HSBC Bank plc
Annual Report and Accounts 2011

HSBC

Annual Reports and Accounts 2011

Contents

Financial Highlights of the group ... 1

Products and Services ... 2

Report of the Directors ... 4

Business Review

Principal activities ... 4
Business segments ... 4
Strategic direction ... 5
Key performance indicators ... 6
Economy ... 8
Reconciliation of reported and underlying profit ... 8
Financial summary
Income statement ... 10
Review of business performance ... 10
Balance sheet ... 14
Performance and business review ... 16
Other information ... 24

Risk

Risk management ... 27
Challenges and uncertainties ... 27
Regulation and supervision ... 30
Outlook ... 32
Credit risk ... 32
Liquidity and funding risk ... 57
Market risk ... 60
Operational risk ... 65
Risk management of insurance operations ... 66
Other material risks ... 73

Capital management and allocation ... 75

Governance

Directors ... 79
Board of Directors and Board Committees ... 80
Internal control ... 80
Corporate sustainability ... 84

Statement of Directors' Responsibilities ... 87

Independent Auditor's Report ... 88

Financial Statements ... 89

Notes on the Financial Statements ... 99

Presentation of Information

This document comprises the *Annual Report and Accounts 2011* 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.

With effect from 1 March 2011, the Asset Management business was moved from Global Banking and Markets to Personal Financial Services which has been renamed 'Retail Banking and Wealth Management' within the UK Retail and Continental Europe Retail business segments. All periods have been adjusted accordingly.

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

	2011	2010	2009
For the year (£m)			
Profit on ordinary activities before tax	**3,111**	4,011	4,014
Total operating income	**16,205**	18,099	19,102
Net operating income before loan impairment charges and other credit risk provisions	**14,023**	15,076	15,562
Profit attributable to shareholders of the parent company	**2,329**	2,959	3,092
At year-end (£m)			
Total equity attributable to shareholders of the parent company	**31,090**	31,825	27,787
Risk weighted assets	**227,679**	201,720	203,281
Loans and advances to customers (net of impairment allowances)	**288,014**	285,218	274,659
Customer accounts	**346,129**	344,123	332,896
Capital ratios[1] (%)			
Core Tier 1 ratio	**9.1**	10.5	10.2
Tier 1 ratio	**10.0**	11.4	11.2
Total capital ratio	**14.4**	16.1	15.7
Performance ratios (%)			
Return on average invested capital (on underlying basis)[2]	**4.7**	8.7	9.2
Return on average shareholders' funds (equity) of the parent company[3]	**7.4**	9.9	13.2
Post-tax return on average total assets	**0.2**	0.3	0.4
Pre-tax return on average risk-weighted assets	**1.5**	2.0	1.8
Credit coverage ratios (%)			
Loan impairment charges as a percentage of total operating income	**7.5**	9.0	13.7
Loan impairment charges as a percentage of average gross customer advances	**0.4**	0.7	1.1
Efficiency and revenue mix ratios (%)			
Cost efficiency ratio[4]	**66.2**	60.5	52.7
As a percentage of total operating income:			
- net interest income	**44.6**	42.5	42.4
- net fee income	**24.1**	22.3	21.3
- net trading income	**9.5**	11.7	13.7
Financial ratios (%)			
Ratio of customer advances to customer accounts	**83.2**	82.9	82.5
Average total shareholders' equity to average total assets	**3.3**	3.4	2.7

1 *The group's capital ratios have been impacted by the implementation of CRDIII requirements (commonly known as Basel 2.5) which took effect as of 31 December 2011 and resulted in an increase in the group's credit and counterparty risk risk-weighted assets ('RWAs') by £5 billion and market risk RWAs, primarily due to the introduction of Stressed VAR, by £16 billion.*

2 *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 36 '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.*

3 *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.*

4 *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 offers products and services to customers based on their individual needs. Premier and Advance branded services are targeted at mass affluent and emerging affluent customers who value international connectivity and benefit from HSBC's global reach and scale. For customers who have simpler everyday banking needs, the group offers a full range of banking products and services reflecting local requirements.

In addition, we are one of the largest card issuers in the world, offering HSBC branded cards, co-branded cards with selected partners and private label (store) cards.

Typically, customer offerings include personal banking products (current and savings accounts, mortgages and personal loans, credit cards, debit cards and local and international payment services) and wealth management services (insurance and investment products and financial planning services).

- HSBC Premier provides preferential banking services and global recognition to high net worth 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 with free money transfers between them.
- HSBC Advance provides a range of preferential products and services customised to meet local needs. With a dedicated telephone service, access to wealth advice and online tools to support financial planning, it gives customers an online 'global view' of their Advance accounts with money transfers between them.
- 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 best-in-class investment and wealth insurance products manufactured by in-house partners (Global Asset Management, Global Markets and HSBC Insurance) and by selected third party providers.
- Global Asset Management offers investment solutions to institutions, financial intermediaries and individual investors globally.

Customers can interact with the bank via a range of channels such as internet banking and self-service terminals in addition to traditional and automated branches and telephone service centres.

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. This enables the development of tailored customer propositions while adopting a broader view of the entire commercial banking sector, from sole traders to large corporations. 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, who are typically the key to innovation and growth in market economies.

The group places particular emphasis on geographical collaboration 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, enhancing collaboration with Global Banking and Markets and driving efficiency gains through adopting a global operating model.

- International trade: the group provides various international trade products and services, to both buyers and suppliers such as documentary credits, import and export finance, guarantees, documentary collections and forfeiting to facilitate trade payments, finance the trade cycle and help mitigate risk throughout the supply chain.
- Receivables Finance: the group offers a market-leading Receivables Financing proposition for domestic and international customers through an extensive network.
- Payments and cash management: HSBC is a leading provider of domestic and cross-border payments and 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 today as well as in the future.
- Global Markets: Commercial Banking customers represent a key base for Global Markets products and services, particularly cash and derivatives in foreign exchange and rates, and debt capital markets.
- Capital markets & advisory: capital raising on debt and equity markets and advisory services are available.
- Commercial cards: card issuing helps customers enhance cash management, credit control and purchasing. Card acquiring services enable merchants to accept credit and debit card payments in person or remotely.
- Insurance: Commercial Banking offers business protection, financial protection, trade insurance, employee benefits, corporate wealth management and a variety of other commercial risk insurance products.
- Direct channels: these include online, and direct banking offerings such as telephone banking, automated teller machines, HSBCnet, Business Internet Banking and smart phone applications (iApp).

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 the group's footprint and facilitates seamless delivery of its products and services to clients.

- 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

HSBC Private Bank is the principal marketing name of the group's international private banking business. Utilising the most suitable products from the marketplace, Private Banking works with high net-worth clients to offer both traditional and innovative ways to manage and preserve wealth while optimising returns.

Private Banking accesses expertise in six major advisory centres in Hong Kong, Singapore, Geneva, New York, Paris and London to identify opportunities which meet clients' needs and investment strategies.

- Private Banking services comprise multi-currency deposit accounts and fiduciary deposits, credit and specialist lending, treasury trading services, cash management, securities custody and clearing. HSBC Private Bank works to ensure that its clients have full access to other products and services available in the group such as credit cards, internet banking, corporate banking and investment banking.
- Investment Management comprises both advisory and discretionary investment services. A wide range of investment vehicles is covered, including bonds, equities, derivatives, options, futures, structured products, mutual funds and alternatives (hedge funds, private equity and real estate).
- Trust Solutions comprises inheritance planning, trustee and other fiduciary services designed to protect wealth and preserve it for future generations through structures tailored to meet the individual needs of each family. Areas of expertise include trusts, foundation and company administration, charitable trusts and foundations, insurance, family office advisory and philanthropy.
- Corporate Finance Solutions helps provide clients with cross border solutions for their companies, working in conjunction with Global Banking and Markets.

