trading portfolios was as follows:

*Stressed value at risk**(Unaudited)*

	2012 £m	2011 £m
At 31 December	99.2	153.4

Stressed VAR for trading intent portfolios reduced primarily as a result of the de-risking of exposures to eurozone sovereigns and interest rate risks being managed down, together with the impact of lower credit spread levels on the VAR calculation.

Credit spread risk

The risk associated with movements in credit spreads is primarily managed through sensitivity limits, stress testing and VAR.

Credit spread risk also arises on credit derivative transactions entered into by Global Banking in order to manage the risk concentrations within the group's corporate loan portfolio and so enhance capital efficiency. At 31 December 2012, the credit VAR on these transactions was £1.4 million (2011: £4.1 million). The mark-to-market of these transactions is reflected in the income statement.

Gap risk

Even for transactions that are structured to render the risk to the group negligible under a wide range of market conditions or events, there exists a remote possibility that a significant gap event could lead to loss. A gap event could arise from a significant change in market price with no accompanying trading opportunity, with the result that the threshold is breached beyond which the risk profile changes from having no risk to full exposure to the underlying structure. Such movements may occur, for example, when in reaction to an adverse event or unexpected news announcements, the market for a specific investment becomes illiquid, making hedging impossible.

Given their characteristics, these transactions make little or no contribution to VAR or to traditional market risk sensitivity measures. The group captures the risks within the stress testing scenarios and monitors gap risk on an ongoing basis. The group regularly considers the probability of gap loss and fair value adjustments are booked against this risk. During 2012 gap risk continued to be managed down. The group did not incur any material gap loss in respect of such transactions in 2012.

Non-trading portfolios*(Audited)**Value at risk of the non-trading portfolios**(Audited)*

	2012 £m	2011 £m
As at 31 December	61.2	160.6
Average	97.1	136.1
Minimum	57.1	101.2
Maximum	171.0	183.9

Report of the Directors: Risk (continued)

Contributions to group non-trading VAR are mainly driven by interest rates and credit spread risks. The decrease of non-trading VAR during 2012 was due primarily to the reduced contribution of credit spread risks, as a result of lower volatilities and credit spread baselines utilised in the VAR calculations.

Risk measurement and control

The principal objective of market risk management of non-trading portfolios is to optimise net interest income. Interest rate 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 embedded optionality within certain product areas such as the incidence of mortgage prepayments, and from behavioural assumptions regarding the economic duration of liabilities which are contractually repayable on demand such as current accounts.

The group's control of market risk in non-trading portfolios is based on transferring the risks to the books managed by Global Markets or the local ALCO. The net exposure is typically managed through the use of interest rate swaps within agreed limits. The VAR for these portfolios is included within the group VAR (see 'Value at risk of the trading and non-trading portfolios' above).

Available-for-sale debt securities

At 31 December 2012, the sensitivity of equity capital to the effect of movements in credit spreads based on credit spread VAR, on the group's available-for-sale debt securities was £54.6 million (2011: £171.3 million). The sensitivity was calculated on the same basis as for the trading portfolio. It increased to £76.0 million (2011: £222.8 million) after including the gross exposure for the SICs consolidated within the group's balance sheet. This sensitivity is calculated before taking into account losses which would have been absorbed by the capital note holders. At 31 December 2012, the capital note holders can absorb the first US\$2.3 billion (2011: US\$2.3 billion) of any losses incurred by the SICs prior to the group incurring any equity losses.

Credit spread VAR for available-for-sale debt securities is always included in the bank's total VAR.

Fixed-rate securities

The principal non-trading risk which is not included in the VAR reported for Global Banking and Markets arises out of Fixed Rate Subordinated Notes. The VAR related to these instruments was £24.8 million at 31 December 2012 (2011: £34.5 million); while the average, minimum and maximum during the year was £32.9 million, £17.3 million and £37.7 million respectively (2011: £25.9 million, £13.2 million and £35.0 million).

Equity securities held as available-for-sale

Market risk arises on equity securities held as available-for-sale. The fair value of these securities at 31 December 2012 was £1,029 million (2011: £1,224 million).

The fair value of the constituents of equity securities held as available-for-sale can fluctuate considerably. For details of the impairment incurred on available-for-sale equity securities see the accounting policies in Note 2(j).

Structural foreign exchange exposures

(Unaudited)

Structural foreign exchange exposures represent net investments in subsidiaries, branches and associates, the functional currencies of which are currencies other than sterling. An entity's functional currency is the currency of the primary economic environment in which the entity operates.

Exchange differences on structural exposures are recognised in other comprehensive income.

The group hedges structural foreign currency exposures only in limited circumstances. The group's structural foreign exchange exposures are managed with the primary objective of ensuring, where practical, that the group's consolidated capital ratios and the capital ratios of individual banking subsidiaries are largely protected from the effect of changes in exchange rates. This is usually achieved by ensuring that, for each subsidiary bank, the ratio of structural exposures in a given currency to risk-weighted assets denominated in that currency is broadly equal to the capital ratio of the subsidiary in question.

The group may also transact hedges where a currency in which the group have structural exposures is considered likely to revalue adversely and it is possible in practice to transact a hedge. Any hedging is undertaken using forward foreign exchange contracts which are accounted for under IFRSs as hedges of a net investment in a foreign operation, or by financing with borrowings in the same currencies as the functional currencies involved.

For details of structural foreign exchange exposures see Note 35 'Foreign exchange exposures'.

Sensitivity of net interest income

(Unaudited)

A principal element of the group's management of market risk in non-trading portfolios is monitoring the sensitivity of projected net interest income under varying interest rate scenarios (simulation modelling). The group aims to mitigate the effect of prospective interest rate movements which could reduce future net interest income, while balancing the cost of hedging such activities on the current revenue stream.

Report of the Directors: Risk (continued)

For simulation modelling, businesses use a combination of scenarios relevant to them, the local markets and standard scenarios which are required throughout the group. The standard scenarios are consolidated to illustrate the combined pro forma effect on the group's consolidated portfolio valuations and net interest income.

Defined benefit pension scheme

(Audited)

Market risk also arises within the group's defined benefit pension schemes to the extent that the obligations of the schemes are not fully matched by assets with determinable cash flows. Pension scheme obligations fluctuate with changes in long-term interest rates, inflation, salary increases and the longevity of scheme members. Pension scheme assets will include equities and debt securities, the cash flows of which change as equity prices and interest rates vary. There are risks that market movements in equity prices and interest rates could result in assets which are insufficient over time to cover the level of projected obligations and these, in turn, could increase with a rise in inflation and members living longer. Management, together with the trustees who act on behalf of the pension scheme beneficiaries, assess these risks using reports prepared by independent external actuaries and takes action and, where appropriate, adjust investment strategies and contribution levels accordingly.

The present value of the group's defined benefit pension schemes' liabilities was £16.9 billion at 31 December 2012 compared with £16.7 billion at 31 December 2011. Assets of the defined benefit schemes at 31 December 2012 comprised: equity investments 13 per cent (13 per cent at 31 December 2011); debt securities 76 per cent (76 per cent at 31 December 2011) and other (including property) 11 per cent (11 per cent at 31 December 2011).

Operational risk

(Unaudited)

Operational risk is relevant to every aspect of the group's business and covers a wide spectrum of issues. Losses arising through fraud, unauthorised activities, errors, omission, inefficiency, systems failure or from external events all fall within the definition of operational risk.

The objective of the group's operational risk management is to manage and control operational risk in a cost effective manner within targeted levels of operational risk consistent with the Group's risk appetite, as defined by the Group Management Board.

A formal group-wide governance structure provides oversight over the management of operational risk. A Global Operational Risk and Internal Control Committee ('GORICC'), which reports to the Group RMM, meets at least quarterly to discuss key risk issues

and review the effective implementation of the Group's operational risk management framework. Regions are responsible for ensuring that country and business unit Operational Risk and Internal Control Committees ('ORICC') are established within the Region and Global Business consistent with the need to maintain oversight over all businesses and operations. Accordingly, at the regional level, the group's Operational Risk and Internal Control Committee ('HBEU ORICC') meets monthly to ensure that the operational risks inherent in the regional activities are identified, assessed and controlled in accordance with the regional risk appetite. Local country and business line ORICCs feed into the HBEU ORICC and are held at least quarterly. In addition, output and significant issues from the regional, country and business line ORICCs are fed into the group's Risk Management Meeting and the group's Board as appropriate. The HBEU ORICC also reports to the GORICC.

The group's Regional Operational Risk and Internal Control team supports the European Chief Financial Officer and Chief Risk Officer through continuing oversight and assurance over the management of operational risk by businesses and operations. Operational Risk and Internal Control teams have also been established in all countries in the region with responsibility for coordinating and providing oversight over implementation of the Operational Risk Management Framework locally.

The group continued to enhance its operational risk management framework ('ORMF') policies and procedures in 2012, including the implementation of a Top Risk analysis process to improve the quantification and management of material risks through scenario analysis. This provides a top down, forward-looking view of risks to ensure effective management within the group's risk appetite or whether further management action is required.

Responsibility for minimising operational risk management lies primarily with HSBC's management and staff. Each country, business unit and functional head is required to maintain oversight over operational risk and internal control covering all business and operational activities for which they are responsible.

Operational Risk Management framework

The Group Operational Risk function and the ORMF assist business management in discharging their responsibilities.

The ORMF defines minimum standards and processes, and the governance structure for operational risk and internal control across the Group. Inherent to the ORMF is a 'Three lines of defence' model to the management of risk.

The three lines of defence model provides a format within which to structure and demonstrate roles,

Report of the Directors: Risk (continued)

responsibilities and accountabilities for decision making, risk and control to achieve effective governance, risk management and assurance.

The first line of defence ensures all key risks within their operations are identified, mitigated and monitored by appropriate internal controls within an overall control environment. Every employee is responsible for the risks that are a part of their day to day jobs.

The second line of defence consists of the Global Functions such as Global Risk, Finance and HR who are responsible for providing assurance, challenge and oversight of the activities conducted by the first line.

The third line of defence covers the role of Internal Audit, who provide independent assurance over the first and second lines of defence.

Business managers are responsible for maintaining an acceptable level of internal control, commensurate with the scale and nature of operations across Europe. They are responsible for identifying and assessing risks, designing controls and monitoring the effectiveness of these controls. The operational risk management framework assists managers to fulfil these responsibilities by defining a standard risk assessment methodology and providing a tool for the systematic reporting of operational loss data. Central Operational Risk and Internal Control teams within the country and at the regional level provide assurance and oversight over the business control activities through a programme of risk and control reviews during the year.

A centralised database is used to record the results of the operational risk management process. Operational risk control assessments are input and maintained by business units. To ensure that operational risk losses are consistently reported and monitored at country, regional and group level, all group companies are required to report individual losses when the net loss is expected to exceed US\$10,000.

Legal risk

Each operating company is required to implement procedures to manage legal risk that conform to the Group's standards. Legal risk falls within the definition of operational risk and includes:

- contractual risk; which is the risk that the rights and/or obligations of a group company within a contractual relationship are defective;
- dispute risk; which is made up of the risks that a group company is subject to when it is involved in or managing a potential or actual dispute;
- legislative risk; which is the risk that a group company fails to adhere to the laws of the jurisdictions in which it operates; and
- non-contractual rights risk which is the risk that a group company's assets are not properly owned or are

infringed by others, or a group company infringes another party's rights.

The group has a legal function, headed by the General Counsel for Europe, to assist management in controlling legal risk. The function provides legal advice and support in managing claims against the group's companies, as well as in respect of non-routine debt recoveries or other litigation against third parties. There are legal departments in a number of countries in which the group operates.

The group's operating companies must notify the appropriate legal department immediately any litigation is either threatened or commenced against the group or an employee. Any claims which exceed £1 million must be advised to the General Counsel for Europe. The General Counsel for Europe must also be immediately advised of any action by a regulatory authority, where the proceedings are criminal, or where the claim might materially affect the group's reputation.

In addition, the group's operating companies are required to submit semi annual returns detailing outstanding claims where the claim (or group of similar claims) exceeds US\$10 million, where the action is by a regulatory authority, where the proceedings are criminal or where the claim might materially affect the group's reputation. These returns are used for reporting to various committees within the group.

Compliance risk

Compliance risk falls within the definition of operational risk. All group companies are required to observe the letter and spirit of all relevant laws, codes, rules, regulations and standards of good market practice. These rules, regulations, other standards and group policies include those relating to anti-money laundering, counter terrorist financing and sanctions compliance.

The Group Compliance function supports line management in ensuring that there are adequate policies, procedures and resources to mitigate compliance risk. The Regional Compliance Officer oversees compliance teams in all of the countries where the group operates. Additionally, Global Compliance Officers oversee compliance arrangements within large and complex businesses such as the bank and Global Banking and Markets.

Group Compliance policies and procedures require the prompt identification and escalation of all actual and suspected breaches of any law, rule, regulation, Group policy or other relevant requirement. These escalation procedures are supplemented by a requirement for the submission of a compliance certificate at the half-year and year-end by all group companies detailing any known breaches. The contents of these escalation and certification processes are used for reporting to the RMM, the Risk Committee and the Board and disclosure in the Annual Report and Accounts and Interim Report, if appropriate.

Report of the Directors: Risk (continued)

In 2012, the group continued to experience increasing levels of compliance risk as regulators and other agencies pursued investigations into historic activities and as the group continued to work with them in relation to already identified issues. These included:

- the mis-selling of interest rate derivative products to SMEs in the UK and the settlement of claims by HSBC Bank to provide appropriate redress;
- investigations related to certain past submissions made by panel banks in connection with the setting of LIBOR, EURIBOR and other interest rates. As certain HSBC entities are members of such panels, HSBC Holdings and certain of its subsidiaries have been the subject of regulatory demands for information;
- appearance before the US Senate Permanent Subcommittee on Investigations ('PSI') about Group compliance with US regulations including anti-money laundering laws, the BSA and OFAC sanctions. The Group has previously disclosed these matters and has co-operated with relevant US authorities since 2010; and
- ongoing investigations by US regulatory and law enforcement authorities into Group compliance with anti-money laundering laws, the BSA and OFAC sanctions.

Group security and fraud risk

Security and Fraud Risk, Europe, which has responsibility for physical risk, fraud, information and contingency risk, is fully integrated within the group's Technology and Services function, but with functional direction from Group Security and Fraud Risk. This enables management to identify and mitigate the permutations of these and other non-financial risks across the countries in which the group operates. All group companies manage their risk in accordance with standards set by Security and Fraud Risk, Europe, which also provide expert advice and support.

Conduct risk

Conduct risk is defined as both the risk of the group treating its customers unfairly and that of delivering inappropriate outcomes for customers. The HSBC Values are central to the group's approach to managing conduct risk which is embedded in the way business is undertaken and has evolved over a number of years, most noticeably in the UK with the focus on making better products, selling them properly and keeping them sold. In light of the development of the regulatory approach with an increased focus on conduct risk, further enhancements are underway across all business lines including values-based training programmes, improved management information to inform business decision making and revised incentivisation strategies. Many of the activities identified are being implemented through the on-going programmes

of the wealth risk framework, Global Standards and local business and risk initiatives.

Risk management of insurance operations

(Audited)

The group operates an integrated bancassurance model which provides wealth and protection insurance products principally for customers with whom the group has a banking relationship. Insurance products are sold through all global businesses, predominantly by Retail Banking and Wealth Management and Commercial Banking, through branches and direct channels.

The insurance contracts the group sells primarily relate to the underlying needs of the group's banking customers, which it can identify from its point-of-sale contacts and customer knowledge. The majority of sales are of savings and investment products and term and credit life contracts. By focusing largely on personal and SME lines of business, the group is able to optimise volumes and diversify individual insurance risks.

Where the group has the operational scale and risk appetite, mostly in life insurance, these insurance products are manufactured by the group's companies. Manufacturing insurance allows the group to retain the risks and rewards associated with writing insurance contracts as both the underwriting profit and the commission paid by the manufacturer to the bank distribution channel are kept within the group.

Where the group does not have the risk appetite or operational scale to be an effective manufacturer, third parties are engaged to provide insurance products through the group's banking network and direct channels. The group works with a limited number of market-leading partners to provide the products. These arrangements are generally structured with the group's exclusive strategic partners and earn the group a combination of commissions, fees and profit-share.

The majority of the risk in the group's insurance business derives from manufacturing activities and can be categorised between insurance risk and financial risks; financial risks include market risk, credit risk and liquidity risk. Insurance manufacturers set their own control procedures in addition to complying with guidelines issued by the Group Insurance Head Office.

The control framework for monitoring risk includes the Group Insurance Risk Management Committee, which oversees the status of the significant risk categories in the insurance operations. Five subcommittees of this Committee focus on products and pricing, market and liquidity risk, credit risk, operational risk and insurance risk, respectively. In addition, local ALCOs and Risk Management Committees monitor certain risk exposures, mainly for life business where the duration and cash flow

Report of the Directors: Risk (continued)

matching of insurance assets and liabilities are reviewed.

All insurance products, whether manufactured internally or by a third party, are subjected to a product approval process prior to introduction. Approval by Group Insurance Head Office may be required, depending on the type of product and its risk profile. The approval process is formalised through the Product and Pricing Committee, which comprises the heads of the relevant risk functions within insurance.

Risk management of insurance operations in 2012

This section provides disclosures on the risks arising from insurance manufacturing operations including insurance risk and financial risks such as market risk, credit risk and liquidity risk.

Risks in these operations are managed within the insurance entities using methodologies and processes appropriate to the insurance activities, but remain subject to oversight at Group level.

Insurance risk

Insurance risk is the risk, other than financial risk, of loss transferred from the holder of the insurance contract to the issuer (the group).

Insurance risk is principally measured in two ways:

- liabilities to policyholders on life insurance contracts; and
- net written insurance premiums for non-life contracts.

The insurance risk profile of the group's life insurance manufacturing businesses has not changed materially during 2012 despite the increase in liabilities to policyholders on these contracts to £17.9 billion (2011: £16.2 billion). This growth in liabilities largely resulted from market value gains on underlying financial assets in addition to new business generated during 2012.

The insurance risk profile of the group's non-life insurance manufacturing businesses changed during the year as net written insurance premiums declined to £11 million (2011: £29 million). This was in line with the group's strategy to focus on the manufacturing of life insurance products, with non-life manufacturing entities in Ireland sold during 2012.

The principal risk faced by the group is that, over time, the cost of acquiring and administering a contract,

claims and benefits may exceed the aggregate amount of premiums received and investment income. The cost of claims and benefits can be influenced by many factors, including mortality and morbidity experience, lapse and surrender rates and, if the policy has a savings element, the performance of the assets held to support the liabilities.

In respect of financial risks, subsidiaries manufacturing products with guarantees are usually exposed to falls in market interest rates and equity prices to the extent that the market exposure cannot be managed by utilising any discretionary participation (or bonus) features within the contracts they issue.

The insurance contracts sold by the group relate, primarily, to core underlying banking activities, such as savings, investment and/or credit life products. Life and non-life business insurance risks are controlled by high level policies and procedures set both centrally and locally, taking into account, where appropriate, local market conditions and regulatory requirements. Formal underwriting, reinsurance and claims-handling procedures designed to ensure compliance with regulations are applied, and supplemented with stress testing.

As well as exercising underwriting controls, reinsurance is also used as a means of mitigating exposure. Where the group manages exposure to insurance risk through the use of third-party reinsurers, the associated revenue and manufacturing profit is ceded to the reinsurers. Although reinsurance provides a means of managing insurance risk, such contracts expose the group to credit risk, the risk of default by the reinsurer (see page 77).

A principal tool used by the group to manage its exposure to insurance risk, in particular for life insurance contracts, is asset and liability matching. In certain markets in which the group operates it is neither possible nor appropriate to follow a perfect asset and liability matching strategy. For long dated non-linked contracts in particular this results in a duration mismatch between assets and liabilities. The group therefore structures portfolios to support projected liabilities from non-linked contracts. In the absence of insurable events occurring, unit linked contracts match assets more directly with liabilities. This results in the policyholder bearing the majority of the financial risk exposure.

The following tables analyse the group's insurance risk exposures by type of business.

Report of the Directors: Risk (continued)

Analysis of life insurance risk – liabilities to policyholders (Audited)

	2012 £m	2011 £m
Life (non-linked)		
– Insurance contracts with DPF ¹	219	216
– Credit life	99	141
– Annuities	363	334
Term assurance and other long-term contracts	135	60
Total life (non-linked)	816	751
Life (linked)	2,010	1,620
Investment contracts with DPF ^{1,2}	15,078	13,872
Insurance liabilities to policyholders	17,904	16,243

¹ Insurance contracts and investment contracts with discretionary participation features ('DPF') give policyholders the contractual right to receive, as a supplement to their guaranteed benefits, additional benefits that are likely to be a significant portion of the total contractual benefits, but whose amount or timing is contractually at the discretion of the group. These additional benefits are contractually based on the performance of a specified pool of contracts or assets, or the profit of the company issuing the contracts.

² Although investment contracts with DPF are financial investments, the group continues to account for them as insurance contracts as permitted by IFRS 4.

Insurance risk arising from life insurance depends on the type of business and varies considerably. The principal drivers of insurance risks are mortality, morbidity, lapse, surrender and expense levels. The liabilities for long-term contracts are set by reference to a range of assumptions around these drivers, typically reflecting each entity's own experience. Economic assumptions, such as investment returns and interest rates, are usually based on observable market data. Changes in underlying assumptions affect the liabilities.

Non-life insurance risk – net written insurance premiums

Non-life insurance contracts include accident and health, fire and other damage to property, and repayment

protection. The legacy non-life business in Ireland continued to run-off and the business was sold in October 2012.

Net written insurance premiums amounted to: Accident and health: £4 million (2011: £15 million), Fire and other damage: £ nil (2011: £5 million), Credit: £ nil (2011: £4 million) and Marine, aviation and other: £7 million (2011: £5 million).

Financial risks of insurance operations

The group's insurance businesses are exposed to a range of financial risks which can be categorised into:

- Market risk – risks arising from changes in the fair values of financial assets or their future cash flows from fluctuations in variables such as interest rates, foreign exchange rates and equity prices;
- Credit risk – risk of financial loss following the default of third parties to meet their obligations; and
- Liquidity risk – risk of not being able to make payments to policyholders as they fall due as a result of insufficient assets that can be realised as cash.

Local regulatory requirements prescribe the type, quality and concentration of assets that the group's insurance manufacturing companies must maintain to meet insurance liabilities. These requirements complement Group-wide policies.

The following table analyses the assets held in the group's insurance manufacturing companies by type of contract, and provides a view of the exposure to financial risk. For linked contracts, which pay benefits to policyholders which are determined by reference to the value of the investments supporting the policies, the group typically designate assets at fair value; for non-linked contracts, the classification of the assets is driven by the nature of the underlying contract.

Report of the Directors: Risk (continued)*Financial assets held by insurance manufacturing subsidiaries*
(Audited)

At 31 December 2012					
	Life linked contracts £m	Life non-linked contracts £m	Non-life insurance £m	Other assets £m	Total £m
Financial assets designated at fair value					
Debt securities	1,983	565	–	101	2,649
Equity securities	4,493	3,428	–	313	8,234
	<u>6,476</u>	<u>3,993</u>	<u>–</u>	<u>414</u>	<u>10,883</u>
Financial investments - available-for-sale					
Debt securities	–	10,011	–	577	10,588
Equity securities	–	–	4	12	16
	<u>–</u>	<u>10,011</u>	<u>4</u>	<u>589</u>	<u>10,604</u>
Derivatives	10	72	–	43	125
Other financial assets	379	865	3	191	1,438
	<u>6,865</u>	<u>14,941</u>	<u>7</u>	<u>1,237</u>	<u>23,050</u>
At 31 December 2011					
	Life linked contracts £m	Life non-linked contracts £m	Non-life insurance £m	Other assets £m	Total £m
Financial assets designated at fair value					
Treasury bills	3	2	–	–	5
Debt securities	1,749	631	–	206	2,586
Equity securities	3,961	3,135	–	377	7,473
	<u>5,713</u>	<u>3,768</u>	<u>–</u>	<u>583</u>	<u>10,064</u>
Financial investments - available-for-sale					
Other eligible bills	–	–	–	32	32
Debt securities	–	8,973	14	761	9,748
Equity securities	–	–	–	11	11
	<u>–</u>	<u>8,973</u>	<u>14</u>	<u>804</u>	<u>9,791</u>
Derivatives	5	148	–	4	157
Other financial assets	400	835	13	237	1,485
	<u>6,118</u>	<u>13,724</u>	<u>27</u>	<u>1,628</u>	<u>21,497</u>

Approximately 57 per cent of financial assets were invested in debt securities at 31 December 2012 (2011: 57 per cent), with 36 per cent invested in equity securities (2011: 35 per cent).

In life linked insurance, premium income less charges levied is invested in a portfolio of assets. The group manages the financial risks of this product on behalf of the policyholders by holding appropriate assets in segregated funds or portfolios to which the liabilities are linked. These assets represented 30 per cent of the total financial assets of the group's insurance manufacturing companies at the end of 2012 (2011: 28 per cent).

The remaining financial risks are managed either solely on behalf of the shareholder, or jointly on behalf of

the shareholder and policyholders where discretionary participation features exist.

Market risk of insurance operations

Market risk arises when mismatches occur between product liabilities and the investment assets which back them. For example, mismatches between asset and liability yields and maturities give rise to interest rate risk.

The main features of products manufactured by the group's insurance manufacturing companies which generate market risk, and the market risk to which these features expose the companies, are discussed below.

Long-term insurance or investment products may incorporate either investment return or capital repayment

Report of the Directors: Risk (continued)

guarantees or both. Companies manufacturing products with guarantees are usually exposed to falls in market interest rates as they result in lower yields on the assets supporting guaranteed investment returns payable to policyholders.

The proceeds from insurance and investment products with DPF are primarily invested in bonds with a proportion allocated to equity securities in order to provide customers with the potential for enhanced returns. Subsidiaries with portfolios of such products are exposed to the risk of falls in the market prices when they cannot be fully reflected in the discretionary bonuses. An increase in market volatility could also result in an increase in the value of the guarantee to the policyholder.

Long-term insurance and investment products typically permit the policyholder to surrender the policy or let it lapse at any time. When the surrender value is not linked to the value realised from the sale of the associated supporting assets, the subsidiary is exposed to market risk. In particular, when customers seek to surrender their policies when asset values are falling, assets may have to be sold at a loss to fund redemptions.

For unit-linked contracts, market risk is substantially borne by the policyholder, but market risk exposure typically remains as fees earned for management are related to the market value of the linked assets.

Each insurance manufacturing subsidiary manages market risk by using some or all of the following techniques:

- for products with DPF, adjusting bonus rates to manage the liabilities to policyholders. The effect is that a significant portion of the market risk is borne by the policyholder;
- structuring asset portfolios to support liability cash flows;
- using derivatives, to a limited extent, to protect against adverse market movements or better match liability cash flows;
- for new products with investment guarantees, considering the cost when determining the level of premiums or the price structure;
- periodically reviewing products identified as higher risk, which contain investment guarantees and embedded optionality features linked to savings and investment products;
- including features designed to mitigate market risk in new products;
- exiting, to the extent possible, investment portfolios whose risk is considered unacceptable; and
- repricing of premiums charged to policyholders.

The group's insurance manufacturing companies monitor exposures against mandated limits regularly and

report these quarterly to the Group Insurance Head Office. Exposures are aggregated and reported to senior risk management forums, including the Group Insurance Market and Liquidity Risk Committee, Group Insurance Risk Management Committee and the Group Stress Test Review Group.

Standard measures for quantifying market risks are as follows:

- for interest rate risk, the sensitivities of the net present values of asset and expected liability cash flows, in total and by currency, to a one basis point parallel upward shift in the discount curves used to calculate the net present values;
- for equity price risk, the total market value of equity holdings and the market value of equity holdings by region and country; and
- for foreign exchange risk, the total net short foreign exchange position and the net foreign exchange positions by currency.

The standard measures are relatively straightforward to calculate and aggregate, but they have limitations. The most significant one is that a parallel shift in yield curves of one basis point does not capture the non-linear relationships between the values of certain assets and liabilities and interest rates. Non-linearity arises, for example, from investment guarantees and product features which enable policyholders to surrender their policies. The group bears the shortfall if the yields on investments held to support contracts with guaranteed benefits are less than the investment returns implied by the guaranteed benefits.

The group recognises these limitations and augments its standard measures with stress tests which examine the effect of a range of market rate scenarios on the aggregate annual profits and total equity of the insurance manufacturing companies after taking into consideration tax and accounting treatments where material and relevant. The results of these stress tests are reported to the Group Insurance Head Office and risk committees every quarter.

The following table illustrates the effect of various interest rates, equity price and credit spread scenarios on the profits for the year and total equity of insurance manufacturing subsidiaries. Where appropriate, the impact of the stress on the present value of the in-force long-term insurance business asset ('PVIF') is included in the results of the sensitivity tests. The relationship between the profit and total equity and the risk factors is non-linear and, therefore, the results disclosed should not be extrapolated to measure sensitivities to different levels of stress. The sensitivities are stated before allowance for the effect of management actions which may mitigate changes in market rates, and for any factors such as policyholder behaviour that may change in response to changes in market risk.

Report of the Directors: Risk (continued)

Sensitivity of the group's insurance companies to risk factors (Audited)

	2012		2011	
	Effect on profit for the year £m	Effect on total equity £m	Effect on profit for the year £m	Effect on total equity £m
+ 100 basis points parallel shift in yield curves	(3)	(14)	(19)	(30)
– 100 basis points parallel shift in yield curves	(21)	(9)	7	19
10 per cent increase in equity prices	15	15	16	16
10 per cent decrease in equity prices	(16)	(16)	(16)	(16)
Sensitivity to credit spread increases	–	(2)	(1)	(4)

Credit risk of insurance operations

Credit risk can give rise to losses through default and can lead to volatility in income statement and balance sheet figures through movements in credit spreads, principally on the £11.3 billion (2011: £10.6 billion) non-linked bond portfolio.

As tabulated above, the sensitivity of the net profit after tax of the group's insurance manufacturing companies to the effects of changes in credit spreads is £nil (2011: a fall of £1 million). The sensitivity is calculated using simplified assumptions based on a one-day movement in credit spreads over a two-year period. A confidence level of 99 per cent, consistent with the Group's VAR, has been applied.

Management of the group's insurance manufacturing companies is responsible for the credit risk, quality and performance of their investment portfolios. The assessment of creditworthiness of issuers and counterparties is based primarily upon internationally recognised credit ratings and other publicly available information.

Investment credit exposures are monitored against limits by the local insurance manufacturing subsidiaries, and are aggregated and reported to Group Credit Risk, the Group Insurance Credit Risk Committee and the Group

Insurance Risk Management Committee. Stress testing is performed by the Group Insurance Head Office on the investment credit exposures using credit spread sensitivities and default probabilities. The stresses are reported to the Group Insurance Credit Risk Meeting.

A number of tools are used to manage and monitor credit risk. These include a Credit Watch Report which contains a watch list of investments with current credit concerns and is circulated fortnightly to senior management in the Group Insurance Head Office and to the individual Country Chief Risk Officers to identify investments which may be at greater risk of future impairment.

Credit quality

The following table presents an analysis of treasury bills, other eligible bills and debt securities within the group's insurance business by measures of credit quality. The five credit quality classifications are defined on page 47. Only assets supporting non-linked insurance liabilities, investment contract liabilities and shareholders' funds are included in the table, as financial risk on assets supporting linked liabilities is predominantly borne by the policyholder. 86 per cent (2011: 93 per cent) of the assets included in the table are invested in investments rated as 'Strong'.

Treasury bills, other eligible bills and debt securities in the group's insurance manufacturing companies (Audited)

	At 31 December 2012			At 31 December 2011		
	Strong £m	Good/ Satisfactory £m	Total ² £m	Strong £m	Good/ Satisfactory £m	Total ² £m
Financial assets designated at fair value ¹	549	117	666	731	109	840
– treasury and other eligible bills	–	–	–	3	–	3
– debt securities	549	117	666	728	109	837
Financial investments	9,100	1,488	10,588	9,160	620	9,780
– treasury and other similar bills	–	–	–	32	–	32
– debt securities	9,100	1,488	10,588	9,128	620	9,748
	9,649	1,605	11,254	9,891	729	10,620

1 Impairment is not measured for debt securities designated at fair value, as assets in such portfolios are managed according to movements in fair value, and the fair value movement is taken directly through the income statement.

2 Total is the maximum exposure to credit risk on the treasury bills, other eligible bills and debt securities in the group's insurance companies.

Credit risk also arises when assumed insurance risk is ceded to reinsurers. The split of liabilities ceded to reinsurers and outstanding reinsurance recoveries,

analysed by credit quality, is shown below. The group's exposure to third parties under the reinsurance agreements is included in this table.

Report of the Directors: Risk (continued)

Reinsurers' share of liabilities under insurance contracts (Audited)

	Strong £m	Good/ Satisfactory £m	Past due not impaired £m	Total ^{1,2} £m
At 31 December 2012				
Linked insurance contracts	34	–	–	34
Non-linked insurance contracts	458	4	–	462
Total	492	4	–	496
Reinsurance debtors	5	–	–	5
At 31 December 2011				
Linked insurance contracts	29	–	–	29
Non-linked insurance contracts	438	3	–	441
Total	467	3	–	470
Reinsurance debtors	6	–	2	8

1 No amounts reported within Reinsurers' share of liabilities under insurance contracts were classified as sub-standard or impaired.

2 Total is the maximum exposure to credit risk in respect of reinsurers' share of liabilities under insurance contracts.

Liquidity risk of insurance operations

It is an inherent characteristic of almost all insurance contracts that there is uncertainty over the amount of claims liabilities that may arise, and the timing of their settlement, and this creates liquidity risk.

There are three aspects to liquidity risk. The first arises in normal market conditions and is referred to as funding liquidity risk; specifically, the capacity to raise sufficient cash when needed to meet payment obligations. Secondly, market liquidity risk arises when the size of a particular holding may be so large that a sale cannot be completed at the market price. Finally, standby liquidity risk refers to the capacity to meet payment terms in abnormal conditions.

The group's insurance manufacturing companies primarily fund cash outflows arising from claim liabilities from the following sources of cash inflows:

- premiums from new business, policy renewals and recurring premium products;
- interest and dividends on investments and principal repayments of maturing debt investments;
- cash resources; and
- the sale of investments.

They manage liquidity risk by utilising some or all of the following techniques:

- matching cash inflows with expected cash outflows using specific cash flow projections or more general asset and liability matching techniques such as duration matching;
- maintaining sufficient cash resources;
- investing in good credit-quality investments with deep and liquid markets to the degree to which they exist;

- monitoring investment concentrations and restricting them where appropriate, for example, by debt issues or issuers; and
- establishing committed contingency borrowing facilities.

Each of these techniques contributes to mitigating the three types of liquidity risk described above.

Every quarter, the group's insurance manufacturing companies are required to complete and submit liquidity risk reports to the Group Insurance Head Office for collation and review by the Group Insurance Market and Liquidity Risk Committee. Liquidity risk is assessed in these reports by measuring changes in expected cumulative net cash flows under a series of stress scenarios designed to determine the effect of reducing expected available liquidity and accelerating cash outflows. This is achieved, for example, by assuming new business or renewals are lower, and surrenders or lapses are greater, than expected.

The following tables show the expected undiscounted cash flows for insurance contract liabilities and the remaining contractual maturity of investment contract liabilities. A significant proportion of the group's non-life insurance business is viewed as short-term, with the settlement of liabilities expected to occur within one year of the period of risk. There is a greater spread of expected maturities for the life business where, in a large proportion of cases, the liquidity risk is borne in conjunction with policyholders (wholly owned by the policyholders in the case of unit-linked business).

The profile of the expected maturity of the insurance contracts as at 31 December 2012 has shifted towards earlier maturity categories compared with 2011 following the sale of non-life businesses in Ireland and updates to lapse assumptions for certain linked contracts which have brought forward some expected payments.

Report of the Directors: Risk (continued)*Expected maturity of insurance contract liabilities*
(Audited)

	Expected cash flows (undiscounted)				Total £m
	Within 1 year £m	1-5 years £m	5-15 years £m	Over 15 years £m	
At 31 December 2012					
Non-life insurance	9	–	–	–	9
Life insurance (non-linked)	86	187	378	316	967
Life insurance (linked)	170	584	829	599	2,182
Total	265	771	1,207	915	3,158
At 31 December 2011					
Non-life insurance	43	44	15	2	104
Life insurance (non-linked)	71	134	394	333	932
Life insurance (linked)	94	332	497	734	1,657
Total	208	510	906	1,069	2,693

Remaining contractual maturity of investment contract liabilities
(Audited)

	Liabilities under investment contracts by insurance underwriting subsidiaries					Total £m
	Within 1 year £m	1-5 years £m	5-10 years £m	Over 10 years £m	Undated ¹ £m	
At 31 December 2012						
Linked investment contracts	112	418	452	1,275	2,558	4,815
Investment contracts with DPF	–	–	–	–	15,078	15,078
Total	112	418	452	1,275	17,636	19,893
At 31 December 2011						
Linked investment contracts	106	384	332	1,333	2,340	4,495
Investment contracts with DPF	–	–	–	–	13,872	13,872
Total	106	384	332	1,333	16,212	18,367

¹ In most cases, policyholders have the option to terminate their contracts at any time and receive the surrender values of their policies. These may be significantly lower than the amounts shown above.

Present value of in-force long-term insurance business

The group's life insurance business is accounted for using the embedded value approach which, inter alia, provides a risk and valuation framework. The sensitivity of the present value of the in-force ('PVIF') long-term asset to changes in economic and non-economic assumptions is described in Note 22.

Other material risks

(Unaudited)

Pension risk

The group operates a number of pension plans throughout Europe. Some of them are defined benefit plans, of which the largest is the HSBC Bank (UK) Pension Scheme ('the principal plan').

In order to fund the benefits associated with these plans, group companies (and, in some instances, employees) make regular contributions in accordance with advice from actuaries and in consultation with the scheme's trustees (where relevant). The defined benefit plans invest these contributions in a range of investments designed to meet their long-term liabilities.

The level of these contributions has a direct impact on the group's cash flow and would normally be set to ensure that there are sufficient funds to meet the cost of the accruing benefits for the future service of active members. Higher contributions will be required when plan assets are considered insufficient to cover the existing pension liabilities as a deficit exists. Contribution rates are typically revised annually or triennially, depending on the plan. The agreed contributions to the principal plan are revised triennially.

A deficit in a defined benefit plan may arise from a number of factors, including:

- investments delivering a return below that required to provide the projected plan benefits. This could arise, for example, when there is a fall in the market value of equities, or when increases in long-term interest rates cause a fall in the value of fixed income securities held;
- the prevailing economic environment leading to corporate failures, thus triggering write-downs in asset values (both equity and debt);
- a change in either interest rates or inflation which causes an increase in the value of the scheme liabilities; and

Report of the Directors: Risk (continued)

- scheme members living longer than expected (known as longevity risk).

A plan's investment strategy is determined after taking into consideration the market risk inherent in the investments and its consequential impact on potential future contributions. The long-term investment objectives of both the group and, where relevant and appropriate, the trustees are:

- to limit the risk of the assets failing to meet the liabilities of the plans over the long-term; and
- to maximise returns consistent with an acceptable level of risk so as to control the long-term costs of the defined benefit plans.

In pursuit of these long-term objectives, a benchmark is established for the allocation of the defined benefit plan assets between asset classes. In addition, each permitted asset class has its own benchmarks, such as stock market or property valuation indices and, where relevant, desired levels of out-performance. The benchmarks are reviewed at least triennially within 18 months of the date at which an actuarial valuation is made, or more frequently if required by local legislation or circumstances. The process generally involves an extensive asset and liability review.

Ultimate responsibility for investment strategy rests with either the trustees or, in certain circumstances, a management committee. The degree of independence of the trustees from the group varies in different jurisdictions. For example, the principal plan, which accounts for approximately 94 per cent of the obligations of the group's defined benefit pension plans, is overseen by a corporate trustee who regularly monitors the market risks inherent in the scheme.

The principal plan holds a diversified portfolio of investments to meet future cash flow liabilities arising from accrued benefits as they fall due to be paid. The trustee of the principal plan is required to produce a written Statement of Investment Principles which governs decision-making about how investments are made.

In 2006, the bank and the trustee of the principal plan agreed to change the investment strategy to reduce the investment risk. The target asset allocations for this strategy in 2006, and as revised in 2011, demonstrating the ongoing evolution of the strategy, are shown below. The strategy is to hold the majority of assets in bonds, with the remainder in a more diverse range of investments, and includes a commitment to undertake a programme of swap arrangements (see Note 42) by which the principal plan makes LIBOR-related interest payments in exchange for the receipt of cash flows which are based on projected future benefit payments to be made from the principal plan.

	2012 & 2011	2006
	%	%
Equities	15.5	15.0
Bonds	60.5	50.0
Alternative assets ¹	9.5	10.0
Property	9.0	10.0
Cash	5.5	15.0
	100.0	100.0

¹ In 2012 and 2011, alternative assets include ABSs, MBSs and infrastructure assets. In 2006, alternative assets included loans and infrastructure assets.

Reputational risk

All employees must safeguard the reputation of the group by maintaining the highest standards of conduct at all times and by being aware of issues, activities or associations that might pose a threat to the reputation of the group. The long-term success of the group is closely linked to the confidence of its stakeholders. Safeguarding and building upon the group's reputation is the responsibility of every employee. Any lapse in standards of integrity, compliance, customer service or operating efficiency represents a potential reputational risk.

The group always aspires to the highest standards of conduct and, as a matter of routine, takes account of reputational risks to its business. Reputational risks can arise from a wide variety of causes, including Environmental, Social and Governance ('ESG') issues and operational risk events. As a banking group, a good reputation depends not only upon the way in which the group conducts its business, but also the way in which clients, to whom financial services are provided, conduct themselves. Accordingly second order reputational risks are also regularly reviewed within the group.

Standards on all major aspects of business are set for the Group and for individual subsidiaries, businesses and functions. Reputational risks, including ESG matters, are considered and assessed by regional and local committees and management during the formulation of policy and the establishment of the Group's standards. These policies, which form an integral part of the internal control system, are communicated through manuals and statements of policy and are promulgated through internal communications and training. The policies cover ESG issues and set out operational procedures in all areas of reputational risk, including money laundering deterrence, counter-terrorist financing, environmental impact, anti-corruption measures and employee relations. The policy manuals address risk issues in detail and co-operation between departments and businesses is required to ensure a strong adherence to the group's risk management system and sustainability practices.

Report of the Directors: Capital Management

A Reputational Risk Committee ('RRC') exists to manage reputational risks across HSBC Bank plc. The RRC meets on a regular basis, and includes regular consideration of issues relating to communications and corporate sustainability, significant customer complaints and any new products and business initiatives. Minutes from the RRC are tabled at the Group Reputational Risk Policy Committee. In addition, all businesses are required to perform a Risk and Control Assessment ('RCA') at least annually that covers all material activities within their businesses. The RCA requires an assessment of operational risk exposures, including specific consideration of reputational impacts, to determine whether additional mitigating controls should be implemented.

The group regularly reviews its policies and procedures for safeguarding against reputational and operational risks. This is an evolutionary process which takes account of relevant developments, industry guidance, best practice and societal expectations.

Capital management and allocation

(Audited)

Capital management

The group's capital management approach is driven by its strategic and organisational requirements, taking into account the regulatory, economic and commercial environment in which it operates.

It is the group's policy to maintain a strong capital base to support the development of its business and to meet regulatory capital requirements. To achieve this, the group manages its own capital within the context of an annual capital plan which is approved by the Board that determines the optimal amount and mix of capital required to support planned business growth and meet local regulatory capital requirements. Capital generated in excess of planned requirements is returned to the Group in the form of dividends.

The group's policy is underpinned by its capital management framework, which enables the group to manage its capital in a consistent manner. The framework incorporates a number of capital measures which govern the management and allocation of capital within the group. These capital measures include invested capital, economic capital and regulatory capital defined by the group as follows:

- invested capital is the equity capital provided to the group by HSBC;
- economic capital is the internally calculated capital requirement which is deemed necessary by the group to support the risks to which it is exposed; and
- regulatory capital is the minimum level of capital which the group is required to hold in accordance with the rules set by the FSA for the bank and the

consolidated group and by the local regulators for individual subsidiary companies.

The following risks managed through the capital management framework have been identified as material: credit, market, operational, interest rate risk in the banking book, pension fund, insurance and residual risks.

Stress testing is incorporated into the capital management framework and is an important component of understanding the sensitivities of the core assumptions in the group's capital plans to the adverse effect of extreme, but plausible, events. Stress testing allows senior management to formulate its response, including risk mitigating actions, in advance of conditions starting to reflect the stress scenarios identified. The actual market stresses experienced by the financial system in recent years have been used to inform the capital planning process and further develop the stress scenarios employed by the group.

Other stress tests are also carried out, both at the request of regulators and by the regulators themselves using their prescribed assumptions. The group takes into account the results of all such regulatory stress testing when undertaking its internal capital management assessment.

The group's approach to managing its capital position has been to ensure the group exceeds current regulatory requirements and is well placed to meet expected regulatory requirements arising from the future implementation of CRD IV. Therefore the group continues to review its capital targets on an ongoing basis, reflecting any changes as they develop.

Further information on regulatory changes can be found on page 31.

Capital measurement

The FSA is the supervisor of the bank and lead supervisor of the group. The FSA sets capital requirements and receives information on the capital adequacy for the bank and the group. The bank and the group complied with the FSA's capital adequacy requirements throughout 2012.

Individual banking subsidiaries are directly regulated by their local banking supervisors, who set and monitor local capital adequacy requirements.

The group calculates capital using the Basel II framework, as amended for CRD III, commonly known as Basel 2.5. The Capital Requirements Directive ('CRD') implemented Basel II in the EU and the FSA then gave effect to the CRD by including the requirements of the CRD in its own rulebooks.

Basel II is structured around three 'pillars': Pillar 1: minimum capital requirements, Pillar 2: Supervisory Review and Evaluation Process and Pillar 3: market discipline.

Report of the Directors: Capital Management (continued)

There were no material changes to the group's policies and practices in capital measurement in 2012.

Risk-weighted assets

(Unaudited)

During 2012, RWAs reduced by £34 billion to £193 billion due to movements in credit and counterparty risk, market risk and operational risk.

Credit and counterparty risk RWAs decreased by £24 billion. This reduction was primarily attributable to a combination of a reduction in assets following the disposal of HSBC Private Banking Holdings (Suisse) SA, reduced risk appetite and lower demand from corporate and commercial customers reflecting the economic situation in Europe, increased application of counterparty netting and refinements in counterparty static data, downgrades in some securitisation assets (these are deducted from capital) and updates to methodology and regulatory policy in the calculation of RWAs.

Market Risk RWAs declined by £7 billion, primarily through lower risk levels following reductions in exposures and improvements in market conditions.

The reduction of £3.5 billion in operational risk RWAs was mainly attributable to the disposal of HSBC Private Banking Holdings (Suisse) SA.

During 2011, RWAs increased by £26 billion due to movements in credit and counterparty risk and market risk. The increase was primarily due to the implementation of CRD III which increased the group's credit risk RWAs by £5 billion and was the main reason for the £16 billion increase in market risk RWAs.

Regulatory capital

The group's capital comprises tier 1 capital and tier 2 capital:

- tier 1 capital is divided into core tier 1 and other tier 1 capital. Core tier 1 capital is comprised of shareholders' equity from which are deducted the book values of goodwill and intangible assets and other regulatory adjustments for items reflected in shareholders' equity which are treated differently for the purposes of capital adequacy. Qualifying capital instruments such as non-cumulative perpetual preference shares and hybrid capital securities are included in other tier 1 capital; and
- tier 2 capital comprises qualifying subordinated loan capital, allowable collective impairment allowances and unrealised gains arising on the fair valuation of equity instruments held as available for-sale. Tier 2 capital also includes reserves arising from the revaluation of properties.

The FSA's rules set limits on the amount of hybrid capital instruments that can be included in tier 1 capital relative to core tier 1 capital and also limits total tier 2 capital to no more than tier 1 capital.