Report of the Directors: Business Review

Introduction

In 2011, eurozone debt concerns continued to dominate European market sentiment and there remained a challenging operating environment in most European countries. HSBC's financial strength, premium customer base and ability to leverage its brand and global network ensured that the group remained strong and profitable. However, a resilient performance in most business segments, together with a gain in own credit spreads on long-term debt, was more than offset by lower revenues in Global Banking and Markets.

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

Results for 2011

The consolidated profit for the year attributable to the shareholders of the bank was £2,329 million.

Interim dividends of £915 million (in lieu of a final dividend in respect of the previous financial year) and £800 million were paid on the ordinary share capital during the year.

A second interim dividend of £200 million in respect of 2011 was declared after 31 December 2011, payable on 28 February 2012.

Further information about the results is given in the consolidated income statement on page 89.

Principal activities

The group offers 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 Private Banking.

As at 31 December 2011, the bank had 1,249 branches in the United Kingdom and 14 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, Slovakia, South Africa, Spain and Switzerland.

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

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.

UK Retail Banking

Within the UK, the retail banking segment comprises two Global Businesses: Retail Banking and Wealth Management and Commercial Banking. UK Retail Banking and Wealth Management provides current accounts, savings, personal loans, mortgages, cards, financial planning, as well as life and general insurance to UK personal customers through a variety of distribution channels under various brands, including HSBC, first direct, Marks & Spencer Money and partnership card™. UK Commercial Banking provides a wide range of products and services to commercial organisations, from sole proprietors to quoted companies. These include current and savings accounts, payments, electronic banking, trade finance, loans, overdrafts, asset finance, foreign exchange and other treasury and capital markets instruments, wealth management services and general insurance.

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 in Europe. The principal Continental European Retail Banking operations are in France, Turkey, Malta and Germany.

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.

Private Banking

Private Banking mainly reflects the operations of HSBC Private Banking Holdings (Suisse) S.A. and its subsidiaries. Private Banking helps high net worth individuals and families meet their complex international financial needs by offering product and service leadership in areas such as credit, alternative investments, estate planning and investment advice.

Other

Activities or transactions which do not relate directly to the business segments are reported in Other. Other includes the result of certain property activities, unallocated investment activities, movements in the fair value of own debt and financing operations.

Report of the Directors: Business Review (continued)

Strategic direction

HSBC is one of the few truly international banks and its advantages lie in its network of markets relevant for international financial flows, access and exposure to high growth markets and businesses, and its strong balance sheet generating a resilient stream of earnings.

Based on its competitive position, the Group strategy has two parts:

Network of businesses connecting the world – HSBC is ideally positioned to capture the growing international financial flows. The Group franchise puts HSBC in a privileged position to serve corporate clients as they grow from small enterprises into large and international corporates, and personal clients as they become more affluent. Access to local retail funding and the Groups international product capabilities allows HSBC to offer distinctive solutions to these clients in a profitable manner.

Wealth management and retail with local scale – HSBC will leverage its position in faster-growing markets to capture social mobility and wealth creation through its Wealth Management and Private Banking businesses. The Group will only invest in retail businesses in markets where it can achieve profitable scale.

In Europe the group intends 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 its strategy for each of the four Global Businesses while focusing on increasing capital and cost efficiency.

Retail Banking and Wealth Management's strategy will focus on selected markets where the group has scale and growth opportunities. Selected investment will be focused in the markets in which the group has scale, notably the UK, France, Turkey and Malta and in growing the group's wealth management franchise. At the same time the group will look to rationalise its portfolio and exit underperforming businesses.

The strategy in 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 and strengthening connectivity by selectively extending the European footprint. The continuing investment in product platforms, such as payments and cash management, trade and receivables will enhance the group's product offerings.

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, will provide seamless global liquidity solutions across Europe. The group will continue to increase cross-border collaboration and integration with other Global Businesses.

Global Private Banking will look to optimise market coverage and create synergies across Europe for domestic and faster growing markets clients.

In improving the deployment of its capital the group has introduced a strategic and financial framework assessing each of its businesses on a set of five strategic evaluation criteria, namely international connectivity, economic development, profitability, cost efficiency and liquidity. The results of this review determine whether the group invests in, turns around, continues with or exits businesses. In addition, the group is focusing on improving cost efficiency through implementation of consistent business models, reengineering 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.

Group values

HSBC is putting a new emphasis on values, so that employees are empowered to do the right thing and to act with courageous integrity. Over the past year, the values have been made explicit to ensure the expectations of society, customers, regulators and investors are met.

Those values are that employees of the group are: dependable, open to different ideas and cultures and connected to customers, communities, regulators and each other. By setting the highest standards of behaviour, the aim is that all employees and customers can be proud of the business.

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. Delivery of this strategy will be achieved through:

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

The UK Commercial Banking strategy is to be the leading international trade and business bank, using HSBC's extensive geographical network together with product expertise in payments, trade receivables finance

Report of the Directors: Business Review (continued)

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. During 2012, the group intends to optimise further its distribution platform and develop its wealth management capabilities to widen product offerings and increase net new money in deposits and long–term investments.

In Commercial Banking, the strategy is to strengthen HSBC's position as 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 now well established 'emerging markets-led and financing-focused' strategy, encompassing its objective to be a leading wholesale bank by:

- utilising the Group's extensive distribution network;
- developing Global Banking and Markets' hub-and-spoke business model; and
- continuing to build capabilities in major hubs to support the delivery of an advanced suite of services to corporate, institutional and government clients across the HSBC network.

The combination of product depth and distribution strength to meet the needs of both existing and new clients is expected to allow Global Banking and Markets to achieve its strategic goals.

Private Banking

Private Banking strives to be the world's leading international private bank, recognised for excellent client experience and global connections.

HSBC's brand, capital strength, extensive global network and positioning provides a foundation from which Private Banking continues to attract and retain clients. Product and service leadership in areas such as alternative investments, foreign exchange, estate planning, credit and investment advice helps meet the complex international financial needs of high net worth individuals and families.

Through continuing investment in people, integrated IT solutions, and focusing on domestic operations in emerging markets, HSBC believes Private Banking is positioned for sustainable long-term growth.

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 using both financial and non-financial measures.

Following a review of the group's high-level key performance indicators ('KPI's) and reflecting the increased focus on the quality of the capital base, it was decided to adopt a core tier 1 capital ratio instead of a tier 1 capital ratio as the primary indicator of the strength of the group's capital base and its ability to support the growth of the business and meet regulatory requirements.

Management remains focused on improving the group's capital deployment to support the achievement of its return targets. In order to support this aim, the Group has developed and applied a five filter analysis across its portfolio of businesses. This looks at the strategic relevance of each country, and each business in each country, in terms of connectivity and economic development, and its current returns, in terms of profitability, cost efficiency and liquidity. In 2011, the group announced a number of closures and disposals as a result of using the five filter analysis and will continue to evaluate businesses during 2012 using this methodology.

Financial KPIs

	2011	2010	2009
	%	%	%
Risk adjusted revenue growth	**(5.5)**	7.6	(2.3)
Cost efficiency	**66.2**	60.5	52.7
Pre-tax return on average risk-weighted assets	**1.5**	2.0	1.8
Core tier 1 capital	**9.1**	10.5	10.2
Advances to core funding ratio	**91.2**	95.7	96.5

Report of the Directors: Business Review (continued)

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 lower revenues in Global Banking and Markets as turmoil in eurozone sovereign debt markets escalated, particularly in the second half of 2011.

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 in part due to lower revenues in Global Banking and Markets and higher costs, most notably from customer redress programmes, restructuring costs and an increase in staff costs reflecting higher average FTEs and wage inflation in key markets.

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 of 1.5 per cent 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 decrease in core tier 1 capital to 9.1 per cent reflected an increase in risk-weighted assets due primarily to the impact of the introduction of the Basel 2.5 requirements.

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 strong funding position has allowed the group to take advantage of loan growth opportunities during the year.

Non-financial KPIs

In addition to the use of financial KPIs, the group employs three non-financial measures to assess performance against its strategic objectives.

Employee engagement

Employee engagement is a measure of employees' emotional and intellectual commitment to an organisation. At HSBC, engagement is measured through a Global People Survey ('GPS') which is carried out annually in July. In 2011, nearly 57,000 colleagues from HSBC's UK and European businesses shared their views on what works well and what needs to change to create a working environment where people can perform at their best. Compared with 2010, employee engagement rose by 3 per cent to 67 per cent for 2011.

Management have discussed the results of the GPS with their respective teams and formulated action plans to address key focus areas. Actions will centre upon team effectiveness, creating a value-led environment and enhancing career development.

Brand perception

HSBC's brand is one of the most recognised and respected in the world. It reflects the trust HSBC's customers place in the bank and represents the values that guide its business. The stronger, more trusted and recognised the brand is, the more likely HSBC is to attract business and to retain existing customers.

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

The brand health index in both Retail Banking and Wealth Management and Commercial Banking were the most favourable in the market amongst their key competitors.

Customer recommendation

In addition to tracking the strength of its brand, HSBC closely tracks through independent market research, how satisfied customers are and how likely they are to recommend the bank to others.

The resulting scores are benchmarked against competitors. The bank does this by aggregating data from accredited independent organisations.

The brand remains the clear leader for customer satisfaction amongst Premier or equivalent customers in the UK. In Commercial Banking, HSBC's competitive position on recommendation improved in the second half of the year to a position above the market average.

Awards

HSBC was recognised in several industry awards throughout 2011. A small selection of those follows:

- 'Best High Street Mortgage Provider' and 'First Time Mortgage Buyers' Choice' - Moneyfacts (HSBC)
- 'Most Trusted Financial Provider' - Moneywise (first direct)
- 'Best Current Account' – Moneynet Personal Finance (first direct)
- 'Best Student Account Provider' – the Sunday Times (HSBC)
- 'Best Business Bank for Service' and 'Best Online Banking Provider' - Moneyfacts
- 'Best Bank for FX for corporate clients' – FX Week Best Banks Awards

Report of the Directors: Business Review (continued)

- 'Best Debt House in Western Europe' – (Euromoney Awards for Excellence 2011)

Economy

After growing by 2.1 per cent in 2010, UK Gross Domestic Product ('GDP') growth eased to 0.9 per cent in 2011. The unemployment rate rose to 8.4 per cent in December 2011. Despite the weakness in the domestic economy, an increase in the rate of value added tax and rising oil prices early in the year pushed the annual rate of Consumer Price Index ('CPI') inflation to 5.2 per cent in September 2011 before moderating to 3.6 per cent in December 2011. The Bank of England maintained the base rate at 0.5 per cent throughout the year and expanded the size of its Asset Purchase Programme by £75 billion to £275 billion in October 2011.

The eurozone economy grew by 1.5 per cent in 2011, on the back of a recovery in global trade in the first half of 2011 and domestic fixed investment growth. Within the region, Germany saw the strongest recovery with GDP growing by 3 per cent. The German unemployment rate, as measured by the International Labour Organisation, fell during the year, touching 5.5 per cent in December, but for the eurozone as a whole joblessness rose further to 10.4 per cent in December. Concerns about sovereign debt sustainability persisted in 2011, leading to banking sector strains. The European Central Bank cut interest rates to 1 per cent and introduced several new measures to ease strains in the banking sector including long-term refinancing operations of 36 months maturity and easing of commercial banks' collateral requirements for use in these liquidity operations.

Reconciliation of reported and underlying profit before tax

The group measures its performance internally on a like-for-like basis by eliminating acquisitions, disposals of subsidiaries and businesses, and fair value movements on own debt designated at fair value attributable to credit spread where the net result of such movements will be zero upon maturity of the debt, all of which distort period-on-period comparisons. The group refers to this as its underlying performance. Reported results include the effects of the above items. They are excluded when monitoring progress against operating plans and past results because management believes that the underlying basis more accurately reflects operating performance.

Underlying performance

The tables below compare the group's underlying performance in 2011, 2010 and 2009 with reported profits in those years.

The following items comprise the underlying adjustments:

- the change in own credit spread on long-term debt which resulted in a gain of £832 million in 2011; a loss of £122 million in 2010 and a loss of £439 million in 2009 in *Net income/(expense) from financial instruments designated at fair value*;
- the operating results of HSBC International Trustee Limited since its acquisition in July 2011;
- the operating results for 2010 and the £114 million impact of the disposal of Eversholt Rail Group in December 2010 (footnote 2);
- the operating results to date of disposal of HSBC Insurance Brokers Limited in April 2010 and the gain on disposal of £83 million;
- the £180 million gain on the disposal of the residual 49 per cent stake in a UK merchant acquiring business in June 2009.

Report of the Directors: Business Review (continued)

Reconciliation of reported and underlying profit before tax

	2011 compared with 2010							
	2011 reported £m	2011 adjust-ments	**2011 under-lying £m**	2010 reported £m	2010 adjust-ments	2010 under-lying £m	Reported change %	Under-lying change %
Net interest income	**7,223**	(3)	**7,220**	7,694	23	7,717	(6%)	(6%)
Net fee income	**3,900**	(29)	**3,871**	4,040	(31)	4,009	(3%)	(3%)
Trading income	**1,536**	–	**1,536**	2,117	151	2,268	(27%)	(32%)
Net income from financial instruments designated at fair value[1]	**433**	(832)	**(399)**	276	122	398	57%	(200%)
Gains less losses from financial investments	**292**	–	**292**	537	–	537	(46%)	(46%)
Net earned insurance premiums	**2,580**	–	**2,580**	2,635	(4)	2,631	(2%)	(2%)
Other operating income	**241**	(7)	**234**	800	(475)	325	(70%)	(28%)
Total operating income	**16,205**	(871)	**15,334**	18,099	(214)	17,885	(10%)	(14%)
Net insurance claims incurred and movement in liabilities to policyholders	**(2,182)**	(26)	**(2,208)**	(3,023)	4	(3,019)	28%	27%
Net operating income before impairments and provisions	**14,023**	(897)	**13,126**	15,076	(210)	14,866	(7%)	(12%)
Loan impairment charges and other credit risk provisions	**(1,623)**	–	**(1,623)**	(1,951)	–	(1,951)	17%	17%
Net operating income	**12,400**	(897)	**11,503**	13,125	(210)	12,915	(6%)	(11%)
Total operating expenses	**(9,288)**	22	**(9,266)**	(9,119)	156	(8,963)	(2%)	(3%)
Operating profit	**3,112**	(875)	**2,237**	4,006	(54)	3,952	(22%)	(43%)
Share of profit in associates and joint ventures	**(1)**	–	**(1)**	5	–	5	–	–
Profit before tax	**3,111**	(875)	**2,236**	4,011	(54)	3,957	(22%)	(43%)