The basis of consolidation for financial accounting purposes is described on page 106 and differs from that used for regulatory purposes. Investments in banking associates, which are equity accounted in the financial accounting consolidation, are proportionally consolidated for regulatory purposes. Subsidiaries and associates engaged in insurance and non-financial activities are excluded from the regulatory consolidation and are deducted from regulatory capital. The regulatory consolidation also excludes Special Purpose Entities ('SPEs') where significant risk has been transferred to third parties. Exposures to these SPEs are risk weighted as securitisation positions for regulatory purposes.

Pillar 1 capital requirements

Pillar 1 covers the capital resources requirements for credit risk (including counterparty credit risk and securitisations), market risk and operational risk. These requirements are expressed in terms of risk-weighted assets.

Credit risk capital requirements

Basel II applies three approaches of increasing sophistication to the calculation of pillar 1 credit risk capital requirements. The most basic, the standardised approach, requires banks to use external credit ratings to determine the risk weightings applied to rated counterparties and group other counterparties into broad categories and apply standardised risk weightings to these categories. The next level, the internal ratings-based ('IRB') foundation approach, allows banks to calculate their credit risk capital requirement on the basis of their internal assessment of the probability that a counterparty will default ('PD'), but subjects their quantified estimates of exposure at default ('EAD') and loss given default ('LGD') to standard supervisory parameters. Finally, the IRB advanced approach allows banks to use their own internal assessment in both determining PD and quantifying EAD and LGD.

The capital resources requirement, which is intended to cover unexpected losses, is derived from a formula specified in the regulatory rules, which incorporates these factors and other variables such as maturity and correlation. Expected losses under the IRB approaches are calculated by multiplying PD by EAD and LGD. Expected losses are deducted from capital to the extent that they exceed accounting impairment allowances.

For credit risk, the group has adopted the IRB advanced approach for the majority of its business, with the remainder on either IRB foundation or standardised approaches or under exemption from IRB treatment. A rollout plan is in place, over the next few years, to extend coverage of the advanced approaches, for both local and consolidated group reporting, leaving a small residue of exposures on the standardised approach.

Report of the Directors: Capital Management (continued)

Counterparty credit risk

Counterparty credit risk arises for over-the-counter derivatives and securities financing transactions. It is calculated in both the trading and non-trading books and is the risk that the counterparty to a transaction may default before completing the satisfactory settlement of the transaction. Three approaches to determining counterparty credit risk exposure values are defined by Basel II: standardised, mark-to-market and internal model method. These exposure values are used to determine capital requirements under one of the credit risk approaches: standardised, IRB foundation and IRB advanced.

The group uses the mark-to-market and internal model method approaches for counterparty credit risk. The longer-term aim is to migrate more positions from mark-to-market to the internal model method approach.

Securitisation

Securitisation positions are held in both the trading book and the non-trading book.

For non-trading book securitisation positions, Basel II specifies two methods for calculating credit risk requirements, these being the standardised and IRB approaches. Both approaches rely on the mapping of rating agency credit ratings to risk weights, which range between 7 per cent and 1,250 per cent. Positions that would otherwise be weighted at 1,250 per cent are deducted from capital.

Within the IRB approach, the Ratings Based Method is used for the majority of the non-trading book securitisation positions, and the Internal Assessment Approach for unrated liquidity facilities and programme-wide enhancements for asset-backed securitisations.

The majority of securitisation positions in the trading book are treated for capital purposes as if they are held in the non-trading book under the standardised or IRB approaches.

Other traded securitisation positions, known as correlation trading are included within an internal model separately approved by the FSA.

Market risk capital requirement

Market risk is the risk that movements in market risk factors, including foreign exchange, commodity prices, interest rates, credit spread and equity prices will reduce group's income or the value of its portfolios. The market risk capital requirement is measured using internal market risk models where approved by the FSA, or the FSA's standard rules.

Under Basel 2.5, the group's market risk models comprise VAR, stressed VAR, incremental risk charge and correlation trading under the comprehensive risk measure

Operational risk capital requirement

Basel II includes a capital requirement for operational risk, again utilising three levels of sophistication. The capital required under the basic indicator approach is a simple percentage of gross revenues, whereas under the standardised approach it is one of three different percentages of gross revenues allocated to each of eight defined business lines. Both these approaches use an average of the last three financial years' revenues. Finally, the advanced measurement approach uses banks' own statistical analysis and modelling of operational risk data to determine capital requirements.

The group has adopted the standardised approach in determining its operational risk capital requirements.

Pillar 2 capital requirement

The group conducts an Internal Capital Adequacy Assessment Process ('ICAAP') to determine a forward looking assessment of its capital requirements given its business strategy, risk profile, risk appetite and capital plan. This process incorporates the risk management processes and governance of the firm. A range of stress tests are applied to the base capital plan. These, coupled with the group's risk management practices are used to assess its capital adequacy requirements.

The group provides ICAAP documentation to the FSA summarising the ICAAP process and capital adequacy conclusions. This forms part of the basis of the FSA's Supervisory Review and Evaluation Process ('SREP'), which occurs periodically to enable the FSA to define the minimum capital requirements for the bank and the group. In 2013 the FSA also set a capital resources floor for the bank based on current FSA rules for core tier 1 capital.

Pillar 3 disclosure requirements

Pillar 3 of Basel II is related to market discipline and aims to make firms more transparent by requiring them to publish specific details of their risks, capital and risk management under the Basel II framework. Pillar 3 disclosures are published as a separate document on the bank's website.

Report of the Directors: Capital Management (continued)

Capital structure at 31 December

	At 31 December 2012 £m	At 31 December 2011 £m
Composition of regulatory capital (Audited)		
Shareholders' equity ¹	31,840	32,449
Shareholders' equity per balance sheet	31,675	31,090
Preference share & related premium	(431)	(431)
Other equity instruments	–	–
Deconsolidation of special purpose entities ^{2,4}	596	1,790
Non controlling interests	375	364
Non-controlling interests per balance sheet	525	514
Of which representing non-controlling interests in preference shares	(150)	(150)
Regulatory adjustments to the accounting basis	(1,833)	(1,032)
Unrealised (gains)/losses on available-for-sale debt securities ³	(163)	1,261
Own credit spread	89	(706)
Defined benefit pension fund adjustment ⁴	(1,219)	(1,058)
Cash flow hedging reserve	(259)	(236)
Reserves arising from revaluation of property & unrealised gains on available-for-sale equities	(226)	(272)
Other regulatory adjustments	(55)	(21)
Deductions	(8,294)	(11,051)
Goodwill capitalised & intangible assets	(7,107)	(10,274)
50% of securitisation positions	(922)	(570)
50% of excess expected losses over impairment allowances	(288)	(286)
50% of tax credit adjustment for excess expected losses	23	79
Core tier 1 capital	22,088	20,730
Other tier 1 capital before deductions	2,363	2,377
Preference shares & related premium	581	581
Hybrid capital securities	1,782	1,796
Deductions	(434)	(368)
Unconsolidated investments ⁵	(457)	(447)
50% of tax credit adjustment for excess expected losses	23	79
Tier 1 capital	24,017	22,739
Total qualifying tier 2 capital before deductions	11,634	11,837
Reserves arising from unrealised gains on revaluation of property & available-for-sale equities	226	272
Collective impairment allowances ⁶	271	235
Perpetual subordinated debt	2,743	2,863
Term subordinated debt	8,394	8,467
Total deductions other than from tier 1 capital	(2,187)	(1,908)
Unconsolidated investments ⁵	(971)	(1,045)
50% of securitisation positions	(922)	(570)
50% of excess expected losses over impairment allowances	(288)	(286)
Other deductions	(6)	(7)
Total regulatory capital	33,464	32,668
Risk-weighted assets (Unaudited)		
Credit and counterparty risk	149,970	173,693
Market risk	21,566	28,605
Operational risk	21,866	25,381
Total	193,402	227,679
Capital ratios (Unaudited)		
Core tier 1 ratio	11.4	9.1
Tier 1 ratio	12.4	10.0
Total capital ratio	17.3	14.4

1 Includes externally verified profits for the year to 31 December 2012. Does not include the interim dividend of £1,400 million declared by the Board of Directors after 31 December 2012.

2 Mainly comprises unrealised losses on available-for-sale debt securities owned by deconsolidated special purpose entities.

3 Under FSA rules unrealised gains/losses on available-for-sale debt securities must be excluded from capital resources.

4 FSA rules require banks to exclude from capital resources any surplus in a defined benefit pension scheme.

5 Mainly comprise investments in insurance entities.

6 Under FSA rules collective impairment allowances on loan portfolios under the standardised approach may be included in tier 2 capital.

Report of the Directors: Governance

Corporate Governance Report

The statement of corporate governance practices set out on pages 85 to 92 and information incorporated by reference constitutes the Corporate Governance Report of HSBC Bank plc.

The Directors serving as at the date of this report are set out below.

Directors

J W Leng, Chairman, 67

A Director since 2010 and Chairman since August 2012. European Chairman of American European Associates and a non-executive Director of Alstom SA and Genel Energy plc. Former Chairman of Corus Group plc and former Chief Executive of Laporte plc.

B Robertson, Chief Executive, 58

Chief Executive and a Director since December 2010. A Group Managing Director since 2008. Formerly Group Chief Risk Officer. Joined HSBC in 1975.

P Antika, Non-Executive Director, 52

A Director since July 2011. Consultant, Antika Partners. Formerly Chief Executive of HSBC Bank AS, Turkey and a Group General Manager of HSBC Holdings plc until her retirement in March 2011.

Dame Denise Holt, Independent Non-Executive Director, 63

A member of the Risk Committee.

A Director since February 2011. Formerly a senior British Ambassador with 40 years' experience of working in Government, including postings in Ireland, Mexico, Brazil and, most recently, as British Ambassador to Spain from 2007 until her retirement in 2009.

S W Leathes, Independent Non-Executive Director, 65

A member of the Audit and Risk Committees.

A Director since May 2012. Formerly Vice-Chairman of Barclays Capital and Group Finance Director of S.G. Warburg Group plc.

Dame Mary Marsh, Independent Non-Executive Director, 66

A Director since January 2009. Director of the Clore Social Leadership Programme. A member of the Corporate Sustainability Committee of HSBC Holdings plc. Formerly Chief Executive of the NSPCC.

R E S Martin, Independent Non-Executive Director, 52

A Director since 2005. General Counsel & Company Secretary, Vodafone Group plc.

T B Moulouquet, Independent Non-Executive Director, 61

A Director since July 2012. A Director and Chairman of the Audit and Risk Committee, HSBC France. A Director of Fitch Rating Group Inc; Fimalac; Groupe Lucien Barrière and Valéo. Formerly Executive Vice President and Chief Financial Officer of Renault Group.

A R D Monro-Davies, Independent Non-Executive Director, 72

A member of the Audit and Risk Committees.

A Director since 2004. A Director and member of the Audit and Risk Committee of HSBC Bank Middle East Limited. Formerly Chief Executive Officer, Fitch Ratings.

P M Shawyer, Independent Non-Executive Director, 62

A member of the Audit and Risk Committees.

A Director since 2004. A Director and a member of the Audit and Risk Committee of HSBC France. Formerly a Managing Partner of Deloitte.

A P Simoes, Deputy Chief Executive, Head of UK Bank and Head of Retail Banking and Wealth Management, Europe, 37

A Director since 1 February 2012. A Group General Manager since January 2011. Formerly Group Head of Strategy and Planning. Joined HSBC in 2007.

J F Trueman, Independent Non-Executive Director, 70

Chairman of the Audit and Risk Committees.

A Director since 2004. Formerly Deputy Chairman of S.G. Warburg & Co.

Secretary

J H McKenzie, 59

Joined HSBC in 1987.

Registered Office: 8 Canada Square, London E14 5HQ

Report of the Directors: Governance (continued)

Board of Directors

The objectives of the management structures within the bank, headed by the Board of Directors and led by the Chairman, are to deliver sustainable value to shareholders. Implementation of the strategy set by the Board is delegated to the bank's Executive Committee.

The Board meets regularly and Directors receive information between meetings about the activities of committees and developments in the bank's business. All Directors have full and timely access to all relevant information and may take independent professional advice if necessary.

The names of Directors serving at the date of this report and brief biographical particulars for each of them are set out on page 85.

All Directors, including those appointed by the Board to fill a casual vacancy, are subject to annual re-election at the bank's Annual General Meeting. Non-executive Directors have no service contracts.

J W Leng was appointed Chairman on 6 August 2012. A P Simoes was appointed as a Director on 1 February 2012. S W Leathes was appointed an independent non-executive Director on 17 May 2012. T B Moulouguet was appointed an independent non-executive Director on 27 July 2012.

A A Flockhart resigned as Director and Chairman on 31 July 2012. P J Houze, J D Garner and P W Boyles resigned as Directors on 26 April 2012, 31 October 2012 and 10 December 2012 respectively.

Directors' emoluments

Details on the emoluments of the Directors of the bank for 2012, disclosed in accordance with the Companies Act, are shown in Note 7 'Employee compensation and benefits'.

Board committees

The Board has appointed a number of committees consisting of certain Directors and, where appropriate, senior executives.

As at the date of this report, the following are the principal committees:

Audit Committee

The Audit Committee meets regularly with the bank's senior financial management and the external auditor to consider, inter alia, the bank's financial reporting, the nature and scope of audit reviews and the effectiveness of the systems of internal control.

The members of the Audit Committee are J F Trueman (Chairman), S W Leathes, A R D Monro-

Davies, and P M Shawyer. All of the members of the Audit Committee who served during 2012 are independent non-executive Directors.

Risk Committee

The Risk Committee meets regularly with the bank's senior financial, risk, internal audit and compliance management and the external auditor to consider, inter alia, risk reports and internal audit reports and the effectiveness of compliance.

The members of the Risk Committee are J F Trueman (Chairman), D M Holt, S W Leathes, A R D Monro-Davies, and P M Shawyer. All of the members of the Risk Committee who served during 2012 are independent non-executive Directors.

Executive Committee

The Executive Committee meets regularly and operates as a general management committee under the direct authority of the Board, exercising all of the powers, authorities and discretions of the Board in so far as they concern the management and day to day running of the bank, in accordance with such policies and directions as the Board may from time to time determine. The members of the Executive Committee include the bank's executive Directors: B Robertson (Committee Chairman) and A P Simoes.

Remuneration Committee

The functions of the Remuneration Committee are fulfilled by the Remuneration Committee of the Board of the bank's parent company, HSBC Holdings plc.

Internal control

The Directors are responsible for internal control in the group and for reviewing its effectiveness. Procedures have been designed for safeguarding assets against unauthorised use or disposal; for maintaining proper accounting records; and for the reliability and usefulness of financial information used within the business or for publication. Such procedures are designed to manage and mitigate the risk of failure to achieve business objectives and can only provide reasonable and not absolute assurance against material misstatement, errors, losses or fraud. The procedures also enable the bank to discharge its obligations under the Handbook of Rules and Guidance issued by the Financial Services Authority, the bank's lead regulator.

The key procedures are designed to provide effective internal control within the group and accord with the Internal Control: Revised Guidance for Directors on the Combined Code issued by the Financial Reporting Council. Such procedures for the ongoing identification, evaluation and management of the significant risks faced by the group have been in place throughout the year and

Report of the Directors: Governance (continued)

up to 4 March 2013, the date of approval of the *Annual Report and Accounts 2012*.

Key internal control procedures include the following:

- **Global standards:** Functional, operating, financial reporting and certain management reporting standards are established by HSBC global function management committees, for application across the whole of the Group. These are supplemented by operating standards set by functional and local management as required for the type of business and geographical location of each subsidiary.
- **Delegation of authority within limits set by the Board:** Authority to operate the bank and responsibility for financial performance against plans and capital expenditure, is delegated to the Chief Executive who has responsibility for overseeing the establishment and maintenance of systems of control appropriate to the business and who has the authority to delegate such duties and responsibilities as he sees fit. The appointment of executives to the most senior positions within the group requires the approval of the Board of Directors of HSBC Holdings.
- **Risk identification and monitoring:** Systems and procedures are in place in the group to identify, control and report on the major risks including credit, market, liquidity, capital, financial management, model, reputational, pension, strategic, sustainability and operational risk (including accounting, tax, legal, compliance, fiduciary, information, external fraud, internal fraud, political, physical, business continuity, systems operations, project and people risk). Exposure to these risks is monitored by risk management committees, asset and liability committees and executive committees. The group's operational risk profile and the effective implementation of the group's operational risk management framework is monitored by the bank's Risk Management Meeting ('RMM'). The minutes of this meeting are submitted to the Group RMM.
- **Changes in market conditions/practices:** Processes are in place to identify new risks arising from changes in market conditions/practices or customer behaviours, which could expose the group to heightened risk of loss or reputational damage.
- **Strategic plans:** Periodic strategic plans are prepared for global businesses and certain geographies, including the home and priority growth markets in Europe. The geographic plans are designed to align closely with Group strategy, with significant input and ultimate endorsement by the Directors of the bank. These strategic plans set the direction and pace of development of individual businesses and also cover key business initiatives

that will enable the business to deliver its operating result.

The bank also prepares annual operating plans which concern financial performance and are informed by detailed analysis of risk appetite, the impact of key initiatives deriving from the strategic planning process, economic forecasts and anticipated customer behaviour.

- **Disclosure Committee:** The Disclosure Committee reviews material public disclosures made by the bank for any material errors, misstatements or omissions. The integrity of disclosures is underpinned by structures and processes within the Finance and Risk functions that support expert and rigorous analytical review of financial reporting complemented by certified reviews by the business and functions.
- **Financial reporting:** The group's financial reporting process for preparing the consolidated *Annual Report and Accounts 2012* is controlled using documented accounting policies and reporting formats, supported by a chart of accounts with detailed instructions and guidance on reporting requirements, issued by Group Finance to the bank and all reporting entities within the group in advance of each reporting period end. The submission of financial information from each reporting entity is subject to certification by the responsible financial officer, and analytical review procedures at reporting entity and group levels.
- **Responsibility for risk management:** Management of businesses and functions are primarily accountable for managing, measuring and monitoring their risks and controls. Processes consistent with the Three Lines of Defence principle are in place to ensure weaknesses are escalated to senior management and addressed.
- **IT operations:** Centralised functional control is exercised over all IT developments and operations. Common systems are employed for similar business processes wherever practicable.
- **Functional management:** Global functional management is responsible for setting policies, procedures and standards for the following risks: credit, market, liquidity, capital, financial management, model, reputational, pension, strategic, sustainability and operational risk (including accounting, tax, legal, compliance, fiduciary, information security, security and fraud, systems and people risk). Authorities to enter into credit and market risk exposures are delegated with limits to line management of group companies. The concurrence of the appropriate global function is required, however, to credit proposals with specified

Report of the Directors: Governance (continued)

higher risk characteristics. Credit and market risks are measured and reported on in subsidiaries and aggregated for review of risk concentrations on a Group-wide basis.

- CEO Attestation Process:** Operational Risk coordinate the annual CEO Attestation process under which the Chief Executive Officers of the group's material subsidiaries confirm on behalf of their subsidiaries that the internal control framework has been reviewed through the CEO Attestation process and significant open issues identified with action plans in place to address weaknesses for review by the Risk Committee and the Audit Committee. These issues are then tracked by the Operational Risk and Internal Control (ORIC) teams for the relevant businesses through reports to their ORIC committees and quarterly updates on progress to Regional Operational Risk.
- Internal Audit:** The establishment and maintenance of appropriate systems of internal control is primarily the responsibility of business management. The Internal Audit function, which is centrally controlled, provides independent assurance as to the effectiveness of the design, implementation and embeddedness of the risk management and control frameworks across the Group, focussing on the areas of greatest risk to HSBC using a risk-based approach.
- Internal Audit recommendations:** Executive management is responsible for ensuring that recommendations made by the Internal Audit function are implemented within an appropriate and agreed timetable. Confirmation to this effect must be provided to Internal Audit.
- Reputational risk:** Policies to guide the bank, subsidiary companies and management at all levels in the conduct of business to safeguard the Group's reputation are established by the Group, subsidiary company boards and committees, board committees and senior management. Reputational risks can arise from almost any aspect of the Group's operations including environmental, social and governance issues, or as a consequence of operational risk events, as a consequence of operational risk events or as a result of employees acting in a manner inconsistent with the HSBC values. As a banking group, HSBC's good reputation depends upon the way in which it conducts its business but it can also be affected by the way in which clients, to which it provides financial services, conduct their business or use financial products and services.

The Risk Committee and the Audit Committee have kept under review the effectiveness of this system of internal control and have reported regularly to the Board

of Directors. In carrying out their reviews, the committees receive regular business and operational risk assessments; regular reports from the heads of key risk functions, which cover all internal controls, both financial and non-financial; semi-annual confirmations from senior executives that there have been no material losses, contingencies or uncertainties caused by weaknesses in internal controls; internal audit reports; external audit reports; prudential reviews; and regulatory reports.

The Risk Committee monitors the status of top and emerging risks which impact or may impact the group and considers whether the mitigating actions put in place are appropriate. In addition, when unexpected losses have arisen or when incidents have occurred which indicate gaps in the control framework or in adherence to HSBC Group policies, the Risk Committee reviews special reports, prepared at the instigation of management, which analyse the cause of the issue, the lessons learned and the actions proposed by management to address the issue.

The Directors, through the Audit and Risk Committees, have conducted an annual review of the effectiveness of the group's system of internal control covering all material controls, including financial, operational and compliance controls and risk management systems, the adequacy of resources, qualifications and experience of staff of the accounting and financial reporting function, and their training programmes and budget. The Audit and Risk Committees have received confirmation that executive management has taken or is taking the necessary actions to remedy any failings or weaknesses identified through the operation of the group's framework of controls.

The Audit Committee has non-executive responsibility for oversight of internal controls over financial reporting and the Risk Committee has non-executive responsibility for oversight of internal controls other than over financial reporting.

Health and safety

The maintenance of appropriate health and safety standards remains a key responsibility of all managers and the bank is committed to proactively managing all health and safety risks associated with its business. The bank's objectives are to identify, remove, reduce or control material risks relating to fires and accidents or injuries to employees, customers and visitors.

Group policies, standards and guidance for the management of health and safety are set by global Corporate Real Estate. Achieving these in each country in which the Group operates is the responsibility of the Chief Operating Officer of that country with support and coordination provided by the Health and Safety Coordinator for that country.

Report of the Directors: Governance (continued)

In terms of physical and geopolitical risk, Global Security and Fraud Risk provide regular Security Risk Assessments to assist management in judging the level of terrorist and violent criminal threat. Regional Security and Fraud Risk functions conduct regular security reviews of all Group buildings to ensure measures to protect staff, buildings, assets and information are appropriate to the level of threat.

HSBC remains committed to maintaining its preparedness and to ensuring the highest standards of health and safety wherever in the world the Group operates.

Diversity and inclusion

The group continues to be committed to providing equal opportunities to employees and encourage an inclusive workplace in line with the group's brand promise.

Progress in this area is measured by the Diversity & Inclusion Index which is part of the group's employee engagement survey (please see *'employee engagement'* section for additional information). All survey items in the Diversity & Inclusion Index performed above the UK and Ireland external 'Best in Class' average and the Financial Services norm.

Employees with disabilities

The group continues to recruit, train and develop disabled employees and make reasonable adjustments to employment terms and the working environment for employees that are disabled or become disabled during their employment.

The bank continues to support the commitments of the two tick symbol employability campaign to interview disabled candidates who meet the minimum job criteria. The symbol is a recognition given by Jobcentre Plus to employers who have agreed to make certain positive commitments regarding the employment, retention, training and career development of disabled people.

Employee involvement

As a large organisation with a unified strategic purpose, it is vital that HSBC involves and engages its employees.

Among various means of achieving this, coordinated communications to HSBC employees are key. A dedicated global team is responsible for strategy, alignment, and delivery of all central communications to HSBC employees, and supporting teams are in place for the continental European and UK audiences.

Within HSBC's internal communications portfolio, the global and country websites are those most used by employees and therefore are the primary vehicles for systematic dissemination of news and video content

relating to HSBC strategy, values, policy and employee matters and industry activity. Feedback and 'listening' channels are increasingly used to ensure communications and certain business activities are responsive to employee views and concerns.

In the UK, HSBC works with a number of elected employee consultation bodies, along with recognising Unite, an accredited trade union, for collective bargaining purposes for specific groups of employees. Within individual European countries there are a variety of consultation mechanisms with both trade unions and works councils and, in some countries, specific Collective Bargaining agreements. Additionally, HSBC currently operates a European Works Council, with employee members elected from across the Bank's European operations for consultation in respect of transnational matters. The purpose of each of these relationships is to provide information on matters that may affect employees, and to consult over these matters to ensure that employees' views are taken into account when making decisions. Meetings are held on a regular and ad hoc basis with each body. Through these consultation mechanisms, HSBC ensures that it meets its statutory obligations for information and consultation, along with helping to inform the decision-making process through the input and consideration of a wide range of ideas and opinions.

All employees are invited annually to participate in the bank's Sharesave scheme. The Sharesave scheme provides employees with the opportunity to buy shares in HSBC Holdings plc at a future date at a discounted option price set at the start of the savings period. Employees are also able to buy shares from their pre-tax salary via the Share Incentive Plan up to a maximum of £125 per month. Both schemes provide an accessible way for employees to have a stake in the business and the wider HSBC Group through share ownership and actively engage employees in the company's performance.

To help achieve HSBC's goals, the association between individual, team, business area and company performances must be demonstrated. Therefore, in addition to HSBC's day-to-day communications, specific mechanisms are in place to explain and familiarise employees with internal and external factors affecting the company's performance. These include regular editorials from HSBC's economists, business reviews by senior managers, financial news stories and a share price tracker. Focus is particularly given internally to HSBC's Annual and Interim Results, with dedicated communications and online content designed to provide relevance and understanding for employees.

Employee engagement

'Employee engagement' describes employees' emotional

Report of the Directors: Governance (continued)

and intellectual commitment to any organisation. HSBC's annual survey of employees shows that they value HSBC's commitment to sustainable business practices and view the bank as being a leader in this regard.

As an HSBC Group member, the bank has a well established framework for employees to provide feedback and develop action plans at local and national levels to improve the working experience and engagement.

In 2012 a quarterly Pulse survey was undertaken to monitor employee engagement. According to the results, 70 per cent of the employees who completed the survey indicated that different ideas and perspectives were welcome, even if they challenge the way things have always been done. Since 2011 a Global People Survey is performed biannually. The next Global People Survey will be in 2013.

In the UK, the bank has continued to use numerous complementary programmes to involve and seek feedback from employees, including: Best Place to Suggest, Idea of the Month, My Health & Wellbeing and a social networking tool. Employees can also comment on many of HSBC's internal blogs and communications.

Corporate sustainability

Sustainability Governance

The Corporate Sustainability Committee of the HSBC Holdings Board is responsible for advising the Board, committees of the Board and executive management on corporate sustainability policies across the Group including environmental, social and ethical issues. Dame Mary Marsh, an independent non-executive Director of the Bank is a member of the Corporate Sustainability Committee.

Corporate Sustainability exists as a global function, with senior executives charged with implementing sustainable business practice in all major regions, through inclusion in the HSBC Global Standards Manuals, and through induction and developmental training. Local teams are in charge of embedding corporate sustainability strategies within banking activities.

HSBC Holdings plc reports on its progress in developing and implementing its sustainability strategy annually in the HSBC Sustainability Report, which is independently verified and prepared using the Global Reporting Initiative framework. The *HSBC Sustainability Report 2012* will be issued on the 24th May 2013 and will be available at www.hsbc.com/sustainability.

Corporate sustainability

HSBC recognises that environmental, social and economic issues can impact on the Group's long term success as a business. Corporate Sustainability means

achieving sustainable profit growth so that HSBC can continue to reward shareholders and employees, build long-lasting relationships with customers and suppliers, pay taxes and duties in those countries where it operates, and invest in communities for future growth.

The way the group does business is as important as what it does. The group's responsibility to its customers, employees and shareholders as well as the countries and communities in which it operates goes far wider than simply being profitable.

HSBC's continuing financial success depends, in part, on its ability to identify and address certain factors which present risks or opportunities for the business. These can affect reputation, drive employee engagement, help manage the risks of lending, leverage savings through eco-efficiency and secure new revenue streams. These generally fall into the four broad areas discussed below.

Business finance

HSBC aims to build long-term customer relationships around the world through the provision of a consistent and high quality service and customer experience. HSBC uses the benefits of its scale, financial strength, geographic reach and strong brand value to achieve this.

HSBC aims to take advantage of the opportunities and manage the risks presented by emerging global trends by developing sustainable business models to address these. When setting strategy, HSBC considers factors such as population growth; increased longevity; urbanisation and the resulting resource constraints and rising atmospheric CO₂ levels.

Operational environmental efficiency

HSBC focuses its environmental initiatives primarily on addressing and responding to issues associated with climate change, including energy use, water and waste management. Climate change has the potential to materially affect HSBC's customers and, by extension, HSBC's long-term success, introducing new risks to business activity. At the end of 2011, HSBC committed to a series of targets stretching through to 2020, which will further reduce HSBC's impact on the environment. Work began in 2012 to achieve these targets.

Community Investment

HSBC has a long-standing commitment to the communities in which it operates. HSBC's operations bring benefits to local people and businesses through employment, training, purchasing and investment. Beyond its core business, HSBC aims to encourage social and economic opportunity through community investment activities.

HSBC's focus is on education and the environment, which it believes are essential building blocks for the

Report of the Directors: Governance (continued)

development of communities and are prerequisites for economic growth. These philanthropic programmes aim to involve employees in the work of local non-governmental organisations and charities.

During 2012, the bank supported community activities in the UK through charitable donations, and UK employees volunteered around 62,900 hours in work time. In the UK in 2012, the UK Bank gave £5 million in charitable donations.

Sustainability risk

Assessing the environmental and social impacts of providing finance to the bank's customers has been firmly embedded into its overall risk management processes. Sustainability risks arise from the provision of financial services to companies or projects which run counter to the needs of sustainable development. HSBC manages potential environmental and social risks in its lending and investment activity by identifying the key sectors where such risks can arise and developing policies to guide how it does business in those sectors: forest land and forest products; mining and metals; chemicals; freshwater infrastructure; and energy. HSBC also has a defence equipment policy which clarifies its approach to companies involved with weaponry. The policies apply to all lending and other forms of financial assistance, primary debt and equity markets activities, project finance and advisory work. HSBC has also adopted the Equator Principles, a set of voluntary guidelines that help financial institutions assess and monitor environmental and social impacts when providing finance to large projects. Where sustainability risks are assessed to be high, an independent review of transactions is undertaken.

Valuation of freehold and leasehold land and buildings

The group's freehold and long leasehold properties were valued in 2012. The value of these properties was £48 million in excess of their carrying amount in the consolidated balance sheet. The group no longer revalues freehold and long leasehold properties under IFRS.

Supplier payment policy

HSBC has signed up to the Government's Prompt Payment Code (further information on, and copies of, the Code can be obtained by visiting www.promptpaymentcode.org.uk).

Contracts with many suppliers are negotiated by HSBC Procurement with payment terms (including creditor days) set out in the contract or in HSBC's general terms and conditions for supply. For other suppliers, payment periods under the general terms and conditions of supply are usually 42 days from the date of invoice.

The amount due to trade creditors at 31 December 2012 represented 39 days average daily purchases of goods and services received from such creditors calculated in accordance with the Companies Act 2006 as amended by Statutory Instrument 2008 No. 410.

Auditor

Auditor KPMG Audit Plc has expressed its willingness to continue in office and the Board recommends that it be reappointed. A resolution proposing the reappointment of KPMG Audit Plc as auditor of the bank and giving authority to the Directors to determine its remuneration will be submitted to the forthcoming Annual General Meeting.

Conflicts of interest and indemnification of Directors

The bank's Articles of Association give the Board authority to approve Directors' conflicts and potential conflicts of interest. The Board has adopted a policy and procedures for the approval of Director's conflicts or potential conflicts of interest. The Board's powers to authorise conflicts are operating effectively and the procedures are being followed. A review of situational conflicts which have been authorised, including the terms of authorisation, is undertaken annually.

The Articles of Association of the bank provide that Directors are entitled to be indemnified out of the assets of the company against claims from third parties in respect of certain liabilities arising in connection with the performance of their functions, in accordance with the provisions of the UK Companies Act 2006. Such indemnity provisions have been in place during the financial year but have not been utilised by the Directors.

Going concern basis

The Financial Statements are prepared on a going concern basis, as the Directors are satisfied that the group and bank have the resources to continue in business for the foreseeable future. In making this assessment, the Directors have considered a wide range of information relating to present and future conditions. Further information relevant to the assessment is provided in the Report of the Directors, in particular:

A description of the group's principal activities, strategic direction and challenges and uncertainties.

A summary of financial performance and review of business performance.

The group's approach to capital management and allocation.

In addition, the objectives, policies and processes for managing credit, liquidity and market risk are set out in

Report of the Directors: Governance (continued)

the *'Report of the Directors: Risk'*.

The Directors have also considered future projections of profitability, cash flows and capital resources in making their assessment.

Disclosure of information to the Auditor

The Directors who held office at the date of approval of this Directors' report confirm that, so far as they are each

aware, there is no relevant audit information of which the bank's auditors are unaware; and each Director has taken all the steps that he ought to have taken as a Director to make himself aware of any relevant audit information and to establish that the company's auditors are aware of that information.

On behalf of the Board
J H McKenzie, *Secretary*
Registered number 14259

4 March 2013

Statement of Directors' Responsibilities in Respect of the *Annual Report and Accounts 2012* and the Financial Statements

The following statement, which should be read in conjunction with the Auditor's statement of their responsibilities set out in their report on the next page, is made with a view to distinguishing for shareholders the respective responsibilities of the Directors and of the Auditor in relation to the financial statements.

The Directors are responsible for preparing the Annual Report, the consolidated financial statements of HSBC Bank plc and its subsidiaries (the 'group') and parent company financial statements for HSBC Bank plc (the 'bank') in accordance with applicable laws and regulations.

Company law requires the Directors to prepare group and parent company financial statements for each financial year. The Directors are required to prepare the group financial statements in accordance with IFRSs as adopted by the EU and have elected to prepare the bank financial statements on the same basis.

Under company law the Directors must not approve the financial statements unless they are satisfied that they give a true and fair view of the state of affairs of the group and parent company and of their profit or loss for that period. In preparing each of the group and parent company financial statements, the Directors are required to:

- select suitable accounting policies and then apply them consistently;
- make judgments and estimates that are reasonable and prudent; and
- state whether they have been prepared in accordance with IFRSs as adopted by the EU.

The Directors are required to prepare the financial statements on the going concern basis unless it is not appropriate. Since the Directors are satisfied that the group has the resources to continue in business for the foreseeable future, the financial statements continue to be prepared on a going concern basis.

The Directors have responsibility for ensuring that sufficient accounting records are kept that disclose with reasonable accuracy at any time the financial position of the bank and enable them to ensure that its financial statements comply with the Companies Act 2006.

The Directors have general responsibility for taking such steps as are reasonably open to them to safeguard the assets of the group and to prevent and detect fraud and other irregularities.

The Directors have responsibility for the maintenance and integrity of the *Annual Report and Accounts* as they appear on the bank's website. Legislation in the UK governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

The Directors, the names of whom are set out in the *'Report of Directors: Governance'* section on page 85 of this Annual Report, confirm to the best of their knowledge:

- in accordance with rule 4.1.12(3)(a) of the Disclosure and Transparency Rules, the consolidated financial statements, which have been prepared in accordance with IFRSs as issued by the IASB and as adopted by the EU, have been prepared in accordance with the applicable set of accounting standards and give a true and fair view of the assets, liabilities, financial position and profit or loss of the bank and the undertakings included in the consolidation taken as a whole; and
- the management report represented by the Report of the Directors has been prepared in accordance with rule 4.1.12(3)(b) of the Disclosure and Transparency Rules, and includes a fair review of the development and performance of the business and the position of the bank and the undertakings included in the consolidation as a whole, together with a description of the principal risks and uncertainties that the group faces.

On behalf of the Board
J H McKenzie, *Secretary*

4 March 2013

Independent Auditor's Report to the Member of HSBC Bank plc

We have audited the group and parent company financial statements of HSBC Bank plc ('the bank') for the year ended 31 December 2012 set out on pages 95 to 208. The financial reporting framework that has been applied in their preparation is applicable law and International Financial Reporting Standards (IFRSs) as adopted by the EU and, as regards the parent company financial statements, as applied in accordance with the provisions of the Companies Act 2006.

This report is made solely to the bank's member, as a body, in accordance with Chapter 3 of Part 16 of the Companies Act 2006. Our audit work has been undertaken so that we might state to the bank's member those matters we are required to state to them in an auditors' report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the bank and the bank's member, as a body, for our audit work, for this report, or for the opinions we have formed.

Respective responsibilities of directors and auditor

As explained more fully in the Directors' Responsibilities Statement set out on page 93, the directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view. Our responsibility is to audit, and express an opinion on, the financial statements in accordance with applicable law and International Standards on Auditing (UK and Ireland). Those standards require us to comply with the Auditing Practices Board's (APB's) Ethical Standards for Auditors.

Scope of the audit of the financial statements

A description of the scope of an audit of financial statements is provided on the Financial Reporting Council's website at www.frc.org.uk/auditscopeukprivate.

Opinion on financial statements

In our opinion:

- the financial statements give a true and fair view of the state of the group's and of the parent company's affairs as at 31 December 2012 and of the group's profit for the year then ended;
- the group financial statements have been properly prepared in accordance with IFRSs as adopted by the EU;
- the parent company financial statements have been properly prepared in accordance with IFRSs as adopted by the EU and as applied in accordance with the provisions of the Companies Act 2006; and
- the financial statements have been prepared in accordance with the requirements of the Companies Act 2006 and, as regards the group financial statements, Article 4 of the IAS Regulation.

Opinion on other matter prescribed by the Companies Act 2006

In our opinion the information given in the Directors' Report for the financial year for which the financial statements are prepared is consistent with the financial statements.

Matters on which we are required to report by exception

We have nothing to report in respect of the following matters where the Companies Act 2006 requires us to report to you if, in our opinion:

- adequate accounting records have not been kept by the parent company, or returns adequate for our audit have not been received from branches not visited by us; or
- the parent company financial statements are not in agreement with the accounting records and returns; or
- certain disclosures of directors' remuneration specified by law are not made; or
- we have not received all the information and explanations we require for our audit.

P McIntyre, Senior Statutory Auditor

for and on behalf of KPMG Audit Plc, Statutory Auditor
Chartered Accountants
London, England

4 March 2013

Financial Statements

Consolidated income statement for the year ended 31 December 2012¹

	2012			2011		
	Continuing operations	Discontinued operations	Total	Continuing operations	Discontinued operations	Total
	Notes	£m	£m	£m	£m	£m
Interest income	10,214	460	10,674	10,689	662	11,351
Interest expense	(3,695)	(75)	(3,770)	(4,006)	(122)	(4,128)
Net interest income	6,519	385	6,904	6,683	540	7,223
Fee income	4,522	533	5,055	4,541	652	5,193
Fee expense	(1,213)	(61)	(1,274)	(1,200)	(93)	(1,293)
Net fee income	3,309	472	3,781	3,341	559	3,900
Trading income excluding net interest income	645	247	892	348	243	591
Net interest income on trading activities	942	–	942	940	5	945
Net trading income	1,587	247	1,834	1,288	248	1,536
Net income from financial instruments designated at fair value	118	–	118	433	–	433
Gains less losses from financial investments	335	1	336	282	10	292
Dividend income	15	1	16	14	2	16
Net earned insurance premiums	2,286	–	2,286	2,580	–	2,580
Other operating income	129	3	132	219	6	225
Total operating income	14,298	1,109	15,407	14,840	1,365	16,205
Net insurance claims incurred and movement in liabilities to policyholders.....	5 (2,919)	–	(2,919)	(2,182)	–	(2,182)
Net operating income before loan impairment charges and other credit risk provisions	11,379	1,109	12,488	12,658	1,365	14,023
Loan impairment charges and other credit risk provisions	6 (1,246)	1	(1,245)	(1,585)	(38)	(1,623)
Net operating income	10,133	1,110	11,243	11,073	1,327	12,400
Employee compensation and benefits	7 (4,353)	(436)	(4,789)	(4,026)	(555)	(4,581)
General and administrative expenses	(4,626)	(280)	(4,906)	(3,857)	(301)	(4,158)
Depreciation and impairment of property, plant and equipment	23 (353)	(13)	(366)	(336)	(17)	(353)
Amortisation and impairment of intangible assets	22 (174)	(1)	(175)	(195)	(1)	(196)
Total operating expenses	(9,506)	(730)	(10,236)	(8,414)	(874)	(9,288)
Operating profit	627	380	1,007	2,659	453	3,112
Share of (loss)/profit in associates and joint ventures ...	(3)	–	(3)	(1)	–	(1)
Profit before tax	624	380	1,004	2,658	453	3,111
Tax credit/(expense)	10 220	(64)	156	(656)	(78)	(734)
Profit for the year before gain on disposal of discontinued operations	844	316	1,160	2,002	375	2,377
Gain on sale of discontinued operations	–	1,265	1,265	–	–	–
Profit for the year	844	1,581	2,425	2,002	375	2,377
Profit attributable to shareholders of the parent company	803	1,581	2,384	1,960	369	2,329
Profit attributable to non-controlling interests	41	–	41	42	6	48

¹ In November 2012, the group sold HSBC Private Banking Holdings (Suisse) SA to HSBC Holdings plc. The ownership of HSBC Private Bank (UK) Limited remains within the group. The comparative statement of comprehensive income has been re-presented to show the discontinued operation separately from continuing operations.

The accompanying notes on pages 105 to 208 and the audited sections of 'Report of the Directors: Risk' on pages 27 to 80 and 'Report of the Directors: Capital Management' on pages 81 to 84 form an integral part of these financial statements.

Financial Statements (continued)

Consolidated statement of comprehensive income for the year ended 31 December 2012

	2012			2011		
	Continuing operations	Discontinued operations	Total	Continuing operations	Discontinued operations	Total
	£m	£m	£m	£m	£m	£m
Profit for the year	844	1,581	2,425	2,002	375	2,377
Other comprehensive income						
Available-for-sale investments						
– fair value gains/(losses)	2,378	136	2,514	(200)	(141)	(341)
– fair value (losses)/gains transferred to the income statement on disposal	(342)	89	(253)	(212)	112	(100)
– amounts transferred to the income statement in respect of impairment losses	444	1	445	338	31	369
– income taxes	(88)	(29)	(117)	218	7	225
Cash flow hedges						
– fair value gains	217	6	223	363	6	369
– fair value losses transferred to the income statement	(181)	(12)	(193)	(289)	(11)	(300)
– income taxes	(7)	–	(7)	(23)	–	(23)
Actuarial gains on defined benefit plans						
– before income taxes	89	8	97	1,190	(49)	1,141
– income taxes	1	(2)	(1)	(327)	11	(316)
Exchange differences and other	(224)	(1,486)	(1,710)	(548)	12	(536)
Other comprehensive income for the year, net of tax.	2,287	(1,289)	998	510	(22)	488
Total comprehensive income for the year.....	3,131	292	3,423	2,512	353	2,865
Total comprehensive income for the year attributable to:						
– shareholders of the parent company.....	3,098	292	3,390	2,489	347	2,836
– non-controlling interests	33	–	33	23	6	29
	3,131	292	3,423	2,512	353	2,865

The accompanying notes on pages 105 to 208 and the audited sections of 'Report of the Directors: Risk' on pages 27 to 80 and 'Report of the Directors: Capital Management' on pages 81 to 84 form an integral part of these financial statements.

Financial Statements (continued)

Consolidated statement of financial position at 31 December 2012

	Notes	2012 £m	2011 £m
ASSETS			
Cash and balances at central banks		51,613	56,460
Items in the course of collection from other banks		1,961	1,663
Trading assets	16	161,516	126,598
Financial assets designated at fair value	17	15,387	15,332
Derivatives	18	177,808	176,993
Loans and advances to banks	33	32,286	44,603
Loans and advances to customers	33	282,685	288,014
Financial investments	19	71,265	93,112
Other assets	25	6,366	7,137
Current tax assets		200	262
Prepayments and accrued income		2,584	2,937
Interests in associates and joint ventures	21	67	76
Goodwill and intangible assets	22	7,826	10,995
Property, plant and equipment	23	2,024	2,204
Deferred tax assets	10	274	140
Retirement benefit assets	7	1,619	1,444
Total assets		815,481	827,970
LIABILITIES AND EQUITY			
Liabilities			
Deposits by banks	33	39,571	41,032
Customer accounts	33	324,886	346,129
Items in the course of transmission to other banks		1,017	1,154
Trading liabilities	26	122,896	119,211
Financial liabilities designated at fair value	27	32,918	31,992
Derivatives	18	181,095	178,121
Debt securities in issue	33	40,358	42,688
Other liabilities	28	6,846	4,570
Current tax liability		122	131
Liabilities under insurance contracts issued	29	17,913	16,347
Accruals and deferred income		3,250	3,509
Provisions	30	1,641	820
Deferred tax liabilities	10	99	266
Retirement benefit liabilities	7	319	398
Subordinated liabilities	31	10,350	9,998
Total liabilities		783,281	796,366
Equity			
Called up share capital	37	797	797
Share premium account		20,025	20,025
Other reserves		394	(537)
Retained earnings		10,459	10,805
Total equity attributable to shareholders of the parent company		31,675	31,090
Non-controlling interests		525	514
Total equity		32,200	31,604
Total equity and liabilities		815,481	827,970

The accompanying notes on pages 105 to 208 and the audited sections of 'Report of the Directors: Risk' on pages 27 to 80 and 'Report of the Directors: Capital Management' on pages 81 to 84 form an integral part of these financial statements.

Financial Statements (continued)

Consolidated cash flow statement for the year ended 31 December 2012

	Notes	2012 £m	2011 £m
Cash flows from operating activities			
Profit before tax		1,004	3,111
Adjustments for:			
– non-cash items included in profit before tax	38	3,988	3,090
– change in operating assets	38	(34,029)	20,932
– change in operating liabilities	38	23,887	(8,348)
– elimination of exchange differences ¹		4,162	1,726
– net gain from investing activities		(344)	(327)
– share of loss in associates and joint ventures		3	1
– contributions paid to defined benefit plans		(197)	(397)
– tax paid		(171)	(486)
Net cash (used in)/generated from operating activities		<u>(1,697)</u>	<u>19,302</u>
Cash flows from investing activities			
Purchase of financial investments		(47,431)	(67,343)
Proceeds from the sale and maturity of financial investments		54,772	74,328
Purchase of property, plant and equipment		(347)	(391)
Proceeds from the sale of property, plant and equipment		30	34
Purchase of intangible assets		(229)	(281)
Proceeds from the sale of intangible assets		3	–
Net cash outflow from the acquisition of subsidiaries		–	(139)
Net cash outflow from acquisition of associates		–	(2)
Proceeds from disposal of subsidiaries		51	–
Proceeds from disposal of associates		–	14
Net cash disposed of on sale of subsidiaries		(10,008)	–
Purchases of HSBC Holdings plc shares to satisfy share-based payment transactions		(3)	(32)
Net cash generated from/(used in) investing activities		<u>(3,162)</u>	<u>6,188</u>
Cash flows from financing activities			
Subordinated liabilities issued, net of perpetual subordinated debt classified as equity repaid		473	1,602
Subordinated loan capital repaid		(350)	(704)
Net cash outflow from increase in stake of subsidiaries		(2)	(50)
Dividends paid to shareholders		(2,821)	(1,819)
Dividends paid to non-controlling interests		(20)	(31)
Net cash generated from financing activities		<u>(2,720)</u>	<u>(1,002)</u>
Net increase in cash and cash equivalents		(7,579)	24,488
Cash and cash equivalents at 1 January		108,440	86,005
Effect of exchange rate changes on cash and cash equivalents		(2,703)	(2,053)
Cash and cash equivalents at 31 December	38	<u>98,158</u>	<u>108,440</u>

¹ Adjustment to bring changes between opening and closing balance sheet amounts to average rates. This is not done on a line-by-line basis, as details cannot be determined without unreasonable expense.