	2010 compared with 2009							
	2010 reported £m	2010 adjust-ments	2010 under-lying £m	2009 reported £m	2009 adjust-ments	2009 under-lying £m	Reported change %	Under-lying change %
Net interest income	7,694	–	7,694	8,091	(1)	8,090	(5%)	(5%)
Net fee income	4,040	(31)	4,009	4,077	(185)	3,892	(1%)	3%
Trading income	2,117	–	2,117	2,626	–	2,626	(19%)	(19%)
Net income / (expense) from financial instruments designated at fair value[1]	276	122	398	543	439	982	(49%)	(59%)
Gains less losses from financial investments	537	–	537	(73)	–	(73)	836%	836%
Net earned insurance premiums	2,635	–	2,635	2,716	–	2,716	(3%)	(3%)
Other operating income	800	(246)	554	1,122	(182)	940	(29%)	(41%)
Total operating income	18,099	(155)	17,944	19,102	71	19,173	(5%)	(6%)
Net insurance claims incurred and movement in liabilities to policyholders	(3,023)	–	(3,023)	(3,540)	–	(3,540)	15%	15%
Net operating income before impairments and provisions	15,076	(155)	14,921	15,562	71	15,633	(3%)	(5%)
Loan impairment charges and other credit risk provisions	(1,951)	–	(1,951)	(3,364)	–	(3,364)	42%	42%
Net operating income	13,125	(155)	12,970	12,198	71	12,269	8%	6%
Total operating expenses	(9,119)	52	(9,067)	(8,198)	176	(8,022)	(11%)	(13%)
Operating profit	4,006	(103)	3,903	4,000	247	4,247	–	(8%)
Share of profit in associates and joint ventures	5	–	5	14	(1)	13	(64%)	(61%)
Profit before tax	**4,011**	**(103)**	**3,908**	**4,014**	**246**	**4,260**	–	**(8%)**

1 *Changes in fair value due to movements in own credit spread on long-term debt issued. This does not include the fair value changes due to own credit spread on structured notes issues and other hybrid instruments included within trading liabilities.*
2 *In the 2010 compared with 2009 table, underlying results include the trading results of Eversholt Rail Group in both years. These are excluded from the 2010 underlying position in the 2011 compared with 2010 table.*

Report of the Directors: Business Review

Financial summary

Summary consolidated income statement

	2011 £m	2010 £m	2009 £m
Net interest income	**7,223**	7,694	8,091
Net fee income	**3,900**	4,040	4,077
Trading income	**1,536**	2,117	2,626
Net income / (expense) from financial instruments designated at fair value	**433**	276	543
Gains less losses from financial investments	**292**	537	(73)
Net earned insurance premiums	**2,580**	2,635	2,716
Other operating income	**241**	800	1,122
Total operating income	**16,205**	18,099	19,102
Net insurance claims incurred and movement in liabilities to policyholders	**(2,182)**	(3,023)	(3,540)
Net operating income before impairments and provisions	**14,023**	15,076	15,562
Loan impairment charges and other credit risk provisions	**(1,623)**	(1,951)	(3,364)
Net operating income	**12,400**	13,125	12,198
Total operating expenses	**(9,288)**	(9,119)	(8,198)
Operating profit	**3,112**	4,006	4,000
Share of profit in associates and joint ventures	**(1)**	5	14
Profit before tax	**3,111**	4,011	4,014
Tax expense	**(734)**	(996)	(856)
Profit for the year	**2,377**	3,015	3,158
Profit attributable to shareholders of the parent company	**2,329**	2,959	3,092
Profit attributable to non-controlling interests	**48**	56	66

Review of business performance

2011 compared with 2010

HSBC Bank plc and its subsidiary undertakings reported profit before tax of £3,111 million, 22 per cent lower than 2010. Underlying profit before tax decreased by 43 per cent as eurozone debt concerns continued to dominate European market sentiment resulting in markedly lower revenues in Global Banking and Markets.

During the year, the group started to reshape its business portfolio, announcing the closure of the retail banking businesses in Poland and Russia, the exit of operations from Georgia, and the disposal of the UK motor insurance business. In order to improve cost efficiency, measures were also taken to streamline processes while maintaining high standards of service. As a result of both of these initiatives, total restructuring costs of £237 million were incurred across the region in 2011.

Retail Banking in both the UK and Continental Europe recorded resilient financial performances in challenging economic conditions. In Continental Europe there was strong demand in term lending and growth in the deposit base, whilst in the UK, the bank increased its share of new mortgage lending to 10 per cent with an average loan to value ratio of 53 per cent.

Commercial Banking made progress in its strategy of becoming the leading international trade and business bank, delivering enhanced Trade and Receivables Finance and Payments and Cash Management product offerings in Continental Europe. In the UK, term lending grew despite an overall market contraction, and the bank exceeded its 2011 lending intentions under the Project Merlin agreement both in terms of total and SME facilities.

Global Banking and Markets continued to focus on cross-border initiatives to position the business to leverage trade flows, and also invested in technology platforms, including Equities and Prime Services, to capture medium-term opportunities in the region. In Payments and Cash Management, enhanced network capabilities together with innovative liquidity, channel and payables solutions allowed the group to win substantial business across the corporate and financial institution business segments.

In Private Banking, revenue growth was driven by increased net new money and client activity, although this was offset by a rise in impairment charges and higher costs primarily due to the strengthening of the Swiss franc against sterling.

The following items are significant in a comparison of 2011's underlying results to 2010:

- provisions of £507 million in 2011, for customer redress programmes including the estimated redress for the possible mis-selling of PPI policies in previous years and redress in relation to advice given to some customers of NHFA;
- 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 May 2011;

- operating expenses of £237 million in 2011 in relation to restructuring;
- the sale and leaseback of the Paris headquarters building in February 2010 resulted in a gain of £125 million being reported as an increase in *Other operating income* in 2010; and
- one-off payroll and bonus taxes amounting to £218 million in respect of certain 2009 bonuses was recognised and paid in 2010 reported as an increase in *Total operating expenses;*

The commentary that follows is on an underlying basis.

Net interest income decreased by £497 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 coupled with 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 £138 million or 3 per cent as income from management services generated from investment conduits was lower, together with higher intercompany fees payable on intragroup 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 £732 million or 32 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 let 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 decreased by £797 million, primarily due to 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'.

These losses were partly offset by lower adverse foreign exchange movements on foreign currency debt designated at fair value, issued as part of our overall funding strategy, with an offset reported in *Trading income.*

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 £51 million or 2 per cent driven by the non-renewal and transfer to third parties of certain contracts in our Irish 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 DPF in France and unit-linked products in the UK.

Other operating income decreased by £91 million driven by the non-recurrence of the £125 million gain on the sale and leaseback of our Paris headquarters 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 £811 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 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 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 £303 million or 3 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 percent (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.

2010 compared with 2009

HSBC Bank plc and its subsidiary undertakings reported profit before tax of £4,011 million, in line with the £4,014 million in 2009, but 8 per cent lower on an underlying basis. The differences between reported and underlying results are explained on page 10. The fall in underlying profits was largely due to lower levels of Global Banking and Markets income, where the exceptional results of 2009 were not repeated.

Global Banking and Markets results remained strong by historical standards. However Global Banking and Markets income decreased in 2010 due to the more difficult market conditions and a reduced contribution from Balance Sheet Management. In Private Banking, reported profit before tax decreased as the impact on revenues persisted in the low interest rate environment and higher costs from increased investment in systems and compliance costs.

Retail Banking in both the UK and Continental Europe recorded a resilient financial performance in a challenging economic environment. In Retail Banking and Wealth Management, sustainable long term relationships continued to be built with the Premier and Advance customer segments, focusing on wealth management and secured lending. During 2010, the group increased its market share of UK mortgage lending while maintaining a conservative loan to value ratio. In Commercial Banking, progress continued to be made on the group's strategy of becoming the leading international business bank and the group actively supported corporates and SMEs in response to changing economic circumstances.

The following items are significant in a comparison of 2010's underlying results to 2009:

- the sale and leaseback of the Paris headquarters building in February 2010 resulted in a gain of £125 million being reported as an increase in *Other operating income* in 2010;
- one-off payroll and bonus taxes amounting to £218 million in respect of certain 2009 bonuses was recognised and paid in 2010 reported as an increase in *Total operating expenses;*
- a loss of £179 million, booked across various lines, for HSBC Insurance (UK) Limited in 2009 (as the UK motor insurance underwriter was significantly affected by adverse claims experience during the year) compared with £7 million profit in 2010. The motor insurance underwriting business was placed into run-off during 2009 with no new customer business written in 2010;
- a gain of £322 million related to a change in the delivery of certain staff benefits in the main UK

pension scheme reported as a reduction in *Total operating expenses in 2009*; and

- a gain of £353 million on the sale of the Group's London headquarters building reported as an increase in *Other operating income* in 2009.

The commentary that follows is on an underlying basis.

Net interest income decreased by £396 million or 5 per cent. Net interest income in Balance Sheet Management decreased, as expected, from the strong levels in 2009 as higher yielding positions taken in prior years matured and opportunities for reinvestment at equivalent yields were limited by prevailing low interest rates and flatter yield curves. The fall in income from interest-earning assets was driven by the group repositioning its lending portfolios towards lower yielding but higher quality secured assets. In Private Banking, the continuing low interest rate environment impacted customer deposit margins resulting in lower net interest income. These reductions were offset, in part, by a £6 billion increase in average mortgage balances in the UK and improved asset margins.

Net fee income increased by £117 million or 3 per cent. Higher fee income from sales of investment products was driven by a stronger investment performance in funds and improved customer sentiment. There was also an increase in fee income from credit facilities in line with higher customer volumes. Fees were also received for management services provided by the bank to structured investment conduits. Partially offsetting these increases were reductions in the level of fees from equity capital markets due to reduced client activity.

Trading income decreased by £509 million or 19 per cent. Credit and Rates revenues were adversely affected by the unfavourable market conditions caused by the impact of the European sovereign debt crisis. Foreign exchange reported lower revenues reflecting spread compression resulting from increased competition. This was partly offset by lower net fair value losses on structured liabilities and a net release of previous write-downs on legacy positions as asset prices improved.

In addition, *Trading income* included foreign exchange gains on trading assets held as economic hedges of foreign currency debt designated at fair value, compared to losses reported in 2009. An offsetting amount is reported *in Other income.*

Net income from financial instruments designated at fair value decreased by £584 million. The growth in equity markets in 2010 was lower than 2009 resulting in lower investment gains recognised on the fair value of assets held to meet liabilities under insurance and investment contracts. To the extent that these gains 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*. In addition, foreign exchange losses were reported in the year on foreign currency debt designated at fair value, issued as part of our overall funding strategy with an offset from trading assets held as economic hedges reported in *Trading income*.

Gains less losses from financial investments were £537 million, compared to a £73 million loss recognised in 2009. This reflected gains on sale of private equity investments as market conditions improved and higher net gains in Balance Sheet Management on disposal of available-for-sale debt securities. There was also a reduction in the level of write-downs required on equity investments.

Net earned insurance premiums decreased by £81 million following the decision in 2009 to place the UK motor insurance business into run-off; no new premiums were written in 2010 in this business. The decision taken during 2010 not to renew certain contracts in the Irish business resulted in a further decrease in premiums. This was partly offset by strong sales activity in the UK Life and French insurance businesses.

Other operating income decreased by £386 million or 41 per cent, as the non-recurrence of the gain on the sale and leaseback of the Group's London headquarters building in 2009 was only partly offset by the £125 million gain recorded on the sale and leaseback of the Paris headquarters in 2010.

Net insurance claims incurred and movement in liabilities to policyholders decreased by £517 million in 2010. This was in line with the movement in liabilities to insurance and investment with DPF policyholders reported above in *Net income from financial instruments designated at fair value*. In addition, the non-recurrence of the strengthening of reserves in 2009, on the now-closed UK motor insurance book and the decision not to renew certain contracts in the Irish business also resulted in lower claims.

Loan impairment charges and other credit risk provisions decreased by £1,413 million or 42 per cent reflecting the more stable credit environment and the risk mitigation actions taken by management. In Global Banking and Markets, loan restructuring activity and the non-recurrence of specific charges taken in relation to a small number of customers in 2009 contributed to a decline in loan impairment charges. Credit risk provisions on certain available-for-sale asset backed securities also decreased due to a slowing in the rate of anticipated losses on the underlying collateral pools.

The loan impairment charges in both UK and Continental Europe Retail Banking were significantly

lower than in 2009. In Retail Banking and Wealth Management, lower loan impairment charges were driven by improved delinquencies across both the secured and unsecured lending portfolios due to enhanced credit risk management practices and improved collections. In UK Commercial Banking, loan impairments were lower, with the improvement spread across most industry sectors. Reductions were also seen across the Commercial Banking business in Continental Europe.

Total operating expenses increased by £1,045 million or 13 per cent. Included in 2010 was a one-off payroll and bonus tax levied on certain 2009 bonuses in the UK and France amounting to £218 million, primarily in Global Banking and Markets. Operating expenses in 2009 included an accounting gain of £322 million relating to a change in the basis of delivering of certain staff benefits in the main UK pension scheme. Excluding these items, operating expenses were £505 million higher than the prior year. This was mainly driven by continued strategic investments in Global Banking and Markets capabilities and operational infrastructure to drive future growth. In addition, there were also increases in rental expenses, following the sale and leaseback of the London and Paris headquarters, and litigation provisions.

The effective tax rate was 24.8 per cent (2009: 21.3 per cent). This is lower than the UK statutory tax rate of 28 per cent (2009: 28 per cent). The major items of note are the benefit of tax free capital gains and profits earned in lower tax jurisdictions, partially offset by the non-deductibility of the one-off bonus tax paid in the UK.

Summary consolidated balance sheet

	2011 £m	2010 £m	2009 £m
Total assets	**827,970**	798,494	751,928
Cash and balances at central banks	**56,460**	24,495	14,274
Trading assets	**126,598**	159,552	165,008
Financial assets designated at fair value	**15,332**	15,467	16,435
Derivative assets	**176,993**	129,158	118,516
Loans and advances to banks	**44,603**	57,027	46,994
Loans and advances to customers	**288,014**	285,218	274,659
Financial investments	**93,112**	102,086	86,695
Other	**26,858**	25,491	29,347
Total liabilities	**796,366**	766,137	723,500
Deposits by banks	**41,032**	48,287	57,729
Customer accounts	**346,129**	344,123	332,896
Trading liabilities	**119,211**	132,360	118,881
Financial liabilities designated at fair value	**31,992**	27,935	18,164
Derivative liabilities	**178,121**	129,204	118,689
Debt securities in issue	**42,688**	48,119	39,340
Liabilities under insurance contracts issued	**16,347**	17,116	16,505
Other	**20,846**	18,993	21,296
Total equity	**31,604**	32,357	28,428
Total shareholders' equity	**31,090**	31,825	27,787
Non-controlling interests	**514**	532	641

Movements in 2011

Total reported assets were £828 billion, 4 per cent higher than at 31 December 2010.

Strong growth in deposits enabled the group to continue to support its customers' borrowing requirements, leading to higher term lending and mortgage balances in the UK. In addition, the fair value of derivative contracts increased markedly, as the result of an increase in the fair value of interest rate contracts and an increase in balances with other HSBC companies.