The accompanying notes on pages 105 to 208 and the audited sections of 'Report of the Directors: Risk' on pages 27 to 80 and 'Report of the Directors: Capital Management' on pages 81 to 84 form an integral part of these financial statements.

Consolidated statement of changes in equity for the year ended 31 December 2012

	2012									
	Other reserves									
	Called up Share capital £m	Share premium £m	Other equity instruments £m	Retained earnings £m	Available- for-sale fair value reserve £m	Cash flow hedging reserve ³ £m	Foreign exchange reserve £m	Total share- holders' equity £m	Non- controlling interests £m	Total equity £m
At 1 January	797	20,025	–	10,805	(2,793)	236	2,020	31,090	514	31,604
Profit for the year	–	–	–	2,384	–	–	–	2,384	41	2,425
Other comprehensive income (net of tax)	–	–	–	101	2,578	23	(1,696)	1,006	(8)	998
Available-for-sale investments	–	–	–	–	2,578	–	–	2,578	11	2,589
Cash flow hedges	–	–	–	–	–	23	–	23	–	23
Actuarial gains/(losses) on defined benefit plans	–	–	–	101	–	–	–	101	(5)	96
Exchange differences and other	–	–	–	–	–	–	(1,696)	(1,696)	(14)	(1,710)
Total comprehensive income for the year	–	–	–	2,485	2,578	23	(1,696)	3,390	33	3,423
Dividends to shareholders	–	–	–	(2,821)	–	–	–	(2,821)	(20)	(2,841)
Net impact of equity-settled share-based payments ¹	–	–	–	14	–	–	–	14	–	14
Other movements	–	–	–	–	–	–	–	–	–	–
Disposal of subsidiaries ²	–	–	–	(26)	84	–	(58)	–	(2)	(2)
Tax on items taken directly to equity - current	–	–	–	2	–	–	–	2	–	2
At 31 December	797	20,025	–	10,459	(131)	259	266	31,675	525	32,200

1 Includes deferred tax of £18 million.

2 Relates to the sale of HSBC Private Banking Holdings (Suisse) SA. See Note 42 for further details.

3 Movements in the cash flow hedging reserve include amounts transferred to the income statement of £193 million comprising a £211 million loss taken to 'Net interest income' and a £18 million loss taken to 'Net trading income'.

The accompanying notes on pages 105 to 208 and the audited sections of 'Report of the Directors: Risk' on pages 27 to 80 and 'Report of the Directors: Capital Management' on pages 81 to 84 form an integral part of these financial statements.

	2011									
	Called up share capital £m	Share premium £m	Other equity instruments £m	Retained earnings £m	Other reserves			Total share- holders' equity £m	Non- controlling interests £m	Total equity £m
Available- for-sale fair value reserve £m					Cash flow Hedging Reserve ² £m	Foreign exchange reserve £m				
At 1 January	797	20,025	1,750	9,473	(2,949)	190	2,539	31,825	532	32,357
Profit for the year	-	-	-	2,329	-	-	-	2,329	48	2,377
Other comprehensive income (net of tax)	-	-	-	827	156	46	(522)	507	(19)	488
Available-for-sale investments	-	-	-	-	156	-	-	156	(3)	153
Cash flow hedges	-	-	-	-	-	46	-	46	-	46
Actuarial gains/(losses) on defined benefit plans	-	-	-	827	-	-	-	827	(2)	825
Exchange differences and other	-	-	-	-	-	-	(522)	(522)	(14)	(536)
Total comprehensive income for the year.....	-	-	-	3,156	156	46	(522)	2,836	29	2,865
Dividends to shareholders	-	-	-	(1,819)	-	-	-	(1,819)	(31)	(1,850)
Net impact of equity-settled share-based payments ¹	-	-	-	124	-	-	-	124	-	124
Repayment of capital securities	-	-	(1,750)	(6)	-	-	-	(1,756)	-	(1,756)
Other movements	-	-	-	-	-	-	3	3	-	3
Acquisition of subsidiaries	-	-	-	(108)	-	-	-	(108)	-	(108)
Change in ownership interest in subsidiaries that did not result in loss of control	-	-	-	(30)	-	-	-	(30)	(16)	(46)
Tax on items taken directly to equity - current	-	-	-	15	-	-	-	15	-	15
At 31 December	797	20,025	-	10,805	(2,793)	236	2,020	31,090	514	31,604

¹ Includes deferred tax of £13 million.

² Movements in the cash flow hedging reserve include amounts transferred to the income statement of £300 million comprising a £246 million loss taken to 'Net interest income' and a £54 million loss taken to 'Net trading income'.

The accompanying notes on pages 105 to 208 and the audited sections of 'Report of the Directors: Risk' on pages 27 to 80 and 'Report of the Directors: Capital Management' on pages 81 to 84 form an integral part of these financial statements.

Financial Statements (continued)

HSBC Bank plc statement of financial position at 31 December 2012

	Notes	2012 £m	2011 £m
ASSETS			
Cash and balances at central banks		45,262	44,967
Items in the course of collection from other banks		1,213	908
Trading assets	16	137,999	106,339
Financial assets designated at fair value	17	4,373	4,595
Derivatives	18	140,340	145,424
Loans and advances to banks	33	17,207	22,203
Loans and advances to customers	33	225,567	210,561
Financial investments	19	36,603	42,240
Other assets	25	4,688	4,016
Current tax assets		168	308
Prepayments and accrued income		1,174	1,249
Interests in associates and joint ventures	21	62	65
Investments in subsidiary undertakings	24	11,031	15,047
Goodwill and intangible assets	22	879	799
Property, plant and equipment	23	1,241	1,347
Deferred tax assets	10	204	55
Retirement benefit assets	7	1,619	1,444
Total assets		629,630	601,567
LIABILITIES AND EQUITY			
Liabilities			
Deposits by banks	33	30,129	32,324
Customer accounts	33	256,341	237,654
Items in the course of transmission to other banks		334	446
Trading liabilities	26	104,946	94,584
Financial liabilities designated at fair value	27	23,513	22,861
Derivatives	18	143,921	147,251
Debt securities in issue	33	24,970	25,705
Other liabilities	28	5,248	2,380
Current taxation		30	25
Accruals and deferred income		1,758	1,769
Provisions	30	1,250	565
Deferred tax liability	10	2	2
Retirement benefit liabilities	7	153	172
Subordinated liabilities	31	9,968	9,893
Total liabilities		602,563	575,631
Equity			
Called up share capital	37	797	797
Share premium account		20,025	20,025
Other reserves		(343)	(340)
Retained earnings		6,588	5,454
Total equity		27,067	25,936
Total equity and liabilities		629,630	601,567

The accompanying notes on pages 105 to 208 and the audited sections of 'Report of the Directors: Risk' on pages 27 to 80 and 'Report of the Directors: Capital Management' on pages 81 to 84 form an integral part of these financial statements.

B Robertson, Chief Executive

4 March 2013

Financial Statements (continued)

HSBC Bank plc cash flow statement for the year ended 31 December 2012

	Notes	2012 £m	2011 £m
Cash flows from operating activities			
Profit before tax		2,132	2,770
Adjustments for:			
– non-cash items included in profit before tax	38	3,752	1,956
– change in operating assets	38	(20,023)	22,991
– change in operating liabilities	38	19,029	1,033
– elimination of exchange differences ¹		(464)	(617)
– net gain from investing activities		(317)	(239)
– contributions paid to defined benefit plans		(150)	(379)
– tax received/(paid)		251	(133)
Net cash (used in)/generated from operating activities		<u>4,210</u>	<u>27,382</u>
Cash flows from investing activities			
Purchase of financial investments		(26,873)	(31,107)
Proceeds from the sale of financial investments		31,641	30,585
Purchase of property, plant and equipment		(175)	(272)
Proceeds from the sale of property, plant and equipment		10	24
Purchase of goodwill and intangible assets		(202)	(245)
Proceeds from the sale of intangible assets		–	–
Net cash outflow from acquisition of subsidiaries		(707)	–
Proceeds from disposal of associates		–	1
Net cash generated from/(used in) investing activities		<u>3,694</u>	<u>(1,014)</u>
Cash flows from financing activities			
Subordinated loan capital repaid		(350)	(684)
Subordinated liabilities issued, net of perpetual subordinated debt classified as equity repaid		350	1,326
Net cash outflow from acquisition of and increase in stake of subsidiaries		(2)	–
Dividends paid		(2,816)	(1,815)
Net cash generated from financing activities		<u>(2,818)</u>	<u>(1,173)</u>
Net increase in cash and cash equivalents		5,086	25,195
Cash and cash equivalents at 1 January		75,356	51,359
Effect of exchange rate changes on cash and cash equivalents		(1,781)	(1,198)
Cash and cash equivalents at 31 December	38	<u>78,661</u>	<u>75,356</u>

1 Adjustment to bring changes between opening and closing balance sheet amounts to average rates. This is not done on a line-by-line basis, as details cannot be determined without unreasonable expense.

The accompanying notes on pages 105 to 208 and the audited sections of 'Report of the Directors: Risk' on pages 27 to 80 and 'Report of the Directors: Capital Management' on pages 81 to 84 form an integral part of these financial statements.

HSBC Bank plc statement of changes in equity for the year ended 31 December 2012

	2012							Total equity £m
	Called up share capital £m	Share premium £m	Other equity instruments £m	Retained earnings £m	Available- for-sale fair value reserve £m	Cash flow hedging reserve ² £m	Foreign exchange reserve £m	
At 1 January	797	20,025	–	5,454	(457)	138	(21)	25,936
Profit for the year	–	–	–	3,751	–	–	–	3,751
Other comprehensive income (net of tax)	–	–	–	136	80	29	(112)	133
Available-for-sale investments	–	–	–	–	80	–	–	80
Cash flow hedges	–	–	–	–	–	29	–	29
Actuarial gains on defined benefit plans	–	–	–	136	–	–	–	136
Exchange differences and other	–	–	–	–	–	–	(112)	(112)
Total comprehensive income for the year	–	–	–	3,887	80	29	(112)	3,884
Dividends to shareholders	–	–	–	(2,816)	–	–	–	(2,816)
Net impact of equity-settled share-based payments ¹	–	–	–	60	–	–	–	60
Other	–	–	–	3	–	–	–	3
Tax on items taken directly to equity - current	–	–	–	–	–	–	–	–
At 31 December	797	20,025	–	6,588	(377)	167	(133)	27,067

¹ Includes deferred tax of £18 million.

² Movements in the cash flow hedging reserve include an amount transferred to the income statement of £189 million loss taken to 'Net interest income'.

The accompanying notes on pages 105 to 208 and the audited sections of 'Report of the Directors: Risk' on pages 27 to 80 and 'Report of the Directors: Capital Management' on pages 81 to 84 form an integral part of these financial statements.

	2011							Total equity £m
	Called up share capital £m	Share premium £m	Other equity Instruments £m	Retained earnings £m	Other reserves			
					Available- for-sale fair value reserve £m	Cash flow hedging reserve ² £m	Foreign exchange reserve £m	
At 1 January	797	20,025	1,750	3,968	(68)	130	(20)	26,582
Profit for the year	–	–	–	2,320	–	–	–	2,320
Other comprehensive income (net of tax)	–	–	–	877	(389)	8	(1)	495
Available-for-sale investments	–	–	–	–	(389)	–	–	(389)
Cash flow hedges	–	–	–	–	–	8	–	8
Actuarial gains on defined benefit plans	–	–	–	877	–	–	–	877
Exchange differences and other	–	–	–	–	–	–	(1)	(1)
Total comprehensive income for the year	–	–	–	3,197	(389)	8	(1)	2,815
Dividends to shareholders	–	–	–	(1,815)	–	–	–	(1,815)
Net impact of equity-settled share-based payments ¹	–	–	–	94	–	–	–	94
Repayment of capital securities ²	–	–	(1,750)	(6)	–	–	–	(1,756)
Tax on items taken directly to equity - current	–	–	–	16	–	–	–	16
At 31 December	797	20,025	–	5,454	(457)	138	(21)	25,936

¹ Includes deferred tax of £13 million.

² Movements in the cash flow hedging reserve include an amount transferred to the income statement of £237 million loss taken to 'Net interest income'.

The accompanying notes on pages 105 to 208 and the audited sections of 'Report of the Directors: Risk' on pages 27 to 80 and 'Report of the Directors: Capital Management' on pages 81 to 84 form an integral part of these financial statements.

Notes on the Financial Statements

1 Basis of preparation

(a) Compliance with International Financial Reporting Standards

The consolidated financial statements of the group and the separate financial statements of HSBC Bank plc have been prepared in accordance with International Financial Reporting Standards ('IFRSs') as issued by the International Accounting Standards Board ('IASB') and as endorsed by the EU. EU-endorsed IFRSs may differ from IFRSs as issued by the IASB if, at any point in time, new or amended IFRSs have not been endorsed by the EU.

At 31 December 2012, there were no unendorsed standards effective for the year ended 31 December 2012 affecting these consolidated and separate financial statements, and there was no significant difference between IFRSs endorsed by the EU and IFRSs issued by the IASB in terms of their application to the group. Accordingly, the group's financial statements for the year ended 31 December 2012 are prepared in accordance with IFRSs as issued by the IASB.

IFRSs comprise accounting standards issued by the IASB and its predecessor body as well as interpretations issued by the IFRS Interpretations Committee ('IFRIC') and its predecessor body.

As a result of evolving market practice, the group revised its methodology for determining 'credit valuation adjustment' ('CVA') for derivatives, at 31 December 2012. Historically, the probability of default used in the CVA calculation has been based on HSBC's internal credit rating for the counterparty taking into account how credit ratings may deteriorate over the duration of the exposure based on historical rating transition matrices. As a result of evolving market practice, HSBC has decided to revise the methodology for determining the probability of default to one derived from current market levels for certain transaction types such as credit default swaps without adjusting factors where the credit default swap or other market data relates to the counterparty. Where relevant information for a particular counterparty is not available in the market, adjustments are made as necessary to other appropriate market information to determine the appropriate probability of default. Such adjustments are driven by considerations of the credit rating of the counterparty.

In addition, as a result of the evolving market practices and in conjunction with the revised methodology for determining CVA, the group aligned its methodology for determining the 'debit valuation adjustment' (DVA). Historically the group had adopted a zero DVA. At 31 December 2012, the effect of the changes in fair value estimate as a result of the revisions to methodology was to reduce derivative liabilities by £191 million and to reduce derivative assets by £387 million resulting in a net trading loss of £196 million. It is impracticable to estimate the effect of the changes in fair value estimate on future periods. See Note 32 for further information on credit valuation adjustment and debit valuation adjustment methodologies.

During 2012, in addition to the above, the group adopted a number of standards, interpretations and amendments to standards which had an insignificant effect on the consolidated financial statements of the group and the separate financial statements of HSBC Bank plc.

(b) Presentation of information

Disclosures under IFRS 4 'Insurance Contracts' ('IFRS 4') and IFRS 7 'Financial Instruments: Disclosures' ('IFRS 7') concerning the nature and extent of risks relating to insurance contracts and financial instruments have been included in the audited sections of the 'Report of the Directors: Risk' on pages 27 to 80.

Capital disclosures under IAS 1 'Presentation of Financial Statements' ('IAS 1') have been included in the audited sections of the 'Report of the Directors: Capital Management' on pages 81 to 84.

Disclosures relating to the group's securitisation activities and structured products have been included in the audited section of 'Report of the Directors: Risk' on pages 59 to 60.

In publishing the parent company financial statements here together with the group financial statements, the bank has taken advantage of the exemption in section 408(3) of the Companies Act 2006 not to present its individual income statement, individual statement of comprehensive income and related notes that form a part of these financial statements.

The functional currency of the bank is Sterling, which is also the presentation currency of the consolidated financial statements of the group.

Notes on the Financial Statements (continued)

(c) Consolidation

The consolidated financial statements of the group comprise the financial statements of HSBC Bank plc and its subsidiaries made up to 31 December.

Subsidiaries are consolidated from the date that the group gains control. The acquisition method of accounting is used when subsidiaries are acquired by the group. The cost of an acquisition is measured at the fair value of the consideration, including contingent consideration, given at the date of exchange. Acquisition-related costs are recognised as an expense in the income statement in the period in which they are incurred. The acquired identifiable assets, liabilities and contingent liabilities are measured at their fair values at the date of acquisition. Goodwill is measured as the excess of the aggregation of the consideration transferred, the amount of non-controlling interest and the fair value of the acquirer's previously held equity interest, if any, over the net of the amounts of the identifiable assets acquired and the liabilities assumed. The amount of non-controlling interest is measured either at fair value or at the non-controlling interest's proportionate share of the acquiree's identifiable net assets. In a business combination achieved in stages, the previously held equity interest is remeasured at the acquisition-date fair value with the resulting gain or loss recognised in the income statement. In the event that the amounts of net assets acquired is in excess of the aggregate of the consideration transferred, the amount of non-controlling interest and the fair value of the group's previously held equity interest, the difference is recognised immediately in the income statement.

Changes in a parent's ownership interest in a subsidiary that do not result in a loss of control are treated as transactions between equity holders and are reported in equity.

Entities that are controlled by the group are consolidated until the date that control ceases.

In the context of Special Purpose Entities ('SPEs'), the following circumstances may indicate a relationship in which, in substance, the group controls and, consequently, consolidates an SPE:

- the activities of the SPE are being conducted on behalf of the group according to its specific business needs so that the group obtains benefits from the SPE's operation;
- the group has the decision-making powers to obtain the majority of the benefits of the activities of the SPE or, by setting up an 'autopilot' mechanism, the group has delegated these decision-making powers;
- the group has rights to obtain the majority of the benefits of the SPE and therefore may be exposed to risks incidental to the activities of the SPE; or
- the group retains the majority of the residual or ownership risks related to the SPE or its assets in order to obtain benefits from its activities.

The group performs a re-assessment of consolidation whenever there is a change in the substance of the relationship between the group and an SPE.

All intra-group transactions are eliminated on consolidation.

The consolidated financial statements of the group also include the attributable share of the results and reserves of joint ventures and associates. These are based on financial statements made up to dates not earlier than three months prior to 31 December, adjusted for the effect of any significant transactions or events that occur between that date and the group's reporting date.

(d) Future accounting developments

At 31 December 2012, a number of standards and interpretations, and amendments thereto, had been issued by the IASB, which are not effective for the group's consolidated financial statements or the separate financial statements of HSBC Bank plc as at 31 December 2012. In addition to the projects to complete financial instrument accounting, the IASB is continuing to work on projects on insurance, revenue recognition and lease accounting, which together with the standards described below, will represent widespread and significant changes to accounting requirements in the future.

Standards and Interpretations issued by the IASB

Standards applicable in 2013

In May 2011, the IASB issued IFRS 10 'Consolidated Financial Statements' ('IFRS 10'), IFRS 11 'Joint Arrangements' ('IFRS 11') and IFRS 12 'Disclosure of Interests in Other Entities' ('IFRS 12'). In June 2012, the IASB issued amendments to IFRS 10, IFRS 11 and IFRS 12 'Transition Guidance'. The standards and

Notes on the Financial Statements (continued)

amendments are effective for annual periods beginning on or after 1 January 2013 with early adoption permitted. IFRSs 10 and 11 are required to be applied retrospectively.

Under IFRS 10, there will be one approach for determining consolidation for all entities, based on the concept of power, variability of returns and their linkage. This will replace the current approach which emphasises legal control or exposure to risks and rewards, depending on the nature of the entity. IFRS 11 places more focus on the investors' rights and obligations than on structure of the arrangement, and introduces the concept of a joint operation. IFRS 12 includes the disclosure requirements for subsidiaries, joint arrangements and associates and introduces new requirements for unconsolidated structured entities.

Based on the group's assessment to date, while the consolidation status of some entities may change because HSBC has control but not the majority of risks and rewards, or vice versa, the group does not expect the overall impact of IFRS 10 and IFRS 11 on the financial statements to be material.

In May 2011, the IASB also issued IFRS 13 'Fair Value Measurement' ('IFRS 13'). This standard is effective for annual periods beginning on or after 1 January 2013 with early adoption permitted. IFRS 13 is required to be applied prospectively from the beginning of the first annual period in which it is applied. The disclosure requirements of IFRS 13 do not require comparative information to be provided for periods prior to initial application.

IFRS 13 establishes a single source of guidance for all fair value measurements required or permitted by IFRSs. The standard clarifies the definition of fair value as an exit price, which is defined as a price at which an orderly transaction to sell the asset or to transfer the liability would take place between market participants at the measurement date under current market conditions, and enhances disclosures about fair value measurement.

The impact of IFRS 13 is not expected to be material to HSBC.

In June 2011, the IASB issued amendments to IAS 19 'Employee Benefits' ('IAS 19 revised'). The revised standard is effective for annual periods beginning on or after 1 January 2013 with early adoption permitted. IAS 19 revised is required to be applied retrospectively.

The most significant amendment for the group is the replacement of interest cost and expected return on plan assets by a finance cost component comprising the net interest on the net defined benefit liability or asset. This finance cost component is determined by applying the same discount rate used to measure the defined benefit obligation to the net defined benefit liability or asset. The difference between the actual return on plan assets and the return included in the finance cost component in the income statement will be presented in other comprehensive income. The effect of this change is to increase the pension expense by the difference between the current expected return on plan assets and the return calculated by applying the relevant discount rate.

Based on the group's estimate of the impact of this particular amendment on the 2012 consolidated financial statements, the change would have an immaterial effect on total operating expenses and pre-tax profit, with no effect on the pension liability. Therefore, the effect at the date of adoption on 1 January 2013 was not material to the group.

In December 2011, the IASB issued amendments to IFRS 7 'Disclosures – Offsetting Financial Assets and Financial Liabilities' which requires the disclosures about the effect or potential effects of offsetting financial assets and financial liabilities and related arrangements on an entity's financial position. The amendments are effective for annual periods beginning on or after 1 January 2013 and interim periods within those annual periods. The amendments are required to be applied retrospectively.

Standards applicable in 2014

In December 2011, the IASB issued amendments to IAS 32 'Offsetting Financial Assets and Financial Liabilities' which clarified the requirements for offsetting financial instruments and addressed inconsistencies in current practice when applying the offsetting criteria in IAS 32 'Financial Instruments: Presentation'. The amendments are effective for annual periods beginning on or after 1 January 2014 and are required to be applied retrospectively.

Based on the group's initial assessment, the amendments to IAS 32 are not expected to have a material impact on the group's financial statements.

In October 2012, the IASB issued amendments to IFRS 10, IFRS 12 and IAS 27 'Investment Entities', which introduced an exception to the principle that all subsidiaries shall be consolidated. The amendments require a parent that is an investment entity to measure its investments in particular subsidiaries at fair value through profit or loss instead of consolidating all subsidiaries in its consolidated and separate financial statements. The amendments are effective from 1 January 2014 with early adoption permitted. Based on the group's initial

Notes on the Financial Statements (continued)

assessment, the amendments are not expected to have a material impact on the group's consolidated financial statements.

Standards applicable in 2015

In November 2009, the IASB issued IFRS 9 'Financial Instruments' ('IFRS 9') which introduced new requirements for the classification and measurement of financial assets. In October 2010, the IASB issued additions to IFRS 9 incorporating requirements for financial liabilities. Together, these changes represent the first phase in the IASB's planned replacement of IAS 39 'Financial Instruments: Recognition and Measurement' ('IAS 39') with a less complex and improved standard for financial instruments.

Following the IASB's decision in December 2011 to defer the effective date, the standard is effective for annual periods beginning on or after 1 January 2015 with early adoption permitted. IFRS 9 is required to be applied retrospectively but prior periods need not be restated.

The second and third phases in the IASB's project to replace IAS 39 will address the impairment of financial assets measured at amortised cost and hedge accounting.

The IASB is in the process of amending the requirements for classification and measurement in IFRS 9 to address practice and other issues.

As a result of uncertainties with regard to the final IFRS 9 requirements for classification and measurement and impairment, the group remains unable to provide a date by which it will apply IFRS 9 as a whole and it remains impracticable to quantify the effect of IFRS 9 as at the date of the publication of these financial statements.

EU endorsement

All the standards applicable in 2013 and 2014 have been endorsed for use in the EU, except for the amendments to IFRS 10, IFRS 11 and IFRS 12 'Transition Guidance' and the amendments to IFRS 10, IFRS 12 and IAS 27 'Investment Entities'. Until these amendments are endorsed, the relief they provide for comparatives disclosures in accordance with IFRS 12 will not be available.

2 Summary of significant accounting policies

(a) Interest income and expense

Interest income and expense for all financial instruments except for those classified as held-for-trading or designated at fair value (other than debt securities issued by the group and derivatives managed in conjunction with such debt securities issued) are recognised in 'Interest income' and 'Interest expense' in the income statement using the effective interest method. The effective interest method is a way of calculating the amortised cost of a financial asset or a financial liability (or groups of financial assets or financial liabilities) and of allocating the interest income or interest expense over the relevant period.

The effective interest rate is the rate that exactly discounts estimated future cash receipts or payments through the expected life of the financial instrument or, where appropriate, a shorter period, to the net carrying amount of the financial asset or financial liability. When calculating the effective interest rate, the group estimates cash flows considering all contractual terms of the financial instrument but not future credit losses. The calculation includes all amounts paid or received by the group that are an integral part of the effective interest rate of a financial instrument, including transaction costs and all other premiums or discounts.

Interest on impaired financial assets is recognised using the rate of interest used to discount the future cash flows for the purpose of measuring the impairment loss.

(b) Non interest income

Fee income is earned from a diverse range of services provided by the group to its customers. Fee income is accounted for as follows:

- income earned on the execution of a significant act is recognised as revenue when the act is completed (for example, fees arising from negotiating, or participating in the negotiation of, a transaction for a third party, such as an arrangement for the acquisition of shares or other securities);
- income earned from the provision of services is recognised as revenue as the services are provided (for example, asset management, portfolio and other management advisory and service fees); and

Notes on the Financial Statements (continued)

- income which forms an integral part of the effective interest rate of a financial instrument is recognised as an adjustment to the effective interest rate (for example, certain loan commitment fees) and recorded in 'Interest income' (Note 2(a)).

Net trading income comprises all gains and losses from changes in the fair value of financial assets and financial liabilities held for trading, together with related interest income, expense and dividends.

Net income from financial instruments designated at fair value includes all gains and losses from changes in the fair value of financial assets and financial liabilities designated at fair value through profit or loss. Interest income and expense and dividend income arising on those financial instruments are also included in 'Net income from financial instruments designated at fair value', except for interest arising from debt securities issued, and derivatives managed in conjunction with those debt securities, which is recognised in 'Interest expense' (Note 2(a)).

Dividend income is recognised when the right to receive payment is established. This is the ex-dividend date for listed equity securities, and usually the date when shareholders have approved the dividend for unlisted equity securities.

(c) Operating Segments

The group's operating segments are organised as follows: UK Retail Banking, Continental Europe Retail, Global Banking and Markets, Private Banking and Other. Due to the nature of the group, the chief operating decision-maker regularly reviews operating activity on a number of bases, including by geography, by customer group, and by retail businesses and global businesses. The group's operating segments were determined using the same measure reported to the chief operating decision-maker for the purpose of making decisions about allocating resources and assessing performance.

Measurement of segment assets, liabilities, income and expenses is based on the group's accounting policies. Segment income and expenses include transfers between segments and these transfers are conducted on arm's length terms and conditions. Shared costs are included in segments on the basis of the actual recharges made.

(d) Determination of fair value

All financial instruments are recognised initially at fair value. In the normal course of business, the fair value of a financial instrument on initial recognition is the transaction price (that is, the fair value of the consideration given or received). In certain circumstances, however, the fair value will be based on other observable current market transactions in the same instrument, without modification or repackaging, or on a valuation technique whose variables include only data from observable markets, such as interest rate yield curves, option volatilities and currency rates. When such evidence exists, the group recognises a trading gain or loss on inception of the financial instrument, being the difference between the transaction price and the fair value. When unobservable market data have a significant impact on the valuation of financial instruments, the entire initial difference in fair value indicated by the valuation model from the transaction price is not recognised immediately in the income statement but is recognised over the life of the transaction on an appropriate basis, or when the inputs become observable, or the transaction matures or is closed out, or when the group enters into an offsetting transaction.

Subsequent to initial recognition, the fair values of financial instruments measured at fair value are measured in accordance with the group's valuation methodologies, which are described in Note 32 Fair value of financial instruments.

(e) Reclassification of financial assets

Non-derivative financial assets (other than those designated at fair value through profit or loss upon initial recognition) may be reclassified out of the fair value through profit or loss category in the following circumstances:

- financial assets that would have met the definition of loans and receivables at initial recognition (if the financial asset had not been required to be classified as held for trading) may be reclassified out of the fair value through profit or loss category if there is the intention and ability to hold the financial asset for the foreseeable future or until maturity; and
- financial assets (except financial assets that would have met the definition of loans and receivables at initial recognition) may be reclassified out of the fair value through profit or loss category and into another category in rare circumstances.

Notes on the Financial Statements (continued)

When a financial asset is reclassified as described in the above circumstances, the financial asset is reclassified at its fair value on the date of reclassification. Any gain or loss already recognised in the income statement is not reversed. The fair value of the financial asset on the date of reclassification becomes its new cost or amortised cost, as applicable.

(f) Loans and advances to banks and customers

Loans and advances to banks and customers include loans and advances originated by the group which are not classified either as held for trading or designated at fair value. Loans and advances are recognised when cash is advanced to borrowers. They are derecognised when either the borrower repays its obligations, or the loans are sold or written off, or substantially all the risks and rewards of ownership are transferred. They are initially recorded at fair value plus any directly attributable transaction costs and are subsequently measured at amortised cost using the effective interest method, less impairment losses. Where exposures are hedged by derivatives designated and qualifying as fair value hedges, the carrying value of the loans and advances so hedged includes a fair value adjustment for the hedged risk only.

The group may commit to underwrite loans on fixed contractual terms for specified periods of time, where the drawdown of the loan is contingent upon certain future events outside the control of the group. Where the loan arising from the lending commitment is expected to be held for trading, the commitment to lend is recorded as a trading derivative and measured at fair value through profit and loss. On drawdown, the loan is classified as held for trading and measured at fair value through profit and loss. Where it is not the group's intention to trade the loan, a provision on the loan commitment is only recorded where it is probable that the group will incur a loss. This may occur, for example, where a loss of principal is probable or the interest rate charged on the loan is lower than the cost of funding. On inception the loan, the hold portion is recorded at its fair value and subsequently measured at amortised cost using the effective interest method. However, where the initial fair value is lower than the cash amount advanced (for example, due to the rate of interest charged on the loan being below the market rate of interest), the write down is charged to the income statement. The write down will be recovered over the life of the loan, through the recognition of interest income using the effective interest method, unless the loan becomes impaired. The write down is recorded as a reduction to other operating income.

Financial assets which have been reclassified out of the fair value through profit and loss category into the loans and receivables category are initially recorded at the fair value at the date of reclassification. The reclassified assets are subsequently measured at amortised cost, using the effective interest rate determined at the date of reclassification.

(g) Impairment of loans and advances

Losses for impaired loans are recognised promptly when there is objective evidence that impairment of a loan or portfolio of loans has occurred. Impairment losses are calculated on individual loans and on groups of loans assessed collectively. Impairment losses are recorded as charges to the income statement. The carrying amount of impaired loans on the balance sheet is reduced through the use of impairment allowance accounts. Losses which may arise from future events are not recognised.

Individually assessed loans and advances

The factors considered in determining that a loan is individually significant for the purposes of assessing impairment include:

- the size of the loan;
- the number of loans in the portfolio;
- the importance of the individual loan relationship, and how this is managed; and
- whether volumes of defaults and losses are sufficient to enable a collective assessment methodology to be applied.

Loans considered as individually significant are typically to corporate and commercial customers and are for larger amounts, which are managed on an individual relationship basis. Retail lending portfolios are generally assessed for impairment on a collective basis as the portfolios generally consist of large pools of homogeneous loans.

For all loans that are considered individually significant, the group assesses on a case-by-case basis at each balance sheet date whether there is any objective evidence that a loan is impaired. The criteria used by the group to determine that there is such objective evidence include:

Notes on the Financial Statements (continued)

- known cash flow difficulties experienced by the borrower;
- past due contractual payments of either principal or interest;
- the probability that the borrower will enter bankruptcy or other financial realisation; and
- a significant downgrading in credit rating by an external credit rating agency.

For those loans where objective evidence of impairment exists, impairment losses are determined considering the following factors:

- the group's aggregate exposure to the customer;
- the viability of the customer's business model and its capability to trade successfully out of financial difficulties and generate sufficient cash flow to service its debt obligations;
- the amount and timing of expected receipts and recoveries;
- the likely dividend available on liquidation or bankruptcy;
- the extent of other creditors' commitments ranking ahead of, or *pari passu* with, the group and the likelihood of other creditors continuing to support the company;
- the complexity of determining the aggregate amount and ranking of all creditor claims and the extent to which legal and insurance uncertainties are evident;
- the realisable value of security (or other credit mitigants) and likelihood of successful repossession;
- the likely deduction of any costs involved in recovery of amounts outstanding;
- the ability of the borrower to obtain, and make payments in, the currency of the loan if not denominated in local currency; and
- when available, the secondary market price of the debt.

The realisable value of security is determined based on the current market value when the impairment assessment is performed. The value is not adjusted for expected future increases in market prices however adjustments are made to reflect local conditions, such as forced sale discounts.

Impairment losses are calculated by discounting the expected future cash flows of a loan at its original effective interest rate, and comparing the resultant present value with the loan's current carrying amount. The impairment allowances on individually significant accounts are reviewed at least quarterly, and more regularly when circumstances require. This normally encompasses re-assessment of the enforceability of any collateral held and the timing and amount of actual and anticipated receipts. Individually assessed impairment allowances are only released when there is reasonable and objective evidence of a reduction in the established loss estimate.

Collectively assessed loans and advances

Impairment is assessed on a collective basis in two circumstances:

- to cover losses which have been incurred but have not yet been identified on loans subject to individual assessment; and
- for homogeneous groups of loans that are not considered individually significant.

Incurred but not yet identified impairment

Individually assessed loans for which no evidence of loss has been specifically identified on an individual basis are grouped together according to their credit risk characteristics for the purpose of calculating an estimated collective loss. This reflects impairment losses that the group has incurred as a result of events occurring before the balance sheet date, which the group is not able to identify on an individual loan basis, and that can be reliably estimated. These losses will only be individually identified in the future. As soon as information becomes available which identifies losses on individual loans within the group, those loans are removed from the group and assessed on an individual basis for impairment.

The collective impairment allowance is determined after taking into account:

- historical loss experience in portfolios of similar credit risk characteristics (for example, by industry sector, loan grade or product);
- the estimated period between impairment occurring and the loss being identified and evidenced by the establishment of an appropriate allowance against the individual loan; and

Notes on the Financial Statements (continued)

- management's experienced judgement as to whether current economic and credit conditions are such that the actual level of inherent losses at the balance sheet date is likely to be greater or less than that suggested by historical experience.

The period between a loss occurring and its identification is estimated by local management for each identified portfolio.

Homogeneous groups of loans and advances

Statistical methods are used to determine impairment losses on a collective basis for homogeneous groups of loans that are not considered individually significant, because individual loan assessment is impracticable. Losses in these groups of loans are recorded on an individual basis when individual loans are written off, at which point they are removed from the group. Two alternative methods are used to calculate allowances on a collective basis:

- when appropriate empirical information is available, the group uses roll-rate methodology. This methodology employs statistical analyses of historical data and experience of delinquency and default to estimate the amount of loans that will eventually be written off as a result of the events occurring before the balance sheet date which the group is not able to identify on an individual loan basis, and that can be reliably estimated. Under this methodology, loans are grouped into ranges according to the number of days past due, and statistical analysis is used to estimate the likelihood that loans in each range will progress through the various stages of delinquency and ultimately prove irrecoverable. Current economic conditions are also evaluated when calculating the appropriate level of allowance required to cover inherent loss. The estimated loss is the difference between the present value of expected future cash flows, discounted at the original effective interest rate of the portfolio, and the carrying amount of the portfolio. In certain highly developed markets, sophisticated models also take into account behavioural and account management trends as revealed in, for example, bankruptcy and rescheduling statistics.
- when the portfolio size is small or when information is insufficient or not reliable enough to adopt a roll-rate methodology, the group adopts a basic approach based on historical experience.

In normal circumstances, historical experience provides the most objective and relevant information from which to assess inherent loss within each portfolio, though sometimes it provides less relevant information about the inherent loss in a given portfolio at the balance sheet date, for example, when there have been changes in economic, regulatory or behavioural conditions which result in the most recent trends in portfolio risk factors being not fully reflected in the statistical models. In these circumstances, the risk factors are taken into account by adjusting the impairment allowances derived solely from historical loss experience.

These additional portfolio risk factors may include recent loan portfolio growth and product mix, unemployment rates, bankruptcy trends, geographic concentrations, loan product features (such as the ability of borrowers to repay adjustable-rate loans where reset interest rates give rise to increases in interest charges), economic conditions such as national and local trends in housing markets and interest rates, portfolio seasoning, account management policies and practices, current levels of write-offs, changes in laws and regulations and other items which can affect customer payment patterns on outstanding loans, such as natural disasters. These risk factors, where relevant, are taken into account when calculating the appropriate level of impairment allowances by adjusting the impairment allowances derived solely from historical loss experience.

Roll rates, loss rates and the expected timing of future recoveries are regularly benchmarked against actual outcomes to ensure they remain appropriate.

Write-off of loans and advances

Loans (and the related impairment allowance account) are normally written off, either partially or in full, when there is no realistic prospect of recovery. Where loans are secured, this is generally after receipt of any proceeds from the realisation of security. In circumstances where the net realisable value of any collateral has been determined and there is no reasonable expectation of further recovery, write off may be earlier.

Reversals of impairment

If the amount of an impairment loss decreases in a subsequent period, and the decrease can be related objectively to an event occurring after the impairment was recognised, the excess is written back by reducing the loan impairment allowance account accordingly. The write-back is recognised in the income statement.

Notes on the Financial Statements (continued)

Reclassified loans and advances

Where financial assets have been reclassified out of the fair value through profit or loss category to the loans and receivables category, the effective interest rate determined at the date of reclassification is used to calculate any impairment losses.

Following reclassification, where there is a subsequent increase in the estimates of future cash receipts as a result of increased recoverability of those cash receipts, the effect of that increase is recognised as an adjustment to the effective interest rate from the date of change in the estimate rather than as an adjustment to the carrying amount of the asset at the date of change in the estimate.

Assets acquired in exchange for loans

Non-financial assets acquired in exchange for loans as part of an orderly realisation are recorded as assets held for sale and reported in 'Other assets' if the carrying amounts of the assets are recovered principally through sale, the assets are available for sale in their present condition and their sale is highly probable. The asset acquired is recorded at the lower of its fair value less costs to sell and the carrying amount of the loan (net of impairment allowance) at the date of exchange. No depreciation is charged in respect of assets held for sale. Any subsequent write-down of the acquired asset to fair value less costs to sell is recognised in the income statement, in 'Other operating income'. Any subsequent increase in the fair value less costs to sell, to the extent this does not exceed the cumulative write down, is also recognised in 'Other operating income', together with any realised gains or losses on disposal.

Renegotiated loans

Loans subject to collective impairment assessment whose terms have been renegotiated are no longer considered past due, but are treated as up to date loans for measurement purposes once the minimum numbers of payments required under the new arrangements have been received. Renegotiated loans are considered when calculating collective impairment provisions, either through management's judgment or by segregation from other parts of the loan portfolio, to recognise that higher rates of losses are often encountered in this segment of the portfolio. Loans subject to individual impairment assessment, whose terms have been renegotiated, are subject to ongoing review to determine whether they remain impaired or should be considered past due. The carrying amount of loans that have been classified as renegotiated retain this classification until maturity or derecognition. Interest is recorded on renegotiated loans taking into account the new contractual terms following renegotiation.

A loan that is renegotiated is derecognised if the existing agreement is cancelled and a new agreement made on substantially different terms, or if the terms of an existing agreement are modified, such that the renegotiated loan is substantially a different financial instrument.

(h) Trading assets and trading liabilities

Treasury bills, debt securities, equity shares, loans, deposits, debt securities in issue, and short positions in securities are classified as held for trading if they have been acquired principally for the purpose of selling or repurchasing in the near term, or they form part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent pattern of short-term profit-taking. These financial assets or financial liabilities are recognised on trade date, when the group enters into contractual arrangements with counterparties to purchase or sell financial instruments, and are normally derecognised when either sold (assets) or extinguished (liabilities). Measurement is initially at fair value, with transaction costs taken to the income statement. Subsequently their fair values are remeasured, and gains and losses from changes therein are recognised in the income statement in 'Net trading income'.

(i) Financial instruments designated at fair value

Financial instruments, other than those held for trading, are classified in this category if they meet one or more of the criteria set out below, and are so designated by management. The group may designate financial instruments at fair value when the designation:

- eliminates or significantly reduces measurement or recognition inconsistencies that would otherwise arise from measuring financial assets or financial liabilities, or recognising gains and losses on them, on different bases. Under this criterion, the main classes of financial instruments designated by the group are:

Long-term debt issues – The interest payable on certain fixed rate long-term debt securities issued has been matched with the interest on 'receive fixed/pay variable' interest rate swaps as part of a documented interest rate risk management strategy. An accounting mismatch would arise if the debt securities issued were

Notes on the Financial Statements (continued)

accounted for at amortised cost, because the related derivatives are measured at fair value with changes in the fair value recognised in the income statement. By designating the long-term debt at fair value, the movement in the fair value of the long-term debt will also be recognised in the income statement.

Financial assets and financial liabilities under investment contracts – Liabilities to customers under linked contracts are determined based on the fair value of the assets held in the linked funds, with changes recognised in the income statement. If no designation was made for the assets relating to the customer liabilities they would be classified as available-for-sale and the changes in fair value would be recorded directly in other comprehensive income. These financial instruments are managed on a fair value basis and information is provided to management on that basis. Designation at fair value of the financial assets and liabilities under investment contracts allows the changes in fair values to be recorded in the income statement and presented in the same line.

- applies to groups of financial assets, financial liabilities or combinations thereof that are managed, and their performance evaluated, on a fair value basis in accordance with a documented risk management or investment strategy, and where information about the groups of financial instruments is reported to management on that basis. Under this criterion, certain financial assets held to meet liabilities under insurance contracts are the main class of financial instrument so designated. The group has documented risk management and investment strategies designed to manage such assets at fair value, taking into consideration the relationship of assets to liabilities in a way that mitigates market risks. Reports are provided to management on the fair value of the assets. Fair value measurement is also consistent with the regulatory reporting requirements under the appropriate regulations for these insurance operations.
- relates to financial instruments containing one or more embedded derivatives that significantly modify the cash flows resulting from those financial instruments, including certain debt issues and debt securities held.

The fair value designation, once made, is irrevocable. Designated financial assets and financial liabilities are recognised when the group enters into the contractual provisions of the arrangements with counterparties, which is generally on trade date, and are normally derecognised when sold (assets) or extinguished (liabilities). Measurement is initially at fair value, with transaction costs taken directly to the income statement. Subsequently, the fair values are remeasured, and gains and losses from changes therein are recognised in the income statement in ‘Net income from financial instruments designated at fair value’.

(j) Financial investments

Treasury bills, debt securities and equity shares intended to be held on a continuing basis, other than those designated at fair value, are classified as available-for-sale or held-to-maturity. Financial investments are recognised on trade date, when the group enters into contractual arrangements with counterparties to purchase securities, and are normally derecognised when either the securities are sold or the borrowers repay their obligations.

- Available-for-sale financial assets are initially measured at fair value plus direct and incremental transaction costs. They are subsequently remeasured at fair value, and changes therein are recognised in other comprehensive income in “Available-for-sale investments – fair value gains/ (losses)” until the financial assets are either sold or become impaired. When available-for-sale financial assets are sold, cumulative gains or losses previously recognised in other comprehensive income are recognised in the income statement as ‘Gains less losses from financial investments’.

Interest income is recognised on available-for-sale debt securities using the effective interest method, calculated over the asset’s expected life. Premiums and/or discounts arising on the purchase of dated investment securities are included in the calculation of their effective interest rates. Dividends are recognised in the income statement when the right to receive payment has been established.

At each balance sheet date an assessment is made of whether there is any objective evidence of impairment in the value of a financial asset. Impairment losses are recognised if, and only if, there is objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the financial asset (a ‘loss event’) and that loss event (or events) has an impact on the estimated future cash flows of the financial asset that can be reliably estimated.

If the available-for-sale financial asset is impaired, the difference between the financial asset’s acquisition cost (net of any principal repayments and amortisation) and the current fair value, less any previous impairment loss recognised in the income statement, is removed from other comprehensive income and recognised in the income statement.

Notes on the Financial Statements (continued)

Impairment losses for available-for-sale debt securities are recognised within 'Loan impairment charges and other credit risk provision' in the income statement and impairment losses for available-for-sale equity securities are recognised within 'Gains less losses from financial investments' in the income statement. The impairment methodologies for available-for-sale financial assets are set out in more detail below.

- Available-for-sale debt securities: When assessing available-for-sale debt securities for objective evidence of impairment at the reporting date, the group considers all available evidence, including observable data or information about events specifically relating to the securities which may result in a shortfall in recovery of future cash flows. These events may include a significant financial difficulty of the issuer, a breach of contract such as a default, bankruptcy or other financial reorganisation, or the disappearance of an active market for the debt security because of financial difficulties relating to the issuer.

These types of specific event and other factors such as information about the issuers' liquidity, business and financial risk exposures, levels of and trends in default for similar financial assets, national and local economic trends and conditions, and the fair value of collateral and guarantees may be considered individually, or in combination, to determine if there is objective evidence of impairment of a debt security.

In addition, when assessing available-for-sale asset-backed securities ('ABS's) for objective evidence of impairment, the group considers the performance of underlying collateral and the extent and depth of market price declines. Changes in credit ratings are considered but a downgrade of a security's credit rating is not, of itself, evidence of impairment. The primary indicators of potential impairment are considered to be adverse fair value movements, and the disappearance of an active market for a security.

- Available-for-sale equity securities: Objective evidence of impairment for available-for sale equity securities may include specific information about the issuer as detailed above, but may also include information about significant changes in technology, markets, economics or the law that provides evidence that the cost of the equity securities may not be recovered.

A significant or prolonged decline in the fair value of the asset below its cost is also objective evidence of impairment. In assessing whether it is significant, the decline in fair value is evaluated against the original cost of the asset at initial recognition. In assessing whether it is prolonged, the decline is evaluated against the period in which the fair value of the asset has been below its original cost at initial recognition.

Once an impairment loss has been recognised on an available-for-sale financial asset, the subsequent accounting treatment for changes in the fair value of that asset differs depending on the nature of the available-for-sale financial asset concerned:

- for an available-for-sale debt security, a subsequent decline in the fair value of the instrument is recognised in the income statement when there is further objective evidence of impairment as a result of further decreases in the estimated future cash flows of the financial asset. Where there is no further objective evidence of impairment, the decline in fair value of the financial asset is recognised in other comprehensive income. If the fair value of the debt security increases in a subsequent period, and the increase can be objectively related to an event occurring after the impairment loss was recognised in the income statement, the impairment loss is reversed through the income statement to the extent of the increase in fair value.
 - for an available-for-sale equity security, all subsequent increases in the fair value of the instrument are treated as a revaluation and are recognised directly in other comprehensive income. Impairment losses recognised on the equity security are not reversed through the income statement. Subsequent decreases in the fair value of the available-for-sale equity security are recognised in the income statement, to the extent that further cumulative impairment losses have been incurred in relation to the acquisition cost of the equity security.
- (ii) Held-to-maturity investments are non-derivative financial assets with fixed or determinable payments and fixed maturities that the group positively intends, and is able, to hold until maturity. Held-to-maturity investments are initially recorded at fair value plus any directly attributable transaction costs, and are subsequently measured at amortised cost using the effective interest method, less any impairment losses.