The group maintained a strong and liquid balance sheet with the ratio of customer advances to customer accounts at 83.2 percent (2010: 82.9 per cent).

The group's reported tier 1 ratio stood at 10.0 percent (2010: 11.4 percent). The implementation of the CRD III requirements was the principal reason for the decline. CRDIII increased the group's credit and counterparty risk risk-weighted assets by £5 billion and market risk risk-weighted assets, primarily due to the introduction of Stressed VAR, by £16 billion.

Assets

Cash and balances at central banks rose by 130 per cent. The increasingly prominent role played by western central banks in the functioning of the money markets resulted in a larger portion of the group's excess liquidity being held with central banks in Europe. Particular focus was placed on transferring surplus

liquidity away from sovereign and bank-issued debt securities and money market placements with banks to placements with central banks in the most highly-rated European countries.

Trading assets decreased by 21 per cent. Economic uncertainty led to a decline in market activity. As a result, the group reduced its holdings of government and highly-rated corporate debt securities and equity positions and did not replace maturities in the reverse repo book. This was partly offset by higher cash collateral posted with external counterparties as the fair value of derivative liabilities rose.

Financial assets designated at fair value were in line with 2010.

Derivative assets increased by 37 per cent, due to a significant rise in the fair value of interest rate contracts. The increase was driven by the downward movements of yield curves in major currencies following the global monetary response to continued economic weakness, including quantitative easing measures. There was also a customer-driven increase in the notional value of outstanding contracts during the period. The increase in the fair value of derivative assets was partly offset by higher netting as a result of increased trading through clearing houses.

Loans and advances to banks declined by 22 per cent, as funds from maturing term loans and reverse repo balances were deposited with central banks in Europe.

Loans and advances to customers were broadly in line with the prior year. Growth in commercial lending as a result of targeted marketing campaigns and residential mortgages due to competitive pricing, were offset by a reduced levels of unsecured customer overdrafts and reverse repo balances.

The bank in the UK exceeded its 2011 lending intentions under the Project Merlin agreement with the UK Government in respect of both total and SME facilities.

Financial investments decreased by 9 per cent as the group took the decision to place a portion of the proceeds from sales and maturities of financial investments with central banks.

Liabilities

Deposits by banks fell by 15 per cent due to a reduction in repo balances as a result of lower market activity and money market deposits, primarily in the UK.

Customer accounts were in line with prior year as increased levels of customer deposits were offset by lower levels of repo balances.

Trading liabilities fell by 10 per cent. Net short bond and equity positions decreased in line with the reduction in holdings of debt and equity securities, which fell as a result of lower market activity. Repo balances also declined, reflecting lower funding requirements as trading assets fell. These declines were offset in part by a rise in cash collateral posted by external counterparties in line with the increase in the fair value of derivative contracts.

Financial liabilities designated at fair value increased by 15 per cent. Funding from new debt issuances were partly offset by maturities.

Derivative assets increased by 37 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 11 per cent reflecting maturity without replacement as a result of lower funding requirements.

Liabilities under insurance contracts fell by 4 per cent. The increase driven by reserves established for new business premiums written, in France and the UK was more than offset by the effect of a fall in equity markets, which resulted in a decline in the fair value of assets held to support unit-linked and investment and insurance contracts with DPF. In addition, the fall reflects the non-renewal and transfer to third parties of certain contracts in the group's Irish businesses and the impact of the sale of the motor business in the UK during 2011.

Equity

Total shareholders' equity fell by 2 per cent. The decrease arose from the repayment of £1,750 million of perpetual subordinated debt reported as *Other equity instruments*. At the same, to replace this funding, the bank issued US$2,862 million of perpetual subordinated debt which is reported within *Subordinated liabilities*. This fall was partially offset by the retention of profits generated during the year and actuarial gains arising in the defined benefit pension plans.

Report of the Directors (continued)

Performance and Business Review

Profit on ordinary activities before tax

	2011 £m Reported	2010 £m Reported	2009 £m Reported	2011 £m Underlying	2010 £m Underlying	2009 £m Underlying
UK Retail Banking[1]	**1,547**	1,321	997	**1,518**	1,273	800
Continental Europe Retail Banking[1]	**314**	374	234	**314**	374	234
Global Banking and Markets[1]	**(94)**	1,816	2,465	**(95)**	1,688	2,469
Private Banking	**528**	616	728	**497**	616	728
Other/Intersegment	**816**	(116)	(410)	**2**	6	29
	3,111	4,011	4,014	**2,236**	3,957	4,260

1 *Restated to reflect the transfer of the Asset Management business*

HSBC Bank plc and its subsidiary undertakings reported a pre-tax profit of £3,111 million, £900 million or 22 per cent lower than 2010 or 43 per cent lower on an underlying basis.

Strong performance was reported by UK Retail Banking, with profit before tax of £226m higher than 2010. Continental Europe Retail Banking and Private Banking both recorded lower levels of profit than 2010. Revenues in Global Banking and Markets were markedly lower in 2011 due to the turmoil associated with the impact of the European sovereign debt crisis.

The figures in the following tables are on a reported basis.

UK Retail Banking[1]

	2011 £m	2010 £m	2009 £m
Net interest income	**3,602**	3,536	3,362
Net fee income	**1,776**	1,866	1,927
Trading income	**54**	10	29
Other income	**194**	255	241
Net operating income before impairments and provisions	**5,626**	5,667	5,559
Loan impairment charges and other credit risk provisions	**(796)**	(1,221)	(1,600)
Net operating income	**4,830**	4,446	3,959
Total operating expenses	**(3,282)**	(3,128)	(2,975)
Operating profit	**1,548**	1,318	984
Share of profit in associates and joint ventures	**(1)**	3	13
Profit before tax	**1,547**	1,321	997

1 *Restated to reflect the transfer of the Asset Management business*

2011 compared with 2010

Overview

The challenging economic environment continued to impact the UK and eurozone economies, however 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.

On an underlying basis, profit before tax was £1,518 million, an increase of 19 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;
- 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 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

The commentary that follows is on an underlying basis, but does not adjust for the significant items detailed above.

Net interest income increased by £63 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 £66 million or 4 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 £26 million or 14 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 £191 million or 6 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, and restructuring costs of £43 million, operating expenses were £67 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.

2010 compared with 2009

Overview

The year remained a challenging period for the UK economy and, in this environment, the group’s financial strength and diversification enabled it to continue to support its personal and commercial customers in managing their financial challenges and planning for the future. This resulted in a resilient financial performance.

UK Retail Banking reported strong profit before tax of £1,321 million in the period, compared with £997 million in 2009, an increase of 32 per cent. This was primarily as a result of significantly lower loan impairment charges in both the personal and commercial sectors. The lower charge was as a result of actions taken to improve collections performance, together with the change in mix of new business towards secured and away from unsecured lending. The continuing low interest environment in the UK has also allowed many customers to reduce debt levels.

On an underlying basis, adjusting for the disposal of the residual stake in the UK card acquiring joint venture in June 2009 and UK Retail Banking’s element of the disposal of the Insurance Brokers business in April 2010, profit before tax was £1,273 million in 2010, an increase of 59 per cent.

Report of the Directors: Business Review (continued)

In understanding the comparison for UK Retail Banking, the following items are significant:

- a change in the basis of delivering death-in-service, ill health and early retirement benefits which generated an accounting gain of £264 million in June 2009;
- a loss of £179 million for HSBC Insurance (UK) Limited in 2009, as the motor insurance underwriter was adversely impacted by claims experience, compared with a £7 million profit in 2010.