Notes on the Financial Statements (continued)

(k) Sale and repurchase agreements (including stock lending and borrowing)

When securities are sold subject to a commitment to repurchase them at a predetermined price ('repos'), they remain on the balance sheet and a liability is recorded in respect of the consideration received. Securities purchased under commitments to sell ('reverse repos') are not recognised on the balance sheet and the consideration paid is recorded in 'Loans and advances to banks' or 'Loans and advances to customers' as appropriate. The difference between the sale and repurchase price is treated as interest and recognised over the life of the agreement.

Securities lending and borrowing transactions are generally secured, with collateral taking the form of securities or cash advanced or received. The transfer of securities to counterparties under these agreements is not normally reflected on the balance sheet. Cash collateral advanced or received is recorded as an asset or a liability respectively.

Securities borrowed are not recognised on the balance sheet. If they are sold on to third parties, an obligation to return the securities is recorded as a trading liability and measured at fair value, and any gains or losses are included in 'Net trading income'.

(l) Derivatives and hedge accounting

Derivatives are recognised initially, and are subsequently remeasured, at fair value. Fair values of exchange-traded derivatives are obtained from quoted market prices. Fair values of over-the-counter derivatives are obtained using valuation techniques, including discounted cash flow models and option pricing models.

Derivatives may be embedded in other financial instruments, for example, a convertible bond with an embedded conversion option. Embedded derivatives are treated as separate derivatives when their economic characteristics and risks are not clearly and closely related to those of the host contract; the terms of the embedded derivative would meet the definition of a stand-alone derivative if they were contained in a separate contract, and the combined contract is not held for trading nor designated at fair value. These embedded derivatives are measured at fair value with changes therein recognised in the income statement.

Derivatives are classified as assets when their fair value is positive, or as liabilities when their fair value is negative. Derivative assets and liabilities arising from different transactions are offset only if the transactions are with the same counterparty, a legal right of offset exists, and the parties intend to settle the cash flows on a net basis.

The method of recognising fair value gains or losses depends on whether derivatives are held for trading or are designated as hedging instruments, and if the latter, the nature of the risks being hedged. All gains and losses from changes in the fair value of derivatives held for trading are recognised in the income statement. When derivatives are designated as hedges, the group classifies them as either: (i) hedges of the change in fair value of recognised assets or liabilities or firm commitments ('fair value hedges'); (ii) hedges of the variability in highly probable future cash flows attributable to a recognised asset or liability, or a forecast transaction ('cash flow hedges'). Hedge accounting is applied to derivatives designated as hedging instruments in a fair value, cash flow or net investment hedge provided certain criteria are met.

Hedge accounting

At the inception of a hedging relationship, the group documents the relationship between the hedging instruments and hedged items, its risk management objective and its strategy for undertaking the hedge. The group also requires a documented assessment, both at hedge inception and on an ongoing basis, of whether or not the hedging instruments, primarily derivatives, that are used in hedging transactions are highly effective in offsetting the changes attributable to the hedged risks in the fair values or cash flows of the hedged items. Interest on designated qualifying hedges is included in 'Net interest income'.

Fair value hedge

Changes in the fair value of derivatives that are designated and qualify as fair value hedging instruments are recorded in the income statement, along with changes in the fair value of the hedged assets, liabilities or group thereof that are attributable to the hedged risk.

If a hedging relationship no longer meets the criteria for hedge accounting, the cumulative adjustment to the carrying amount of the hedged item is amortised to the income statement based on a recalculated effective interest rate over the residual period to maturity, unless the hedged item has been derecognised, in which case it is released to the income statement immediately.

Notes on the Financial Statements (continued)

Cash flow hedge

The effective portion of changes in the fair value of derivatives that are designated and qualify as cash flow hedges is recognised in other comprehensive income within the “Cash flow hedging reserve”. Any gain or loss in fair value relating to an ineffective portion is recognised immediately in the income statement.

The accumulated gains and losses recognised in other comprehensive income are reclassified to the income statement in the periods in which the hedged item will affect profit or loss. However, when the forecast transaction that is hedged results in the recognition of a non-financial asset or a non-financial liability, the gains and losses previously recognised in other comprehensive income are reclassified and removed from equity and included in the initial measurement of the cost of the asset or liability.

When a hedging instrument expires or is sold, or when a hedge no longer meets the criteria for hedge accounting, any cumulative gain or loss existing in other comprehensive income at that time remains separately in equity until the forecast transaction is eventually recognised in the income statement. When a forecast transaction is no longer expected to occur, the cumulative gain or loss that was reported in other comprehensive income is immediately reclassified to the income statement.

Net investment hedge

Hedges of net investments in foreign operations are accounted for in a similar way to cash flow hedges. A gain or loss on the effective portion of the hedging instrument is recognised in other comprehensive income; a gain or loss on the ineffective portion is recognised immediately in the income statement. Gains and losses previously recognised in other comprehensive income are reclassified to the income statement on the disposal of the foreign operation.

Hedge effectiveness testing

To qualify for hedge accounting, the group requires that at the inception of the hedge and throughout its life, each hedge must be expected to be highly effective (prospective effectiveness) and demonstrate actual effectiveness (retrospective effectiveness) on an ongoing basis.

The documentation of each hedging relationship sets out how the effectiveness of the hedge is assessed. The method a group entity adopts for assessing hedge effectiveness will depend on its risk management strategy.

For prospective effectiveness the hedging instrument must be expected to be highly effective in offsetting changes in fair value or cash flows attributable to the hedged risk during the period for which the hedge is designated. For actual effectiveness to be achieved, the changes in fair value or cash flows must offset each other in the range of 80 per cent to 125 per cent.

Hedge ineffectiveness is recognised in the income statement in ‘Net trading income’.

Derivatives that do not qualify for hedge accounting

All gains and losses from changes in the fair values of derivatives that do not qualify for hedge accounting are recognised immediately in the income statement. These gains and losses are reported in ‘Net trading income’, except where derivatives are managed in conjunction with financial instruments designated at fair value (other than derivatives managed in conjunction with debt securities issued by the group), in which case gains and losses are reported in ‘Net income from financial instruments designated at fair value’. The interest on derivatives managed in conjunction with debt securities issued by the group which are designated at fair value is recognised in ‘Interest expense’. All other gains and losses on these derivatives are reported in ‘Net income from financial instruments designated at fair value’.

(m) Derecognition of financial assets and liabilities

Financial assets are derecognised when the contractual right to receive cash flows from the assets has expired; or when the group has transferred its contractual right to receive the cash flows of the financial assets, and either:

- substantially all the risks and rewards of ownership have been transferred; or
- the group has neither retained nor transferred substantially all the risks and rewards, but has not retained control.

Financial liabilities are derecognised when they are extinguished, that is when the obligation is discharged, cancelled or expires.

Notes on the Financial Statements (continued)

(n) Offsetting financial assets and financial liabilities

Financial assets and financial liabilities are offset and the net amount is reported in the balance sheet when there is a legally enforceable right to offset the recognised amounts and there is an intention to settle on a net basis, or realise the asset and settle the liability simultaneously.

(o) Subsidiaries, associates and joint ventures

The group classifies investments in entities which it controls as subsidiaries. Where the group is a party to a contractual arrangement whereby, together with one or more parties, it undertakes an economic activity that is subject to joint control, the group classifies its interest in the venture as a joint venture. The group classifies investments in entities over which it has significant influence, and that are neither subsidiaries nor joint ventures, as associates. For the purpose of determining this classification, control is considered to be the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities.

The bank's investments in subsidiaries are stated at cost less any impairment losses. An impairment loss recognised in the prior period shall be reversed through profit and loss if, and only if, there has been a change in the estimates used to determine the investment in subsidiary's recoverable amount since the last impairment loss was recognised.

Investments in associates and interests in joint ventures are recognised using the equity method. Under this method, such investments are initially stated at cost, including attributable goodwill, and are adjusted thereafter for the post-acquisition change in the group's share of net assets.

Profits on transactions between the group and its associates and joint ventures are eliminated to the extent of the group's interest in the respective associates or joint ventures. Losses are also eliminated to the extent of the group's interest in the associates or joint ventures unless the transaction provides evidence of an impairment of the asset transferred.

(p) Goodwill and intangible assets

(i) Goodwill arises on the acquisition of subsidiaries, when the aggregate of the fair value of the consideration transferred, the amount of any non-controlling interest and the fair value of any previously held equity interests in the acquiree exceed the amounts of the identifiable assets and liabilities acquired. If they do not exceed the amounts of the identifiable assets and liabilities of an acquired business, the difference is recognised immediately in the income statement. Goodwill arises on the acquisition of interests in joint ventures and associates when the cost of investment exceeds the group's share of the net fair value of the associate's or joint venture's identifiable assets and liabilities.

Intangible assets are recognised separately from goodwill when they are separable or arise from contractual or other legal rights, and their fair value can be measured reliably.

Goodwill is allocated to cash-generating units for the purpose of impairment testing, which is undertaken at the lowest level at which goodwill is monitored for internal management purposes. Impairment testing is performed at least annually, and whenever there is an indication that the cash-generating unit may be impaired, by comparing the recoverable amount from a cash-generating unit with the carrying amount of its net assets, including attributable goodwill. The recoverable amount of an asset is the higher of its fair value less cost to sell and its value in use. Value in use is the present value of the expected future cash flows from a cash-generating unit. If the recoverable amount is less than the carrying value, an impairment loss is charged to the income statement. Goodwill is stated at cost less accumulated impairment losses.

Goodwill on acquisitions of interests in joint ventures and associates is included in 'Interests in associates and joint ventures' and is not tested separately for impairment.

At the date of disposal of a business, attributable goodwill is included in the group's share of net assets in the calculation of the gain or loss on disposal.

Goodwill is included on a disposal group held for sale if the group is a cash-generating unit ('CGU') to which goodwill has been allocated or it is an operation within such a CGU. The goodwill associated with the operation disposed of is measured on the basis of the relative values of the operation disposed of and the portion of the CGU retained.

(ii) Intangible assets include the present value of in-force long-term insurance business, computer software, trade names, mortgage service rights, customer lists, core deposit relationships, credit card customer relationships and merchant or other loan relationships. Intangible assets are subject to impairment review if

Notes on the Financial Statements (continued)

there are events or changes in circumstances that indicate that the carrying amount may not be recoverable. Where:

- intangible assets that have an indefinite useful life, or are not yet ready for use, are tested for impairment annually. This impairment test may be performed at any time during the year, provided it is performed at the same time every year. An intangible asset recognised during the current period is tested before the end of the current year; and
- intangible assets that have a finite useful life, except for the present value of in-force long-term insurance business, are stated at cost less amortisation and accumulated impairment losses and are amortised over their estimated useful lives. Estimated useful life is the lower of legal duration and expected useful life. The amortisation of mortgage servicing rights is included within ‘Net fee income’.

For the accounting policy governing the present value of in-force long-term insurance businesses, see note 2(y).

(iii) Intangible assets with finite useful lives are amortised, generally on a straight-line basis, over their useful lives as follows:

Trade names	10 years
Mortgage service rights	generally between 5 and 12 years
Internally generated software	between 3 and 5 years
Purchased software	between 3 and 5 years
Customer/merchant relationships	between 3 and 10 years
Other	generally 10 years

(q) Property, plant and equipment

Land and buildings are stated at historical cost, or fair value at the date of transition to IFRSs (‘deemed costs’), less any impairment losses and depreciation calculated to write off the assets over their estimated useful lives as follows:

- freehold land is not depreciated;
- freehold buildings are depreciated at the greater of 2% per annum on a straight-line basis or over their remaining useful lives; and
- leasehold buildings are depreciated over the shorter of their unexpired terms of the leases or over their remaining useful lives.

Equipment, fixtures and fittings (including equipment on operating leases where the group is the lessor) are stated at cost less any impairment losses and depreciation calculated on a straight-line basis to write off the assets over their useful lives, which run to a maximum of 35 years but are generally between 5 years and 20 years.

Property, plant and equipment is subject to an impairment review if there are events or changes in circumstances which indicate that the carrying amount may not be recoverable.

The group holds certain properties as investments to earn rentals or for capital appreciation, or both. Investment properties are included in the balance sheet at fair value with changes therein recognised in the income statement in the period of change. Fair values are determined by independent professional valuers who apply recognised valuation techniques.

(r) Finance and operating leases

Agreements which transfer to counterparties substantially all the risks and rewards incidental to the ownership of assets, but not necessarily legal title, are classified as finance leases. When the group is a lessor under finance leases the amounts due under the leases, after deduction of unearned charges, are included in ‘Loans and advances to banks’ or ‘Loans and advances to customers’, as appropriate. The finance income receivable is recognised in ‘Net interest income’ over the periods of the leases so as to give a constant rate of return on the net investment in the leases.

When the group is a lessee under finance leases, the leased assets are capitalised and included in ‘Property, plant and equipment’ and the corresponding liability to the lessor is included in ‘Other liabilities’. A finance lease and its corresponding liability are recognised initially at the fair value of the asset or, if lower, the present value of the minimum lease payments. Finance charges payable are recognised in ‘Net interest income’ over the period of

Notes on the Financial Statements (continued)

the lease based on the interest rate implicit in the lease so as to give a constant rate of interest on the remaining balance of the liability.

All other leases are classified as operating leases. When acting as lessor, the group includes the assets subject to operating leases in 'Property, plant and equipment' and accounts for them accordingly. Impairment losses are recognised to the extent that residual values are not fully recoverable and the carrying value of the assets is thereby impaired. When the group is the lessee, leased assets are not recognised on the balance sheet. Rentals payable and receivable under operating leases are accounted for on a straight-line basis over the periods of the leases and are included in 'General and administrative expenses' and 'Other operating income' respectively.

A sale and leaseback transaction involves the sale of an asset followed by the leasing back of the same asset. The resulting lease is classified either as a finance lease or an operating lease and it is accounted for accordingly. If a sale and leaseback transaction results in the recognition of a finance lease, any excess of sales proceeds over the carrying amount is deferred and amortised over the lease term. If a sale and leaseback transaction results in an operating lease, and it is clear that the transaction is established at fair value, any profit or loss is recognised immediately. If the sale price is below fair value, any profit or loss is recognised immediately except that, if the loss is compensated for by future lease payments below market price, it is deferred and amortised in proportion to the lease payments over the period for which the asset is expected to be used. If the sale price is above fair value, the excess over fair value is deferred and amortised over the period for which the asset is expected to be used.

(s) Income tax

Income tax comprises current tax and deferred tax. Income tax is recognised in the income statement except to the extent that it relates to items recognised in other comprehensive income or directly in equity, in which case it is recognised in the same statement in which the related item appears.

Current tax is the tax expected to be payable on the taxable profit for the year, calculated using tax rates enacted or substantively enacted by the balance sheet date, and any adjustment to tax payable in respect of previous years. Current tax assets and liabilities are offset when the group intends to settle on a net basis and the legal right to offset exists.

Deferred tax is recognised on temporary differences between the carrying amounts of assets and liabilities in the balance sheet and the amounts attributed to such assets and liabilities for tax purposes. Deferred tax liabilities are generally recognised for all taxable temporary differences and deferred tax assets are recognised to the extent that it is probable that future taxable profits will be available against which deductible temporary differences can be utilised.

Deferred tax is calculated using the tax rates expected to apply in the periods in which the assets will be realised or the liabilities settled based on tax rates and laws enacted, or substantively enacted, by the balance sheet date. Deferred tax assets and liabilities are offset when they arise in the same tax reporting group and relate to income taxes levied by the same taxation authority, and when the group has a legal right to offset.

Deferred tax relating to actuarial gains and losses on post-employment benefits is recognised directly in other comprehensive income. Deferred tax relating to share-based payment transaction is recognised directly in other comprehensive income to the extent that the amount of the estimated future tax deduction exceeds the amount of the related cumulative remuneration expense. Deferred tax relating to fair value remeasurements of available-for-sale investments and cash flow hedging instruments which are charged or credited directly to other comprehensive income, is also credited or charged directly to other comprehensive income and is subsequently recognised in the income statement when the deferred fair value gain or loss is recognised in the income statement.

(t) Pension and other post-employment benefits

The group operates a number of pension and other post-employment benefit plans. These plans include both defined benefit and defined contribution plans and various other post-employment benefits such as post-employment healthcare.

Payments to defined contribution plans and state-managed retirement benefit plans, where the group's obligations under the plans are equivalent to a defined contribution plan, are charged as an expense as they fall due.

The defined benefit pension costs and the present value of defined benefit obligations are calculated at the reporting date by the scheme's actuaries using the Projected Unit Credit Method. The net charge to the income

Notes on the Financial Statements (continued)

statement mainly comprises the current service cost, plus the unwinding of the discount rate on plan liabilities, less the expected return on plan assets, and is presented in operating expenses. Past service costs are charged immediately to the income statement to the extent that the benefits have vested, and are otherwise recognised on a straight-line basis over the average period until the benefits vest. Actuarial gains and losses comprise experience adjustments (the effects of differences between the previous actuarial assumptions and what has actually occurred), as well as the effects of changes in actuarial assumptions. Actuarial gains and losses are recognised in other comprehensive income in the period in which they arise.

The defined benefit liability recognised in the balance sheet represents the present value of defined benefit obligations adjusted for unrecognised past service costs and reduced by the fair value of plan assets. Any net defined benefit surplus is limited to unrecognised past service costs plus the present value of available refunds and reductions in future contributions to the plan.

The costs of obligations arising from other defined post-employment benefits plans, such as defined benefit health-care plans, are accounted for on the same basis as defined benefit pension plans.

(u) Share-based payments

The cost of share-based payment arrangements with employees is measured by reference to the fair value of equity instruments on the date they are granted, and recognised as an expense on a straight-line basis over the vesting period, with a corresponding credit to 'Retained Earnings'. The vesting period is the period during which all the specified vesting conditions of a share-based payment arrangement are to be satisfied. The fair value of equity instruments that are made available immediately, with no vesting period attached to the award, are expensed immediately.

Fair value is determined by using appropriate valuation models, taking into account the terms and conditions upon which the equity instruments were granted. Vesting conditions include service conditions and performance conditions. Market performance conditions are taken into account when estimating the fair value of equity instruments at the date of grant, so that an award is treated as vesting irrespective of whether the market performance condition or non-vesting condition is satisfied, provided all other conditions are satisfied.

Vesting conditions, other than market performance conditions, are not taken into account in the initial estimate of the fair value at the grant date. They are taken into account by adjusting the number of equity instruments included in the measurement of the transaction, so that the amount recognised for services received as consideration for the equity instruments granted shall be based on the number of equity instruments that eventually vest. On a cumulative basis, no expense is recognised for equity instruments that do not vest because of a failure to satisfy non-market performance or service conditions.

Where an award has been modified, as a minimum, the expense of the original award continues to be recognised as if it had not been modified. Where the effect of a modification is to increase the fair value of an award or increase the number of equity instruments, the incremental fair value of the award or incremental fair value of liabilities are measured at the higher of the initial fair value, less cumulative amortisation, and the best estimate of the expenditure required to settle the obligation.

A cancellation that occurs during the vesting period is treated as an acceleration of vesting, and recognised immediately for the amount that would otherwise have been recognised for services over the vesting period.

HSBC Holdings is the grantor of its equity instrument for all share awards and share options across the group. The credit to 'Retained earnings' over the vesting period on expensing an award represents the effective capital contribution from HSBC Holdings. To the extent the group will be, or has been, required to fund a share-based payment arrangement, this capital contribution is reduced and the fair value of shares expected to be released to employees is recorded within 'Other liabilities'.

(v) Foreign currencies

Items included in the financial statements of each of the group's entities are measured using the currency of the primary economic environment in which the entity operates ('the functional currency').

Transactions in foreign currencies are recorded in the functional currency at the rate of exchange prevailing on the date of the transaction. Monetary assets and liabilities denominated in foreign currencies are translated into the functional currency at the rate of exchange ruling at the balance sheet date. Any resulting exchange differences are included in the income statement. Non-monetary assets and liabilities that are measured at historical cost in a foreign currency are translated into the functional currency using the rate of exchange at the date of the initial transaction. Non-monetary assets and liabilities measured at fair value in a foreign currency are

Notes on the Financial Statements (continued)

translated into the functional currency using the rate of exchange at the date the fair value was determined. Any exchange component of a gain or loss on a non-monetary item is recognised in other comprehensive income if the gain or loss on the non-monetary item is recognised in other comprehensive income. Any exchange component of a gain or loss on a non-monetary item is recognised in the income statement if the gain or loss on the non-monetary item is recognised in the income statement

In the consolidated financial statements, the assets, including related goodwill where applicable, and liabilities of branches, subsidiaries, joint ventures and associates whose functional currency is not sterling, are translated into the group's presentational currency at the rate of exchange ruling at the balance sheet date. The results of branches, subsidiaries, joint ventures and associates whose function currency is not sterling are translated into sterling at the average rates of exchange for the reporting period. Exchange differences arising from the retranslation of opening foreign currency net investments, and exchange differences arising from retranslation of the result for the reporting period from the average rate to the exchange rate prevailing at the period end, are recognised in other comprehensive income. Exchange differences on a monetary item that is part of a net investment in a foreign operation are recognised in the income statement of the separate financial statements. In consolidated financial statements these exchange differences are recognised in other comprehensive income. On disposal of a foreign operation, exchange differences relating thereto and previously recognised in other comprehensive income are recognised in the income statement.

(w) Provisions

Provisions are recognised when it is probable that an outflow of economic benefits will be required to settle a current legal or constructive obligation, which has arisen as a result of past events, and for which a reliable estimate can be made of the amount of the obligation.

Contingent liabilities, which include certain guarantees and letters of credit pledged as collateral security, are possible obligations that arise from past events whose existence will be confirmed only by the occurrence, or non-occurrence, of one or more uncertain future events not wholly within the control of the group; or are present obligations that have arisen from past events but are not recognised because it is not probable that settlement will require outflow of economic benefits, or because the amount of the obligations cannot be reliably measured. Contingent liabilities are not recognised in the financial statements but are disclosed unless the probability of settlement is remote.

(x) Financial guarantee contracts

Liabilities under financial guarantee contracts not classified as insurance contracts are recorded initially at their fair value, which is generally the fee received or receivable. Subsequently, the financial guarantee liabilities are measured at the higher of the initial fair value, less cumulative amortisation, and the best estimate of the expenditure required to settle the obligations.

The group has issued financial guarantees and similar contract to other group entities. Where it has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting applicable to insurance contracts, the group may elect to account for guarantees as insurance contracts. This election is made on a contract by contract basis, but the election for each contract is irrevocable. Where these guarantees have been classified as insurance contracts, they are measured and recognised as insurance liabilities.

Where the group is the recipient of a guarantee, including from other HSBC Group companies, amounts receivable under a claim are recognised when their receipt is virtually certain. Any fees payable to the guarantor are expensed over the period of the guarantee contract.

(y) Insurance contracts

Through its insurance subsidiaries, the group issues contracts to customers that contain insurance risk, financial risk or a combination thereof. A contract under which the group accepts significant insurance risk from another party by agreeing to compensate that party on the occurrence of a specified uncertain future event is classified as an insurance contract. An insurance contract may also transfer financial risk, but is accounted for as an insurance contract if the insurance risk is significant.

While investment contracts with discretionary participation features are financial instruments, they continue to be treated as insurance contracts as permitted by IFRS 4.

Insurance contracts are accounted for as follows:

Notes on the Financial Statements (continued)

Insurance premiums

Premiums for life insurance contracts are accounted for when receivable, except in unit-linked insurance contracts where premiums are accounted for when liabilities are established.

Gross insurance premiums for non-life insurance business are reported as income over the term of the insurance contract based on the proportion of risks borne during the accounting period. The unearned premium (the proportion of the business underwritten in the accounting year relating to the period of risk after the balance sheet date) is calculated on a daily or monthly pro rata basis.

Reinsurance premiums are accounted for in the same accounting period as the premiums for the direct insurance contracts to which they relate.

Insurance claims and reinsurance recoveries

Gross insurance claims for life insurance contracts reflect the total cost of claims arising during the year, including claim handling costs and any policyholder bonuses allocated in anticipation of a bonus declaration. Claims arising in the year include maturities, surrenders and death claims.

Maturity claims are recognised when due for payment. Surrenders are recognised when paid or at an earlier date on which, following notification, the policy ceases to be included within the calculation of the related insurance liabilities. Death claims are recognised when notified.

Gross insurance claims for non-life insurance contracts include paid claims and movements in outstanding claims liabilities.

Reinsurance recoveries are accounted for in the same period as the related claim.

Liabilities under insurance contracts

Liabilities under non-linked life insurance contracts are calculated by each life insurance operation based on local actuarial principles. Liabilities under unit-linked life insurance contracts are at least equivalent to the surrender or transfer value which is calculated by reference to the value of the relevant underlying funds or indices.

Outstanding claims liabilities for non-life insurance contracts are based on the estimated ultimate cost of all claims incurred but not settled at the balance sheet date, whether reported or not, together with related claim-handling costs and a reduction for the expected value of salvage and other recoveries. Liabilities for claims incurred but not reported are made on an estimated basis, using appropriate statistical techniques.

A liability adequacy test is carried out on insurance liabilities to ensure that the carrying amount of the liabilities is sufficient in the light of current estimates of future cash flows. When performing the liability adequacy test, all contractual cash flows are discounted and compared with the carrying value of the liability. When a shortfall is identified it is charged immediately to the income statement.

Future profit participation on insurance contracts with discretionary participation features

Where contracts provide discretionary profit participation benefits to policyholders, liabilities for these contracts include provisions for the future discretionary benefits to policyholders. These provisions reflect actual performance of the investment portfolio to date and management expectation on the future performance in connection with the assets backing the contracts, as well as other experience factors such as mortality, lapses and operational efficiency, where appropriate. This benefit may arise from the contractual terms, regulation, or past distribution policy.

Investment contracts

Unit linked and non-unit linked

Customer liabilities under linked and certain non-linked investment contracts and the corresponding financial assets are designated at fair value. Movements in fair value are recognised in 'Net income from financial instruments designated at fair value'. Premiums receivable and amounts withdrawn are accounted for as increases or decreases in the liability recorded in respect of investment contracts.

Liabilities under linked investment contracts are at least equivalent to the surrender or transfer value which is calculated by reference to the value of the relevant underlying funds or indices.

Notes on the Financial Statements (continued)

Investment management fees receivable are recognised in the income statement over the period of the provision of the investment management services, in 'Net fee income'.

The incremental costs directly related to the acquisition of new investment contracts or renewing existing investment contracts are deferred and amortised over the period during which the investment management services are provided.

Investment contracts with discretionary participation features

While investment contracts with discretionary participation features are financial instruments, they continue to be treated as insurance contracts as permitted by IFRS 4. The Group therefore recognises the premiums for those contracts as revenue and recognises as an expense the resulting increase in the carrying amount of the liability.

In the case of net unrealised investment gains on these contracts, whose discretionary benefits principally reflect the actual performance of the investment portfolio, the corresponding increase in the liabilities is recognised in either the income statement or other comprehensive income, following the treatment of the unrealised gains on the relevant assets. In the case of net unrealised losses, a deferred participating asset is recognised only to the extent that its recoverability is highly probable. Movements in the liabilities arising from realised gains and losses on relevant assets are recognised in the income statement.

Present value of in-force long-term insurance business

The value placed on insurance contracts that are classified as long-term insurance business or long term investment contracts with discretionary participating features ("DPF") and are in force at the balance sheet date is recognised as an asset. The asset represents the present value of the equity holders' interest in the issuing insurance companies' profits expected to emerge from these contracts written at the balance sheet date.

The present value of in-force long-term insurance business and long term investment contracts with DPF, referred to as 'PVIF', is determined by discounting the equity holders' interest in future profits expected to emerge from business currently in force using appropriate assumptions in assessing factors such as future mortality, lapse rates and levels of expenses and a risk discount rate that reflects the risk premium attributable to the respective contracts. The PVIF incorporates allowances for both non-market risk and the value of financial options and guarantees. The PVIF asset is presented gross of attributable tax in the balance sheet and movements in the PVIF asset are included in "Other operating income" on a gross of tax basis.

(z) Debt securities in issue and deposits by customers and banks

Financial liabilities are recognised when the group enters into the contractual provisions of the arrangements with counterparties, which is generally on trade date, and initially measured at fair value, which is normally the proceeds received net of directly attributable transaction costs incurred. Subsequent measurement of financial liabilities, other than those measured at fair value through profit or loss and financial guarantees, is at amortised cost, using the effective interest rate method to amortise the difference between proceeds received, net of directly attributable transaction costs incurred, and the redemption amount over the expected life of the instrument.

(aa) Share capital and other equity instruments

Shares are classified as equity when there is no contractual obligation to transfer cash or other financial assets. Incremental costs directly attributable to the issue of equity instruments are shown in equity as a deduction from the proceeds, net of tax.

(bb) Cash and cash equivalents

For the purpose of the cash flow statement, cash and cash equivalents include highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of change in value. Such investments are normally those with less than three months' maturity from the date of acquisition, and include cash and balances at central banks, treasury bills and other eligible bills, loans and advances to banks, items in the course of collection from or in transmission to other banks and certificates of deposit.

(cc) Discontinued operations

A discontinued operation is a component of the group's business, the operations and cash flows of which can be clearly distinguished from the rest of the group and which:

- Represents a separate major line of business or geographical area of operations;

Notes on the Financial Statements (continued)

- Is part of a single co-ordinated plan to dispose of a separate major line of business or geo graphical area of operations; or
- Is a subsidiary acquired exclusively with a view to re-sale.

Classification as a discontinued operation occurs on disposal or when the operation meets the criteria to be classified as held-for-sale, if earlier.

When an operation is classified as a discontinued operation, the comparative consolidated income statement is re-presented as if the operation had been discontinued from the start of the comparative year.

3 Critical accounting policies

The results of the group are sensitive to the accounting policies, assumptions and estimates that underlie the preparation of its consolidated financial statements. The accounting policies used in the preparation of the consolidated financial statements are described in detail in Note 2.

When preparing the financial statements, it is the Directors' responsibility under UK company law to select suitable accounting policies and to make judgements and estimates that are reasonable and prudent.

The accounting policies that are deemed critical to the group's results and financial position, in terms of the materiality of the items to which the policy is applied, or which involve a high degree of judgement including the use of assumptions and estimation, are disclosed below:

Impairment of loans and advances

The group's accounting policy for losses arising from the impairment of customer loans and advances is described in Note 2(g). Further information can be found in the Report of the Directors: Risk (Credit Risk). Loan impairment allowances represent management's best estimate of losses incurred in the loan portfolios at balance sheet date.

Management is required to exercise judgement in making assumptions and estimations when calculating loan impairment allowances on both individually and collectively assessed loans and advances. The most significant judgemental area is the calculation of collective impairment allowances.

The methods used to calculate collective impairment allowances on homogeneous groups of loans that are not considered individually significant are disclosed in Note 2(g). They are subject to estimation uncertainty, in part because it is not practicable to identify losses on an individual loan basis because of the large number of individually insignificant loans in the portfolio.

The methods involve the use of statistically assessed historical information which is supplemented with significant management judgement to assess whether current economic and credit conditions are such that the actual level of inherent losses is likely to be greater or less than that suggested by historical experience. In normal circumstances, historical experience provides the most objective and relevant information from which to assess inherent loss within each portfolio. In certain circumstances, historical loss experience provides less relevant information about the inherent loss in a given portfolio at the balance sheet date, for example, where there have been changes in economic, regulatory or behavioural conditions such that the most recent trends in the portfolio risk factors are not fully reflected in the statistical models. In these circumstances, such risk factors are taken into account when calculating the appropriate levels of impairment allowances, by adjusting the impairment allowances derived solely from historical loss experience.

Risk factors include loan portfolio growth, product mix, unemployment rates, bankruptcy trends, geographic concentrations, loan product features, economic conditions such as national and local trends in housing markets, the level of interest rates, portfolio seasoning, account management policies and practices, changes in laws and regulations, and other factors that can affect customer payment patterns. Different factors are applied in different regions and countries to reflect different economic conditions and laws and regulations. The methodology and the assumptions used in calculating impairment losses are reviewed regularly in the light of differences between loss estimates and actual loss experience. For example, roll rates, loss rates and the expected timing of future recoveries are regularly benchmarked against actual outcomes to ensure they remain appropriate.

However, the exercise of judgement requires the use of assumptions which are highly sensitive to the risk factors, in particular, to changes in economic and credit conditions across geographical areas. Many of the factors have a high degree of interdependency and there is no one single factor to which the group's loan impairment allowances as a whole are sensitive. It is possible that the outcomes within the next financial year could be different from the assumptions built into the models, resulting in a material adjustment to the carrying amount of loans and advances.

Notes on the Financial Statements (continued)

Goodwill impairment

The group's accounting policy for goodwill is described in Note 2(p). The review of goodwill impairment represents management's best estimate of the factors below:

- the future cash flows of the cash-generating units ('CGUs') are sensitive to the cash flows projected for the periods for which detailed forecasts are available, and to assumptions regarding the long-term pattern of sustainable cash flows thereafter. Forecasts are compared with actual performance and verifiable economic data, but they necessarily and appropriately reflect management's view of future business prospects at the time of the assessment; and
- the discount rate used to discount the future expected cash flows is based on the cost of capital assigned to an individual CGU, and can have a significant effect on their valuation. The cost of capital percentage is generally derived from a Capital Asset Pricing Model, which incorporates inputs reflecting a number of financial and economic variables, including the risk-free interest rate in the country concerned and a premium for the inherent risk of the business being evaluated. These variables are subject to fluctuations in external market rates and economic conditions beyond management's control and are therefore require the exercise of significant management judgment and are consequently subject to uncertainty.

A decline in a CGU's expected cash flows and/ or an increase in its cost of capital reduces the CGU'S estimated recoverable amount. If this is lower than the carrying value of the CGU, a charge for impairment of goodwill is recognised in the income statement for the year.

The accuracy of forecast cash flows is subject to a high degree of uncertainty in volatile market conditions. In such market conditions, management retests goodwill for impairment more frequently than annually to ensure that the assumptions on which the cash flow forecasts are based continue to reflect current market conditions and management's best estimate of future business prospects.

Management reviewed the current and expected performance of the CGUs as at 31 December 2012 and determined that there was no indicator of potential impairment of the goodwill allocated to the CGUs. However, in the event of further significant deterioration in the economic and credit conditions beyond the levels already reflected by management in the cash flow forecasts for the CGUs, a material adjustment to a CGU's recoverable amount may occur which may result in the recognition of an impairment charge in the income statement.

Note 22 includes details of the CGUs with significant balances of goodwill and states the key assumptions used to assess the goodwill in each CGU for impairment.

Valuation of financial instruments

The group's accounting policy for valuation of financial instruments is described in Note 2(d) on the Financial Statement. The best evidence of fair value is a quoted price in an actively traded market. In the event that the market for a financial instrument is not active, a valuation technique is used. The majority of valuation techniques employ only observable market data, and so the reliability of the fair value measurement is high. However, certain financial instruments are valued on the basis of valuation techniques that feature one or more significant market inputs that are unobservable. Valuation techniques that rely to a greater extent on unobservable inputs require a higher level of management judgement to calculate a fair value than those based wholly on observable inputs.

Valuation techniques used to calculate fair values are discussed in Note 32. The main assumptions and estimates which management considers when applying a model with valuation techniques are:

- the likelihood and expected timing of future cash flows on the instrument. These cash flows are estimated based on the terms of the instrument, although management judgment may be required when the ability of the counterparty to service the instrument in accordance with the contractual terms is in doubt. Future cash flows may be sensitive to changes in market rates;
- selecting an appropriate discount rate for the instrument. The determination of this rate is based on an assessment of what a market participant would regard as the appropriate spread of the rate for the instrument over the appropriate risk-free rate; and
- judgment to determine what model to use to calculate fair value in areas where the choice of valuation model is particularly subjective, for example, when valuing complex derivative products.

When applying a model with unobservable inputs, estimates are made to reflect uncertainties in fair values resulting from a lack of market data inputs, for example, as a result of illiquidity in the market. For these instruments, the fair value measurement is less reliable. Inputs into valuations based on unobservable data are inherently uncertain because there are little or no current market data available from which to determine the level at which an arm's length

Notes on the Financial Statements (continued)

transaction would occur under normal business conditions. However, in most cases there are some market data available on which to base a determination of fair value, for example historical data, and the fair values of most financial instruments will be based on some market observable inputs even where the unobservable inputs are significant.

Disclosure of types and amounts of fair value adjustments made in determining the fair value of financial instruments measured at fair value using valuation techniques is provided in Note 32. In addition a sensitivity analysis of fair value for financial instruments with significant unobservable inputs to reasonably possibly alternative assumption and a range of assumption can be found in Note 32. Given the uncertainty and subjective nature of valuing financial instruments at fair value, it is possible that the outcomes within the next financial year could differ from the assumptions used, and this would result in a material adjustment to the carrying amount of financial instruments measured at fair value.

Pensions

The group's accounting policy for pension and other post-employment benefits is described in Note 2(t) on the Financial Statements.

The most significant judgments in measuring the present value of defined benefit obligations relate to the determination of actuarial and financial assumptions. These assumptions include the nominal discount rate, rate of inflation over the period of projected cash flows and member longevity. Management reviews these assumptions in conjunction with its actuarial advisors and benchmarks its conclusions against market practice.

Judgment is also required in selecting the expected rate of return on plan assets which determines the net expense recognised. The expected rate of return on plan assets represents the best estimate of long-term future asset returns, which takes into account historical market returns plus additional factors such as the current rate of inflation and interest rates. The expected rates of return are weighted on the basis of the fair value of the plan assets.

The key assumptions used, and the sensitivity to changes in these assumptions, are disclosed in Note 7 Employee compensation and benefits. It is reasonably possible that the actuarial and financial assumptions determined at the end of the next year, are significantly different to these assumptions. This could result in the group recording material actuarial gains or losses in the next financial year.

Provisions

The accounting policy for provisions is described in Note 2(w) on the Financial Statements. Note 30 on the Financial Statements discloses the major categories of provisions recognised.

Provisions are uncertain in timing or amount, and are recognised when there is a present obligation as a result of a past event and the outflow of economic benefit is probable and can be estimated reliably. Judgement is involved in determining whether an obligation exists, and in estimating the probability, timing and amount of any outflows. Professional expert advice is taken on litigation provisions, property provisions (including onerous contracts) and similar liabilities.

Provisions for legal proceedings and regulatory matters typically require a higher degree of judgement than other types of provisions. When cases are at an early stage, accounting judgements can be difficult because of the high degree of uncertainty associated with determining whether a present obligation exists as a result of a past event, estimating the probability of outflows and making estimates of the amount of any outflows that may arise. As matters progress through various stages of development, management and legal advisers evaluate on an ongoing basis whether provisions should be recognised and their estimated amounts, revising previous judgements and estimates as appropriate. At more advanced stages, it is typically possible to make judgements and estimates around a better defined set of possible outcomes. However, such judgements can be very difficult and the amount of any provision can be very sensitive to the assumptions used. There could be a wide range of possible outcomes for any pending legal proceedings, investigations or inquiries. As a result, it is often not practicable to quantify a range of possible outcomes for individual matters. It is also not practicable to meaningfully quantify ranges of potential outcomes in aggregate for these types of provisions because of the diverse nature and circumstances of such matters and the wide range of uncertainties involved. For a detailed description of the nature of uncertainties and assumptions and the effect on the amount and timing of possible cash outflows on material matters, see Note 41 on the Financial Statements.

Provisions for customer remediation also require significant levels of estimation and judgement. The amounts of provisions recognised depend on a number of different assumptions, for example, the number of customer complaints expected to be received, the response rates from customers who are contacted as part of customer outreach activities,

Notes on the Financial Statements (continued)

the uphold rate for complaints and the amounts payable in respect of compensation and costs of conducting reviews. These assumptions are revised as additional information becomes available.

In view of the inherent uncertainties and the high level of subjectivity involved in the recognition and measurement of provisions, it is possible that the outcomes in the next financial year could differ from those on which management's estimates are based, resulting in materially different amounts of provisions recognised and outflows of economic benefits from those estimated by management for the purposes of the 2012 Financial Statements.

4 Net earned insurance premiums

	Non-life insurance £m	Life insurance (non-linked) £m	Life insurance (linked) £m	Investment contracts with discretionary participation features £m	Total £m
2012					
Gross written premiums	11	310	380	1,705	2,406
Movement in unearned premiums	4	23	–	–	27
Gross earned premiums	15	333	380	1,705	2,433
Gross written premiums ceded to reinsurers ...	–	(117)	(4)	–	(121)
Reinsurers' share of movement in unearned premiums	(4)	(22)	–	–	(26)
Reinsurers' share of gross earned premiums ...	(4)	(139)	(4)	–	(147)
Net earned insurance premiums	11	194	376	1,705	2,286
2011					
Gross written premiums	30	318	341	1,965	2,654
Movement in unearned premiums	20	46	–	–	66
Gross earned premiums	50	364	341	1,965	2,720
Gross written premiums ceded to reinsurers ...	(1)	(118)	(4)	–	(123)
Reinsurers' share of movement in unearned premiums	(3)	(14)	–	–	(17)
Reinsurers' share of gross earned premiums ...	(4)	(132)	(4)	–	(140)
Net earned insurance premiums	46	232	337	1,965	2,580

5 Net insurance claims incurred and movement in liabilities to policyholders

	Non-life insurance £m	Life insurance (non-linked) £m	Life insurance (linked) £m	Investment contracts with discretionary participation features £m	Total £m
2012					
Claims, benefits and surrenders paid	16	158	139	1,589	1,902
Movement in liabilities	(11)	118	393	713	1,213
Gross claims incurred and movement in liabilities	5	276	532	2,302	3,115
Reinsurers' share of claims, benefits and surrenders paid	(9)	(82)	(4)	–	(95)
Reinsurers' share of movement in liabilities ...	8	(104)	(5)	–	(101)
Reinsurers' share of claims incurred and movement in liabilities	(1)	(186)	(9)	–	(196)
Net insurance claims incurred and movement in liabilities to policyholders	4	90	523	2,302	2,919

Notes on the Financial Statements (continued)

	Non-life insurance £m	Life insurance (non-linked) £m	Life insurance (linked) £m	Investment contracts with discretionary participation features £m	Total £m
2011					
Claims, benefits and surrenders paid.....	85	290	113	1,634	2,122
Movement in liabilities.....	(118)	(84)	160	243	201
Gross claims incurred and movement in liabilities	(33)	206	273	1,877	2,323
Reinsurers' share of claims, benefits and surrenders paid.....	(9)	(78)	(4)	–	(91)
Reinsurers' share of movement in liabilities ..	7	(56)	(1)	–	(50)
Reinsurers' share of claims incurred and movement in liabilities	(2)	(134)	(5)	–	(141)
Net insurance claims incurred and movement in liabilities to policyholders	(35)	72	268	1,877	2,182

6 Net operating income

Net operating income is stated after the following items of income, expense, gains and losses:

	2012 £m	2011 £m
Income		
Interest recognised on impaired financial assets	25	45
Fees earned on financial assets or liabilities not held for trading nor designated at fair value, other than fees included in effective interest rate calculations on these types of assets and liabilities	2,851	2,836
Fees earned on trust and other fiduciary activities where the group holds or invests assets on behalf of its customers	710	723
Expense		
Interest on financial instruments, excluding interest on financial liabilities held for trading or designated at fair value	3,340	3,727
Fees payable on financial assets or liabilities not held for trading nor designated at fair value, other than fees included in effective interest rate calculations on these types of assets and liabilities.....	502	502
Fees payable on trust and other fiduciary activities where the group holds or invests assets on behalf of its customers	2	2
Gains/(losses)		
(Losses)/gains on disposal or settlement of loans and advances	(41)	18
Gains/(losses) on financial liabilities measured at amortised cost	1	5
Impairment of available-for-sale equity shares.....	(26)	(18)
Gain on disposal of assets held for sale	–	8
(Losses)/gains on disposal of property, plant and equipment, intangible assets and non-financial investments.....	(17)	17
Loan impairment charges and other credit risk provisions		
Net impairment charge on loans and advances	(1,213)	(1,222)
Net impairment of available-for-sale debt securities	(29)	(393)
Net impairment in respect of other credit risk provisions.....	(3)	(8)
	(1,245)	(1,623)

Notes on the Financial Statements (continued)

7 Employee compensation and benefits

Total employee compensation

	2012 £m	2011 £m
Wages and salaries	3,943	4,053
Social security costs	512	557
Post-employment benefits	334	(29)
Total ¹	<u>4,789</u>	<u>4,581</u>

¹ Includes £436 million in respect of discontinued operations (2011: £555 million).

Average number of persons employed by the group during the year

	2012	2011
UK Retail	38,761	41,279
Continental Europe Retail	13,092	13,968
Global Banking and Markets ¹	6,941	8,143
Private Banking ²	4,183	5,302
Other ¹	11,213	11,321
Total	<u>74,190</u>	<u>80,013</u>

¹ Employees included within 'Other' are employees of Global Functions who provide services to a number of the group business segments. The 2011 comparatives include 1,200 employees who were reassigned from Global Banking and Markets to Global Functions.

² Includes an average of 3,395 employees in respect of discontinued operations (2011: an average of 4,409 employees).

Post-employment benefit plans

Income statement charge

	2012 £m	2011 £m
Defined benefit pension plans		
- HSBC Bank (UK) Pension Scheme	106	(261)
- Other plans	35	35
Defined contribution pension plans.....	186	190
	<u>327</u>	<u>(36)</u>
Defined benefit healthcare plans	7	7
	<u>334</u>	<u>(29)</u>

Notes on the Financial Statements (continued)

Defined benefit post-employment benefit plans

Net assets/(liabilities) recognised on balance sheet in respect of defined benefit plans

	2012 £m	2011 £m
Defined benefit pension plans	1,439	1,204
– HSBC Bank (UK) Pension Scheme	1,619	1,444
Fair value of plan assets	17,999	17,183
Present value of defined benefit obligations	(16,380)	(15,739)
– Other plans	(180)	(240)
Fair value of plan assets	298	728
Present value of defined benefit obligations	(482)	(972)
Effect of limit on plan surpluses	–	–
Unrecognised past service cost	4	4
Defined benefit healthcare plans	(139)	(158)
Fair value of plan assets	–	–
Present value of defined benefit obligations	(139)	(158)
Unrecognised past service cost	–	–
Fair value of plan assets	18,297	17,911
Present value of defined benefit obligations	(17,001)	(16,869)
Effect of limit on plan surpluses	–	–
Unrecognised past service cost	4	4
	1,300	1,046
Retirement benefit liabilities	(319)	(398)
Retirement benefit assets	1,619	1,444

Pension plans

The extant plans are funded defined benefit plans with assets held in trust or similar funds separate from the group. The plans are reviewed at least annually or in accordance with local practice and regulations by qualified actuaries. The actuarial assumptions used to calculate the defined benefit obligations and related current service costs vary according to the economic conditions of the countries in which the plans are situated.

Defined benefit pension arrangements for bank employees who are members of defined benefit pension plans, as well as certain other employees of the group and HSBC, are provided principally by the HSBC Bank (UK) Pension Scheme (the ‘Scheme’), the assets of which are held in a separate trust fund. The Pension Scheme is administered by a corporate trustee, HSBC Bank Pension Trust (UK) Limited (the ‘Trustee’), whose Board is comprised of 13 Directors, four of whom are elected by employees and two by pensioners. The Trustee Directors of the Pension Scheme are required to act in the best interest of the Scheme’s beneficiaries.

Healthcare benefit plans

The group provides post-employment healthcare benefits under plans in the United Kingdom, which are unfunded. Post-employment healthcare benefit plans are accounted for in the same manner as pension plans. The plans are reviewed at least annually or in accordance with local practice and regulations by qualified actuaries. The actuarial assumptions used to calculate the defined benefit obligation and related current service cost vary according to the economic conditions of the countries in which they are situated. The group’s total healthcare cost for the year was £7 million (2011: £7 million).

Notes on the Financial Statements (continued)

Post-employment defined benefit plans' principal actuarial assumptions

The principal actuarial financial assumptions used to calculate the group's obligations under its UK defined benefit pension and post-employment healthcare plans at 31 December were as follows. These assumptions will also form the basis for measuring periodic costs under the plans in the following year:

	Discount rate	Inflation rate	Rate of increase for pensions in payment and deferred pensions	Deferred revaluation	Rate of pay increase	Healthcare cost trend rates
	%	%	%	%	%	%
2012	4.50	3.10	2.90	2.30	3.60	6.60
2011	4.80	3.20	3.10	2.25	3.70	7.20

The group determines the discount rates to be applied to its obligations in consultation with the plans' local actuaries, on the basis of the current average yield of high quality (AA rated or equivalent) debt instruments, with maturities consistent with those of the defined benefit obligations.

The mortality tables and average life expectancy at 65 in the UK used at 31 December were as follows:

	Mortality table	Life expectancy at age 65 for a male member currently:		Life expectancy at age 65 for a female member currently:	
		Aged 65	Aged 45	Aged 65	Aged 45
2012	SAPS S1 ¹	23.9	25.6	25.2	27.1
2011	SAPS MC ¹	22.5	24.3	23.5	25.3

¹ Adjusted SAPS S1 with CMI_2011 improvements and a 1.25 per cent long-term annual improvement. Light table with 1.01 rating for male pensioners and 1.02 rating for female pensioners. (2011: Adjusted SAPS MC with medium cohort improvements and a 1 per cent minimum annual improvement. Light table with 1.08 rating for male pensioners and standard table with 1.06 rating for female pensioners.)

Actuarial assumption sensitivities

The discount rate is sensitive to changes in market conditions arising during the reporting period. The mortality rates used are sensitive to experience from the plan member profile. The following table shows the effect of changes in these and the other key assumptions on the principal plan:

Notes on the Financial Statements (continued)

	HSBC Bank (UK) Pension Scheme	
	2012 £m	2011 £m
Discount rate		
Change in pension obligation at year end from a 25bps increase	(737)	(633)
Change in pension obligation at year end from a 25bps decrease	789	675
Change in following year pension cost from a 25bps increase ¹	(48)	1
Change in following year pension cost from a 25bps decrease ¹	46	(1)
Rate of inflation		
Change in pension obligation at year end from a 25bps increase	545	663
Change in pension obligation at year end from a 25bps decrease	(521)	(632)
Change in following year pension cost from a 25bps increase	29	37
Change in following year pension cost from a 25bps decrease	(29)	(35)
Rate of increase for pensions in payment and deferred revaluation		
Change in pension obligation at year end from a 25bps increase	445	566
Change in pension obligation at year end from a 25bps decrease	(428)	(543)
Change in following year pension cost from a 25bps increase	21	28
Change in following year pension cost from a 25bps decrease	(22)	(27)
Rate of pay increase		
Change in pension obligation at year end from a 25bps increase	108	160
Change in pension obligation at year end from a 25bps decrease	(107)	(155)
Change in following year pension cost from a 25bps increase	8	12
Change in following year pension cost from a 25bps decrease	(9)	(10)
Investment return		
Change in following year pension cost from a 25bps increase ¹		(42)
Change in following year pension cost from a 25bps decrease ¹		43
Mortality		
Change in pension obligation from each additional year of longevity assumed	410	400

¹ The change in the following year pension cost from a 25bps increase/decrease was calculated in accordance with IAS 19 revised, which will be adopted from 1 January 2013. The comparative numbers were calculated in accordance with the accounting policy set out in Note 1(f).

The following table shows the effect of changes in the mortality rates on defined benefit pension plans other than the principal plan:

	Other Plans	
	2012 £m	2011 £m
Change in pension obligation from each additional year of longevity assumed	9	9

Defined benefit pension plans

Value recognised on the balance sheet

	HSBC Bank (UK) Pension Scheme			
	2012		2011	
	Expected rates of return %	Value £m	Expected rates of return %	Value £m
Fair value of plan assets		17,999		17,183
Equities	7.1	2,412	7.2	2,061
Bonds	4.0	13,729	4.1	13,351
Property	6.7	980	6.7	985
Other	3.0	878	2.8	786
Defined benefit obligation		(16,380)		(15,739)
Net asset/(liability) ¹		1,619		1,444

Notes on the Financial Statements (continued)

	Other plans			
	2012		2011	
	Expected rates of return %	Value £m	Expected rates of return %	Value £m
Fair value of plan assets		298		728
Equities	6.2	43	7.0	176
Bonds	4.9	122	3.5	307
Property	5.7	10	5.1	34
Other	6.2	123	5.5	211
Defined benefit obligation (funded)		(482)		(972)
Present value of funded obligations		(328)		(845)
Present value of unfunded obligations		(154)		(127)
Effect of limit on plan surpluses		-		-
Unrecognised past service cost		4		4
Net liability ¹		(180)		(240)

1 £1,605 million of the net asset for defined benefit pension plans relates to the bank (2011: net assets of £1,430 million).

The principal plan has entered into derivative transactions with the bank to manage the risks arising from its portfolio. These derivatives comprise interest rate (London Interbank Offered Rate – ‘LIBOR’) swaps and inflation (UK Retail Prices Index – ‘RPI’) swaps. Under the terms of these swaps, the plan is committed to making LIBOR-related interest payments in exchange for cash flows paid into the Scheme based on a projection of the future benefit payments to the Scheme members. Further details of these swap arrangements are included in Note 42.

Net liability under defined benefit pension plans

	2012		2011	
	HSBC Bank (UK) Pension Scheme	Other plans	HSBC Bank (UK) Pension Scheme	Other plans
	£m	£m	£m	£m
<i>Fair value of plan assets</i>				
At 1 January	17,183	728	14,317	738
Expected return on plan assets	786	29	827	36
Normal contributions by the group	150	47	194	19
Special contributions by the group	-	-	184	-
Contributions by employees	23	9	21	12
Experience gains/(losses)	429	16	2,146	(39)
Benefits paid	(572)	(27)	(506)	(29)
Disposal of subsidiaries	-	(490)	-	-
Exchange differences	-	(14)	-	(9)
At 31 December	17,999	298	17,183	728
<i>Present value of defined benefit obligations</i>				
At 1 January	15,739	972	14,712	912
Current service cost	149	37	157	38
Interest cost	743	25	769	30
Contributions by employees	23	9	21	12
Actuarial (gains)/losses	298	71	946	32
Benefits paid	(572)	(43)	(506)	(43)
Past service (credit)/cost - vested immediately	-	2	(360)	3
Disposal of subsidiaries	-	(570)	-	-
Exchange differences	-	(21)	-	(12)
At 31 December	16,380	482	15,739	972

Notes on the Financial Statements (continued)

The actual return on plan assets for the year ended 31 December 2012 was a positive return £1,260 million (2011: positive return of £2,970 million). The group expects to make £172 million of normal contributions to defined benefit pension plans during 2013.

Total expense recognised in the income statement in 'Employee compensation and benefits'

	2012		2011	
	HSBC Bank (UK) Pension Scheme £m	Other plans £m	HSBC Bank (UK) Pension Scheme £m	Other plans £m
Current service cost	149	37	157	38
Interest cost	743	25	769	30
Expected return on plan assets	(786)	(29)	(827)	(36)
Past service (credit)/cost	–	2	(360)	3
Total (gain)/ expense	106	35	(261)	35

Total net actuarial gains/(losses)

Total net actuarial losses recognised in other comprehensive income since transition to IFRSs are £406 million. The total effect of the limit on plan surpluses recognised within actuarial gains or losses in other comprehensive income during 2012 was nil (2011: gain of £5 million).

Triennial valuation

UK regulation requires pension schemes be valued formally every three years and a funding plan agreed between the trustee and scheme sponsor. The most recent triennial actuarial valuation of the UK Scheme performed by the Scheme Actuary on behalf of the Trustee has been carried out as at 31 December 2011. At that date, the market value of the Scheme's assets was £17.2 billion. The market value of the plan represented 100 per cent of the amount expected to be required, on the basis of the assumptions adopted, to provide the benefits accrued to members after allowing for expected future increases in earnings, and resulted in neither surplus nor deficit. The method adopted for this valuation was the projected unit method.

The expected cash flows from the plan were projected by reference to the UK Retail Prices Index ('RPI') swap break-even curve at 31 December 2011. Salary increases were assumed to be 0.5 per cent per annum above RPI and inflationary pension increases, subject to a minimum of 0 per cent per annum and a maximum of 5 per cent per annum (maximum of 3 per cent per annum in respect of service accrued since 1 July 2009) were assumed to be in line with RPI. The projected cash flows were discounted at the LIBOR swap curve at 31 December 2011 plus a margin for the expected return on the investment strategy of 160 basis points per annum.

The mortality experience of the Scheme's pensioners over the three year period since the previous valuation was analysed and the mortality assumption set on the basis of the experience in the six years 2006-2011, using the SAPS S1 series of tables with adjustment for the specific mortality experience of the Scheme. Allowance for future improvements in longevity was made in line with the medium cohort effect with a long-run rate of improvements of 2.0 per cent for males and 1.5 per cent for females.

Based on there being no deficit, no Technical Provisions Recovery Plan is required and the schedule of future funding payments agreed after the 2008 actuarial valuation was dissolved.

General Framework

The bank and the trustee have developed a general Framework, which, over time, will see the Scheme's asset strategy evolve to be less risky and further aligned to future cash-flows, referred to as the Target Matching Portfolio (TMP). Evolution to the TMP can be achieved by asset returns in excess of that assumed and/or additional funding. In February 2013, the bank agreed to make three General Framework contributions of £64 million in each of the next three calendar years commencing 2013.

Notes on the Financial Statements (continued)

Investment Performance

After the 2008 triennial valuation, the bank considered that the agreed Technical Provisions Recovery Plan together with investment returns at an expected level of 240 basis points above the LIBOR swap curve would be sufficient to meet the deficit as at 31 December 2008 over the agreed period to 2018. The bank also agreed with the Trustees that at each subsequent actuarial valuation, any shortfall in investment returns relative to this expected level, subject to a maximum of 50 basis points per annum, would be eliminated by payment of equal cash instalments over the remaining years to the end of the recovery plan period.

Although the 2011 triennial disclosed no deficit and no Technical Provisions Recovery Plan is required, the bank and Trustees have agreed to maintain this investment performance underwriting agreement. The investment performance will be assessed every three years with an end date of 2017. Any payments due would only be payable if a Technical Provisions deficit is present at the reference date.

Ongoing contributions

The bank is also making ongoing contributions to the Scheme in respect of future benefit accrual for defined benefit section members. Since April 2010, after completion of the 2008 triennial valuation, the bank has paid contributions at the rate of 34 per cent of pensionable salaries.

Following the completion of the 2011 triennial valuation, the bank will pay contributions at the rate of 43 per cent of pensionable salaries (less member contributions) from 1 April 2013. An additional employer contribution will be paid on or before 30 April 2013 equal to 9 per cent of pensionable salaries, in respect of the period 1 January 2012 to 31 March 2013.

Solvency position

As part of the 31 December 2011 valuation, calculations were also carried out as to the amount of assets that might be needed to meet the liabilities if the Scheme was discontinued and the members' benefits bought out with an insurance company (although in practice this may not be possible for a plan of this size) or the Trustee continued to run the plan without the support of the bank. The amount required under this approach was estimated to be £26,200 million as at 31 December 2011. In estimating the solvency position for this purpose, a more prudent assumption about future mortality was made than for the assessment of the ongoing position and it was assumed that the Trustee would alter the investment strategy to be an appropriately matched portfolio of cash and interest and inflation swaps. An explicit allowance for expenses was also included.

Special contribution December 2011

In December 2011, HSBC Bank plc made a US\$286 million (£184 million) special contribution to the Scheme. Following the contribution, the Scheme purchased asset-backed securities from the group at an arm's length value determined by the Scheme's independent third party advisors.

Future accrual

In January 2013, as part of a wider review of employee benefits, the bank announced a proposal to cease future accrual of service for active members of the Defined Benefit Section with effect from 30 June 2014. Under the proposals, all active members of the Defined Benefit Section would become deferred members from 30 June 2014 and will become members of the Defined Contribution Section from 1 July 2014. From that date, active members would be treated in the same way as deferred pensioners.

The valuation of the Scheme's defined benefit obligation is sensitive to changes in actuarial assumptions, as outlined above. The proposed removal of future salary escalation from the pay assumptions is estimated to reduce the defined benefit obligation by approximately £0.2 billion. The proposed change in membership status from active to deferred alters the underlying inflation assumption for indexation from RPI to CPI and is estimated to reduce the defined benefit obligation by a further £0.3 billion. The proposed cessation of the Scheme to provide ill-health benefits to members, to be covered by insurance policies provided by the bank under these proposals, is estimated to reduce the defined benefit obligation by £0.3 billion.

The consultation period for these proposals ends and a final decision is expected to be made in the second quarter of 2013 at which time a past service credit will be recognised in the income statement.

The future impact from these proposed changes on the income statement is dependant primarily on the level of pension contributions made by the bank and employees to the Defined Contribution Section, the final outcome of which remains uncertain. In all reasonably likely scenarios, the net impact on earnings over time is not expected to be material.

Notes on the Financial Statements (continued)

Summary

	HSBC Bank (UK) Pension Scheme				
	2012 £m	2011 £m	2010 £m	2009 £m	2008 £m
Defined benefit obligation	(16,380)	(15,739)	(14,712)	(13,262)	(10,460)
Fair value of plan assets	17,999	17,183	14,317	10,908	10,191
Net surplus/(deficit)	1,619	1,444	(395)	(2,354)	(269)
Experience losses on plan liabilities	548	(240)	(207)	(143)	(7)
Experience gains/(losses) on plan assets	429	2,146	1,150	424	(1,643)
(Losses)/gains from changes in actuarial assumptions	(846)	(706)	(717)	(2,718)	1,671
Total net actuarial gains/(losses)	131	1,200	226	(2,437)	21
	Other plans				
	2012 £m	2011 £m	2010 £m	2009 £m	2008 £m
Defined benefit obligation	(482)	(972)	(912)	(805)	(889)
Fair value of plan assets	298	728	738	649	617
Effect of limit on plan surpluses	–	–	(5)	(21)	–
Net deficit	(184)	(244)	(179)	(177)	(272)
Experience gains/(losses) on plan liabilities	(3)	(6)	11	15	(6)
Experience (losses)/gains on plan assets	16	(39)	(4)	41	(130)
(Losses)/gains from changes in actuarial assumptions	(68)	(26)	(61)	25	(47)
Total net actuarial gains/(losses)	(55)	(71)	(54)	81	(183)

Directors' emoluments

The aggregate emoluments of the Directors of the bank, computed in accordance with the Companies Act 2006 as amended by statutory instrument 2008 No.410, were:

	2012 £000	2011 £000
Fees ¹	1,087	652
Salaries and other emoluments	2,266	2,091
Bonuses	5,294 ²	5,733 ³
	8,647	8,476
Vesting of Restricted Share Plan awards	873	1,528

1 Fees included fees paid to non-executive directors.

2 Awards made to executive Directors in respect of 2012 performance comprise a mixture of cash and HSBC Holdings plc ordinary shares. The amount shown is comprised of £827,306 in cash, £1,146,459 in deferred cash (vesting in full after five years), £764,306 in Restricted Shares with retention and £1,146,459 in deferred Restricted Shares (vesting in full after five years) issued under the HSBC Share Plan 2011, and £1,409,627 in deferred Restricted Shares issued under schedule 4 of the HSBC Share Plan 2011 (Group Performance Share Plan ('GPSP')). GPSP awards normally vest in full after five years subject to the Director remaining an employee on the vesting date. Any shares (net of tax) which the Director becomes entitled to on the vesting date are subject to a retention requirement until cessation of employment.

3 Awards made to executive Directors in respect of 2011 performance comprise a mixture of cash and HSBC Holdings plc ordinary shares. The amount shown is comprised of £346,973 in cash, £461,960 in deferred cash (vesting annually over a three-year period), £1,274,527 in Restricted Shares and £1,911,792 in deferred Restricted Shares (vesting annually over a three-year period) issued under the HSBC Share Plan 2011, and £1,737,719 in deferred Restricted Shares issued under schedule 4 of the HSBC Share Plan 2011 (Group Performance Share Plan ('GPSP')). GPSP awards normally vest in full after five years subject to the Director remaining an employee on the vesting date. Any shares (net of tax) which the Director becomes entitled to on the vesting date are subject to a retention requirement until cessation of employment.

One Director exercised share options over HSBC Holdings plc ordinary shares during the year.

Awards were made to five Directors under long-term incentive plans in respect of qualifying services rendered in 2012 (2011: five Directors). During 2012, three Directors received shares in respect of awards under long-term incentive plans that vested during the year (2011: five Directors).

Retirement benefits are not accruing to any Directors under a defined benefit scheme and are accruing to five Directors under money purchase schemes in respect of Directors' qualifying services. Contributions of £238,467 were made during the year to money purchase arrangements in respect of Directors' qualifying services (2011: £202,942).

Notes on the Financial Statements (continued)

In addition, there were payments under retirement benefit agreements with former Directors of £783,293 (2011: £795,269), including payments in respect of unfunded pension obligations to former Directors of £664,825 (2011: £666,152). The provision as at 31 December 2012 in respect of unfunded pension obligations to former Directors amounted to £11,532,388 (2011: £10,682,217).

Discretionary bonuses for Directors are based on a combination of individual and corporate performance and are determined by the Remuneration Committee of the bank's parent company, HSBC Holdings plc. The cost of any conditional awards under the HSBC Share Plan 2011 are recognised through an annual charge based on the fair value of the awards, apportioned over the period of service to which the award relates. Details of the Plans are contained within the Directors' Remuneration Report of HSBC Holdings plc.

Of these aggregate figures, the following amounts are attributable to the highest paid Director:

	2012 £000	2011 £000
Fees	–	–
Salaries and other emoluments	666	665
Bonuses	2,741 ¹	2,768 ²

- Awards made to the highest paid Director in respect of 2012 performance comprise a mixture of cash and HSBC Holdings plc ordinary shares. The amount shown is comprised of £340,235 in cash, £510,351 in deferred cash (vesting in full after five years), £340,235 in Restricted Shares with retention and £510,353 in deferred Restricted Shares (vesting in full after five years) issued under the HSBC Share Plan 2011, and £1,040,000 in deferred Restricted Shares issued under schedule 4 of the HSBC Share Plan 2011 (Group Performance Share Plan).*
- Awards made to the highest paid Director in respect of 2011 performance will be delivered in HSBC Holdings plc ordinary shares. The amount shown is comprised of £717,113 in Restricted Shares and £1,075,670 in deferred Restricted Shares (vesting annually over a three-year period) issued under the HSBC Share Plan 2011, and £975,000 in deferred Restricted Shares issued under schedule 4 of the HSBC Share Plan 2011 (Group Performance Share Plan).*

The highest paid Director received 111,557 shares, in respect of qualifying services, as the result of awards under long-term incentive plans that vested during the year. The highest paid Director exercised 1,105 share options over HSBC Holdings plc ordinary shares during the year.

Pension contributions of £151,650 were made by the bank in respect of services by the highest paid Director during the year.

8 Auditors' remuneration

	2012 £m	2011 £m
Audit fees payable to KPMG ¹	9.3	9.9
Audit fees payable to non-KPMG entities	0.6	0.7
Total auditors remuneration	9.9	10.6

- Fees payable to KPMG for HSBC Bank plc's statutory audit and the audit of the bank's subsidiaries.*

Notes on the Financial Statements (continued)

The following fees were payable by the group to the group's principal auditor, KPMG Audit Plc and its associates (together 'KPMG'):

	2012	2011
	£m	£m
Audit fees for HSBC Bank plc statutory audit ¹	3.1	3.1
– fees relating to current year	2.8	2.4
– fees relating to prior year	0.3	0.7
Fees for other services provided to the group	12.0	15.3
– audit of the group's subsidiaries, pursuant to legislation ²	6.1	6.8
– audit-related assurance services ³	4.6	6.7
– audit of pension schemes associated with the group	0.1	–
Tax services		
– taxation compliance services	0.1	0.2
– taxation advisory services	0.3	0.5
Other services		
– services relating to information technology	–	0.1
– all other services	0.8	1.0
Total fees payable	15.1	18.4

- Fees payable to KPMG Audit Plc for the statutory audit of the consolidated financial statements of the group and the separate financial statements of the HSBC Bank plc. They exclude amounts payable for the statutory audit of the bank's subsidiaries which have been included in 'Fees payable to KPMG for other services provided to the group'.*
- Including fees payable to KPMG for the statutory audit of the bank's subsidiaries.*
- Including services for assurance and other services that relate to statutory and regulatory filings, including comfort letters and interim reviews.*

Fees payable to KPMG for non-audit services for HSBC Bank plc are not disclosed separately because such fees are disclosed on a consolidated basis for the group.

9 Share-based payments

Income statement charge

	2012	2011
	£m	£m
Restricted and performance share awards ¹	244	298
Savings-related and other share option plans	27	30
Equity-settled share-based payments ²	271	328

- Restricted share awards include awards granted under the Group Performance Share Plan ('GPSP')*
- This charge, which was computed from the fair values of the share-based payment transaction when contracted, arose under employee share awards made in accordance with HSBC's reward structures (discussed further below).*

The share-based payment income statement charge is recognised in wages and salaries (Note 7).

Deferred share awards

Included in the income statement charge above is £230m relating to deferred share awards (2011: £311m). The following table identifies the years in which these awards were, or are expected to be, granted. It also shows the expected charge to be recognised in future years in respect of awards granted in current and prior years and awards expected to be granted in the future.

Income statement impact of deferred share awards on current and future years

	Charge recognised in 2012 in respect of performance year:			Charge expected to be recognised in 2013 or later in respect of performance year:		
	2012	Pre-2012	Total	2012	Pre-2012	Total
	£m	£m	£m	£m	£m	£m
HSBC deferred share awards	62	168	230	70	63	133
	Charge recognised in 2011 in respect of performance year:			Charge expected to be recognised in 2012 or later in respect of performance year:		
	2011	Pre-2011	Total	2011	Pre-2011	Total
	£m	£m	£m	£m	£m	£m
HSBC deferred share awards	20	291	311	83	193	276

Notes on the Financial Statements (continued)

HSBC Share Awards

Restricted share awards

The policy with respect to these awards is:

- vesting of the awards is based on continued employment with HSBC of between one and five years from the date of award;
- shares are awarded without corporate performance conditions; and
- certain shares are awarded subject to a retention requirement.

The purpose of these awards is to reward employee performance and potential, to aid recruitment and retention, and to part-defer annual bonuses.

Performance Share awards

The policy with respect to these awards is:

- vesting of the awards is based on three independent performance measures (HSBC's relative Total Shareholder Return ('TSR') (40%), economic profit (40%) and growth in HSBC earnings per share ('EPS') (20%)) and an overriding 'sustained improvement' judgement by the Group Remuneration Committee;
- performance conditions are measured over a three year period and reviewed annually; and
- awards are forfeited to the extent the performance conditions have not been met.

The purpose of these awards is to align the interests of executives with the creation of shareholder value and recognise individual performance and potential, and to reflect HSBC's relative and absolute performance over the long-term, taking into account an external measure of value creation, a measure of the extent to which the return on capital invested in HSBC is in excess of a benchmark return and a direct measure of the profits generated for shareholders.

Movement on HSBC share awards

	Restricted share awards		Performance share awards¹	
	2012	2011	2012	2011
	Number	Number	Number	Number
	(000s)	(000s)	(000s)	(000s)
Outstanding at 1 January	111,330	95,007	-	99
Additions during the year	110,816	36,947	355	80
Released in the year	(104,792)	(14,751)	-	(42)
Forfeited in the year	(5,931)	(5,873)	-	(137)
Transferred	(23,993)	-	-	-
Outstanding at 31 December	87,430	111,330	355	-
Weighted average fair value of awards granted (£)	4.02	6.19	5.56	6.47

1 Additions during the year comprised reinvested dividend equivalents.

Notes on the Financial Statements (continued)

HSBC Share Option Plans

Savings-related share option plans

The policy with respect to these options is:

- the options are exercisable within three months following the first anniversary of the commencement of a one-year savings contract or within six months following either the third or fifth anniversaries of the commencement of three-year or five-year contracts, respectively; and
- the exercise price is set at a 20% (2011: 20%) discount to the market value immediately preceding the date of invitation.

The purpose of these awards is to enable eligible employees to save up to £250 per month (or its equivalent in euros), with the option to use the savings to acquire shares, and to align the interests of employees with the creation of shareholder value.

HSBC Holdings Group Share Option Plan

The policy with respect to these options is:

- vesting of the options is based on achievement of certain TSR targets; and
- the options are exercisable between the third and tenth anniversaries of the date of grant.

The purpose of these awards was to provide a long-term incentive plan between 2000 and 2005, when certain HSBC employees were awarded share options, and to align the interests of those higher performing employees with the creation of shareholder value.

The table on page 142 shows the movement on HSBC share option plans during the year.

Calculation of fair values

Fair values of share options/awards, measured at the date of grant of the option/award, are calculated using a Black-Scholes model. When modelling options/share awards with vesting dependent on HSBC's TSR over a period, the TSR performance targets are incorporated into the model using Monte-Carlo simulation. The fair values calculated are inherently subjective and uncertain due to the assumptions made and the limitations of the model used.

Significant weighted average assumptions used to estimate the fair value of the options granted were as follows:

	Savings-Related Share Option Plans		
	1-year plan	3-year plans	5-year plans
2012			
Risk-free interest rate ¹ (%)	0.4	0.6	1.2
Expected life ² (years)	1	3	5
Expected volatility ³ (%)	25	25	25
Share price at grant date (£)	5.46	5.46	5.46
	Savings-Related Share Option Plans		
	1-year plan	3-year plans	5-year plans
2011			
Risk-free interest rate ¹ (%)	0.8	1.7	2.5
Expected life ² (years)	1	3	5
Expected volatility ³ (%)	25	25	25
Share price at grant date (£)	6.37	6.37	6.37

1 The risk-free rate was determined from the UK gilts yield curve for certain Savings-Related Share Option Plans, including the UK Plans. A similar yield curve was used for the other Savings-Related Share Option Schemes.

2 The expected life of options depends on the behaviour of option holders, which is incorporated into the option model on the basis of historical observable data and is not a single input parameter but a function of various behavioural assumptions.

3 Expected volatility is estimated by considering both historic average share price volatility and implied volatility derived from traded options over HSBC shares of similar maturity to those of the employee options.

Notes on the Financial Statements (continued)

The expected US dollar denominated dividend yield was determined to be 4.5 per cent per annum in line with consensus analyst forecasts (2011: 4.5 per cent).

Movement on HSBC share option plans

	Savings-related share option plans		HSBC Holdings Group share option plan	
	Number (000s)	WAEP ¹ £	Number (000s)	WAEP ¹ £
2012				
Outstanding at 1 January	71,526	3.82	41,836	6.86
Granted during the year	21,945	4.43	–	0.00
Exercised during the year	(26,066)	3.32	(80)	6.02
Transferred during the year	(1,938)	4.04	(934)	6.77
Forfeited and expired during the year	(9,348)	5.74	(565)	6.95
Outstanding at 31 December	56,119	4.22	40,257	6.87
Weighted average fair value of options granted during the year (£)		1.22		–
Weighted average share price at the date the options were exercised (£)		5.55		5.78
At 31 December 2012				
Exercise price range (£):				
3.00 – 4.50	45,433	3.80	–	–
4.51 – 6.00	9,687	5.31	–	–
6.01 – 7.50	996	6.20	40,057	6.86
7.51 – 9.00	1	7.54	200	7.74
9.01 – 10.50	2	9.08	–	–
Of which exercisable:	2,300	4.55	–	–
Weighted average remaining contractual life (years)		2.01		–
2011				
Outstanding at 1 January	70,536	3.77	42,698	6.86
Granted during the year	8,455	5.09	–	–
Exercised during the year	(1,646)	5.23	(313)	6.05
Transferred during the year	–	–	144	7.17
Forfeited and expired during the year	(5,819)	5.00	(693)	7.77
Outstanding at 31 December	71,526	3.82	41,836	6.86
Weighted average fair value of options granted during the year (£)		1.65		–
Weighted average share price at the date the options were exercised (£)		5.40		5.93
At 31 December 2011				
Exercise price range (£):				
3.00 – 4.50	54,180	3.30	–	–
4.51 – 6.00	15,275	5.34	–	–
6.01 – 7.50	2,026	6.40	41,639	6.86
7.51 – 9.00	43	7.69	197	7.76
9.01 – 10.50	2	9.08	–	–
Of which exercisable:	1,976	6.30	–	–
Weighted average remaining contractual life (years)		9.08		–

1 Weighted Average Exercise Price.

Notes on the Financial Statements (continued)

Pre-IFRS 2 awards

Detailed below are the share-based payment awards made before the date of application of IFRS 2 on 7 November 2002 and therefore not accounted for within the balance sheet or income statement.

The HSBC Holdings Group Share Option Plan

	2012		2011	
	Number (000's)	Weighted average exercise price £	Number (000's)	Weighted average exercise price £
Outstanding at 1 January	15,022	7.31	29,135	7.44
Transferred in the year	(50)	7.13	(36)	6.91
Expired in the year	(14,669)	7.32	(14,077)	7.59
Outstanding at 31 December ^{1, 2}	303	6.50	15,022	7.31

1 The above includes the bank employee awards of 7,692,481 options outstanding at 1 January 2012 (2011: 14,767,030), and 35,000 options outstanding at 31 December 2012 (2011: 7,692,481).

2 The weighted average exercise price for bank employees was £ 7.32 at 1 January 2012 (2011: £7.45) and £6.50 at 31 December 2012 (2011: £7.32).

The number of options and weighted average exercise price for options outstanding at the balance sheet date, analysed by exercise price range, were as follows:

The group

	2012		2011	
	£5.56-£6.50	£6.51-£8.40	£5.56-£6.50	£6.51-£8.40
Exercise price range (£)				
Number (000's)	303	-	315	14,707
Weighted average exercise price (£)	6.50	-	6.50	7.32
Of which exercisable:				
– number (000's)	303	-	315	14,707
– weighted average exercise price (£)	6.50	-	6.50	7.32

The bank

	2012		2011	
	£5.56-£6.50	£6.51-£8.40	£5.56-£6.50	£6.51-£8.40
Exercise price range (£)				
Number (000's)	35	-	35	7,657
Weighted average exercise price (£)	6.50	-	6.50	7.32
Of which exercisable:				
– number (000's)	35	-	35	7,657
– weighted average exercise price (£)	6.50	-	6.50	7.32

Notes on the Financial Statements (continued)

10 Tax expense

	2012 £m	2011 £m
Current taxation		
UK corporation tax charge – on current year profit	172	232
UK corporation tax charge – adjustments in respect of prior years	(312)	18
Overseas tax – on current year profit	389	330
Overseas tax – adjustment in respect of prior years	(3)	1
	<u>246</u>	<u>581</u>
Deferred taxation		
Origination and reversal of temporary differences	(381)	154
Effect of changes in the tax rates	30	(18)
Adjustment in respect of prior years	(51)	17
	<u>(402)</u>	<u>153</u>
Total tax (credited)/charged to the income statement	<u>(156)</u>	<u>734</u>

The UK corporation tax rate applying to HSBC Bank plc and its subsidiaries was 24.5 per cent (2011: 26.5 per cent). Other overseas subsidiaries and overseas branches provided for taxation at the appropriate rates in the countries in which they operate.

The following table reconciles the tax expense which would apply if all profits had been taxed at the UK corporation tax rate:

	2012		2011	
	£m	Percentage of overall tax charge %	£m	Percentage of overall tax charge %
Taxation at UK corporation tax rate of 24.5% (2011: 26.5%)	556	24.5	824	26.5
Effect of taxing overseas profit at different rates	59	2.6	(4)	(0.1)
Non taxable income and gains subject to tax at a lower rate	(49)	(2.2)	(118)	(3.7)
Deferred tax temporary differences not provided	6	0.3	11	0.4
Permanent disallowables	18	0.8	17	0.5
Changes in tax rates	30	1.3	(18)	(0.6)
Local taxes and overseas withholding taxes	70	3.1	27	0.9
Other items	(63)	(2.8)	(41)	(1.4)
Tax loss received for no consideration	(98)	(4.3)	–	–
Adjustment in respect of prior years	(366)	(16.1)	36	1.1
Recycling of foreign exchange revaluation reserve on sale of HSBC Private Banking Holdings (Suisse) SA	(319)	(14.1)	–	–
Total tax (credited)/charged to the income statement	<u>(156)</u>	<u>(6.9)</u>	<u>734</u>	<u>23.6</u>

The effective tax rate ("ETR") for HSBC Bank plc normally falls within a range of 22 per cent to 25 per cent. In 2012 the ETR would have been within that range at 23.3 per cent except for the impact of specific non-recurring items. Adjustment in respect to prior years and non-taxable income on the sale of HSBC Private Banking Holdings (Suisse) SA reduces the 2012 ETR by 16.1 per cent and 14.1 per cent respectively. The adjustment in respect of prior years includes items on which HSBC Holdings plc has agreed to assume the bank's liability as part of a settlement with the UK tax authorities and a tax recovery in respect of European dividends following a recent favourable ruling by the European Court of Justice. The amount of foreign exchange revaluation reserve recycled through the Income Statement, following the sale of HSBC Private Banking Holdings (Suisse) SA, of £1,258 million which is not taxable also reduced the ETR. As a result of these one-off items, the ETR for the year was a credit of 6.9 per cent.

Movement of net deferred tax assets/(liabilities) before offsetting balances within countries
The group

	Retirement benefits £m	Loan impairment allowances £m	Unused tax losses £m	Property, plant and equipment £m	Available- for-sale investments £m	Cash flow hedges £m	Share-based payments £m	Assets leased to customers £m	Revaluation of property £m	Goodwill and intangibles £m	Other £m	Total £m
Assets.....	-	58	7	103	61	-	90	-	-	-	-	319
Liabilities.....	(87)	-	-	-	-	(77)	-	(159)	(23)	-	(99)	(445)
At 1 January 2012.....	(87)	58	7	103	61	(77)	90	(159)	(23)	-	(99)	(126)
Income statement.....	(122)	(3)	304	5	(2)	-	(31)	191	2	42	16	402
Other comprehensive income:												
- available-for-sale investments	-	-	(20)	-	(103)	-	-	-	-	-	-	(123)
- cash flow hedges	-	-	-	-	-	(7)	-	-	-	-	-	(7)
- actuarial movements	(3)	-	-	-	-	-	-	-	-	-	-	(3)
Equity:												
- share-based payments	-	-	-	-	-	-	18	-	-	-	-	18
Acquisitions and disposals	-	-	-	-	-	-	-	-	-	-	-	-
Foreign exchange and other adjustments...	(31)	25	3	(1)	18	2	(1)	1	8	(22)	12	14
	(156)	22	287	4	(87)	(5)	(14)	192	10	20	28	301
Assets.....	-	80	294	108	35	-	76	33	-	20	10	656
Liabilities.....	(243)	-	-	(1)	(61)	(82)	-	-	(13)	-	(81)	(481)
At 31 December 2012	(243)	80	294	107	(26)	(82)	76	33	(13)	20	(71)	175

Movement of net deferred tax assets/(liabilities) before offsetting balances within countries*The group*

	Retirement benefits £m	Loan impairment allowances £m	Unused tax losses £m	Property, plant and equipment £m	Available- for-sale investments £m	Cash flow hedges £m	Share-based payments £m	Assets leased to customers £m	Revaluation of property £m	Other £m	Total £m
Assets.....	534	52	4	60	7	–	76	–	–	–	733
Liabilities.....	–	–	–	(1)	(11)	(59)	–	(194)	(22)	(170)	(457)
At 1 January 2011.....	534	52	4	59	(4)	(59)	76	(194)	(22)	(170)	276
Income statement.....	(260)	6	–	44	2	–	(1)	34	–	22	(153)
Other comprehensive income:											
- available-for-sale investments	–	–	–	–	68	–	–	–	–	–	68
- cash flow hedges	–	–	–	–	–	(23)	–	–	–	–	(23)
- actuarial movements	(316)	–	–	–	–	–	–	–	–	–	(316)
Equity:											
- share-based payments	–	–	–	–	–	–	13	–	–	–	13
Acquisitions and disposals	–	–	–	–	–	–	–	–	–	–	–
Foreign exchange and other adjustments....	(45)	–	3	–	(5)	5	2	1	(1)	49	9
	(621)	6	3	44	65	(18)	14	35	(1)	71	(402)
Assets.....	–	58	7	103	61	–	90	–	–	–	319
Liabilities.....	(87)	–	–	–	–	(77)	–	(159)	(23)	(99)	(445)
At 31 December 2011.....	(87)	58	7	103	61	(77)	90	(159)	(23)	(99)	(126)

Movement of net deferred tax assets/(liabilities) before offsetting balances within countries*The bank*

	Retirement benefits £m	Loan impairment allowances £m	Unused tax losses	Property, plant and equipment £m	Available- for-sale investments £m	Cash flow hedges £m	Share-based payments £m	Goodwill and intangibles	Other £m	Total £m
Assets	–	26	–	101	–	–	76	–	35	238
Liabilities	(138)	–	–	–	–	(47)	–	–	–	(185)
At 1 January 2012	(138)	26	–	101	–	(47)	76	–	35	53
Income statement	(122)	(8)	300	6	–	–	(32)	38	(13)	169
Other comprehensive income:										
- available-for-sale investments	–	–	(20)	–	1	–	–	–	–	(19)
- cash flow hedges	–	–	–	–	–	(4)	–	–	–	(4)
- actuarial movements	(16)	–	–	–	–	–	–	–	–	(16)
Equity:										
- share-based payments	–	–	–	–	–	–	18	–	–	18
Foreign exchange and other adjustments	2	–	–	(2)	–	1	–	–	–	1
	(136)	(8)	280	4	1	(3)	(14)	38	(13)	149
Assets	–	18	280	105	1	–	62	38	22	526
Liabilities	(274)	–	–	–	–	(50)	–	–	–	(324)
At 31 December 2012	(274)	18	280	105	1	(50)	62	38	22	202

Movement of net deferred tax assets/(liabilities) before offsetting balances within countries*The bank*

	Retirement benefits £m	Loan impairment allowances £m	Property, plant and equipment £m	Available- for-sale investments £m	Cash flow hedges £m	Share-based payments £m	Other £m	Total £m
Assets	449	35	58	–	–	71	55	668
Liabilities	–	–	–	(1)	(50)	–	(2)	(53)
At 1 January 2011	449	35	58	(1)	(50)	71	53	615
Income statement								
Other comprehensive income:	(258)	(9)	44	–	–	(8)	(18)	(249)
- available-for-sale investments	–	–	–	1	–	–	–	1
- cash flow hedges	–	–	–	–	2	–	–	2
- actuarial movements	(331)	–	–	–	–	–	–	(331)
Equity:								
- share-based payments	–	–	–	–	–	13	–	13
Foreign exchange and other adjustments	2	–	(1)	–	1	–	–	2
	(587)	(9)	43	1	3	5	(18)	(562)
Assets	–	26	101	–	–	76	35	238
Liabilities	(138)	–	–	–	(47)	–	–	(185)
At 31 December 2011	(138)	26	101	–	(47)	76	35	53

Notes on the Financial Statements (continued)

After netting off balances within countries, the balances as disclosed in the accounts are as follows:

	The group		The bank	
	2012 £m	2011 £m	2012 £m	2011 £m
Deferred tax assets	274	140	204	55
Deferred tax liabilities	(99)	(266)	(2)	(2)
	175	(126)	202	53

For the group, the amount of temporary differences for which no deferred tax asset is recognised in the balance sheet is £708 million (2011: £628 million). This amount is in respect of losses where the recoverability of potential benefits is not considered likely.

For the bank, the amount of temporary differences for which no deferred tax asset is recognised in the balance sheet is nil (2011: nil).

Deferred tax is not recognised in respect of the group's investments in subsidiaries and branches where remittance is not contemplated, and for associates and interests in joint ventures where it has been determined that no additional tax will arise. The aggregate amount of temporary differences associated with such investments is nil (2011: nil). Following the change in the UK tax treatment of dividends on 1 July 2009, no UK tax is expected to arise on distributions from group entities and no temporary difference exists except where withholding tax or other foreign tax could arise on the investments. No meaningful amount of temporary differences associated with such investments can be disclosed.

11 Dividends

HSBC Bank plc dividends to shareholders of the parent company were as follows:

	2012		2011	
	£ per share	Total £m	£ per share	Total £m
Dividends declared on ordinary shares				
Second interim dividend in respect of previous year	0.25	200	1.15	915
First interim dividend in respect of current year	0.72	575	1.00	800
Second interim dividend in respect of current year	2.51	2,000	–	–
	3.48	2,775	2.15	1,715

	2012		2011	
	£ per share	Total £m	£ per share	Total £m
Dividends on preference shares classified as equity				
Dividend on HSBC Bank plc non-cumulative third dollar preference shares	1.17	41	1.17	41
	1.17	41	1.17	41

	2012 £m	2011 £m
Coupons on capital securities classified as equity		
Coupon in respect of the first quarter of the year	–	59
	–	59

12 Discontinued Operations

Sale of HSBC Private Banking Holdings (Suisse) SA

In November 2012, the group sold HSBC Private Banking Holdings (Suisse) SA to HSBC Holdings plc. Prior to the sale, the bank had acquired HSBC Private Bank (UK) Limited from HSBC Private Banking Holdings (Suisse) SA in October 2012. HSBC Private Banking Holdings (Suisse) SA and its subsidiaries comprised the majority of the Private Banking segment. The segment was not a discontinued operation or classified as held for sale as at 31 December 2011 and the comparative statement of comprehensive income has been re-presented to show the discontinued operation separately from continuing operations.

Notes on the Financial Statements (continued)

The profit from discontinued operations, before gain on disposal, of £316 million (2011: £375 million) is attributable entirely to the shareholders of the parent company. Of the profit from continuing operations of £844 million (2011: £2,002 million), an amount of £803 million is attributable to the shareholders of the parent company.

	2012 £m	2011 £m
Cash flows from (used in) discontinued operations		
Net cash used in operating activities	14	(2,646)
Net cash from investing activities	2,323	6,525
Net cash from financing activities	-	(8)
Net cash flows for the year	<u>2,337</u>	<u>3,871</u>
Effect of disposal on the financial position of the group		
Net assets	(3,732)	
Goodwill on consolidation	(2,796)	
Consideration received	<u>6,535</u>	
Profit on disposal	<u>7</u>	

13 Segment analysis

The factors used in identifying the group's reporting segments are discussed in Note 2(c) Operating Segments.

The types of products and services from which each reportable segment derives its revenue are discussed in the 'Report of the Directors: Operating and Financial Review – Business segments'.

Profit/(loss) for the year

	Year ended 31 December 2012						
	UK Retail £m	Continental Europe Retail £m	Banking and Markets £m	Global Private Banking ¹ £m	Other ² £m	Inter- segment £m	Total £m
Net interest income	3,738	1,693	876	597	(43)	43	6,904
Net fee income	1,789	790	616	583	3	-	3,781
Net trading income	87	(29)	1,554	254	(9)	(23)	1,834
Other income	100	(83)	973	8	(936)	(93)	(31)
Net operating income before loan impairment charges and other credit risk provisions	5,714	2,371	4,019	1,442	(985)	(73)	12,488
Loan impairment charges and other credit risk provisions	(651)	(296)	(280)	(18)	-	-	(1,245)
Net operating income	5,063	2,075	3,739	1,424	(985)	(73)	11,243
Employee compensation and benefits	(1,007)	(607)	(1,157)	(557)	(1,461)	-	(4,789)
General and administrative expenses ²	(3,147)	(1,080)	(1,897)	(371)	1,516	73	(4,906)
Depreciation and impairment of property, plant and equipment	(9)	(5)	(5)	(14)	(333)	-	(366)
Amortisation and impairment of intangible assets	(97)	(6)	(34)	(1)	(37)	-	(175)
Total operating expenses	(4,260)	(1,698)	(3,093)	(943)	(315)	73	(10,236)
Operating profit	803	377	646	481	(1,300)	-	1,007
Share of profit in associates and joint ventures	3	(1)	(4)	(1)	-	-	(3)
Profit before tax	806	376	642	480	(1,300)	-	1,004

¹ In November 2012, the group sold HSBC Private Banking Holdings (Suisse) SA to HSBC Holdings plc. The ownership of HSBC Private Bank (UK) Limited remains within the group. Included within the Global Private Banking reporting segment profit before tax of £380 million (2011: £453 million) relating to discontinued operations

² The reallocation and recharging of employee and other expenses incurred directly in the 'Other' reporting segment is shown in 'General and administrative expenses'.

Notes on the Financial Statements (continued)

	Year ended 31 December 2011						Total £m
	UK Retail £m	Continental Europe Retail £m	Banking and Markets £m	Global Private Banking £m	Other ¹ £m	Inter- segment £m	
Net interest income	3,602	1,775	1,323	750	(93)	(134)	7,223
Net fee income	1,776	766	598	700	60	–	3,900
Net trading income	54	(2)	1,083	250	(7)	158	1,536
Other income	194	(90)	267	22	1,064	(93)	1,364
Net operating income before loan impairment charges and other credit risk provisions	5,626	2,449	3,271	1,722	1,024	(69)	14,023
Loan impairment charges and other credit risk provisions	(796)	(212)	(543)	(72)	–	–	(1,623)
Net operating income	4,830	2,237	2,728	1,650	1,024	(69)	12,400
Employee compensation and benefits	(1,147)	(665)	(1,224)	(698)	(847)	–	(4,581)
General and administrative expenses ¹	(2,020)	(1,196)	(1,558)	(404)	951	69	(4,158)
Depreciation and impairment of property, plant and equipment	(4)	(39)	(10)	(19)	(281)	–	(353)
Amortisation and impairment of intangible assets	(111)	(23)	(30)	(1)	(31)	–	(196)
Total operating expenses	(3,282)	(1,923)	(2,822)	(1,122)	(208)	69	(9,288)
Operating profit	1,548	314	(94)	528	816	–	3,112
Share of profit in associates and joint ventures	(1)	–	–	–	–	–	(1)
Profit before tax	1,547	314	(94)	528	816	–	3,111

¹ The reallocation and recharging of employee and other expenses incurred directly in the 'Other' reporting segment is shown in 'General and administrative expenses'.

Other information about the profit/(loss) for the year

	UK Retail £m	Continental Europe Retail £m	Global Banking and Markets £m	Global Private Banking £m	Other £m	Inter- segment £m	Total £m
	Year ended 31 December 2012						
Net operating income:	5,063	2,075	3,739	1,424	(985)	(73)	11,243
External	4,887	2,088	4,232	1,235	(1,199)	–	11,243
Inter-segment	176	(13)	(493)	189	214	(73)	–
Year ended 31 December 2011							
Net operating income:	4,830	2,237	2,728	1,650	1,024	(69)	12,400
External	4,664	2,174	3,214	1,450	898	–	12,400
Inter-segment	166	63	(486)	200	126	(69)	–

Performance ratios

	UK Retail £m	Continental Europe Retail £m	Global Banking and Markets £m	Global Private Banking £m	Other £m	Inter- segment £m	Total £m
	Year ended 31 December 2012						
Share of the group's profit before tax	806	376	642	480	(1,300)	–	1,004
Cost efficiency ratio	74.55%	71.62%	76.96%	65.40%	–	–	81.97%
Year ended 31 December 2011							
Share of the group's profit before tax	1,547	314	(94)	528	816	–	3,111
Cost efficiency ratio	58.34%	78.52%	86.27%	65.16%	20.31%	–	66.23%

Notes on the Financial Statements (continued)

Balance sheet information

	UK Retail £m	Continental Europe Retail £m	Global Banking and Markets £m	Global Private Banking £m	Other £m	Inter- segment £m	Total £m
Year ended 31 December 2012							
Loans and advances to customers (net).....	133,105	37,051	103,729	8,252	548	–	282,685
Investment in associates and joint venture.....	31	4	32	–	–	–	67
Total assets.....	176,722	65,404	641,318	12,101	23,688	(103,752)	815,481
Customer accounts.....	158,061	35,387	121,730	9,250	458	–	324,886
Total liabilities.....	164,397	61,420	632,331	12,033	18,439	(105,339)	783,281
Year ended 31 December 2011							
Loans and advances to customers (net).....	123,102	36,597	104,263	23,600	452	–	288,014
Investment in associates and joint venture.....	28	4	34	1	9	–	76
Total assets.....	166,510	59,400	648,202	68,683	26,458	(141,283)	827,970
Customer accounts.....	147,733	33,546	107,213	57,465	172	–	346,129
Total liabilities.....	155,924	57,550	642,807	65,924	21,228	(147,067)	796,366

Other financial information

Net operating income by customer group and global business

	Retail Banking and Wealth Management £m	Commercial Banking £m	Global Banking and Markets £m	Global Private Banking £m	Other £m	Inter- segment £m	Total £m
Year ended 31 December 2012							
Net operating income:	4,657	2,481	3,739	1,424	(985)	(73)	11,243
External.....	4,282	2,693	4,232	1,235	(1,199)	–	11,243
Inter-segment	375	(212)	(493)	189	214	(73)	–
Year ended 31 December 2011							
Net operating income:	4,603	2,464	2,728	1,650	1,024	(69)	12,400
External.....	4,470	2,370	3,215	1,450	895	–	12,400
Inter-segment.....	133	94	(487)	200	129	(69)	–

Information by country

	31 December 2012		31 December 2011	
	External net Operating income ¹ £m	Non-current assets ² £m	External net Operating income ¹ £m	Non-current assets ² £m
United Kingdom	7,031	3,921	8,059	3,455
France.....	1,727	6,243	1,600	6,350
Switzerland	381	–	509	2,597
Other countries.....	2,104	499	2,232	918
Total.....	11,243	10,663	12,400	13,320

¹ Net operating income is attributed to countries on the basis of the customers' location.