In UK Retail Banking and Wealth Management, Premier customers increased by 18 per cent, while Advance attracted 55,000 new customers to the group as the business focused on building long term sustainable relationships and wealth management revenues with these customer groups. The investment business continued to grow and increased its sales of HSBC World Selection which rose by 112 per cent to £2 billion in the year. The group's share of new UK residential mortgage lending in 2010 was 9 per cent, above the group's total market share of 5 per cent. The average loan to value ratio of this new lending was 54 per cent. The group continued to support the UK housing market, advancing funds to allow 63,000 customers to purchase properties, including 29,000 first time buyers.

In Commercial Banking, progress continued to be made towards becoming the leading bank of choice for international business. The number of UK based customers managed through the international proposition grew by 25 per cent and related income grew 14 per cent. The number of import and export transactions increased by 5 per cent and 10 per cent respectively, with international trade income increasing 23 per cent on prior year. The group opened accounts for over 125,000 customers starting new businesses, and increased gross new lending to SMEs by 19 per cent over 2009.

Financial performance

The commentary that follows is on an underlying basis.

Net interest income increased by £175 million or 5 per cent mainly driven by growth in mortgage balances and wider asset margins. This was partly offset by a narrowing of liability spreads. The group built on its strong deposit base, despite fierce competition for liability balances, with personal customer deposits increasing by 9 per cent. In Commercial Banking, net lending balances grew 3 per cent, with new advances up 17 per cent, despite increased customer propensity to reduce borrowing.

Net fee income increased by £58 million or 3 per cent as the group earned higher levels of fee income from insurance and both domestic and international payments flows. This was partially offset by reduced income from overdraft fees as the portfolio mix continued to move away from unsecured lending.

Other income was £131 million higher primarily due to the non-recurrence of losses in HSBC Insurance (UK) Limited in 2009 relating to the deterioration of motor claims experience.

Loan impairment charges and other credit risk provisions decreased by £379 million or 24 per cent. In the personal sector, loan impairment charges decreased by £257 million due to lower levels of delinquencies across both the secured and unsecured portfolios as a result of actions taken to improve collections performance and improve the quality of new business booked, coupled with the effect of low interest rates. In Commercial Banking, loan impairment charges decreased by £121 million with the improvement spread across most industry sectors.

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

Total operating expenses increased by £242 million or 9 per cent but were broadly flat against prior year after adjusting for the accounting gain of £264 million resulting from the change in delivery of certain staff benefits in the UK main pension scheme. Cost savings 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. In Retail Banking and Wealth Management, the group recruited additional wealth advisors, provided a new range of financial planning tools and continued to invest in the branch network, with 243 branches refurbished in 2010. In Commercial Banking, 160 new international relationship managers and 180 new local business manager roles were created.

Continental Europe Retail Banking[1]

	2011	2010	2009
	£m	£m	£m
Net interest income	**1,775**	1,726	1,684
Net fee income	**766**	684	623
Trading income	**(2)**	21	28
Other income	**(90)**	14	14
Net operating income before impairments and provisions	**2,449**	2,445	2,349
Loan impairment charges and other credit risk provisions	**(212)**	(195)	(338)
Net operating income	**2,237**	2,250	2,011
Total operating expenses	**(1,923)**	(1,876)	(1,777)
Operating profit	**314**	374	234
Share of profit in associates and joint ventures	**–**	–	–
Profit before tax	**314**	374	234

Profit on ordinary Activities before tax - by country

	2011	2010	2009
	£m	£m	£m
France	**163**	177	109
Germany	**68**	44	36
Turkey	**93**	135	125
Malta	**64**	60	58
Other	**(74)**	(42)	(94)
Profit before tax	**314**	374	234

1 *Restated to reflect the transfer of the Asset Management business*

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, whilst 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

The comments that follow are on an underlying basis.

Net interest income for Retail Banking & 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 per cent compared with 2010. Fee income in Retail Banking & 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 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 £102 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.

2010 compared with 2009

Overview

Continental Europe Retail Banking reported a profit of £374 million in 2010, against £234 million in 2009, an increase of 60 per cent. Increased revenues and lower loan impairment charges were partly offset by rising costs, driven largely by investment to achieve business growth. There was no difference between profits on a reported and underlying basis.

Following the restructuring of a number of the group's Retail Banking and Wealth Management businesses in 2009, focus has increasingly centred on wealth management, reflecting the demographics of the region. Increased investment resulted in increased customer numbers, with 65,000 new-to-bank Premier customers acquired in 2010. Customer growth was particularly strong in Poland, Turkey and France, where the group opened two of HSBC's largest Premier centres. The total number of Premier customers in the region rose by 43 per cent to 518,000 by the end of 2010. During the year the Advance

proposition was launched in Turkey, Poland, France, Malta and Greece.

Commercial Banking continued to focus on expanding relationships with international businesses. Growth was seen in trade finance as the region showed tentative signs of business revival particularly in Germany, Turkey and Poland which resulted in an increase in transaction flows. The group launched Business Direct, a new delivery channel, in Poland during the first half of the year and maintains a leading position in receivables finance across the region.

Financial Performance

The comments that follow are on an underlying basis.

Net interest income increased by £42 million or 2 per cent. In Retail Banking and Wealth Management, asset margins improved in France and Malta partially offset by narrowing margins in Turkey following the imposition of a government-regulated cap on credit card interest rates. The severe deposit spread compression seen in Malta in 2009 eased in 2010 and deposit spreads widened as maturing fixed rate deposits rolled over at lower interest rates. The strategic re-focus of the group's personal banking business depressed net interest income but the resultant sharp increase in the number of target segment customers acquired across the region provides a good revenue base going forward.

In Commercial Banking, net interest income increased compared with 2009. Revenue growth in France was offset by strong competition in Turkey, where margins were lower than in 2009. Corporate lending expanded in a number of markets following the downturn in 2009. The pipeline of transactions showed signs of revival, with particularly strong growth in the last two months of the year, providing a firm base for growth in 2011. By focusing on the shipping business and larger international clients, revenue grew in Greece and a number of smaller European sites.

Net fee income increased £61 million or 10 per cent compared with 2009. Fee income in Retail Banking and Wealth Management was 30 per cent higher as growth in France, Turkey and Malta reflected the success of the penetration of the target segment and wealth management business. Growth in Greece, Ireland, Czech Republic and Spain boosted fee income in Commercial Banking.

Loan impairment charges and other credit risk provisions decreased by £143 million or 42 per cent compared with 2009. In Retail Banking and Wealth Management, impairments were sharply lower in Turkey where limit reductions, changes in approval thresholds and a strong focus on collections yielded substantial improvements in recoveries and a reduction in delinquency rates. The closure of Consumer Finance business in Continental Europe in 2009 also contributed to the fall in the 2010 impairment charges.

In Commercial Banking, lower impairment charges were a feature of a number of markets with sharp decrease in France, Turkey and Germany. The fall was partially offset by the raising of a provision against a single exposure in Ireland.

Total operating expenses increased by £99 million or 6 per cent. The higher cost levels were principally due to expansion of the Retail Banking and Wealth Management business in France and Turkey; and Commercial Banking business in Turkey and Germany. The acquisition of a retail business in Kazakhstan also added to the cost base.