² Non current assets consist of property, plant and equipment, goodwill, other intangible assets and certain other assets expected to be recovered more than twelve months after the reporting period.

14 Analysis of financial assets and liabilities by measurement basis

The following tables analyse the carrying amount of financial assets and liabilities by category as defined in IAS 39 and by balance sheet heading:

The group

At 31 December 2012

	Held for trading £m	Designated at fair value £m	Held-to-maturity securities £m	Loans and receivables £m	Available-for-sale securities £m	Financial assets and liabilities at amortised cost £m	Derivatives designated as fair value hedging instruments £m	Derivatives designated as cash flow hedging instruments £m	Total £m
Financial assets									
Cash and balances at central banks	-	-	-	-	-	51,613	-	-	51,613
Items in the course of collection from other banks	-	-	-	-	-	1,961	-	-	1,961
Trading assets	161,516	-	-	-	-	-	-	-	161,516
Financial assets designated at fair value	-	15,387	-	-	-	-	-	-	15,387
Derivatives	176,559	-	-	-	-	-	88	1,161	177,808
Loans and advances to banks	-	-	-	32,286	-	-	-	-	32,286
Loans and advances to customers	-	-	-	282,685	-	-	-	-	282,685
Financial investments	-	-	-	-	71,265	-	-	-	71,265
Other assets	-	-	-	-	-	4,269	-	-	4,269
Accrued income	-	-	-	-	-	2,435	-	-	2,435
Total financial assets	338,075	15,387	-	314,971	71,265	60,278	88	1,161	801,225
Total non-financial assets									14,256
Total assets									815,481
Financial liabilities									
Deposits by banks	-	-	-	-	-	39,571	-	-	39,571
Customer accounts	-	-	-	-	-	324,886	-	-	324,886
Items in the course of transmission to other banks	-	-	-	-	-	1,017	-	-	1,017
Trading liabilities	122,896	-	-	-	-	-	-	-	122,896
Financial liabilities designated at fair value	-	32,918	-	-	-	-	-	-	32,918
Derivatives	178,809	-	-	-	-	-	1,500	786	181,095
Debt securities in issue	-	-	-	-	-	40,358	-	-	40,358
Other liabilities	-	-	-	-	-	6,286	-	-	6,286
Accruals	-	-	-	-	-	2,961	-	-	2,961
Subordinated liabilities	-	-	-	-	-	10,350	-	-	10,350
Total financial liabilities	301,705	32,918	-	-	-	425,429	1,500	786	762,338
Total non-financial liabilities									20,943
Total liabilities									783,281

The group

At 31 December 2011

	Held for trading £m	Designated at fair value £m	Held-to-maturity securities £m	Loans and receivables £m	Available-for-sale securities £m	Financial assets and liabilities at amortised cost £m	Derivatives designated as fair value hedging instruments £m	Derivatives designated as cash flow hedging instruments £m	Total £m
Financial assets									
Cash and balances at central banks	-	-	-	-	-	56,460	-	-	56,460
Items in the course of collection from other banks	-	-	-	-	-	1,663	-	-	1,663
Trading assets	126,598	-	-	-	-	-	-	-	126,598
Financial assets designated at fair value	-	15,332	-	-	-	-	-	-	15,332
Derivatives	175,704	-	-	-	-	-	197	1,092	176,993
Loans and advances to banks	-	-	-	44,603	-	-	-	-	44,603
Loans and advances to customers	-	-	-	288,014	-	-	-	-	288,014
Financial investments	-	-	4,151	-	88,961	-	-	-	93,112
Other assets	-	-	-	-	-	5,742	-	-	5,742
Accrued income	-	-	-	-	-	2,752	-	-	2,752
Total financial assets	302,302	15,332	4,151	332,617	88,961	66,617	197	1,092	811,269
Total non-financial assets									16,701
Total assets									827,970
Financial liabilities									
Deposits by banks	-	-	-	-	-	41,032	-	-	41,032
Customer accounts	-	-	-	-	-	346,129	-	-	346,129
Items in the course of transmission to other banks	-	-	-	-	-	1,154	-	-	1,154
Trading liabilities	119,211	-	-	-	-	-	-	-	119,211
Financial liabilities designated at fair value	-	31,992	-	-	-	-	-	-	31,992
Derivatives	175,935	-	-	-	-	-	1,579	607	178,121
Debt securities in issue	-	-	-	-	-	42,688	-	-	42,688
Other liabilities	-	-	-	-	-	3,972	-	-	3,972
Accruals	-	-	-	-	-	3,222	-	-	3,222
Subordinated liabilities	-	-	-	-	-	9,998	-	-	9,998
Total financial liabilities	295,146	31,992	-	-	-	448,195	1,579	607	777,519
Total non-financial liabilities									18,847
Total liabilities									796,366

The bank

At 31 December 2012

	Held for trading £m	Designated at fair value £m	Held-to-maturity securities £m	Loans and receivables £m	Available-for-sale securities £m	Financial assets and liabilities at amortised cost £m	Derivatives designated as fair value hedging instruments £m	Derivatives designated as cash flow hedging instruments £m	Total £m
Financial assets									
Cash and balances at central banks	-	-	-	-	-	45,262	-	-	45,262
Items in the course of collection from other banks	-	-	-	-	-	1,213	-	-	1,213
Trading assets	137,999	-	-	-	-	-	-	-	137,999
Financial assets designated at fair value	-	4,373	-	-	-	-	-	-	4,373
Derivatives	139,695	-	-	-	-	-	162	483	140,340
Loans and advances to banks	-	-	-	17,207	-	-	-	-	17,207
Loans and advances to customers	-	-	-	225,567	-	-	-	-	225,567
Financial investments	-	-	-	-	36,603	-	-	-	36,603
Other assets	-	-	-	-	-	3,205	-	-	3,205
Accrued income	-	-	-	-	-	1,075	-	-	1,075
Total financial assets	277,694	4,373	-	242,774	36,603	50,755	162	483	612,844
Total non-financial assets									16,786
Total assets									629,630
Financial liabilities									
Deposits by banks	-	-	-	-	-	30,129	-	-	30,129
Customer accounts	-	-	-	-	-	256,341	-	-	256,341
Items in the course of transmission to other banks	-	-	-	-	-	334	-	-	334
Trading liabilities	104,946	-	-	-	-	-	-	-	104,946
Financial liabilities designated at fair value	-	23,513	-	-	-	-	-	-	23,513
Derivatives	142,217	-	-	-	-	-	1,537	167	143,921
Debt securities in issue	-	-	-	-	-	24,970	-	-	24,970
Other liabilities	-	-	-	-	-	5,020	-	-	5,020
Accruals	-	-	-	-	-	1,587	-	-	1,587
Subordinated liabilities	-	-	-	-	-	9,968	-	-	9,968
Total financial liabilities	247,163	23,513	-	-	-	328,349	1,537	167	600,729
Total non-financial liabilities									1,834
Total liabilities									602,563

The bank

At 31 December 2011

	Held for trading £m	Designated at fair value £m	Held-to-maturity securities £m	Loans and receivables £m	Available-for-sale securities £m	Financial assets and liabilities at amortised cost £m	Derivatives designated as fair value hedging instruments £m	Derivatives designated as cash flow hedging instruments £m	Total £m
Financial assets									
Cash and balances at central banks	–	–	–	–	–	44,967	–	–	44,967
Items in the course of collection from other banks	–	–	–	–	–	908	–	–	908
Trading assets	106,339	–	–	–	–	–	–	–	106,339
Financial assets designated at fair value	–	4,595	–	–	–	–	–	–	4,595
Derivatives	144,842	–	–	–	–	–	179	403	145,424
Loans and advances to banks	–	–	–	22,203	–	–	–	–	22,203
Loans and advances to customers	–	–	–	210,561	–	–	–	–	210,561
Financial investments	–	–	–	–	42,240	–	–	–	42,240
Other assets	–	–	–	–	–	3,305	–	–	3,305
Accrued income	–	–	–	–	–	1,155	–	–	1,155
Total financial assets	251,181	4,595	–	232,764	42,240	50,335	179	403	581,697
Total non-financial assets									19,870
Total assets									601,567
Financial liabilities									
Deposits by banks	–	–	–	–	–	32,324	–	–	32,324
Customer accounts	–	–	–	–	–	237,654	–	–	237,654
Items in the course of transmission to other banks	–	–	–	–	–	446	–	–	446
Trading liabilities	94,584	–	–	–	–	–	–	–	94,584
Financial liabilities designated at fair value	–	22,861	–	–	–	–	–	–	22,861
Derivatives	145,514	–	–	–	–	–	1,557	180	147,251
Debt securities in issue	–	–	–	–	–	25,705	–	–	25,705
Other liabilities	–	–	–	–	–	2,128	–	–	2,128
Accruals	–	–	–	–	–	1,595	–	–	1,595
Subordinated liabilities	–	–	–	–	–	9,893	–	–	9,893
Total financial liabilities	240,098	22,861	–	–	–	309,745	1,557	180	574,441
Total non-financial liabilities									1,190
Total liabilities									575,631

Notes on the Financial Statements (continued)

15 Reclassification of financial assets

Reclassification from available-for-sale to held-to-maturity

On 7 January 2009, the group reclassified £6.0 billion of financial assets from the available-for-sale category to the held-to-maturity category. The reclassification was made as a result of the change in intention to hold the assets until maturity.

Reclassification from held for trading to loans and receivables/available-for-sale

In October 2008, the group and the bank reclassified £5.0 billion and £0.2 billion of financial assets classified as held for trading assets into the loans and receivables and available-for-sale categories respectively, with effect from 1 July 2008. During November and December 2008, the group and the bank reclassified £0.9 billion and £1.4 billion of financial assets classified as held for trading into loans and receivables and available-for-sale respectively. These latter reclassifications took effect prospectively.

	At 31 December 2012		At 31 December 2011	
	Carrying amount £m	Fair value £m	Carrying amount £m	Fair value £m
Reclassification to loans and receivables	3,720	3,291	4,587	3,889
Reclassification to available-for-sale	7	7	22	22
	3,727	3,298	4,609	3,911

The reclassifications were made as a result of significant reduction in market liquidity for these assets, and a change in the group's intention to hold the assets for the foreseeable future or to maturity. These circumstances form part of the wider context of market turmoil and are considered a rare event and, as such, the reclassification is permitted under the amendment to IAS 39. On the date of reclassification, the fair value of the asset is deemed to be the asset's new amortised cost, and the assets are thereafter tested for impairment.

If these reclassifications had not been made, the group's profit before tax in 2012 would have been increased by £252 million from £1,004 million to £1,256 million (2011: a decrease of £30 million from £3,111 million to £3,081 million). The changes in group profit would have been entirely in the Global Banking and Markets segment.

The following table shows the fair value gains and losses recognised in the income statement as a result of the reclassification from held for trading to loans and receivables/available-for-sale:

	2012 £m	2011 £m	2010 £m	2009 £m	2008 £m
Reclassification to loans and receivables					
Recorded in the income statement	81	180	316	427	255
Assuming no reclassification	333	152	682	910	(1,405)
Net income statement effect of reclassification	(252)	28	(366)	(483)	1,660
Reclassification to available-for-sale					
Recorded in the income statement	–	1	37	76	13
Assuming no reclassification	–	(1)	38	180	(120)
Net income statement effect of reclassification	–	2	(1)	(104)	133
Total income statement effect of reclassification	(252)	30	(367)	(587)	1,793

Notes on the Financial Statements (continued)

16 Trading assets

	The group		The bank	
	2012 £m	2011 £m	2012 £m	2011 £m
Trading assets:				
– which may be repledged or resold by counterparties	53,883	53,296	36,508	39,350
– not subject to repledge or resale by counterparties	107,633	73,302	101,491	66,989
	161,516	126,598	137,999	106,339
Treasury and other eligible bills	2,258	1,301	1,120	709
Debt securities	54,576	51,286	30,084	27,079
Equity securities	22,892	11,941	22,050	11,487
Loans and advances to banks	32,655	30,335	38,258	36,407
Loans and advances to customers	49,135	31,735	46,487	30,657
	161,516	126,598	137,999	106,339

Included within the above figures for the group are debt securities issued by banks and other financial institutions of £10,163 million (2011: £12,571million), of which £2,078 million (2011: £2,967million) are guaranteed by various governments.

Included within the above figures for the bank are debt securities issued by banks and other financial institutions of £5,049 million (2011: £5,487million), of which £0 million (2011: £1 million) are guaranteed by various governments.

17 Financial assets designated at fair value through profit or loss

	The group		The bank	
	2012 £m	2011 £m	2012 £m	2011 £m
Financial assets designated at fair value:				
–not subject to repledge or resale by counterparties	15,387	15,332	4,373	4,595
Treasury and other eligible bills	–	5	–	–
Debt securities	7,122	7,285	4,373	4,595
Equity securities	8,236	7,476	–	–
Loans and advances to banks	29	70	–	–
Loans and advances to customers	–	496	–	–
	15,387	15,332	4,373	4,595

18 Derivatives

Fair values of derivatives by product contract type held

The group

	At 31 December 2012					
	Assets			Liabilities		
	Trading £m	Hedging £m	Total £m	Trading £m	Hedging £m	Total £m
Foreign exchange	28,212	2	28,214	(30,962)	(25)	(30,987)
Interest rate	352,380	1,247	353,627	(349,088)	(2,261)	(351,349)
Equity	8,523	–	8,523	(11,074)	–	(11,074)
Credit	4,787	–	4,787	(5,123)	–	(5,123)
Commodity and other	646	–	646	(551)	–	(551)
Gross total fair values	394,548	1,249	395,797	(396,798)	(2,286)	(399,084)
Netting			(217,989)			217,989
Total			177,808			(181,095)

Notes on the Financial Statements (continued)

	At 31 December 2011					
	Assets			Liabilities		
	Trading £m	Hedging £m	Total £m	Trading £m	Hedging £m	Total £m
Foreign exchange	35,010	115	35,125	(35,597)	(8)	(35,605)
Interest rate	299,424	1,174	300,598	(296,347)	(2,178)	(298,525)
Equity	8,806	–	8,806	(11,312)	–	(11,312)
Credit	9,228	–	9,228	(9,383)	–	(9,383)
Commodity and other	689	–	689	(749)	–	(749)
Gross total fair values	353,157	1,289	354,446	(353,388)	(2,186)	(355,574)
Netting			(177,453)			177,453
Total			<u>176,993</u>			<u>(178,121)</u>

The bank

	At 31 December 2012					
	Assets			Liabilities		
	Trading £m	Hedging £m	Total £m	Trading £m	Hedging £m	Total £m
Foreign exchange	28,329	–	28,329	(30,905)	–	(30,905)
Interest rate	238,711	645	239,356	(236,121)	(1,704)	(237,825)
Equity	8,450	–	8,450	(10,746)	–	(10,746)
Credit	4,787	–	4,787	(5,121)	–	(5,121)
Commodity and other	652	–	652	(558)	–	(558)
Gross total fair values	280,929	645	281,574	(283,451)	(1,704)	(285,155)
Netting			(141,234)			141,234
Total			<u>140,340</u>			<u>(143,921)</u>

	At 31 December 2011					
	Assets			Liabilities		
	Trading £m	Hedging £m	Total £m	Trading £m	Hedging £m	Total £m
Foreign exchange	34,972	–	34,972	(35,907)	–	(35,907)
Interest rate	209,433	582	210,015	(206,599)	(1,737)	(208,336)
Equity	8,430	–	8,430	(10,831)	–	(10,831)
Credit	9,229	–	9,229	(9,337)	–	(9,337)
Commodity and other	666	–	666	(728)	–	(728)
Gross total fair values	262,730	582	263,312	(263,402)	(1,737)	(265,139)
Netting			(117,888)			117,888
Total			<u>145,424</u>			<u>(147,251)</u>

Use of derivatives

The group transacts derivatives for three primary purposes: to create risk management solutions for clients, to manage the portfolio of risks arising from client business, and to manage and hedge the group's own risks. Derivatives (except for derivatives which are designated as effective hedging instruments as defined in IAS 39) are held for trading. The held for trading classification includes two types of derivatives: those used in sales and trading activities, and those used for risk management purposes but which for various reasons do not meet the qualifying criteria for hedge accounting. The second category includes derivatives managed in conjunction with financial instruments designated at fair value. These activities are described more fully below.

The group's derivative activities give rise to significant open positions in portfolios of derivatives. These positions are managed constantly to ensure that they remain within acceptable risk levels, with matching deals being used to achieve this where necessary. When entering into derivative transactions, the group employs the same credit risk management procedures to assess and approve potential credit exposures that are used for traditional lending.

Trading derivatives

Most of the group's derivative transactions relate to sales and trading activities. Sales activities include the structuring and marketing of derivative products to customers to enable them to take, transfer, modify or reduce current or expected risks. Trading activities in derivatives are entered into principally for the purpose of generating profits from short-term fluctuations in price or margin. Positions may be traded actively or be held over a period of time to benefit from expected changes in currency rates, interest rates, equity prices or other market parameters.

Notes on the Financial Statements (continued)

Trading includes market-making, positioning and arbitrage activities. Market-making entails quoting bid and offer prices to other market participants for the purpose of generating revenues based on spread and volume; positioning means managing market risk positions in the expectation of benefiting from favourable movements in prices, rates or indices; arbitrage involves identifying and profiting from price differentials between markets and products.

As mentioned above, other derivatives classified as held-for-trading include non-qualifying hedging derivatives, ineffective hedging derivatives and the components of hedging derivatives that are excluded from assessing hedge effectiveness. Non-qualifying hedging derivatives are entered into for risk management purposes but do not meet the criteria for hedge accounting. These include derivatives managed in conjunction with financial instruments designated at fair value.

Gains and losses from changes in the fair value of derivatives, including the contractual interest, that do not qualify for hedge accounting are reported in 'Net trading income', except for derivatives managed in conjunction with financial instruments designated at fair value, where gains and losses are reported in 'Net income from financial instruments designated at fair value', together with the gains and losses on the hedged items. Where the derivatives are managed with debt securities in issue, the contractual interest is shown in 'Interest expense' together with the interest payable on the issued debt. Substantially all of the group's derivatives entered into with the group's undertakings are managed in conjunction with financial liabilities designated at fair value.

Notional contract amounts of derivatives held for trading purposes by product type

	At 31 December			
	The group		The bank	
	2012 £m	2011 £m	2012 £m	2011 £m
Foreign exchange	1,752,454	1,586,377	1,787,854	1,586,934
Interest rate	10,694,278	10,380,838	7,465,092	7,019,421
Equity	285,442	135,985	279,793	129,080
Credit	339,538	335,765	339,543	335,755
Commodity	41,533	40,766	44,246	40,641
Total derivatives	13,113,245	12,479,731	9,916,528	9,111,831

The notional or contractual amounts of these instruments indicate the nominal value of transactions outstanding at the balance sheet date; they do not represent amounts at risk.

Derivatives valued using models with unobservable inputs

The difference between the fair value at initial recognition (the transaction price) and the value that would have been derived had valuation techniques used for subsequent measurement been applied at initial recognition, less subsequent releases, is as follows:

	The group		The bank	
	2012 £m	2011 £m	2012 £m	2011 £m
Unamortised balance at 1 January	97	130	91	123
Deferral on new transactions	76	118	76	115
Recognised in the income statement during the period:				
– amortisation	(57)	(79)	(57)	(79)
– subsequent to unobservable inputs becoming observable	–	(43)	–	(41)
– maturity or termination, or offsetting derivative	(23)	(29)	(21)	(27)
Exchange differences	(3)	–	(3)	–
Unamortised balance at 31 December ¹	90	97	86	91

¹ This amount is yet to be recognised in the income statement.

Hedging instruments

The group uses derivatives (principally interest rate swaps) for hedging purposes in the management of its own asset and liability portfolios and structural positions. This enables the group to optimise the overall cost to the group of accessing debt capital markets, and to mitigate the market risk which would otherwise arise from structural imbalances in the maturity and other profiles of its assets and liabilities.

The accounting treatment of hedge transactions varies according to the nature of the instrument hedged and the type of hedge transactions. Derivatives may qualify as hedges for accounting purposes if they are fair value hedges, cash

Notes on the Financial Statements (continued)

flow hedges, or hedges in net investment of foreign operations. These are described under the relevant headings below.

Notional contract amounts of derivatives held for hedging purposes by product type

The notional contract amounts of these instruments indicate the nominal value of transactions outstanding at the balance sheet date; they do not represent amounts at risk.

	The group			
	At 31 December 2012		At 31 December 2011	
	Cash flow hedge £m	Fair value hedge £m	Cash flow hedge £m	Fair value hedge £m
Exchange rate	738	69	716	68
Interest rate	72,553	19,574	93,203	25,011

	The bank			
	At 31 December 2012		At 31 December 2011	
	Cash flow hedge £m	Fair value hedge £m	Cash flow hedge £m	Fair value hedge £m
Exchange rate	179	–	214	–
Interest rate	32,744	16,576	35,138	18,927

Fair value hedges

The group's fair value hedges principally consist of interest rate swaps that are used to protect against changes in the fair value of fixed-rate long-term financial instruments due to movements in market interest rates. For qualifying fair value hedges, all changes in the fair value of the derivative and in the fair value of the item in relation to the risk being hedged are recognised in the income statement. If the hedge relationship is terminated, the fair value adjustment to the hedged item continues to be reported as part of the basis of the item and is amortised to the income statement as a yield adjustment over the remainder of the hedging period.

Fair value of derivatives designated as fair value hedges

The group

	At 31 December 2012		At 31 December 2011	
	Assets £m	Liabilities £m	Assets £m	Liabilities £m
	Foreign exchange	–	–	–
Interest rate	88	(1,500)	197	(1,578)
	88	(1,500)	197	(1,579)

The bank

	At 31 December 2012		At 31 December 2011	
	Assets £m	Liabilities £m	Assets £m	Liabilities £m
	Interest rate	162	(1,537)	179
	162	(1,537)	179	(1,557)

Gains or losses arising from the change in fair value of fair value hedges

	The group		The bank	
	2012 £m	2011 £m	2012 £m	2011 £m
Gains/ (losses)				
– on hedging instruments	(371)	(1,231)	(241)	(1,122)
– on hedged items attributable to the hedged risk	360	1,143	233	1,047

Notes on the Financial Statements (continued)

The gains and losses on ineffective portions of fair value hedges are recognised immediately in 'Net trading income'.

Cash flow hedges

The group's cash flow hedges consist principally of interest rate and cross-currency swaps that are used to protect against exposures to variability in future interest cash flows on non-trading assets and liabilities which bear interest at variable rates or which are expected to be re-funded or reinvested in the future. The amounts and timing of future cash flows, representing both principal and interest flows, are projected for each portfolio of financial assets and liabilities on the basis of their contractual terms and other relevant factors, including estimates of prepayments and defaults. The aggregate principal balances and interest cash flows across all portfolios over time form the basis for identifying gains and losses on the effective portions of derivatives designated as cash flow hedges of forecast transactions. Gains and losses are initially recognised in other comprehensive income, in the cash flow hedging reserve, and are transferred to the income statement when the forecast cash flows affect the income statement.

Fair value of derivatives designated as cash flow hedges

The group

	At 31 December 2012		At 31 December 2011	
	Assets £m	Liabilities £m	Assets £m	Liabilities £m
Foreign exchange	2	(25)	115	(7)
Interest rate	1,159	(761)	977	(600)
	1,161	(786)	1,092	(607)

The bank

	At 31 December 2012		At 31 December 2011	
	Assets £m	Liabilities £m	Assets £m	Liabilities £m
Interest rate	483	(167)	403	(180)

Forecast principal balances on which interest cash flows are expected to arise

The group

	At 31 December 2012			
	3 months or less £m	More than 3 months but less than 1 year £m	5 years or less but more than 1 year £m	More than 5 years £m
Assets	44,530	34,784	26,234	3,022
Liabilities	(17,422)	(9,948)	(6,788)	(1,336)
Net cash inflow/(outflow) exposure	27,108	24,836	19,446	1,686

	At 31 December 2011			
	3 months or less £m	More than 3 months but less than 1 year £m	5 years or less but more than 1 year £m	More than 5 years £m
Assets	59,287	46,833	28,960	2,147
Liabilities	(23,648)	(13,460)	(5,943)	(1,017)
Net cash inflow/(outflow) exposure	35,639	33,373	23,017	1,130

The bank

	At 31 December 2012			
	3 months or less £m	More than 3 months but less than 1 year £m	5 years or less but more than 1 year £m	More than 5 years £m
Assets	29,226	27,014	18,612	82
Liabilities	(3,050)	(3,050)	(3,050)	(230)
Net cash inflow/(outflow) exposure	26,176	23,964	15,562	(148)

Notes on the Financial Statements (continued)

	At 31 December 2011			
	3 months or less £m	More than 3 months but less than 1 year £m	5 years or less but more than 1 year £m	More than 5 years £m
Assets	31,908	30,780	20,934	–
Liabilities	(4,225)	(3,765)	(2,914)	(315)
Net cash inflow/(outflow) exposure	27,683	27,015	18,020	(315)

The gains and losses on ineffective portions of such derivatives are recognised immediately in 'Net trading income'. During the year to 31 December 2012, a gain of £7 million (2011: gain of £6 million) was recognised due to hedge ineffectiveness.

19 Financial investments

	The group		The bank	
	2012 £m	2011 £m	2012 £m	2011 £m
Financial investments:				
– which may be repledged or resold by counterparties	7,979	12,555	4,920	9,025
– not subject to repledge or resale by counterparties	63,286	80,557	31,683	33,215
	71,265	93,112	36,603	42,240
Treasury and other eligible bills	5,203	6,737	4,922	4,106
– available-for-sale	5,203	6,737	4,922	4,106
Debt securities	65,034	85,151	31,194	37,641
– available-for-sale	65,034	81,000	31,194	37,641
– held-to-maturity	-	4,151	-	-
Equity securities	1,028	1,224	487	493
– available-for-sale	1,028	1,224	487	493
Total financial investments	71,265	93,112	36,603	42,240

For the group, £1,953 million (2011: £6,193 million), and for the bank, £358 million (2011: £666 million), of the debt securities issued by banks and other financial institutions are guaranteed by various governments.

20 Transfer of financial assets

The group enters into transactions in the normal course of business by which it transfers recognised financial assets directly to third parties including SPEs. Depending on the circumstances these transfers may either result in these financial assets being derecognised or continuing to be recognised.

- Full derecognition occurs when the group transfers its contractual right to receive cash flows from the financial assets, or retains the right but assumes an obligation to pass on the cash flows from the asset, and transfers substantially all the risks and rewards of ownership. The risks include credit, interest rate, currency, prepayment and other price risks.
- Derecognition does not occur when the group transfers its contractual right to receive cash flows from the financial assets, or retains the right but assumes an obligation to pass on the cash flows from the asset, but either:
 - i) retains substantially all of the risks and rewards of ownership of the transferred asset; or
 - ii) neither retains nor transfers substantially all of the risks and rewards of ownership but has retained control. In this situation the financial assets are recognised on the balance sheet to the extent of the group's continuing involvement.

Notes on the Financial Statements (continued)

The majority of transferred financial assets that do not qualify for derecognition are (i) debt securities held by counterparties as collateral under repurchase agreements or (ii) equity securities lent under securities lending agreements.

As the substance of these transactions is secured borrowings the asset collateral continues to be recognised in full and the related liability reflecting the Group's obligation to repurchase the transferred assets for a fixed price at a future date is recognised in deposits from banks or customers as appropriate. As a result of these transactions, the Group is unable to use, sell or pledge the transferred assets for the duration of the transaction. The Group remains exposed to interest rate risk and credit risk on these pledged instruments. The counterparty's recourse is not limited to the transferred assets.

In a small number of securitisation transactions, the group has neither transferred nor retained substantially all the risks and rewards of ownership of the transferred assets, and has retained control of the transferred assets. Circumstances in which the group has continuing involvement in the transferred assets may include retention of servicing rights over the transferred assets, entering into a derivative transaction with the securitisation vehicle or retaining an interest in the securitisation vehicle. Where the group has continuing involvement it continues to recognise the transferred assets to the extent of its continuing involvement and recognises an associated liability. The net carrying amount of the transferred assets and associated liabilities reflects the rights and obligations that the group has retained.

The following tables analyse the carrying amount of financial assets that did not qualify for derecognition and their associated financial liabilities, including those that are recognised to the extent of the group's continuing involvement and the associated liabilities.

Financial assets not qualifying for full derecognition and associated financial liabilities¹

The group

	Carrying amount of transferred assets £m	Carrying amount of associated liabilities £m	Fair value of transferred assets £m	Fair value of associated liabilities £m	Net Position £m
At 31 December 2012					
Repurchase agreements	58,893	58,617			
Securities lending agreements	3,452	3,416			
Other sales (recourse to transferred asset only) .	665	665	673	673	—

	Carrying amount of assets before transfer £m	Carrying amount of recognised assets £m	Carrying amount of associated liabilities £m	Fair value of recognised assets £m	Fair value of associated liabilities £m	Net position £m
At 31 December 2012						
Securitisations recognised to the extent of continuing involvement	7,823	8	4	8	4	4

The bank

	Carrying amount of transferred assets £m	Carrying amount of associated liabilities £m	Fair value of transferred assets £m	Fair value of associated liabilities £m	Net Position £m
At 31 December 2012					
Repurchase agreements	38,012	38,028			
Securities lending agreements	3,416	3,416			
Other sales (recourse to transferred asset only) .	665	665	673	673	—

Notes on the Financial Statements (continued)

	Carrying amount of assets before transfer £m	Carrying amount of recognised assets £m	Carrying amount of associated liabilities £m	Fair value of recognised assets £m	Fair value of associated liabilities £m	Net Position £m
At 31 December 2012						
Securitisations recognised to the extent of continuing involvement	7,823	8	4	8	4	4

¹ The disclosure for 2012 reflects amendments made to IFRS 7 effective prospectively for annual reporting periods beginning on or after 1 July 2011.

At 31 December 2011, the carrying amounts of transferred assets and associated liabilities for repurchase agreements for the group were £61,861 million and £61,820 million respectively, and for securities lending agreements were £3,991 million and £3,971 million respectively.

At 31 December 2011, the carrying amounts of transferred assets and associated liabilities for repurchase agreements for the bank were £44,404 million and £44,350 million respectively, and for securities lending agreements were £3,971 million and £3,971 million respectively.

At 31 December 2011, the carrying amounts of transferred assets and associated liabilities for securitisations recognised to the extent of continuing involvement for both the group and the bank were £14 million and £7 million respectively. The carrying amount of these assets before transfer was £8,359 million.

Continuing involvement in financial assets and associated financial liabilities qualifying for full derecognition¹

The group and the bank

	At 31 December 2012				Maximum exposure to loss £m	2012		
	Carrying amount of continuing involvement in statement of financial position		Fair value of continuing involvement			Gain or loss recognised at transfer date £m	Income/ (expenses) recognised in reporting period £m	Income/ (expenses) recognised cumu- latively £m
	Assets £m	Liabilities £m	Assets £m	Liabilities £m				
Type of continuing involvement								
Interest in SPEs	243	–	219	–	243	5	5	36

¹ The disclosure for 2012 reflects amendments made to IFRS 7 effective prospectively for annual reporting periods beginning on or after 1 July 2011

The interest in SPEs is included within loans and advances to customers in the statement of financial position.

21 Interests in associates and joint ventures

Principal associates of the group and the bank

VocaLink Holdings Ltd ('VocaLink') is a principal associate of the bank and the group. VocaLink is incorporated in England and its principal activity is that of providing electronic payments and transaction services.

At 31 December 2012, the group had a 15.91% interest in the £133 million issued equity capital of VocaLink (2011: 15.91%). The carrying amount of the group's interest of £56 million at 31 December 2012 (2011: £52 million) reflects the net asset value of the company at that date.

VocaLink is accounted for as an associate due to the group's involvement in the operational activities, policy-making decisions and representation on the board of directors.

Summarised financial information on associates

The group's share of:

	2012 £m	2011 £m
Assets	113	117
Liabilities	65	62
Revenue	23	46
Profit after tax	(3)	(1)

Notes on the Financial Statements (continued)

Interests in significant joint ventures

Vaultex UK Limited is a significant joint venture of the bank and the group. Vaultex UK Limited is incorporated in England and its principal activity is that of cash management services. At 31 December 2012 and 31 December 2011, the group had a 50% interest in the £10 million issued equity capital.

Summarised financial information on joint ventures

The group's share of:

	2012 £m	2011 £m
Current assets	234	123
Non current assets	17	14
Current liabilities	234	121
Non current liabilities	10	10
Income	48	43
Expense	(48)	(43)

Details of all associates and joint ventures, as required under S.409 Companies Act 2006, will be annexed to the next Annual Return of the bank filed with the UK Registrar of Companies.

22 Goodwill and intangible assets

	The group		The bank	
	2012 £m	2011 £m	2012 £m	2011 £m
Goodwill	6,399	9,629	298	298
Present value of in-force long-term assurance business ('PVIFF')	705	708	–	–
Other intangible assets	722	658	581	501
	7,826	10,995	879	799

Goodwill

The group

	2012 £m	2011 £m
Gross amount and Carrying amount		
At 1 January	9,629	9,860
Disposals	(3,000)	(3)
Exchange differences	(230)	(228)
At 31 December	6,399	9,629

The bank

	2012 £m	2011 £m
At 1 January and 31 December	298	298

During 2012, no goodwill impairment was recognised (2011: nil).

Impairment testing in respect of goodwill is performed at least annually by comparing the recoverable amount of cash-generating units ('CGUs') determined as at 1 July 2012 based on a value in use calculation.

The value in use calculation uses cash flow estimates based on management's cash flow projections, extrapolated in perpetuity using a nominal long-term growth rate based on current market assessments of GDP and inflation for the countries within which the CGU operates. Cash flows are extrapolated in perpetuity due to the long-term perspective within the group of the business units making up the CGUs. The discount rate used is based on the cost of capital the group allocates to investments in the countries within which the CGU operates.

The cost of capital assigned to an individual CGU and used to discount its future cash flows can have a significant effect on its valuation. The cost of capital percentage is generally derived from an appropriate capital asset pricing model, which itself depends on inputs reflecting a number of financial and economic variables including the risk-free

Notes on the Financial Statements (continued)

rate in the country concerned and a premium or discount to reflect the inherent risk of the business being evaluated. These variables are established on the basis of management judgement and current market assessments of economic variables.

The review of goodwill impairment represents management's best estimates of the factors set out in Note 3. These values are sensitive to the cash flows projected for the periods for which detailed forecasts are available, and to assumptions regarding the long-term sustainable pattern of cash flows thereafter. While the acceptable range within which underlying assumptions can be applied is governed by the requirement for resulting forecasts to be compared with actual performance and verifiable economic data in future years, the cash flow forecasts necessarily and appropriately reflect management's view of future business prospects. The process of identifying and evaluating goodwill impairment is inherently uncertain because it requires significant management judgement in making a series of estimations, the results of which are highly sensitive to the assumptions used.

The following CGUs, include in their carrying value goodwill that is a significant proportion of total goodwill reported by the group at 31 December 2012. These CGUs do not carry on their balance sheet any intangible assets with indefinite useful lives, other than goodwill.

	Goodwill at 1 July 2012 £m	Discount rate %	Nominal growth rate beyond initial cash flow projections %	Goodwill at 1 July 2011 £m	Discount rate %	Nominal growth rate beyond initial cash flow projections %
Global Banking and Markets	5,292	10%	3.6%	5,915	10%	4.4%
Continental Europe Retail	818	10%	3.5%	890	10%	4.3%
Total goodwill in the CGUs listed above	<u>6,110</u>			<u>6,805</u>		

The group's transfer of HSBC Private Banking Holdings (Suisse) SA to HSBC Holdings plc on 1 November 2012 led to the disposal of goodwill on consolidation which, at 1 July 2012, amounted to £2,912 million. This goodwill related predominantly to the Group Private Banking CGU. Additionally, as at 1 July 2012, aggregate goodwill of £344 million (1 July 2011: £345 million) had been allocated to other CGUs that were not considered individually significant. These CGUs do not carry on their balance sheets any significant intangible assets with indefinite useful lives other than goodwill.

Nominal long-term growth rate: external data that reflects the market's assessment of GDP and inflation for the countries within which the CGU operates. The rates used for 2011 and 2012 do not exceed the long-term growth rate for the countries within which the CGU operates.

Discount rate: the after tax discount rate used to discount the cash flows is based on the cost of capital assigned to each CGU, which is derived using a Capital Asset Pricing Model ('CAPM'). The CAPM depends on inputs reflecting a number of financial and economic variables including the risk-free rate in the country concerned and a premium to reflect the inherent risk of the business being evaluated. These variables are based on the market's assessment of the economic variables and management's judgement. In addition, for the purposes of testing goodwill for impairment, management supplements this process by comparing the discount rates derived using the internally-generated CAPM with cost of capital rates produced by external sources. The group uses externally-sourced cost of capital rates where, in management's judgement, these rates reflect more accurately the current market and economic conditions. For 2012 and 2011, internal costs of capital rates were consistent with externally-sourced rates.

The present value of in-force long-term assurance business

Movement in PVIF

The group

	2012 £m	2011 £m
At 1 January	708	710
Addition from current year new business	97	120
Movement from in-force business (including investment return variances and changes in investment assumptions)	(86)	(150)
Exchange differences and other movements	(14)	28
At 31 December	<u>705</u>	<u>708</u>

Notes on the Financial Statements (continued)

The group's life insurance business is accounted for using the embedded value approach which, inter alia, provides a comprehensive risk and valuation framework. The PVIF asset represents the present value of the shareholders' interest in the profits expected to emerge from the book of in-force policies.

The calculation of PVIF is based upon assumptions that take into account risk and uncertainty. To project these cash flows, a variety of assumptions regarding future experience is made by each insurance operation which reflects local market conditions and management's judgement of local future trends.

PVIF-specific assumptions

The key assumptions used in the computation of PVIF for the group's main life insurance operations were:

	2012		2011	
	France	UK Life	France	UK Life
Risk free rate	2.12%	1.53%	2.77%	2.24%
Risk discount rate	4.05%	2.03%	5.95%	2.74%
Expenses inflation	2.00%	2.84%	2.00%	3.45%

The calculation of the PVIF is based upon assumptions that take into account risk and uncertainty. To project these cash flows, a variety of assumptions regarding future experience is made by each insurance operation which reflects local market conditions and management's judgement of local future trends.

The following table shows the effect on the PVIF of reasonably possible changes in the main economic assumption, risk-free rates, across all insurance manufacturing subsidiaries.

Sensitivity of PVIF to changes in economic assumptions

	PVIF at 31 December	
	2012 £m	2011 £m
+ 100 basis points shift in risk-free rate	1	(16)
- 100 basis points shift in risk-free rate	(28)	5
+ 100 basis points shift in risk discount rate	(17)	(15)
- 100 basis points shift in risk discount rate	20	19

Due to certain characteristics of the contracts, the relationships may be non-linear and the results of the sensitivity-testing should not be extrapolated to higher levels of stress. In calculating the scenario, the shift in the risk-free rate results in changes to investment returns, risk discount rates and bonus rates which are incorporated. The sensitivities shown are before actions that could be taken by management to mitigate impacts and before resultant changes in policyholder behaviour.

Non-economic assumptions

The group determines the policyholder liabilities for non-life manufacturers by reference to non-economic assumptions including claims costs and expense rates.

Policyholder liabilities and PVIF for life manufacturers are determined by reference to non-economic assumptions including mortality and/or morbidity, lapse rates and expense rates. The table below shows the sensitivity of profit for 2012 and total equity at 31 December 2012 to reasonably possible changes in these non-economic assumptions at that date across all of the group's insurance manufacturing companies, with comparatives for 2011.

The cost of claims is a risk associated with non-life insurance business. An increase in claims costs would have a negative effect on profit.

Mortality and morbidity risk is typically associated with life insurance contracts. The effect on profit of an increase in mortality or morbidity depends on the type of business being written.

Sensitivity to lapse rates is dependent on the type of contracts being written. For insurance contracts, the cost of claims is funded by premiums received and income earned on the investment portfolio supporting the liabilities. For a portfolio of term assurance, an increase in lapse rates typically has a negative effect on profit due to the loss of future premium income on the lapsed policies.

Expense rate risk is the exposure to a change in expense rates. To the extent that increased expenses cannot be passed on to policyholders, an increase in expense rates will have a negative impact on profits.

Notes on the Financial Statements (continued)

Sensitivity to changes in non-economic assumptions

	Effect on profit for the year to 31 December		Effect on total equity at 31 December	
	2012 £m	2011 £m	2012 £m	2011 £m
20% increase in claims costs	-	(4)	-	(4)
20% decrease in claims costs	-	4	-	4
10% increase in mortality and/or morbidity rates	(19)	(19)	(19)	(19)
10% decrease in mortality and/or morbidity rates	19	17	19	17
50% increase in lapse rates	(157)	(142)	(157)	(142)
50% decrease in lapse rates	260	234	260	234
10% increase in expense rates	(30)	(27)	(30)	(27)
10% decrease in expense rates	30	27	30	27

Other intangible assets

The analysis of the movement of other intangible assets was as follows:

The group

	Trade Names £m	Internally generated software £m	Purchased Software £m	Customer/ merchant relationships £m	Other £m	Total £m
Cost						
At 1 January 2012	13	1,466	156	208	3	1,846
Additions ¹	1	201	9	18	-	229
Disposals	-	(5)	(6)	-	-	(11)
Amounts written off	-	(365)	(1)	(2)	-	(368)
Exchange differences	-	(3)	(4)	-	-	(7)
Other changes	-	4	7	(4)	-	7
At 31 December 2012	14	1,298	161	220	3	1,696
Accumulated amortisation and impairment						
At 1 January 2012	(12)	(932)	(112)	(131)	(1)	(1,188)
Amortisation charge for the year ²	(2)	(144)	(15)	(12)	-	(173)
Impairment charge for the year ²	-	(1)	(1)	-	-	(2)
Disposals	-	4	2	-	-	6
Amounts written off	-	365	1	2	-	368
Exchange differences	-	3	3	-	-	6
Other changes	-	8	(2)	2	1	9
At 31 December 2012	(14)	(697)	(124)	(139)	-	(974)
Net carrying amount at 31 December 2012	-	601	37	81	3	722
Cost						
At 1 January 2011	16	1,247	161	207	3	1,634
Additions ¹	-	261	19	1	-	281
Disposals	-	-	(5)	-	-	(5)
Amounts written off	-	(30)	(6)	-	-	(36)
Exchange differences	(3)	(5)	(5)	-	-	(13)
Other changes	-	(7)	(8)	-	-	(15)
At 31 December 2011	13	1,466	156	208	3	1,846
Accumulated amortisation and impairment						
At 1 January 2011	(13)	(823)	(111)	(114)	-	(1,061)
Amortisation charge for the year ²	(1)	(123)	(16)	(17)	(1)	(158)
Impairment charge for the year ²	-	(37)	(1)	-	-	(38)
Disposals	-	-	5	-	-	5
Amounts written off	-	30	6	-	-	36
Exchange differences	2	4	4	-	-	10
Other changes	-	17	1	-	-	18
At 31 December 2011	(12)	(932)	(112)	(131)	(1)	(1,188)
Net carrying amount at 31 December 2011	1	534	44	77	2	658

¹ At 31 December 2012, the group did not have any contractual commitments to acquire intangible assets (2011: nil).

² The amortisation and impairment charges for the year are recognised within the income statement under 'Amortisation and impairment of intangible assets'.

Notes on the Financial Statements (continued)

The bank

	Internally generated software £m	Other £m	Total £m
Cost			
At 1 January 2012	1,274	5	1,279
Additions ¹	184	17	201
Disposals	–	(3)	(3)
Amounts written off	(365)	–	(365)
Other changes	10	5	15
At 31 December 2012	1,103	24	1,127
Accumulated amortisation and impairment			
At 1 January 2012	(777)	(1)	(778)
Amortisation charge for the year ²	(133)	(1)	(134)
Impairment charge for the year ²	(1)	–	(1)
Amounts written off	365	–	365
Other changes	2	–	2
At 31 December 2012	(544)	(2)	(546)
Net carrying amount at 31 December 2012	559	22	581
Cost			
At 1 January 2011	1,059	6	1,065
Additions ¹	242	3	245
Disposals	–	(4)	(4)
Amounts written off	(27)	–	(27)
At 31 December 2011	1,274	5	1,279
At 1 January 2011	(672)	(5)	(677)
Amortisation charge for the year ²	(112)	–	(112)
Impairment charge for the year ²	(20)	–	(20)
Disposals	–	4	4
Amounts written off	27	–	27
At 31 December 2011	(777)	(1)	(778)
Net carrying amount at 31 December 2011	497	4	501

¹ At 31 December 2012, the bank did not have any contractual commitments to acquire intangible assets (2011: nil).

² The amortisation and impairment charges for the year are recognised within the income statement under 'Amortisation and impairment of intangible assets'.

Notes on the Financial Statements (continued)

23 Property, plant and equipment

The group

	Freehold land and buildings ⁴ £m	Long leasehold land and buildings £m	Short leasehold land and buildings £m	Equipment, fixtures and fittings ¹ £m	Equipment on operating leases £m	Total ² £m
Cost or fair value						
At 1 January 2012	984	58	448	3,443	46	4,979
Additions at cost ³	23	40	27	226	31	347
Fair value adjustments	(1)	–	–	–	–	(1)
Disposals	(3)	–	(17)	(274)	(9)	(303)
Disposal of subsidiaries	(61)	–	(103)	(101)	–	(265)
Reclassified to held for sale	(5)	–	–	(3)	–	(8)
Exchange and other differences	(3)	1	(3)	(38)	1	(42)
At 31 December 2012	934	99	352	3,253	69	4,707
Accumulated depreciation and impairment						
At 1 January 2012	(144)	(8)	(207)	(2,398)	(18)	(2,775)
Depreciation charge for the year	(17)	(6)	(40)	(266)	(8)	(337)
Disposals	2	2	10	254	8	276
Disposal of subsidiaries	11	–	50	98	–	159
Reclassified to held for sale	1	–	–	2	–	3
Impairment losses (recognised)/reversed	3	–	–	(32)	–	(29)
Exchange and other differences	(6)	(1)	4	21	2	20
At 31 December 2012	(150)	(13)	(183)	(2,321)	(16)	(2,683)
Net carrying amount at 31 December 2012	784	86	169	932	53	2,024

The group

	Freehold land and buildings ⁴ £m	Long leasehold land and buildings £m	Short leasehold land and buildings £m	Equipment, fixtures and fittings ¹ £m	Equipment on operating leases £m	Total ² £m
Cost or fair value						
At 1 January 2011	865	33	501	3,551	35	4,985
Additions at cost ³	21	37	51	271	11	391
Reclassified to held for sale	(15)	(1)	–	(9)	–	(25)
Acquisition of subsidiaries	151	–	–	–	–	151
Fair value adjustments	(15)	–	–	–	–	(15)
Disposals	(52)	(2)	(120)	(302)	–	(476)
Transfers	–	(23)	23	–	–	–
Exchange and other differences	29	14	(7)	(68)	–	(32)
At 31 December 2011	984	58	448	3,443	46	4,979
Accumulated depreciation and impairment						
At 1 January 2011	(120)	(16)	(264)	(2,462)	(15)	(2,877)
Depreciation charge for the year	(18)	(3)	(39)	(277)	(5)	(342)
Reclassified to held for sale	5	–	–	5	–	10
Disposals	32	1	117	295	–	445
Transfers	–	23	(23)	–	–	–
Impairment losses recognised	–	–	(1)	(10)	–	(11)
Exchange and other differences	(43)	(13)	3	51	2	–
At 31 December 2011	(144)	(8)	(207)	(2,398)	(18)	(2,775)
Net carrying amount at 31 December 2011	840	50	241	1,045	28	2,204

1 Including assets held on finance leases with a carrying amount of £ 22 million (2011: £23 million).

2 Including assets with a carrying amount of £11 million (2011: £21 million) pledged as security for liabilities.

3 At 31 December 2012, the group had £3 million (2011: £5 million) of contractual commitments to acquire property, plant and equipment.

4 Including the investment properties on page 173.

Notes on the Financial Statements (continued)

The bank

	Freehold land and buildings £m	Long leasehold land and buildings £m	Short leasehold land and buildings £m	Equipment, fixtures and fittings £m	Total £m
Cost or fair value					
At 1 January 2012	451	60	340	2,600	3,451
Additions at cost ¹	12	43	15	105	175
Reclassified to held for sale	(4)	(1)	–	(3)	(8)
Disposals	–	(1)	(15)	(241)	(257)
Transfers	–	–	–	–	–
Exchange and other differences	3	–	–	(1)	2
At 31 December 2012	462	101	340	2,460	3,363
Accumulated depreciation and impairment					
At 1 January 2012	(107)	(8)	(151)	(1,838)	(2,104)
Depreciation charge for the year	(13)	(6)	(33)	(183)	(235)
Reclassified to held for sale	1	–	–	2	3
Disposals	1	1	10	233	245
Transfers	–	–	–	–	–
Impairment losses recognised	–	–	–	(33)	(33)
Exchange and other differences	1	1	(1)	1	2
At 31 December 2012	(117)	(12)	(175)	(1,818)	(2,122)
Net carrying amount at 31 December 2012	345	89	165	642	1,241

The bank

	Freehold land and buildings £m	Long leasehold land and buildings £m	Short leasehold land and buildings £m	Equipment, fixtures and fittings £m	Total £m
Cost or fair value					
At 1 January 2011	445	34	402	2,649	3,530
Additions at cost ¹	15	37	40	180	272
Reclassified to held for sale	(15)	(1)	–	(9)	(25)
Disposals	(37)	(2)	(119)	(225)	(383)
Transfers	–	(23)	23	–	–
Exchange differences	43	15	(6)	5	57
At 31 December 2011	451	60	340	2,600	3,451
Accumulated depreciation and impairment					
At 1 January 2011	(81)	(16)	(216)	(1,874)	(2,187)
Depreciation charge for the year	(13)	(2)	(31)	(178)	(224)
Reclassified to held for sale	5	–	–	5	10
Disposals	29	1	117	210	357
Transfers	–	23	(23)	–	–
Impairment losses recognised	(3)	–	–	–	(3)
Exchange differences	(44)	(14)	2	(1)	(57)
At 31 December 2011	(107)	(8)	(151)	(1,838)	(2,104)
Net carrying amount at 31 December 2011	344	52	189	762	1,347

¹ At 31 December 2012, the bank had £2 million (2011: £4 million) of contractual commitments to acquire property, plant and equipment.

Notes on the Financial Statements (continued)

Investment properties

The composition of the investment properties at fair value in the year was as follows:

The group

	Freehold land and buildings ¹ £m
Fair value	
At 1 January 2012	259
Additions at cost	6
Fair value adjustments	(1)
Exchange and other changes	(3)
At 31 December 2012	<u>261</u>
Fair value	
At 1 January 2011	140
Acquisition of subsidiaries	151
Fair value adjustments	(15)
Transfers	(8)
Exchange and other changes	(9)
At 31 December 2011	<u>259</u>

¹ Included in 'Property, plant and equipment' on page 171.

Investment properties are valued on an open market value basis as at 31 December each year by independent professional valuers who have recent experience in the location and type of properties.

Included within 'Other operating income' was rental income of £1 million (2011: £1 million) earned by the group on its investment properties. Direct operating expenses of nil (2011: nil) incurred in respect of the investment properties during the year were recognised in 'General and administrative expenses'. Direct operating expenses arising in respect of investment properties that did not generate rental income during the year amounted to nil (2011: nil). Net exchange differences on translation of investment properties were £6 million (2011: £1 million).

The bank

The bank had no investment properties at 31 December 2012 or 2011.

24 Investments in subsidiaries

Principal subsidiary undertakings of HSBC Bank plc

	Country of incorporation or registration	HSBC Bank plc's interest in equity capital %	Share class
HSBC France	France	99.99	Ordinary €5.00
HSBC Asset Finance (UK) Limited	England	100.00	Ordinary £1
HSBC Bank A.S.	Turkey	100.00	A-Common TRL1 B-Common TRL1
HSBC Bank International Limited	Jersey	100.00	Ordinary £1
HSBC Bank Malta p.l.c.	Malta	70.03	Ordinary €0.30
HSBC Invoice Finance (UK) Limited	England	100.00	Ordinary £1
HSBC Life (UK) Limited	England	100.00	Ordinary £1
HSBC Private Bank (UK) Limited	England	100.00	Ordinary £10
HSBC Trinkaus & Burkhardt AG	Germany	80.62	Shares of no par value
HSBC Trust Company (UK) Limited	England	100.00	Ordinary £5
Marks and Spencer Retail Financial Services Holdings Limited	England	100.00	Ordinary £1

Notes on the Financial Statements (continued)

Special purpose entities ('SPEs') consolidated where the group owns less than 50 per cent of the voting rights:

	Carrying value of total consolidated assets £bn	Nature of SPE
Barion Funding Limited	2.4	Securities investment conduit
Bryant Park Funding LLC	0.6	Conduit
Malachite Funding Limited	2.1	Securities investment conduit
Mazarin Funding Limited	4.9	Securities investment conduit
Regency Assets Limited	6.3	Conduit
Solitaire Funding Limited	7.0	Securities investment conduit
Performance Trust	0.5	Securitisation vehicle
Turquoise Receivables Trustee Ltd	0.9	Securitisation vehicle

All the above make their financial statements up to 31 December.

Details of all subsidiaries, as required under S.409 Companies Act 2006, will be annexed to the next Annual Return of the bank filed with the UK Registrar of Companies.

Acquisitions

The group made no acquisitions of subsidiary undertakings during 2012.

Disposals

In October 2012, the group sold HSBC Reinsurance Limited and HSBC Insurance Ireland Limited to Catalina Holdings (Bermuda) Limited for £47 million. The sale was completed on 15 October 2012.

In November 2012, the group sold HSBC Private Banking Holdings (Suisse) SA, by way of an inter-group transfer to HSBC Holdings plc for £6,535 million. The sale was completed on 16 November 2012. The ownership of HSBC Private Bank (UK) Limited remains with HSBC Bank plc.

In August 2012, HSBC sold HSBC Securities S.A. to the management team for £1 million. The sale was completed on 3 August 2012.

In October 2012, HSBC announced the sale of Property Vision Holdings Limited to the management team for circa £1 million. The sale was completed on 12 October 2012.

In November 2012, HSBC sold HSBC Shipping Services Limited through a management buy-out for a nominal consideration of £1. The sale was completed on 6 November 2012.

25 Other assets

	The group		The bank	
	2012 £m	2011 £m	2012 £m	2011 £m
Bullion	1,452	754	1,385	655
Assets held for sale	109	76	98	56
Reinsurers' share of liabilities under insurance contracts	496	470	–	–
Endorsements and acceptances	779	730	525	393
Other accounts	3,530	5,107	2,680	2,912
	6,366	7,137	4,688	4,016

Assets held for sale

	The group		The bank	
	2012 £m	2011 £m	2012 £m	2011 £m
Non-current assets held for sale:				
- property, plant and equipment	42	74	31	56
- other	67	2	67	–
Total assets classified as held for sale	109	76	98	56

Notes on the Financial Statements (continued)

Also included within property plant and equipment classified as held for sale is repossessed property that had been pledged as collateral by customers. These repossessed assets are expected to be disposed of within 12 months of acquisition.

26 Trading liabilities

	The group		The bank	
	2012 £m	2011 £m	2012 £m	2011 £m
Deposits by banks	38,796	30,143	42,643	37,046
Customer accounts	45,063	43,749	40,398	33,293
Other debt securities in issue	13,875	14,834	11,475	11,950
Other liabilities – net short positions	25,162	30,485	10,430	12,295
	122,896	119,211	104,946	94,584

27 Financial liabilities designated at fair value

	The group		The bank	
	2012 £m	2011 £m	2012 £m	2011 £m
Deposits by banks and customer accounts	4,548	4,527	4,373	4,352
Liabilities to customers under investment contracts	4,817	4,527	–	–
Debt securities in issue	20,749	20,124	16,325	15,693
Subordinated liabilities	2,507	2,570	2,815	2,816
Preference shares	297	244	–	–
	32,918	31,992	23,513	22,861

The group

The carrying amount at 31 December 2012 of financial liabilities designated at fair value was £1,812 million higher (2011: £684 million higher) than the contractual amount at maturity. At 31 December 2012, the accumulated amount of change in fair value attributable to changes in credit risk was a loss of £110 million (2011: £955 million gain).

The bank

The carrying amount at 31 December 2012 of financial liabilities designated at fair value was £1,524 million higher (2011: £488 million lower) than the contractual amount at maturity. At 31 December 2012, the accumulated amount of change in fair value attributable to changes in credit risk was a loss of £62 million (2011: £906 million gain).

28 Other liabilities

	The group		The bank	
	2012 £m	2011 £m	2012 £m	2011 £m
Amounts due to investors in funds consolidated by the group	227	317	–	–
Obligations under finance leases	91	169	–	–
Endorsements and acceptances	779	730	524	393
Share-based payment liability to HSBC Holdings	332	422	227	252
Other liabilities	5,417	2,932	4,497	1,735
	6,846	4,570	5,248	2,380

Notes on the Financial Statements (continued)

29 Liabilities under insurance contracts

	At 31 December 2012		
	Gross £m	Reinsurers' share £m	Net £m
Non-life insurance liabilities			
Unearned premium provision	2	–	2
Notified claims	5	(1)	4
Claims incurred but not reported	2	–	2
	9	(1)	8
Life insurance liabilities to policyholders			
Life (non-linked)	816	(461)	355
Investment contracts with discretionary participation features ¹	15,078	–	15,078
Life (linked)	2,010	(34)	1,976
	17,904	(495)	17,409
Total liabilities under insurance contracts	17,913	(496)	17,417
	At 31 December 2011		
	Gross £m	Reinsurers' share £m	Net £m
Non-life insurance liabilities			
Unearned premium provision	18	(15)	3
Notified claims	28	(17)	11
Claims incurred but not reported	45	(28)	17
Other	13	(2)	11
	104	(62)	42
Life insurance liabilities to policyholders			
Life (non-linked)	751	(379)	372
Investment contracts with discretionary participation features ¹	13,872	–	13,872
Life (linked)	1,620	(29)	1,591
	16,243	(408)	15,835
Total liabilities under insurance contracts	16,347	(470)	15,877

¹ Though investment contracts with discretionary participation features are financial instruments, the group continued to treat them as insurance contracts as permitted by IFRS 4.

Notes on the Financial Statements (continued)

Movement on non-life insurance liabilities

	2012		
	Gross £m	Reinsurers' share £m	Net £m
Unearned premium reserve ('UPR')			
At 1 January	18	(15)	3
Changes in UPR recognised as (income)/expense	(4)	4	–
– gross written premiums	11	–	11
– gross earned premiums	(15)	4	(11)
Exchange differences and other movements	(12)	11	(1)
At 31 December	2	–	2
Notified and incurred but not reported claims			
At 1 January	73	(45)	28
– notified claims	28	(17)	11
– claims incurred but not reported	45	(28)	17
Claims paid in current year	(16)	9	(7)
Claims incurred in respect of current year	3	(2)	1
Claims incurred in respect of prior years	2	–	2
Exchange differences and other movements	(55)	37	(18)
At 31 December	7	(1)	6
– notified claims	5	(1)	4
– claims incurred but not reported	2	–	2
Other	–	–	–
Total non-life insurance liabilities	9	(1)	8

	2011		
	Gross £m	Reinsurers' Share £m	Net £m
Unearned premium reserve ('UPR')			
At 1 January	73	(4)	69
Changes in UPR recognised as (income)/expense	(20)	3	(17)
– gross written premiums	30	(1)	29
– gross earned premiums	(50)	4	(46)
Exchange differences and other movements	(35)	(14)	(49)
At 31 December	18	(15)	3
Notified and incurred but not reported claims			
At 1 January	472	(106)	366
– notified claims	257	(94)	163
– claims incurred but not reported	215	(12)	203
Claims paid in current year	(85)	9	(76)
Claims incurred in respect of current year	(11)	(2)	(13)
Claims incurred in respect of prior years	(21)	1	(20)
Exchange differences and other movements	(282)	53	(229)
At 31 December	73	(45)	28
– notified claims	28	(17)	11
– claims incurred but not reported	45	(28)	17
Other	13	(2)	11
Total non-life insurance liabilities	104	(62)	42

Notes on the Financial Statements (continued)

Life insurance liabilities to policyholders

	2012		
	Gross £m	Reinsurers' share £m	Net £m
Life (non-linked)			
At 1 January	751	(379)	372
Benefits paid	(158)	82	(76)
Increase in liabilities to policyholders	276	(186)	90
Exchange differences and other movements	(53)	22	(31)
At 31 December	816	(461)	355
Investment contracts with discretionary participation features			
At 1 January	13,872	–	13,872
Benefits paid	(1,589)	–	(1,589)
Increase in liabilities to policyholders	2,302	–	2,302
Exchange differences and other movements ¹	493	–	493
At 31 December	15,078	–	15,078
Life (linked)			
At 1 January	1,620	(29)	1,591
Benefits paid	(139)	4	(135)
Increase in liabilities to policyholders	532	(9)	523
Exchange differences and other movements ²	(3)	–	(3)
At 31 December	2,010	(34)	1,976
Total liabilities to policyholders	17,904	(495)	17,409

	2011		
	Gross £m	Reinsurers' share £m	Net £m
Life (non-linked)			
At 1 January	888	(292)	596
Benefits paid	(290)	78	(212)
Increase in liabilities to policyholders	206	(134)	72
Exchange differences and other movements	(53)	(31)	(84)
At 31 December	751	(379)	372
Investment contracts with discretionary participation features			
At 1 January	14,205	–	14,205
Benefits paid	(1,634)	–	(1,634)
Increase in liabilities to policyholders	1,877	–	1,877
Exchange differences and other movements ¹	(576)	–	(576)
At 31 December	13,872	–	13,872
Life (linked)			
At 1 January	1,464	(28)	1,436
Benefits paid	(113)	4	(109)
Increase in liabilities to policyholders	273	(5)	268
Exchange differences and other movements ²	(4)	–	(4)
At 31 December	1,620	(29)	1,591
Total liabilities to policyholders	16,243	(408)	15,835

1 Includes movement in liabilities relating to discretionary profit participation benefits due to policyholders arising from net unrealised investment gains recognised in other comprehensive income.

2 Includes amounts arising under reinsurance agreements.

Notes on the Financial Statements (continued)

30 Provisions

	The group		The bank	
	2012 £m	2011 £m	2012 £m	2011 £m
At 1 January	820	425	565	229
Additional provisions/increase in provisions ¹	1,757	671	1,346	527
Provisions utilised	(736)	(242)	(587)	(202)
Amounts reversed	(128)	(41)	(72)	(5)
Disposal of subsidiaries	(72)	–	–	–
Exchange differences and other movements	–	7	(2)	16
At 31 December	1,641	820	1,250	565

¹ Includes unwinding of discounts of £2 million (2011: £3 million) in relation to vacant space provisions.

Provisions include £1,227 million (2011: £483 million) in respect of customer redress programmes. The most significant of these provisions are as follows and relate to both the group and bank, except where stated.

- (i) £692 million (2011: £262 million) for the group relating to the estimated liability for redress in respect of the possible mis-selling of Payment Protection Insurance ('PPI') policies in previous years (the bank: £588 million; 2011 £234 million). An increase in provisions of £938 million was recognised during the year. Cumulative provisions made since the Judicial Review ruling in the first half of 2011 amount to £1,333 million of which £688 million has been paid.

Approximately 3.6 million PPI policies have been sold by the group, which generated estimated revenue of £2.0 billion, and with gross written premiums of approximately £2.6 billion. At 31 December 2012, the estimated total complaints (by policy number) expected to be received was 1.1 million, representing 30% of total policies sold. It is estimated contact will be made with customers with 1.4 million, or 40%, of total policies sold. This estimated contact level includes inbound complaints as well as the group's outbound contact exercise on certain policies.

During 2012, the group increased the estimate of the total number of policies to be ultimately redressed, as the level of complaints received was higher in volume and for a longer period than previously assumed. This change in assumptions contributed approximately £0.7 billion to the increased provision for the year.

The estimated liability for redress is calculated based on the total premiums paid by the customer plus simple interest of 8% per annum (or the rate inherent in the related loan product where higher). Future estimated redress levels are based on historically observed redress per policy for different loan categories.

The following table details the cumulative number of policies at 31 December 2012 and the number of claims expected in the future:

	Cumulative to 31 December 2012	Future expected
Inbound complaints ¹ (000s of policies)	637	287
Outbound contact (000s of policies)	43	487
Response rate to outbound contact	37%	39%
Average uphold rate per claim ²	75%	77%
Average redress per claim	£1,590	£1,490

¹ Excludes invalid claims where complainant has not held a PPI policy.

² Claims include inbound and responses to outbound contact.

The main assumptions in the provision calculation are the current volume of inbound complaints, the projected period of inbound complaints, the decay rate of complaints volumes, the population identified as systemically mis-sold and the number of policies per customer. The main assumptions are likely to evolve over time as root cause analysis continues, more experience is available regarding initiated complaint volumes received and the experience of responses to ongoing active contact exercise.

A 100,000 increase/decrease in overall total inbound complaints (by policy number) would increase/decrease the provision by approximately £110 million. Each 1% increase/decrease in the response rate to the group's outbound contact exercise increases/decreases the provision by £5 million.

In addition to these factors and assumptions, the extent of the required redress will also depend on the facts and circumstances of each individual customer's case. For these reasons, there remains a high degree of uncertainty as to the eventual costs of redress for this matter.

Notes on the Financial Statements (continued)

- (ii) A provision of £375 million (2011: nil) relating to the estimated liability for redress in respect of the possible mis-selling of interest rate derivatives in the UK. Of this provision, £168 million relates to the estimated redress payable to customers in respect of historical payments under derivative contracts, £157 million covers the expected write-off by the bank of open derivative contracts balances, and £50 million covers estimated project costs.

Following a FSA review of the sale of interest rate derivatives, the group agreed with the FSA to pay redress to customers where mis-selling of more complex derivatives has occurred. The group will contact customers who have been sold certain interest rate derivatives, explaining the scope of the contact exercise, and either advising that their product sale will be automatically reviewed, or seeking confirmation from the customer that they wish to have their derivative sale reviewed and requesting further details of the sale.

During the second half of 2012, the group conducted a pilot review of a sample of cases. The FSA issued a report in January 2013 on the findings of that review, together with the pilot exercises conducted by other UK banks. The group's liability at 31 December 2012 is estimated based on the results of that pilot sample and the guidance and clarification in the FSA report.

The extent to which the group is ultimately required to pay redress depends on the responses of contacted and other customers during the review period and the facts and circumstances of each individual case. Those facts and circumstances include whether:

- the customer is classified as 'non-sophisticated' under the relevant criteria;
- the group is deemed to have failed to comply with the relevant sales standards at the time of sale; and
- an alternative interest rate derivative product would have been deemed appropriate, which will impact the calculation of any redress payable and write-down of open products.

For these reasons, there is currently a high degree of uncertainty as to the eventual costs of redress related to this programme.

- (iii) Provisions of £85 million (2011: £51 million) for the estimated cost of redress in relation to the provision of services to a number of trusts by a subsidiary of the bank. The bank has undertaken to reimburse the subsidiary in respect of the initial estimated cost of redress. The total provision is based on a calculation extrapolated from a sample of cases. Uncertainties arise from factors affecting the timing of notifying and reimbursing those affected.
- (iv) Provisions of £65 million (2011: nil) in respect of alleged failings in the sale of card and identity protection products.

Also included in the above table, for the bank and group, are provisions for onerous property contracts of £86 million (2011: £48 million) and £97 million (2011: £50 million) respectively, relating to the discounted future costs associated with leasehold properties that have become vacant. The provisions cover rent voids while finding new tenants, shortfalls in expected rent receivable compared with rent payable, and the cost of refurbishing the buildings to attract tenants. Uncertainties arise from movements in market rents, delays in finding new tenants and the timing of rental reviews.

31 Subordinated liabilities

	The group		The bank	
	2012 £m	2011 £m	2012 £m	2011 £m
Subordinated liabilities:				
– At amortised cost	10,350	9,998	9,968	9,893
Subordinated liabilities	8,100	7,711	9,968	9,893
Preference shares	2,250	2,287	–	–
– Designated at fair value	2,804	2,814	2,815	2,816
Subordinated liabilities	2,507	2,570	2,815	2,816
Preference shares	297	244	–	–
	13,154	12,812	12,783	12,709

Notes on the Financial Statements (continued)

Subordinated borrowings of the group

		Carrying amount	
		2012	2011
		£m	£m
€1,000m	Floating Rate Subordinated Loan 2017	816	835
£500m	4.75% Callable Subordinated Notes 2020 ¹	522	490
€500m	Callable Subordinated Floating Rate Notes 2020	375	355
US\$1,000m	Floating Rate Subordinated Loan 2020	619	646
US\$1,450m	Floating Rate Subordinated Loan 2021	897	937
US\$450m	Subordinated Floating Rate Notes 2021	278	291
€250m	Floating Rate Subordinated Loan 2021	204	209
US\$275m	Floating Rate Subordinated Loan 2021	170	178
£350m	Floating Rate Subordinated Loan 2022	350	–
£350m	5% Callable Subordinated Notes 2023 ²	390	344
£300m	6.5% Subordinated Notes 2023	299	299
US\$300m	7.65% Subordinated Notes 2025	244	242
£350m	5.375% Callable Subordinated Step-up Notes 2030 ³	390	318
£500m	5.375% Subordinated Notes 2033	572	438
£390m	6.9% Subordinated Loan 2033	390	390
US\$977m	Floating Rate Subordinated Loan 2040	605	631
€900m	7.75% Non-cumulative Subordinated Notes 2040	734	752
£225m	6.25% Subordinated Notes 2041	224	224
£600m	4.75% Subordinated Notes 2046	593	592
£700m	5.844% Non-cumulative Step-up Perpetual Preferred Securities ⁴	700	700
£300m	5.862% Non-cumulative Step-up Perpetual Preferred Securities ⁵	297	244
US\$750m	Undated Floating Rate Primary Capital Notes	464	484
US\$500m	Undated Floating Rate Primary Capital Notes	309	323
US\$300m	Undated Floating Rate Primary Capital Notes (Series 3)	186	194
US\$2,862m	Perpetual Subordinated Debt	1,772	1,849
£350m	Callable Subordinated Variable Coupon Notes 2017 ⁶	–	355
	Other subordinated liabilities less than £100m	754	492
		13,154	12,812

1 In September 2015 the interest rate changes to three month sterling LIBOR plus 0.82%.

2 In March 2018 the interest rate changes to become the rate per annum which is the sum of the gross redemption yield of the then prevailing five year UK gilt plus 1.80%.

3 In November 2025 the interest rate changes to three month sterling LIBOR plus 1.50%.

4 In November 2013 the distribution rate changes to six month sterling LIBOR plus 1.76%.

5 In April 2020 the distribution rate changes to six month sterling LIBOR plus 1.85%.

6 On 27 June 2012, the bank called and redeemed the Callable Subordinated Variable Coupon Notes 2017 at par.

Footnotes 1 to 5 all relate to notes that are repayable at the option of the borrower on the date of the change of the interest rate, and at subsequent interest rate reset dates and interest payment dates in some cases, subject to the prior notification to the Financial Services Authority.

32 Fair value of financial instruments carried at fair value

The classification of financial instruments is determined in accordance with the accounting policies set out in Note 2. The use of assumption and estimation in valuing financial instruments is described in Note 3 'Critical accounting policies'.

Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

Notes on the Financial Statements (continued)

Financial instruments carried at fair value:

The group

	Valuation techniques			Total £m
	Level 1 quoted market price £m	Level 2 using observable inputs £m	Level 3 with significant un-observable inputs £m	
At 31 December 2012				
Assets				
Trading assets	86,373	74,789	354	161,516
Financial assets designated at fair value	9,501	5,886	–	15,387
Derivatives	193	176,455	1,160	177,808
Financial investments: available-for-sale	49,035	20,159	2,071	71,265
Liabilities				
Trading liabilities	57,282	64,097	1,517	122,896
Financial liabilities at fair value	3,767	29,151	–	32,918
Derivatives	189	179,598	1,308	181,095
At 31 December 2011				
Assets				
Trading assets	72,839	52,981	778	126,598
Financial assets designated at fair value	9,126	6,206	–	15,332
Derivatives	383	175,055	1,555	176,993
Financial investments: available-for-sale	59,707	26,905	2,349	88,961
Liabilities				
Trading liabilities	48,435	69,072	1,704	119,211
Financial liabilities at fair value	3,787	28,205	–	31,992
Derivatives	635	175,783	1,703	178,121

The bank

	Valuation techniques			Total £m
	Level 1 quoted market price £m	Level 2 using observable inputs £m	Level 3 with significant un-observable inputs £m	
At 31 December 2012				
Assets				
Trading assets	52,468	85,182	349	137,999
Financial assets designated at fair value	–	4,373	–	4,373
Derivatives	158	138,949	1,233	140,340
Financial investments: available-for-sale	30,548	3,420	2,635	36,603
Liabilities				
Trading liabilities	33,256	70,221	1,469	104,946
Financial liabilities at fair value	–	23,513	–	23,513
Derivatives	143	142,378	1,400	143,921
At 31 December 2011				
Assets				
Trading assets	44,198	61,380	761	106,339
Financial assets designated at fair value	243	4,352	–	4,595
Derivatives	177	143,580	1,667	145,424
Financial investments: available-for-sale	36,327	2,790	3,123	42,240
Liabilities				
Trading liabilities	21,110	71,823	1,651	94,584
Financial liabilities at fair value	–	22,861	–	22,861
Derivatives	479	144,941	1,831	147,251

Notes on the Financial Statements (continued)

Control framework

Fair values are subject to a control framework designed to ensure that they are either determined, or validated, by a function independent of the risk-taker.

For all financial instruments where fair values are determined by reference to externally quoted prices or observable pricing inputs to models, independent price determination or validation is utilised. In inactive markets, direct observation of a traded price may not be possible. In these circumstances, the group will source alternative market information to validate the financial instrument's fair value, with greater weight given to information that is considered to be more relevant and reliable. The factors that are considered in this regard are, *inter alia*:

- the extent to which prices may be expected to represent genuine traded or tradable prices;
- the degree of similarity between financial instruments;
- the degree of consistency between different sources;
- the process followed by the pricing provider to derive the data;
- the elapsed time between the date to which the market data relates and the balance sheet date; and
- the manner in which the data was sourced.

For fair values determined using a valuation model, the control framework may include, as applicable, development or validation by independent support functions of (i) the logic within valuation models; (ii) the inputs to those models; (iii) any adjustments required outside the valuation models; and, where possible, (iv) model outputs. Valuation models are subject to a process of due diligence and calibration before becoming operational and are calibrated against external market data on an ongoing basis.

Determination of fair value

Fair values are determined according to the following hierarchy:

- (a) *Level 1 – quoted market price*: financial instruments with quoted prices for identical instruments in active markets.
- (b) *Level 2 – valuation technique using observable inputs*: financial instruments with quoted prices for similar instruments in active markets or quoted prices for identical or similar instruments in inactive markets and financial instruments valued using models where all significant inputs are observable.
- (c) *Level 3 – valuation technique with significant unobservable inputs*: financial instruments valued using models where one or more significant inputs are unobservable.

The best evidence of fair value is a quoted price in an actively traded market. The fair values of financial instruments that are quoted in active markets are based on bid prices for assets held and offer prices for liabilities issued. Where a financial instrument has a quoted price in an active market and it is part of a portfolio, the fair value of the portfolio is calculated as the product of the number of units and quoted price and no block discounts are made. In the event that the market for a financial instrument is not active, a valuation technique is used.

The judgement as to whether a market is active may include, but is not restricted to, the consideration of factors such as the magnitude and frequency of trading activity, the availability of prices and the size of bid/offer spreads. The bid/offer spread represents the difference in prices at which a market participant would be willing to buy compared with the price at which they would be willing to sell. In inactive markets, obtaining assurance that the transaction price provides evidence of fair value or determining the adjustments to transaction prices that are necessary to measure the fair value of the instrument requires additional work during the valuation process.

Valuation techniques incorporate assumptions about factors that other market participants would use in their valuations, including interest rate yield curves, exchange rates, volatilities and prepayment and default rates. For collateralised counterparties and in significant major currencies, the group uses a discounting curve that reflects the overnight interest rate ('OIS discounting').

The majority of valuation techniques employ only observable market data. However, certain financial instruments are valued on the basis of valuation techniques that feature one or more significant market inputs that are unobservable, and for them the derivation of fair value is more judgemental. An instrument in its entirety is classified as valued using significant unobservable inputs if, in the opinion of management, a significant proportion of the instrument's inception profit ('day 1 gain or loss') or greater than 5% of the instrument's carrying value is driven by unobservable inputs. 'Unobservable' in this context means that there is little or no current market data available from which to determine the price at which an arm's length transaction would be likely to occur. It generally does not mean that

Notes on the Financial Statements (continued)

there is no data available at all upon which to base a determination of fair value (consensus pricing data may, for example, be used).

In certain circumstances, the group records its own debt in issue at fair value, based on quoted prices in an active market for the specific instrument concerned, if available. When quoted market prices are unavailable, the own debt in issue is valued using valuation techniques, the inputs for which are either based upon quoted prices in an inactive market for the instrument, or are estimated by comparison with quoted prices in an active market for similar instruments. In both cases, the fair value includes the effect of applying the credit spread which is appropriate to the group's liability. The change in fair value of issued debt securities attributable to the group's own credit spread is computed as follows: for each security at each reporting date, an externally verifiable price is obtained or a price is derived using credit spreads for similar securities for the same issuer. Then, using discounted cash flow, each security is valued using a LIBOR-based discount curve. The difference in the valuations is attributable to the group's own credit spread. This methodology is applied consistently across all securities.

Structured notes issued and certain other hybrid instrument liabilities are included within trading liabilities and are measured at fair value. The credit spread applied to these instruments is derived from the spreads at which the group issues structured notes.

Gains and losses arising from changes in the credit spread of liabilities issued by the group reverse over the contractual life of the debt, provided that the debt is not repaid at a premium or a discount.

Credit valuation adjustment methodology

A separate credit valuation adjustment ('CVA') is calculated for each legal entity of the group, and within each entity for each counterparty to which the entity has exposure. As set out on page 105, from 31 December 2012 the group calculates the CVA by applying the probability of default of the counterparty conditional on the non-default of HSBC, to the expected positive exposure of the group to the counterparty and multiplying by the loss expected in the event of default. Conversely, the group calculates the DVA by applying the probability of default of HSBC conditional on the non-default of the counterparty, to the expected positive exposure of the counterparty to the group and multiplying by the loss expected in the event of default. Both calculations are performed over the life of the potential exposure.

The calculation maximises the use of relevant, observable market data. The probability of default is derived from CDS spreads where these are available and reliable for a specific counterparty, including for HSBC with respect to the DVA, or relevant proxies where not. The derivation of a proxy has regard to the range of market practice, and considers relevant data in this context, including CDS index and rating transition data. For most products, to calculate the expected positive exposure to a counterparty, HSBC uses a simulation methodology to incorporate the range of potential exposures across the portfolio of transactions with the counterparty over the life of an instrument. The simulation methodology includes credit mitigants such as counterparty netting agreements and collateral agreements with the counterparty. A standard loss given default assumption of 60% is generally adopted for developed market exposures, and 75% for emerging market exposures. Alternative loss given default assumptions may be adopted where both the nature of the exposure and the available data support this.

For certain types of exotic derivatives where the products are not currently supported by the simulation, or for derivative exposures in smaller trading locations where the simulation tool is not yet available, the group adopts alternative methodologies. These may involve mapping to the results for similar products from the simulation tool or where such a mapping approach is not appropriate, a simplified methodology is used, generally following the same principles as the simulation methodology. The calculation is applied at a trade level, with more limited recognition of credit mitigants such as netting or collateral agreements than used in the simulation methodology described previously.

The methodologies do not, in general, account for 'wrong-way risk'. Wrong-way risk arises where the underlying value of the derivative prior to any credit valuation adjustment is positively correlated to the probability of default of the counterparty. Where there is significant wrong-way risk, a trade-specific approach is applied to reflect the wrong-way risk within the valuation.

With the exception of certain central clearing parties, the group includes all third party counterparties in the CVA and DVA calculations and does not net these calculations across group entities.

Notes on the Financial Statements (continued)

Financial instruments measured at fair value using a valuation technique with significant unobservable inputs
– Level 3

The group

	Assets				Liabilities		
	Available- for-sale £m	Held for trading £m	Designated at fair value through profit or loss £m	Derivatives £m	Held for trading £m	Designated at fair value through profit or loss £m	Derivatives £m
At 31 December 2012							
Private equity investments	452	51	–	–	–	–	–
Asset-backed securities	1,409	137	–	–	–	–	–
Leverage finance	–	–	–	–	–	–	7
Structured notes	–	5	–	–	1,515	–	–
Derivatives with monolines	–	–	–	65	–	–	–
Other derivatives	–	–	–	1,095	2	–	1,301
Other portfolios	210	161	–	–	–	–	–
	2,071	354	–	1,160	1,517	–	1,308
At 31 December 2011							
Private equity investments	469	51	–	–	–	–	–
Asset-backed securities	1,654	161	–	–	–	–	–
Leverage finance	–	–	–	–	–	–	4
Structured notes	–	–	–	–	1,641	–	–
Derivatives with monolines	–	–	–	149	–	–	–
Other derivatives	–	–	–	1,406	10	–	1,693
Other portfolios	226	566	–	–	53	–	6
	2,349	778	–	1,555	1,704	–	1,703

The bank

	Assets				Liabilities		
	Available- for-sale £m	Held for trading £m	Designated at fair value through profit or loss £m	Derivatives £m	Held for trading £m	Designated at fair value through profit or loss £m	Derivatives £m
At 31 December 2012							
Private equity investments	264	51	–	–	–	–	–
Asset-backed securities	2,164	137	–	–	–	–	–
Leverage finance	–	–	–	–	–	–	7
Structured notes	–	–	–	–	1,467	–	–
Derivatives with monolines	–	–	–	65	–	–	–
Other derivatives	–	–	–	1,168	2	–	1,393
Other portfolios	207	161	–	–	–	–	–
	2,635	349	–	1,233	1,469	–	1,400
At 31 December 2011							
Private equity investments	251	51	–	–	–	–	–
Asset-backed securities	2,646	154	–	–	–	–	–
Leverage finance	–	–	–	–	–	–	4
Structured notes	–	–	–	–	1,641	–	–
Derivatives with monolines	–	–	–	149	–	–	–
Other derivatives	–	–	–	1,518	10	–	1,821
Other portfolios	226	556	–	–	–	–	6
	3,123	761	–	1,667	1,651	–	1,831

- Private equity

The group's private equity positions are generally classified as available-for-sale and are not traded in active markets. In the absence of an active market, an investment's fair value is estimated on the basis of an analysis of the investee's financial position and results, risk profile, prospects and other factors, as well as by reference to market valuations for similar entities quoted in an active market, or the price at which similar companies have changed ownership.

Notes on the Financial Statements (continued)

- *Asset-backed securities (ABSs)*

While quoted market prices are generally used to determine the fair value of these securities, valuation models are used to substantiate the reliability of the limited market data available and to identify whether any adjustments to quoted market prices are required. For ABSs including residential MBSs, the valuation uses an industry standard model and the assumptions relating to prepayment speeds, default rates and loss severity based on collateral type and performance, as appropriate. The valuations output is benchmarked for consistency against observable data for securities of a similar nature.

- *Loans including leveraged finance and loans held for securitisation*

Loans held at fair value are valued from broker quotes and/or market data consensus providers when available. In the absence of an observable market, the fair value is determined using valuation techniques. These techniques include discounted cash flow models, which incorporate assumptions regarding an appropriate credit spread for the loan, derived from other market instruments issued by the same or comparable entities.

- *Structured notes*

The fair value of structured notes valued using a valuation technique is derived from the fair value of the underlying debt security, and the fair value of the embedded derivative is determined as described in the paragraph below on derivatives.

Trading liabilities valued using a valuation technique with significant unobservable inputs principally comprised equity-linked structured notes, which are issued by the group and provide the counterparty with a return that is linked to the performance of certain equity securities, and other portfolios. The notes are classified as level 3 due to the unobservability of parameters such as long-dated equity volatilities and correlations between equity prices, between equity prices and interest rates and between interest rates and foreign exchange rates.

- *Derivatives*

OTC (i.e. non-exchange traded) derivatives are valued using valuation models. Valuation models calculate the present value of expected future cash flows, based upon 'no-arbitrage' principles. For many vanilla derivative products, such as interest rate swaps and European options, the modelling approaches used are standard across the industry. For more complex derivative products, there may be some differences in market practice. Inputs to valuation models are determined from observable market data wherever possible, including prices available from exchanges, dealers, brokers or providers of consensus pricing. Certain inputs may not be observable in the market directly, but can be determined from observable prices via model calibration procedures or estimated from historical data or other sources. Examples of inputs that may be unobservable include volatility surfaces, in whole or in part, for less commonly traded option products, and correlations between market factors such as foreign exchange rates, interest rates and equity prices.

Derivative products valued using valuation techniques with significant unobservable inputs included certain types of correlation products, such as foreign exchange basket options, equity basket options, foreign exchange interest rate hybrid transactions and long-dated option transactions. Examples of the latter are equity options, interest rate and foreign exchange options and certain credit derivatives. Credit derivatives include certain tranching CDS transactions.

Notes on the Financial Statements (continued)

Reconciliation of fair value measurements in Level 3 of the fair value hierarchy

The group

	Assets				Liabilities		
	Available- for-sale £m	Held for trading £m	Designated at fair value through profit or loss £m	Derivatives £m	Held for trading £m	Designated at fair value through profit or loss £m	Derivatives £m
At 1 January 2012	2,349	778	–	1,555	1,704	–	1,703
Total gains or losses recognised in profit or loss	(81)	38	–	(274)	59	–	(394)
Total gains or losses recognised in other comprehensive income	194	–	–	–	–	–	–
Purchases	176	9	–	–	(232)	–	–
Issues	–	–	–	–	565	–	–
Sales	(136)	(131)	–	–	248	–	–
Settlements	(143)	(314)	–	(52)	(611)	–	124
Transfer out	(1,204)	(165)	–	(115)	(221)	–	(148)
Transfer in	950	139	–	45	6	–	17
Exchange differences	(34)	–	–	1	(1)	–	6
At 31 December 2012	2,071	354	–	1,160	1,517	–	1,308
Total gains or losses recognised in profit or loss relating to those assets and liabilities held at 31 December	(62)	41	–	(36)	18	–	(85)

The bank

	Assets				Liabilities		
	Available- for-sale £m	Held for trading £m	Designated at fair value through profit or loss £m	Derivatives £m	Held for trading £m	Designated at fair value through profit or loss £m	Derivatives £m
At 1 January 2012	3,123	761	–	1,667	1,651	–	1,831
Total gains or losses recognised in profit or loss	(69)	37	–	(256)	59	–	(338)
Total gains or losses recognised in other comprehensive income	(240)	–	–	–	–	–	–
Purchases	73	9	–	–	(231)	–	–
Issues	–	–	–	–	563	–	–
Sales	(104)	(131)	–	–	248	–	–
Settlements	(80)	(301)	–	(114)	(603)	–	16
Transfer out	(126)	(164)	–	(119)	(218)	–	(152)
Transfer in	43	139	–	54	–	–	34
Exchange differences	15	(1)	–	1	–	–	9
At 31 December 2012	2,635	349	–	1,233	1,469	–	1,400
Total gains or losses recognised in profit or loss relating to those assets and liabilities held at 31 December	(69)	38	–	(37)	23	–	(25)

Effects of changes in significant unobservable assumptions to reasonably possible alternatives

As discussed above, the fair value of financial instruments are, in certain circumstances, measured using valuation techniques that incorporate assumptions that are not evidenced by prices from observable current market transactions in the same instrument and are not based on observable market data. The following table shows the sensitivity of Level 3 fair values to reasonably possible alternative assumptions:

Notes on the Financial Statements (continued)

The group

	Reflected in profit or loss		Reflected in other comprehensive income	
	Favourable changes	Unfavourable changes	Favourable changes	Unfavourable changes
	£m	£m	£m	£m
At 31 December 2012				
Derivatives/trading assets/trading liabilities ¹	204	(133)	–	–
Financial investments: available-for-sale	–	–	152	(150)
At 31 December 2011				
Derivatives/trading assets/trading liabilities ¹	200	(169)	–	–
Financial investments: available-for-sale	–	–	189	(183)

The bank

	Reflected in profit or loss		Reflected in other comprehensive income	
	Favourable changes	Unfavourable changes	Favourable changes	Unfavourable changes
	£m	£m	£m	£m
At 31 December 2012				
Derivatives/trading assets/trading liabilities ¹	283	(155)	–	–
Financial investments: available-for-sale	–	–	296	(295)
At 31 December 2011				
Derivatives/trading assets/trading liabilities ¹	203	(171)	–	–
Financial investments: available-for-sale	–	–	191	(162)

¹ Derivatives, trading assets and trading liabilities are presented as one category to reflect the manner in which these financial instruments are risk-managed.

Sensitivity of Level 3 fair values to reasonably possible alternative assumptions by instrument type

	Reflected in profit or loss		Reflected in other comprehensive income	
	Favourable changes	Unfavourable changes	Favourable changes	Unfavourable changes
	£m	£m	£m	£m
At 31 December 2012				
Private equity investments	14	(14)	43	(43)
Asset-backed securities	23	(13)	88	(86)
Leverage finance	–	–	–	–
Structured notes	3	(3)	–	–
Derivatives with monolines	36	(6)	–	–
Other derivatives	127	(96)	–	–
Other portfolios	1	(1)	21	(21)

	Reflected in profit or loss		Reflected in other comprehensive income	
	Favourable changes	Unfavourable changes	Favourable changes	Unfavourable changes
	£m	£m	£m	£m
At 31 December 2011				
Private equity investments	51	(26)	60	(59)
Asset-backed securities	3	(3)	118	(113)
Leverage finance	6	(6)	–	–
Structured notes	3	(3)	–	–
Derivatives with monolines	39	(34)	–	–
Other derivatives	75	(78)	–	–
Other portfolios	23	(19)	11	(11)

Favourable and unfavourable changes are determined on the basis of changes in the value of the instrument as a result of varying the levels of the unobservable parameters using statistical techniques. When parameters are not amenable to statistical analysis, quantification of uncertainty is judgemental.

Notes on the Financial Statements (continued)

When the fair value of a financial instrument is affected by more than one unobservable assumption, the above table reflects the most favourable or most unfavourable change from varying the assumptions individually.

In respect of private equity investments, in many of the methodologies, the principal assumption is the valuation multiple to be applied to the main financial indicators. This may be determined with reference to multiples for comparable listed companies and includes discounts for marketability.

For ABSs, the principal assumptions in the models are based on benchmark information about prepayment speeds, default rates, loss severities and the historical performance of the underlying assets.

For leveraged finance, loans held for securitisation and derivatives with monolines the principal assumption concerns the appropriate value to be attributed to the counterparty credit risk. This requires estimation of exposure at default, probability of default and recovery in the event of default. For loan transactions, assessment of exposure at default is straightforward. For derivative transactions, a future exposure profile is generated on the basis of current market data. Probabilities of default and recovery levels are estimated using market evidence, which may include financial information, historical experience, CDS spreads and consensus recovery levels.

For structured notes and other derivatives, principal assumptions concern the value to be attributed to future volatility of asset values and the future correlation between asset values. These principal assumptions include credit volatilities and correlations used in the valuation of structured credit derivatives (including leveraged credit derivatives). For such unobservable assumptions, estimates are based on available market data, which may include the use of a proxy method to derive volatility or a correlation from comparable assets for which market data is more readily available, and/or an examination of historical levels.

33 Fair values of financial instruments not carried at fair value

The accounting policies which determine the classification of financial instruments and the use of assumptions and estimation in valuing them are described in Notes 2 and 3 respectively.

Fair values are, however, provided for information and are calculated as described below.

The group

	At 31 December 2012		At 31 December 2011	
	Carrying amount £m	Fair value £m	Carrying amount £m	Fair value £m
Assets				
Loans and advances to banks	32,286	32,285	44,603	44,588
Loans and advances to customers	282,685	276,397	288,014	282,813
Financial investments: Debt securities	–	–	4,151	4,204
Liabilities				
Deposits by banks ¹	39,571	39,571	41,032	41,032
Customer accounts	324,886	325,029	346,129	346,184
Debt securities in issue	40,358	40,401	42,688	42,661
Subordinated liabilities	10,350	10,013	9,998	9,266

The bank

	At 31 December 2012		At 31 December 2011	
	Carrying amount £m	Fair value £m	Carrying amount £m	Fair value £m
Assets				
Loans and advances to banks	17,207	17,207	22,203	22,189
Loans and advances to customers	225,567	219,416	210,561	205,587
Liabilities				
Deposits by banks ¹	30,129	30,129	32,324	32,324
Customer accounts	256,341	256,341	237,654	237,654
Debt securities in issue	24,970	24,970	25,705	25,705
Subordinated liabilities	9,968	9,581	9,893	9,125

¹ The carrying amounts of these instruments are equal to the fair value because they are short-term in nature or reprice to current market rates frequently.

Notes on the Financial Statements (continued)

(i) *Loans and advances to banks and customers*

The fair value of loans and advances is based on observable market transactions, where available. In the absence of observable market transactions, fair value is estimated using discounted cash flow models.

Loans are grouped, as far as possible, into homogeneous pools segregated by maturity, origination period, interest rate coupon and refixing profile, loan-to-value ratio, currency, and/or internal credit risk rating. Expected credit losses and prepayment behaviour, where appropriate, are applied to contractual cash flows. The resultant expected cash flows are discounted using the group's estimate of the discount rate that a market participant would use in valuing instruments with similar maturity, repricing and credit risk characteristics.

The fair value of a loan portfolio reflects both loan impairments at the balance sheet date, estimates of expectations of credit losses over the life of the loans and the fair value impact of repricing between origination and the balance sheet date.

(ii) *Financial investments*

The fair values of listed financial investments are determined using bid market prices. The fair values of unlisted financial investments are determined using valuation techniques that take into consideration the prices and future earnings streams of equivalent quoted securities.

(iii) *Deposits by banks and customer accounts*

For the purposes of estimating fair value, deposits by banks and customer accounts are grouped by residual maturity. Fair values are estimated using discounted cash flows, applying current rates offered for deposits of similar remaining maturities. The fair value of a deposit repayable on demand is assumed to be the amount payable on demand at the balance sheet date.

(iv) *Debt securities in issue and subordinated liabilities*

Fair values are determined using quoted market prices at the balance sheet date where available, or by reference to quoted market prices for similar instruments.

The fair values in this note are stated at a specific date and may be significantly different from the amounts which will actually be paid on the maturity or settlement dates of the instruments. In many cases, it would not be possible to realise immediately the estimated fair values given the size of the portfolios measured. Accordingly, these fair values do not represent the value of these financial instruments to the group as a going concern.

34 Maturity analysis of assets and liabilities

The balance in the table below will not agree directly with those in the consolidated balance sheet as the table incorporates, on an undiscounted basis, all cash flows relating to principal and future coupon payments (except for trading liabilities and trading derivatives). In addition, loan and other credit-related commitments and financial guarantees and similar contracts are generally not recognised on the balance sheet. Trading liabilities and trading derivatives are included in the 'On demand' time bucket, and not by contractual maturity, because trading liabilities are typically held for short periods of time. The group classifies the undiscounted cash flows payable under hedging derivative liabilities according to their contractual maturities. The undiscounted cash flows potentially payable under financial guarantees and similar contracts are classified on the basis of the earliest date they can be called.

Cash flows payable in respect of customer accounts are primarily contractually repayable on demand or at short notice. However, in practice, short-term deposit balances remain stable as inflows and outflows broadly match and a significant portion of loan commitments expire without being drawn upon. The group therefore manages its balance sheet on both contractual and behaviouralised bases. Each operating entity determines the behaviouralisation of its products within the guidelines set out in the group's liquidity framework and as approved by its Asset and Liability Committee.

The following is an analysis, by remaining contractual maturities at the reporting date, of undiscounted cash flows payable under financial liabilities:

Notes on the Financial Statements (continued)

Cash flows payable under financial liabilities by remaining contractual maturities

The group

	On demand £m	Due within 3 months £m	Due between 3 and 12 months £m	Due between 1 and 5 years £m	Due after 5 years £m	Total £m
At 31 December 2012						
Deposits by banks	13,882	19,935	1,925	7,120	493	43,355
Customer accounts	261,108	56,211	11,098	4,761	298	333,476
Trading liabilities	122,896	–	–	–	–	122,896
Financial liabilities designated at fair value	4,802	409	2,935	16,054	13,461	37,661
Derivatives	181,095	78	477	2,440	292	184,382
Debt securities in issue	40	18,158	13,836	8,623	343	41,000
Subordinated liabilities	4	72	71	642	12,114	12,903
Other financial liabilities	981	6,460	1,104	615	416	9,576
	584,808	101,323	31,446	40,255	27,417	785,249
Loan commitments	113,654	1,342	580	128	21	115,725
Financial guarantee contracts	3,047	1,005	3,776	1,709	2,123	11,660
	701,509	103,670	35,802	42,092	29,561	912,634
At 31 December 2011						
Deposits by banks	11,825	28,748	1,373	5,632	539	48,117
Customer accounts	252,655	77,975	21,166	5,409	422	357,627
Trading liabilities	119,211	–	–	–	–	119,211
Financial liabilities designated at fair value	4,513	266	935	16,481	15,615	37,810
Derivatives	178,121	116	191	1,489	459	180,376
Debt securities in issue	94	21,223	10,829	11,236	221	43,603
Subordinated liabilities	4	44	69	541	11,302	11,960
Other financial liabilities	1,413	4,286	959	439	836	7,933
	567,836	132,658	35,522	41,227	29,394	806,637
Loan commitments	119,032	927	657	246	19	120,881
Financial guarantee contracts	3,439	2,583	4,397	1,427	564	12,410
	690,307	136,168	40,576	42,900	29,977	939,928

Notes on the Financial Statements (continued)

The bank

	On demand £m	Due within 3 months £m	Due between 3 and 12 months £m	Due between 1 and 5 years £m	Due after 5 years £m	Total £m
At 31 December 2012						
Deposits by banks	19,373	7,419	2,101	941	227	30,061
Customer accounts	219,227	24,790	7,674	4,052	–	255,743
Trading liabilities	104,946	–	–	–	–	104,946
Financial liabilities designated at fair value	–	403	1,281	12,670	12,287	26,641
Derivatives	143,921	78	477	1,496	292	146,264
Debt securities in issue	40	6,690	12,058	5,795	641	25,224
Subordinated liabilities	–	44	23	1,095	9,781	10,943
Other financial liabilities	47	5,240	460	115	153	6,015
	487,554	44,664	24,074	26,164	23,381	605,837
Loan commitments	76,654	472	399	95	20	77,640
Financial guarantee contracts	31	1,627	3,865	1,731	2,064	9,318
	564,239	46,763	28,338	27,990	25,465	692,795
At 31 December 2011						
Deposits by banks	10,832	20,885	320	203	127	32,367
Customer accounts	199,768	23,354	9,738	4,265	–	237,125
Trading liabilities	94,584	–	–	–	–	94,584
Financial liabilities designated at fair value	–	159	902	12,940	13,264	27,265
Derivatives	147,251	113	187	837	453	148,841
Debt securities in issue	94	6,357	9,353	9,709	655	26,168
Subordinated liabilities	–	44	28	287	10,562	10,921
Other financial liabilities	97	2,643	247	123	156	3,266
	452,626	53,555	20,775	28,364	25,217	580,537
Loan commitments	80,691	396	532	164	18	81,801
Financial guarantee contracts	33	2,749	3,883	1,354	512	8,531
	533,350	56,700	25,190	29,882	25,747	670,869

Notes on the Financial Statements (continued)

Maturity analysis of assets and liabilities

The group

	At 31 December 2012		
	Due within one year £m	Due after more than one year £m	Total £m
Assets			
Financial assets designated at fair value	282	15,105	15,387
Loans and advances to banks	29,511	2,775	32,286
Loans and advances to customers	128,877	153,808	282,685
Financial investments	13,636	57,629	71,265
Other financial assets	4,469	2,103	6,572
	176,775	231,420	408,195
Liabilities			
Deposits by banks	33,482	6,089	39,571
Customer accounts	320,786	4,100	324,886
Financial liabilities designated at fair value	2,495	30,423	32,918
Debt securities in issue	31,536	8,822	40,358
Other financial liabilities	7,878	1,297	9,175
Subordinated liabilities	34	10,316	10,350
	396,211	61,047	457,258
	At 31 December 2011		
	Due within one year £m	Due after more than one year £m	Total £m
Assets			
Financial assets designated at fair value	282	15,050	15,332
Loans and advances to banks	42,583	2,020	44,603
Loans and advances to customers	137,084	150,930	288,014
Financial investments	19,778	73,334	93,112
Other financial assets	6,585	1,020	7,605
	206,312	242,354	448,666
Liabilities			
Deposits by banks	35,248	5,784	41,032
Customer accounts	341,886	4,243	346,129
Financial liabilities designated at fair value	1,163	30,829	31,992
Debt securities in issue	31,737	10,951	42,688
Other financial liabilities	4,121	1,153	5,274
Subordinated liabilities	–	9,998	9,998
	414,155	62,958	477,113

Notes on the Financial Statements (continued)

The bank

	At 31 December 2012		
	Due within one year £m	Due after more than one year £m	Total £m
Assets			
Financial assets designated at fair value	–	4,373	4,373
Loans and advances to banks	15,854	1,353	17,207
Loans and advances to customers	107,183	118,384	225,567
Financial investments	9,471	27,132	36,603
Other financial assets	3,404	906	4,310
	135,912	152,148	288,060
Liabilities			
Deposits by banks	25,602	4,527	30,129
Customer accounts	252,409	3,932	256,341
Financial liabilities designated at fair value	1,112	22,401	23,513
Debt securities in issue	18,654	6,316	24,970
Other financial liabilities	6,628	370	6,998
Subordinated liabilities	–	9,968	9,968
	304,405	47,514	351,919
At 31 December 2011			
	Due within one year £m	Due after more than one year £m	Total £m
Assets			
Financial assets designated at fair value	4	4,591	4,595
Loans and advances to banks	20,839	1,364	22,203
Loans and advances to customers	94,973	115,588	210,561
Financial investments	10,441	31,799	42,240
Other financial assets	3,630	734	4,364
	129,887	154,076	283,963
Liabilities			
Deposits by banks	28,495	3,829	32,324
Customer accounts	232,640	5,014	237,654
Financial liabilities designated at fair value	1,025	21,836	22,861
Debt securities in issue	15,579	10,126	25,705
Other financial liabilities	2,307	406	2,713
Subordinated liabilities	–	9,893	9,893
	280,046	51,104	331,150

Further discussion of the group's liquidity and funding management can be found in the Risk section of the Report of the Directors.

Notes on the Financial Statements (continued)

35 Foreign exchange exposures

The group's structural foreign currency exposure is represented by the net asset value of its foreign currency equity and subordinated debt investments in subsidiary undertakings, branches, joint ventures and associates.

The group's management of structural foreign currency exposures is discussed in the risk section in the Report of Directors.

Net structural foreign currency exposures

Currency of structural exposure

	2012 £m	2011 £m
Euro	11,891	11,927
US dollars	1,994	3,331
Swiss francs	162	1,553
Turkish lira	1,106	1,011
Russian rouble	186	166
Others, each less than £100 million	269	191
Total	15,608	18,179

36 Assets charged as security for liabilities and collateral accepted as security for assets

Financial assets pledged to secure liabilities are as follows:

	Group assets pledged at 31 December		Bank assets pledged at 31 December	
	2012 £m	2011 £m	2012 £m	2011 £m
Treasury bills and other eligible securities	483	440	–	–
Loans and advances to banks	12,780	11,422	7,708	7,856
Loans and advances to customers	39,833	39,736	21,429	23,407
Debt securities	97,612	102,416	59,855	60,580
Equity shares	3,488	3,993	3,416	3,971
Other	35	54	–	–
	154,231	158,061	92,408	95,814

The table above shows assets over which a legal charge has been granted to secure liabilities. The amount of such assets may be greater than the book value of assets utilised as collateral for funding purposes or to cover liabilities. This is the case for securitisations and covered bonds where the amount of liabilities issued, plus any mandatory over-collateralisation, is less than the book value of financial assets available for funding or collateral purposes in the relevant pool of assets. This is also the case where financial assets are placed with a custodian or settlement agent, which has a floating charge over all the financial assets placed to secure any liabilities under settlement accounts.

These transactions are conducted under terms that are usual and customary to collateralised transactions, including, where relevant, standard securities lending and repurchase agreements.

Collateral accepted as security for assets

The fair value of financial assets accepted as collateral that the group is permitted to sell or repledge in the absence of default is £122,502 million (2011: £144,699 million) (the bank: 2012 £79,852 million; 2011 £85,654 million). The fair value of any such collateral that has been sold or repledged is £80,072 million (2011: £84,228 million) (the bank: 2012 £41,562 million; 2011 £33,581 million). The group is obliged to return equivalent securities.

These transactions are conducted under terms that are usual and customary to standard securities borrowing and reverse repurchase agreements.

Notes on the Financial Statements (continued)

37 Called up share capital and other equity instruments

Issued capital

HSBC Bank plc £1.00 ordinary shares

	Number	£m
At 1 January and 31 December 2012	796,969,107	797
At 1 January and 31 December 2011	796,969,107	797

HSBC Bank plc £1.00 preferred ordinary shares

	Number	£'000
At 1 January and 31 December 2012	1	–
At 1 January and 31 December 2011	1	–

The preferred ordinary share ranks pari passu in all respects with the ordinary shares and with all other shares expressed to rank pari passu therewith. It carries the same rights and is subject to the same limitations as the ordinary shares but in addition the preferred ordinary share confers:

- (i) on each and any distribution of profits by the bank on any class of share (other than the ordinary shares), the right to receive, in priority to any other share, the first £100 of any amount so distributed; and
- (ii) on any distribution on a winding-up of the bank (but not on any redemption, reduction or purchase of any share capital), the right to receive out of the assets of the bank available for distribution, in priority to any other share, a sum equal to the nominal amount of the preferred ordinary share and any premium paid on the issue thereof.

HSBC Bank plc US\$0.01 non-cumulative third dollar preference shares

	Number	£'000
At 1 January and 31 December 2012	35,000,000	172
At 1 January and 31 December 2011	35,000,000	172

The bank has no obligation to redeem the preference shares but may redeem them in part or in whole at any time, subject to prior notification to the Financial Services Authority. Dividends on the preference shares in issue are paid annually at the sole and absolute discretion of the Board of Directors. The Board of Directors will not declare a dividend on the preference shares in issue if payment of the dividend would cause the bank not to meet the capital adequacy requirements of the Financial Services Authority or the profit of the bank, available for distribution as dividends, is not sufficient to enable the bank to pay in full both dividends on the preference shares in issue and dividends on any other shares that are scheduled to be paid on the same date and have an equal right to dividends or if payment of the dividend is prohibited by the rights attached to any class of shares in the capital of the bank, excluding ordinary shares. The preference shares in issue carry no rights to conversion into ordinary shares of the bank. Holders of the preference shares in issue will be able to attend any general meetings of shareholders of the bank and to vote on any resolution proposed to vary or abrogate any of the rights attaching to the preference shares or any resolution proposed to reduce the paid up capital of the preference shares. If the dividend payable on the preference shares in issue has not been paid in full for the most recent dividend period or any resolution is proposed for the winding-up of the bank or the sale of its entire business then, in such circumstances, holders of preference shares will be entitled to vote on all matters put to general meetings. In the case of unpaid dividends the holders of preference shares in issue will be entitled to attend and vote at any general meetings until such time as dividends on the preference shares have been paid in full, or a sum set aside for such payment in full, in respect of one dividend period.

All shares in issue are fully paid.

HSBC Bank plc perpetual subordinated debt

	£m
At 1 January 2012 and 31 December 2012	–
At 1 January 2011	1,750
Debt repaid	(1,750)
At 31 December 2011	–

Notes on the Financial Statements (continued)

38 Notes on the cash flow statement

Non-cash items included in profit before tax

	The group		The bank	
	2012 £m	2011 £m	2012 £m	2011 £m
Depreciation, amortisation and impairment.....	541	549	403	359
Share-based payment expense	271	328	191	213
Credit-related impairment losses.....	1,245	1,623	965	1,109
Provisions raised	1,616	630	1,274	522
Impairment of investments.....	26	18	687	7
Credit charge for defined benefit plans.....	148	(219)	112	(255)
Accretion of discounts and amortisation of premiums	141	161	120	1
	3,988	3,090	3,752	1,956

Change in operating assets

	The group		The bank	
	2012 £m	2011 £m	2012 £m	2011 £m
Change in prepayments and accrued income.....	208	631	75	308
Change in net trading securities and net derivatives.....	(29,920)	17,430	(19,974)	18,628
Change in loans and advances to banks.....	5,446	6,365	8,142	6,787
Change in loans and advances to customers.....	(6,503)	(2,601)	(11,810)	(2,392)
Change in financial assets designated at fair value.....	(55)	122	222	(90)
Change in other assets.....	(3,205)	(1,015)	3,322	(250)
	(34,029)	20,932	(20,023)	22,991

Change in operating liabilities

	The group		The bank	
	2012 £m	2011 £m	2012 £m	2011 £m
Change in accruals and deferred income	(11)	(440)	(11)	(186)
Change in deposits by banks.....	(3,908)	(7,255)	(2,195)	(6,549)
Change in customer accounts.....	27,986	2,006	18,687	7,053
Change in debt securities in issue.....	(4,081)	(5,418)	(735)	(3,712)
Change in financial liabilities designated at fair value.....	1,274	4,057	1,002	4,527
Change in other liabilities.....	2,627	(1,298)	2,281	(100)
	23,887	(8,348)	19,029	1,033

Cash and cash equivalents

	The group		The bank	
	2012 £m	2011 £m	2012 £m	2011 £m
Cash and balances at central banks	51,613	56,460	45,262	44,967
Items in the course of collection from other banks	1,961	1,663	1,213	908
Loans and advances to banks of one month or less	42,859	47,497	30,132	27,109
Treasury bills, other bills and certificates of deposit less than three months	2,742	3,974	2,388	2,818
Less: items in the course of transmission to other banks.....	(1,017)	(1,154)	(334)	(446)
Total cash and cash equivalents¹.....	98,158	108,440	78,661	75,356

¹ Total cash and cash equivalents include the following amounts that are not available for use by the group: Nil held by foreign subsidiaries and subject to foreign exchange control restrictions (2011: nil); and £2,356 million subject to other restrictions (2011: £1,335 million).

Total interest paid by the group during the year was £3,282 million (2011: £5,044 million). Total interest received by the group during the year was £12,565 million (2011: £13,200 million). Total dividends received by the group during the year were £293 million (2011: £234 million).

Notes on the Financial Statements (continued)

39 Contingent liabilities, contractual commitments and guarantees

	The group		The bank	
	2012 £m	2011 £m	2012 £m	2011 £m
Guarantees and other contingent liabilities				
Guarantees	14,829	17,510	11,066	10,883
Other contingent liabilities	55	88	54	60
	14,884	17,598	11,120	10,943
Commitments¹				
Documentary credits and short-term trade-related transactions ...	2,729	2,436	1,172	1,160
Forward asset purchases and forward deposits placed	19	21	–	–
Undrawn formal standby facilities, credit lines and other commitments to lend ²	112,977	118,424	76,468	80,641
	115,725	120,881	77,640	81,801

1 Excluding capital commitments, which are separately disclosed below.

2 Based on original contractual maturity.

The table above discloses the nominal principal amounts of commitments, guarantees and other contingent liabilities. They are mainly credit-related instruments which include both financial and non-financial guarantees and commitments to extend credit. Nominal principal amounts represent the amounts at risk should contracts be fully drawn upon and clients default. As a significant portion of guarantees and commitments is expected to expire without being drawn upon, the total of these nominal principal amounts is not representative of future liquidity requirements.

Contingent liabilities arising from litigation against the group are disclosed in Note 41.

Financial Services Compensation Scheme

The Financial Services Compensation Scheme ('FSCS') has provided compensation to consumers following the collapse of a number of deposit takers. The compensation paid out to consumers is currently funded through loans from the Bank of England and HM Treasury which at 31 December 2012 stood at approximately £18 billion.

The interest rate to be applied on outstanding borrowings in calculating the Management Expenses Levy increased from 12 month LIBOR plus 30 basis points to 12 month LIBOR plus 100 basis points from 1 April 2012. The FSCS confirmed in February 2013 that the first of three annual instalments of approximately £363 million will be levied in total on participating financial institutions in Scheme Year 2013/2014 to repay the balance of the loan principle that is not expected to be recovered.

The bank could be liable to pay a further proportion of the outstanding borrowings that the FSCS has borrowed from HM Treasury.

The accrual of £97 million at 31 December 2012 (2011: £56 million) reflects an estimate in respect of the expected Management Expenses Levy due in Scheme Year 2013/2014 plus the bank's estimated share of the first instalment for loan principal non-recovery. The ultimate FSCS levy to the industry as a result of the collapses cannot currently be estimated reliably as it is dependent on various uncertain factors including the potential recoveries of assets by the FSCS and changes in the interest rate and level of protected deposits and the population of FSCS members at the time.

Guarantees

The group provides guarantees and similar undertakings on behalf of both third party customers and other entities within the group. These guarantees are generally provided in the normal course of the group's banking business. The principal types of guarantees provided, and the maximum potential amount of future payments which the group could be required to make at 31 December, were as follows:

Notes on the Financial Statements (continued)

The group

Guarantee type	At 31 December 2012		At 31 December 2011	
	Guarantees in favour of third parties	Guarantees by the group in favour of other Group entities	Guarantees in favour of third parties	Guarantees by the group in favour of other Group entities
	£m	£m	£m	£m
Financial guarantee contracts ¹	7,549	1,032	9,060	1,458
Credit-related substitutes ²	2,850	229	1,825	67
Other guarantees	3,106	118	5,156	32
Total	13,505	1,379	16,041	1,557

The bank

Guarantee type	At 31 December 2012		At 31 December 2011	
	Guarantees in favour of third parties	Guarantees by the group in favour of other Group entities	Guarantees in favour of third parties	Guarantees by the group in favour of other Group entities
	£m	£m	£m	£m
Financial guarantee contracts ¹	5,776	1,975	5,451	2,320
Credit-related substitutes ²	1,077	490	444	316
Other guarantees	1,636	166	2,336	76
Total	8,489	2,631	8,231	2,712

1 Financial guarantee contracts are contracts that require the issuer to make specified payments to reimburse the holder for a loss incurred because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument. The amounts in the above table are nominal principal amounts.

2 Credit related guarantees are contracts that have similar features to financial guarantee contracts but fail to meet the strict definition of a financial guarantee contract under IAS 39.

The amounts disclosed in the above table reflect the group's maximum exposure under a large number of individual guarantee undertakings. The risks and exposures arising from guarantees are captured and managed in accordance with the group's overall credit risk management policies and procedures. Guarantees with terms of more than one year are subject to the group's annual credit review process.

Other commitments

In addition to the commitments disclosed above, at 31 December 2012 the group had contractual commitments to purchase, within one year, land and buildings and other fixed assets from a number of suppliers for a value of £3 million (2011: £5 million).

The group had no contingent liabilities or commitments in relation to joint ventures or associates, incurred jointly or otherwise.

40 Lease commitments

Finance lease commitments

The group leases land and buildings (including branches) and equipment from third parties under finance lease arrangements to support its operations.

	2012			2011		
	Total future minimum payments	Interest charges	Present value	Total future minimum payments	Interest charges	Present value
	£m	£m	£m	£m	£m	£m
No later than one year	7	(7)	–	8	(8)	–
Later than one year and no later than five years	39	(38)	1	56	(54)	2
Later than five years	105	(15)	90	227	(60)	167
Total	151	(60)	91	291	(122)	169

Notes on the Financial Statements (continued)

At 31 December 2012 future minimum sublease payments of £151 million (2011: £267 million) were expected to be received under non-cancellable subleases at the balance sheet date.

Operating lease commitments

At 31 December 2012, the group was obligated under a number of non-cancellable operating leases for properties, plant and equipment for which the future minimum lease payments extend over a number of years.

	Land and buildings	
	2012	2011
	£m	£m
Future minimum lease payments under non-cancellable operating leases expiring		
No later than one year	158	193
Later than one year and no later than five years	537	685
Later than five years	927	1,143
Total	1,622	2,021

In 2012, £180 million (2011: £164 million) was charged to 'General and administrative expenses' in respect of lease and sublease agreements, all of which related to minimum lease payments.

Finance lease receivables

HSBC leases a variety of assets to third parties under finance leases, including transport assets (such as aircraft), property and general plant and machinery. At the end of lease terms, assets may be sold to third parties or leased for further terms. Lessees may participate in any sales proceeds achieved. Lease rentals arising during the lease terms will either be fixed in quantum or be varied to reflect changes in, for example, tax or interest rates. Rentals are calculated to recover the cost of assets less their residual value, and earn finance income.

	2012			2011		
	Total future minimum payments	Interest charges	Present value	Total future Minimum payments	Interest charges	Present value
	£m	£m	£m	£m	£m	£m
Lease receivables						
No later than one year	1,203	(92)	1,111	1,165	(132)	1,033
Later than one year and no later than five years	3,037	(417)	2,620	3,193	(495)	2,698
Later than five years	1,822	(433)	1,389	2,486	(637)	1,849
	6,062	(942)	5,120	6,844	(1,264)	5,580

At 31 December 2012, unguaranteed residual values of £106 million (2011: £117 million) had been accrued, and the accumulated allowance for uncollectible minimum lease payments receivable amounted to £12m million (2011: £12 million).

In 2012, £30 million (2011: £35 million) was received as contingent rents and recognised in the income statement.

Operating lease receivables

The group leases a variety of different assets to third parties under operating lease arrangements, including property, aircraft and general plant and machinery.

	Equipment	
	2012	2011
	£m	£m
Future minimum lease payments under non-cancellable operating leases expiring		
No later than one year	14	11
Later than one year and no later than five years	40	25
	54	36

In 2012, no contingent rents were received and recognised in 'Other operating income' (2011: nil).

Notes on the Financial Statements (continued)

41 Legal proceedings and regulatory matters

The group is party to legal proceedings, investigations and regulatory matters in a number of jurisdictions arising out of its normal business operations. Apart from the matters described below, the group considers that none of these matters is material, either individually or in the aggregate. The group recognises a provision for a liability in relation to these matters when it is probable that an outflow of economic benefits will be required to settle an obligation which has arisen as a result of past events, and for which a reliable estimate can be made of the amount of the obligation. While the outcome of these matters is inherently uncertain, management believes that, based on the information available to it, appropriate provisions have been made in respect of legal proceedings and regulatory matters as at 31 December 2012.

Bernard L. Madoff Investment Securities LLC

In December 2008, Bernard L. Madoff ('Madoff') was arrested for running a Ponzi scheme and a trustee was appointed for the liquidation of his firm, Bernard L. Madoff Investment Securities LLC ('Madoff Securities'), an SEC-registered broker-dealer and investment adviser. Since his appointment, the trustee has been recovering assets and processing claims of Madoff Securities customers. Madoff subsequently pleaded guilty to various charges and is serving a 150 year prison sentence. He has acknowledged, in essence, that while purporting to invest his customers' money in securities and, upon request, return their profits and principal, he in fact never invested in securities and used other customers' money to fulfil requests for the return of profits and principal. The relevant US authorities are continuing their investigations into his fraud, and have brought charges against others, including certain former employees and the former auditor of Madoff Securities.

Various non-US HSBC companies provided custodial, administration and similar services to a number of funds incorporated outside the US whose assets were invested with Madoff Securities. Based on information provided by Madoff Securities, as at 30 November 2008, the purported aggregate value of these funds was US\$8.4 billion, an amount that includes fictitious profits reported by Madoff. Based on information available to HSBC to date, we estimate that the funds' actual transfers to Madoff Securities minus their actual withdrawals from Madoff Securities during the time that HSBC serviced the funds totalled approximately US\$4 billion.

Plaintiffs (including funds, fund investors, and the Madoff Securities trustee) have commenced Madoff-related proceedings against numerous defendants in a multitude of jurisdictions. Various HSBC companies have been named as defendants in suits in the US, Ireland, Luxembourg and other jurisdictions. Certain suits (which included four US putative class actions) allege that the HSBC defendants knew or should have known of Madoff's fraud and breached various duties to the funds and fund investors.

In November 2011, the US District Court Judge overseeing three related putative class actions in the Southern District of New York dismissed all claims against the HSBC defendants on forum non conveniens grounds, but temporarily stayed this ruling as to one of the actions against the HSBC defendants – the claims of investors in Thema International Fund plc – in light of a proposed amended settlement agreement, pursuant to which, subject to various conditions, the HSBC defendants had agreed to pay from US\$52.5m up to a maximum of US\$62.5m. In December 2011, the court lifted this temporary stay and dismissed all remaining claims against the HSBC defendants, and declined to consider preliminary approval of the settlement. In light of the court's decisions, HSBC terminated the settlement agreement. The Thema plaintiff contests HSBC's right to terminate. Plaintiffs in all three actions have filed notices of appeal to the US Court of Appeals for the Second Circuit. Briefing in that appeal was completed in September 2012; oral argument is expected in early 2013.

In November and December 2012, HSBC settled two of the individual claims commenced by investors in Thema International Fund plc against HSBC in the Irish High Court.

In December 2010, the Madoff Securities trustee commenced suits against various HSBC companies in the US Bankruptcy Court and in the English High Court. The US action (which also names certain funds, investment managers, and other entities and individuals) sought US\$9 billion in damages and additional recoveries from HSBC and the various co-defendants. It sought damages against HSBC for allegedly aiding and abetting Madoff's fraud and breach of fiduciary duty. In July 2011, after withdrawing the case from the Bankruptcy Court in order to decide certain threshold issues, the US District Court Judge dismissed the trustee's various common law claims on the grounds that the trustee lacks standing to assert them. In December 2011, the trustee filed a notice of appeal to the US Court of Appeals for the Second Circuit. Briefing in that appeal was completed in April 2012, and oral argument was held in November 2012. A decision is expected in 2013.

The District Court returned the remaining claims to the US Bankruptcy Court for further proceedings. Those claims seek, pursuant to US bankruptcy law, recovery of unspecified amounts received by HSBC from funds invested with Madoff, including amounts that HSBC received when it redeemed units HSBC held in the various funds. HSBC

Notes on the Financial Statements (continued)

acquired those fund units in connection with financing transactions HSBC had entered into with various clients. The trustee's US bankruptcy law claims also seek recovery of fees earned by HSBC for providing custodial, administration and similar services to the funds. Between September 2011 and April 2012, the HSBC defendants and certain other defendants moved again to withdraw the case from the Bankruptcy Court. The District Court granted those withdrawal motions as to certain issues, and briefing and oral arguments on the merits of the withdrawn issues are now complete. The District Court has issued rulings on two of the withdrawn issues, but decisions with respect to all other issues are still pending and are expected in early 2013.

The trustee's English action seeks recovery of unspecified transfers of money from Madoff Securities to or through HSBC, on the grounds that the HSBC defendants actually or constructively knew of Madoff's fraud. HSBC has not been served with the trustee's English action.

Between October 2009 and April 2012, Fairfield Sentry Limited, Fairfield Sigma Limited and Fairfield Lambda Limited ('Fairfield'), funds whose assets were directly or indirectly invested with Madoff Securities, commenced multiple suits in the British Virgin Islands ('BVI') and the US against numerous fund shareholders, including various HSBC companies that acted as nominees for clients of HSBC's private banking business and other clients who invested in the Fairfield funds. The Fairfield actions seek restitution of amounts paid to the defendants in connection with share redemptions, on the ground that such payments were made by mistake, based on inflated values resulting from Madoff's fraud, and some actions also seek recovery of the share redemptions under BVI insolvency law. The actions in the US are currently stayed in the Bankruptcy Court pending developments in related appellate litigation in the BVI.

There are many factors which may affect the range of possible outcomes, and the resulting financial impact, of the various Madoff-related proceedings, including but not limited to the circumstances of the fraud, the multiple jurisdictions in which the proceedings have been brought and the number of different plaintiffs and defendants in such proceedings. For these reasons, among others, it is not practicable at this time for HSBC to estimate reliably the aggregate liabilities, or ranges of liabilities, that might arise as a result of all such claims but they could be significant. In any event, HSBC considers that it has good defences to these claims and will continue to defend them vigorously.

Anti-money laundering and sanctions-related investigations

In December 2012, HSBC, the bank's parent company, entered into agreements to achieve a resolution with US and UK government agencies that have investigated HSBC's conduct related to inadequate compliance with anti-money laundering ('AML'), US Bank Secrecy Act ('BSA') and sanctions laws. This was as a result of investigations by the US Department of Justice ('DoJ'), the Federal Reserve, the Office of the Comptroller of the Currency and the US Department of Treasury's Financial Crimes Enforcement Network in connection with AML/BSA compliance in various parts of the HSBC Group. As part of the resolution, HSBC and HSBC Bank USA, N.A. entered into a deferred prosecution agreement (the 'DPA') with the DoJ, the United States Attorney's Office for the Eastern District of New York, and the United States Attorney's Office for the Northern District of West Virginia, and a DPA with the New York County District Attorney, and consented to a cease and desist order with the Federal Reserve.

HSBC also entered into an undertaking with the FSA to comply with certain forward-looking obligations with respect to anti-money laundering and sanctions requirements over a five-year term. Under these agreements, HSBC will continue to cooperate fully with US and UK regulatory and law enforcement authorities and take further action to strengthen its compliance policies and procedures. Over the five-year term of the agreements with the DoJ and FSA, a 'skilled person' under section 166 of the Financial Services and Markets Act (FSMA) (also known as an independent monitor) will evaluate HSBC's progress in fully implementing these and other measures it recommends, and will produce regular assessments of the effectiveness of HSBC's compliance function. If HSBC fulfils all of the requirements imposed by the DPA and other agreements, the DOJ's charges against it will be dismissed at the end of the five-year period.

The above agreements cover the activities of all the entities in the HSBC Group, including the bank and its subsidiaries.

The FSA requested the bank, as the FSA authorised and approved entity in the UK, to apply for a variation of its banking permission to ensure that HSBC complies with these undertakings. If HSBC fails to comply with the terms of the DPA, the FSA could take action against the bank including, but not limited to, revocation of the bank's license.

In relation to the DPA, the Group has committed to take or continue to adhere to a number of remedial measures. Breach of the DPA at any time during its term may allow the DoJ or the New York County District Attorney's Office to prosecute HSBC in relation to the matters which are subject to the DPA.

Notes on the Financial Statements (continued)

Steps to address many of the requirements of the DPA have either already been taken or are under way. These include simplifying the Group's control structure, strengthening the governance structure with new leadership appointments, revising key policies and establishing bodies to implement single global standards shaped by the highest or most effective anti-money laundering standards available in any location where the Group operates, as well as substantially increasing spending and staffing in the anti-money laundering and regulatory compliance areas over the past few years.

Investigations into the setting of London interbank offered rates, European interbank offered rates and other benchmark rates

Various regulators and competition and enforcement authorities around the world including in the UK, the US, Canada, the EU, Switzerland and Asia, are conducting investigations and reviews related to certain past submissions made by panel banks and the processes for making submissions in connection with the setting of London interbank offered rates ('Libor'), European interbank offered rates ('Euribor') and other benchmark interest and foreign exchange rates. Several of these panel banks have reached settlements with various regulatory authorities. As certain HSBC entities are members of such panels, HSBC and/or its subsidiaries have been the subject of regulatory demands for information and are cooperating with those investigations and reviews. Based on the facts currently known, there is a high degree of uncertainty as to the resolution of these regulatory investigations and reviews, including the timing. The potential impact and size of any fines or penalties that could be imposed on HSBC cannot be measured reliably.

In addition, HSBC and other panel banks have been named as defendants in private lawsuits filed in the US with respect to the setting of Libor, including putative class action lawsuits which have been consolidated before the US District Court for the Southern District of New York. The complaints in those actions assert claims against HSBC and other panel banks under various US laws including US antitrust laws, the US Commodities Exchange Act, and state law. Based on the facts currently known, it is not practicable at this time for HSBC to predict the resolution of these private lawsuits, including the timing and potential impact on HSBC.

US Tax and Broker-Dealer Investigations

HSBC continues to cooperate in ongoing investigations by the DoJ and the US Internal Revenue Service regarding whether certain Group companies and employees acted appropriately in relation to certain customers who had US tax reporting requirements. In connection with these investigations, HSBC Group companies have produced records and other documents to the DoJ and are cooperating with the investigation. In addition various Group companies are cooperating with the SEC's investigation into adherence with US broker-dealer and investment adviser rules and regulations when dealing with US resident clients.

Based on the facts currently known in respect of each of these investigations, there is a high degree of uncertainty as to the terms on which the ongoing investigations will be resolved and the timing of such resolution, including the amounts of any fines and/or penalties. As matters progress, it is possible that any fines and/or penalties could be significant.

42 Related party transactions

The ultimate parent company of the group is HSBC Holdings plc, which is incorporated in England.

Copies of the Group financial statements may be obtained from the following address:

HSBC Holdings plc
8 Canada Square
London
E14 5HQ

The group's related parties include the parent, fellow subsidiaries, associates, joint ventures, post-employment benefit plans for HSBC employees, Key Management Personnel, close family members of Key Management Personnel and entities which are controlled or jointly controlled or significantly influenced by Key Management Personnel or their close family members.

Notes on the Financial Statements (continued)

(a) Transactions with Directors and other Key Management Personnel

Key Management Personnel are defined as those persons having authority and responsibility for planning, directing and controlling the activities of HSBC Bank plc and the group and includes members of the Boards of Directors of HSBC Bank plc and HSBC Holdings plc and Group Managing Directors of HSBC Holdings plc.

Compensation of Key Management Personnel

The following represents the compensation paid to the Key Management Personnel of the bank in exchange for services rendered to the bank.

	2012	2011
	£000	£000
Short-term employee benefits	4,181	3,090
Post-employment benefits	238	203
Other long-term benefits	727	947
Share-based payments	2,993	4,222
	8,139	8,462

Shareholdings and options of Directors and other Key Management Personnel

	Balance at 31 December 2012	Balance at 31 December 2011
Number of options over HSBC Holdings plc ordinary shares held by Directors and other key management personnel under employee share plans	357,509	630,044
Number of HSBC Holdings plc shares held by Directors and other key management personnel beneficially	14,875,312	16,227,279

Transactions, arrangements and agreements including Directors and other Key Management Personnel

The table below sets out transactions which fall to be disclosed under IAS 24 'Related Party Disclosures' between the group and Key Management Personnel.

	2012		2011	
	Highest balance during the year ¹	Balance at 31 December ¹	Highest balance during the year ¹	Balance at 31 December ¹
	£000	£000	£000	£000
Key Management Personnel²				
Loans	253,742	160,439	181,846	158,196
Credit cards	762	293	881	298
Guarantees	25,770	20,031	43,920	31,036

- ¹ The disclosure of the year-end balance and the highest balance during the year is considered the most meaningful information to represent transactions during the year.
- ² Includes the Key Management Personnel of both the bank and its parent company, HSBC Holdings plc, close family members of Key Management Personnel, and entities which are controlled or jointly controlled by Key Management Personnel or their close family members.

The above transactions were made in the ordinary course of business and on substantially the same terms, including interest rates and security, as for comparable transactions with persons of a similar standing or, where applicable, with other employees. The transactions did not involve more than the normal risk of repayment or present other unfavourable features.

Transactions with Directors: Advances, Credits and Guarantees (Companies Act 2006)

In addition to the requirements of IAS 24, particulars of advances (loans and quasi-loans), credits and guarantees entered into by HSBC Bank plc and its subsidiaries with Directors of HSBC Bank plc are required to be disclosed pursuant to section 413 of the Companies Act 2006. Under the Companies Act there is no requirement to disclose transactions with the Key Management Personnel of the bank's parent company, HSBC Holdings plc.

The table below sets out transactions which fall to be disclosed under section 413 of Companies Act 2006.

Notes on the Financial Statements (continued)

The group

	Balance at 31 December 2012	Balance at 31 December 2011
	£000	£000
Directors		
Loans	4,530	8,582
Credit cards	77	91

No guarantees were issued in favour of Directors during 2012 (2011: nil).

(b) Transactions with other related parties

Associates and joint ventures

The group

	2012		2011	
	Highest balance during the year ¹	Balance at 31 December ¹	Highest balance during the year ¹	Balance at 31 December ¹
	£m	£m	£m	£m
Amounts due from joint ventures – unsubordinated	204	130	208	204
Amounts due from associates – unsubordinated	25	–	25	25
Amounts due to joint ventures	2	–	2	2
Amounts due to associates	1	–	1	1

¹ The disclosure of the year-end balance and the highest balance during the year is considered the most meaningful information to represent transactions during the year.

The bank

	2012		2011	
	Highest balance during the year ¹	Balance at 31 December ¹	Highest balance during the year ¹	Balance at 31 December ¹
	£m	£m	£m	£m
Amounts due from joint ventures – unsubordinated	204	130	208	204
Amounts due from associates – unsubordinated	25	–	25	25
Amounts due to joint ventures	1	–	–	–
Amounts due to associates	1	–	1	1

¹ The disclosure of the year-end balance and the highest balance during the year is considered the most meaningful information to represent transactions during the year.

The above outstanding balances arose from the ordinary course of business and on substantially the same terms, including interest rates and security, as for comparable transactions with third party counterparties.

Transactions of the group with HSBC Holdings plc and fellow subsidiaries of HSBC Holdings plc

Transactions detailed below include amounts due to/from HSBC Holdings plc.

	2012		2011	
	Highest balance during the year ¹	Balance at 31 December ¹	Highest balance during the year ¹	Balance at 31 December ¹
	£m	£m	£m	£m
Assets				
Trading assets	1,884	1,884	36	9
Financial assets designated at fair value	30	21	27	25
Loans and advances to customers	5,014	4,580	465	270
Financial investments	33	33	75	28
Liabilities				
Trading liabilities	16	–	16	16
Deposits by banks	1	–	236	–
Customer accounts	8,211	6,181	7,318	6,857
Subordinated amounts due	5,283	5,099	4,452	4,452
Guarantees	–	–	–	–

Notes on the Financial Statements (continued)

	2012	2011
	£m	£m
Income Statement		
Interest income	13	2
Interest expense	177	148
Fee income	1	1
Dividend income	1	2
Trading income	19	9
Other operating income	14	12
General and administrative expenses	82	81

1 The disclosure of the year-end balance and the highest balance during the year is considered the most meaningful information to represent transactions during the year.

Transactions detailed below include amounts due to/from fellow subsidiaries of HSBC Holdings plc

	2012		2011	
	Highest balance during the year ¹ £m	Balance at 31 December ¹ £m	Highest balance during the year ¹ £m	Balance at 31 December ¹ £m
Assets				
Trading assets	11,199	6,065	11,736	5,887
Derivatives	23,522	19,912	40,658	21,059
Financial assets designated at fair value	15	12	14	10
Loans and advances to banks	8,851	5,312	8,757	8,757
Loans and advances to customers	2,398	1,506	3,348	2,398
Financial investments	7,253	150	7,445	7,229
Liabilities				
Trading liabilities	16,720	12,696	20,055	11,853
Financial liabilities designated at fair value	32	–	34	32
Deposits by banks	13,429	11,997	6,384	5,445
Customer accounts	1,605	1,605	2,855	1,038
Derivatives	22,547	19,089	39,578	20,521
Subordinated amount due	2,099	2,099	1,929	1,878
Guarantees	1,134	1,033	1,171	1,131

1 The disclosure of the year-end balance and the highest balance during the year is considered the most meaningful information to represent transactions during the year.

	2012	2011
	£m	£m
Income Statement		
Interest income	128	134
Interest expense	131	111
Fee income	123	122
Fee expense	223	231
Trading income	64	60
Other operating income	93	84
General and administrative expenses	360	355

The above outstanding balances arose from the ordinary course of business and on substantially the same terms, including interest rates and security, as for comparable transactions with third party counterparties.

Notes on the Financial Statements (continued)

Transactions between HSBC Bank plc and its subsidiaries, HSBC Holdings plc and fellow subsidiaries of HSBC Holdings plc

Transactions detailed below include amounts due to/from HSBC Bank plc and its subsidiaries.

	2012		2011	
	Highest balance during the year ¹ £m	Balance at 31 December ¹ £m	Highest balance during the year ¹ £m	Balance at 31 December ¹ £m
Assets				
Trading assets	25,146	15,184	26,035	18,291
Derivatives	23,803	18,732	20,486	20,486
Financial assets designated at fair value	–	–	77	–
Loans and advances to banks	6,437	2,005	8,287	5,903
Loans and advances to customers	21,253	18,630	21,301	17,764
Financial investments	2,522	2,087	3,309	2,522
Liabilities				
Trading liabilities	20,376	12,028	16,305	14,092
Deposits by banks	11,815	11,026	12,454	11,326
Customer accounts	6,887	3,002	8,909	6,887
Derivatives	19,944	15,783	15,877	15,877
Subordinated amounts due	3,088	2,781	3,292	3,088
Guarantees	1,271	1,191	1,284	1,271

¹ The disclosure of the year-end balance and the highest balance during the year is considered the most meaningful information to represent transactions during the year.

Transactions detailed below include amounts due to/from HSBC Bank plc and HSBC Holdings plc.

	2012		2011	
	Highest balance during the year ¹ £m	Balance at 31 December ¹ £m	Highest balance during the year ¹ £m	Balance at 31 December ¹ £m
Assets				
Trading assets	1,884	1,884	36	9
Loans and advances to customers	5,013	4,579	464	269
Liabilities				
Trading liabilities	16	–	16	16
Deposits by banks	–	–	–	–
Customer accounts	7,654	6,167	7,541	6,292
Subordinated amounts due	5,011	4,835	4,452	4,452
Guarantees	–	–	–	–

¹ The disclosure of the year-end balance and the highest balance during the year is considered the most meaningful information to represent transactions during the year.

In December 2010, the bank received two guarantees from HSBC Holdings plc in respect of monies owing to the bank by its structured investment conduits ('SICs'). The first guarantee covers due but unpaid monies owed by the bank's principal SIC, Solitaire, up to a maximum amount of US\$16 billion, to the extent that unpaid liabilities exceed US\$1 billion. A second guarantee covers due but unpaid monies owed by the bank's other SICs, Mazarin, Barion and Malachite, up to a maximum amount of US\$22 billion, to the extent that unpaid liabilities exceed US\$200 million. In December 2012, the bank received a third guarantee from HSBC Holdings plc that covers due but unpaid monies owed to the bank by its multi-seller conduit, Regency, up to a maximum amount of US\$17 billion, to the extent that unpaid liabilities exceed US\$2 billion.

The bank pays no fee to its parent company for the provision of these guarantees.

Notes on the Financial Statements (continued)

Transactions detailed below include amounts due to/from HSBC Bank plc and fellow subsidiaries of HSBC

	2012		2011	
	Highest balance during the year ¹ £m	Balance at 31 December ¹ £m	Highest balance during the year ¹ £m	Balance at 31 December ¹ £m
Assets				
Trading assets.....	11,018	5,744	11,291	5,869
Derivatives.....	20,728	17,808	20,854	18,779
Loans and advances to banks.....	5,075	4,231	5,065	5,026
Loans and advances to customers.....	2,211	1,463	3,202	2,211
Liabilities				
Trading liabilities.....	16,499	12,441	19,598	11,575
Deposits by banks.....	6,537	6,537	5,274	4,135
Customer accounts.....	1,547	1,547	2,513	868
Derivatives.....	25,330	16,236	20,241	18,819
Subordinated amount due.....	292	278	291	291
Guarantees.....	988	865	988	988

1 The disclosure of the year-end balance and the highest balance during the year is considered the most meaningful information to represent transactions during the year.

The above outstanding balances arose from the ordinary course of business and on substantially the same terms, including interest rates and security, as for comparable transactions with third party counterparties.

Pension funds

At 31 December 2012, fees of £8 million (2011: £8 million) were earned by group companies for management services related to the group's pension funds held under management. The group's pension funds had placed deposits of £148 million (2011: £261 million) with its banking subsidiaries.

The above outstanding balances arose from the ordinary course of business and on substantially the same terms, including interest rates and security, as for comparable transactions with third party counterparties.

The HSBC Bank (UK) Pension Scheme (the 'Scheme') entered into swap transactions with the bank to manage the inflation and interest rate sensitivity of the liabilities. At 31 December 2012, the gross notional value of the swaps was £18,998 million (2011: £16,056 million), the swaps had a negative fair value of £3,233 million to the bank (2011: negative fair value of £3,591 million) and the bank had delivered collateral of £4,423 million (2011: £4,451 million) to the Scheme in respect of these swaps. All swaps were executed at prevailing market rates and within standard market bid/offer spreads.

In order to satisfy diversification requirements, the Trustee has requested special collateral provisions for the swap transactions between the bank and the Scheme. The collateral agreement stipulates that the Scheme never posts collateral to the bank. Collateral is posted to the Scheme by the bank at an amount that the Trustee is highly confident would be sufficient to replace the swaps in the event of default by the bank. Under the terms of the agreement, increases in collateral when required, are posted by the bank on a daily basis and any reductions of collateral are repaid to the bank on a monthly basis.

With the exception of the special collateral arrangements detailed above, all other aspects of the swap transactions between the bank and the Scheme are on substantially the same terms as comparable transactions with third party counterparties.

Sale of HSBC Private Banking Holdings (Suisse) SA

In November 2012, the group sold HSBC Private Banking Holdings (Suisse) SA, by way of an inter-group transfer to HSBC Holdings plc for non-cash consideration of £6,535 million. The sale was completed on 16 November 2012. The ownership of HSBC Private Bank (UK) Limited remains with HSBC Bank plc.

43 Events after the balance sheet date

A third interim dividend for 2012 of £1,400 million to shareholders of the parent company was declared by the Directors after 31 December 2012.

HSBC Bank plc

Incorporated in England with limited liability. Registered in England: number 14259

REGISTERED OFFICE

8 Canada Square, London E14 5HQ, United Kingdom

Web: www.hsbc.co.uk

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