Global Banking and Markets[1]

	2011	2010	2009
	£m	£m	£m
Net interest income[2]	**1,323**	1,913	2,845
Net fee income	**598**	820	847
Trading income[2]	**1,083**	1,711	1,971
Other income	**267**	909	699
Net operating income before impairments and provisions	**3,271**	5,353	6,362
Loan impairment charges and other credit risk provisions	**(543)**	(518)	(1,405)
Net operating income	**2,728**	4,835	4,957
Total operating expenses	**(2,822)**	(3,021)	(2,493)
Operating profit	**(94)**	1,814	2,464
Share of profit in associates and joint ventures	**–**	2	1
Profit before tax	**(94)**	1,816	2,465

Profit on ordinary Activities before tax - by country

	2011	2010	2009
	£m	£m	£m
UK	**(305)**	1,222	1,515
France	**(114)**	238	587
Germany	**92**	115	104
Turkey	**71**	79	92
Other	**162**	162	167
Profit before tax	**(94)**	1,816	2,465

1 *Restated to reflect the transfer of the Asset Management business*

2 *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 12).*

2011 compared with 2010

Overview

Global Banking and Markets reported a pre-tax loss 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.

On an underlying basis, the pre-tax loss in 2011 was £95 million, compared to a pre-tax profit of £1,639 million in 2010.

Report of the Directors: Business Review (continued)

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 our 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

The commentary that follows is on an underlying basis.

Net interest income decreased by £612 million or 32 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, whilst a fall in revenues from our legacy credit portfolio reflected a reduction in effective yields and lower holdings.

Net fee income declined by £216 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 £779 million or 42 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. In our Equities business, revenues rose as investment in platforms improved our 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 £234 million or 47 per cent, primarily due to lower gains as a 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 2010 as the impact of losses arising in the underlying collateral pools generated lower charges on asset-backed securities.

Total operating expenses decreased by £85 million or 3 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 7 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.

2010 compared with 2009

Overview

Global Banking and Markets reported a pre-tax profit of £1,816 million in the period compared with £2,465 million in 2009, a decrease of 26 per cent. The 2010 results, however, remained strong by historical standards and were second only to the exceptional performance of 2009.

On an underlying basis, adjusting for the Global Banking and Markets' element of the disposal of the Insurance Brokers' business in April 2010 and the disposal of Eversholt Rail Group in December 2010, profit before tax was £1,639 million or 34 per cent lower than 2009.

Revenues slowed in 2010, due to less favourable market conditions caused by the impact of the European sovereign debt crisis and the anticipated lower revenues in Balance Sheet Management. Operating expenses included a £208 million charge from the one-off UK and French bonus and payroll taxes applied on certain 2009 bonus payments.

Loan impairment charges and other credit risk provisions decreased significantly by £887 million. The fall reflected improved credit conditions which, together with capital raising and debt restructuring activity, strengthened the credit quality of the portfolio. Credit risk provisions on certain available-for-sale asset backed securities also decreased due to a slowing in the rate of anticipated losses in the underlying collateral pools.

Financial performance

The commentary that follows is on an underlying basis.

Net interest income decreased by £933 million, or 33 per cent against 2009. As anticipated, Balance Sheet Management revenues fell against the exceptional performance of 2009 driven by the maturity of higher yielding positions, low interest rates and flatter yield curves. In Global Banking, the continuation of margin compression resulted in lower levels of income in the credit and lending business.

Net fee income was broadly in line with 2009. Fee income received for management services provided by the group to its structured investment conduits was mostly offset by lower fees from equity capital markets due to a decrease in client activity.

Trading income was £260 million or 13 per cent lower than 2009. Credit and Rates reported lower income as a result of the unfavourable market conditions caused by the impact of the European sovereign debt crisis. This was partly mitigated by a net release of previous write-downs on legacy positions and on monoline exposures. Foreign exchange revenues declined, reflecting margin compression from increased competition. This was partly offset by lower net fair value losses reported on structured liabilities of £18 million compared with losses of £215 million in 2009. Foreign exchange gains were reported on trading assets held as economic hedges of foreign currency debt designated at fair value, compared with losses reported in 2009. The offset is reported in *Other income.*

Other income increased by £30 million or 4 per cent due to higher realisations and lower impairment charges in Principal Investments as market conditions improved. This was partly offset by foreign exchange losses on debt designated at fair value, compared with a gain reported in 2009. The offset is reported in *Trading income.*

Loan impairment charges and other credit risk provisions decreased by £887 million or 63 per cent. Loan impairment charges fell by £459 million as significant loan impairments taken in relation to a small number of clients in 2009 did not recur. Impairments on available-for-sale debt securities fell by £428 million compared with 2009, mainly related to asset-backed securities, due to a slowing of anticipated losses in the underlying collateral pools.

Total operating expenses increased by £563 million or 23 per cent due to the inclusion of £208 million payroll taxes on certain bonuses and continued investment in strategic initiatives to drive future revenue growth, including the development of Prime Services and equity market capabilities and expansion of the Rates and foreign exchange e-commerce platforms. This was compounded by the non-recurrence of a £58 million pension accounting gain recorded in 2009.

Private Banking

	2011	2010	2009
	£m	£m	£m
Net interest income	**750**	724	815
Net fee income	**700**	650	626
Trading income	**250**	253	210
Other income	**22**	22	28
Net operating income before impairments and provisions	**1,722**	1,649	1,679
Loan impairment charges and other credit risk provisions	**(72)**	(17)	(19)
Net operating income	**1,650**	1,632	1,660
Total operating expenses	**(1,122)**	(1,016)	(932)
Operating profit	**528**	616	728
Share of profit in associates and joint ventures	**–**	–	–
Profit before tax	**528**	616	728

2011 compared with 2010

Overview

Private Banking reported pre-tax profit 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.

On an underlying basis, adjusting for the acquisition of HSBC International Trustee Limited in July 2011, profit before tax was £497 million, 19 per cent lower than 2010.

Financial performance

The commentary that follows is on an underlying basis.

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 £23 million or 4 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 customers and impairment charges recorded against Greek available-for-sale debt securities.

Total operating expenses increased by £87 million or 9 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.

Report of the Directors: Business Review (continued)

2010 compared with 2009

Overview

Private Banking reported pre-tax profit of £616 million in 2010 compared with £728 million in 2009, a decrease of 15 per cent. This was mainly due to lower net interest income driven by the narrowing of deposit spreads, offset by an increase in fee and trading income in 2010.

Private Banking has continued to focus on providing excellent client experience and global connections with the ability to offer tailor made services including trust and family office services. A Family Office Partnership was launched with Global Banking and Markets, targeting ultra high net worth clients and family offices seeking quasi-institutional services.

Financial performance

The commentary that follows is on an underlying basis.

Net interest income decreased by £91 million or 11 per cent against 2009 as the continued low interest rate environment continued to effect deposit spreads.

Net fee income increased by £24 million or 4 per cent as market sentiment drove a rise in client activity levels. Net new money amounted to £7.1 billion resulting from strong inflows in Asia and other emerging markets and increased client leverage.

Trading income increased by £43 million or 20 per cent in 2010 driven by higher client transaction volumes as client risk appetite returned, particularly in foreign exchange and debt securities trading.

Total operating expenses increased by £84 million compared to 2009 reflecting the hiring of front-line staff to cover emerging markets as part of a long-term strategy to further the international network and higher compliance costs resulting from the evolving regulatory environment.

Other

	2011	2010	2009
	£m	£m	£m
Net interest income	**(93)**	(100)	(192)
Net fee income	**60**	20	55
Trading income	**(7)**	(8)	(35)
Change in credit spread on long-term debt	**832**	(122)	(439)
Other income	**232**	195	287
Net operating income before impairments and provisions	**1,024**	(15)	(324)
Loan impairment charges and other credit risk provisions	**–**	–	(2)
Net operating income	**1,024**	(15)	(326)
Total operating expenses	**(208)**	(101)	(84)
Operating profit	**816**	(116)	(410)
Share of profit in associates and joint ventures	**–**	–	–
Profit before tax	**816**	(116)	(410)

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.

2010 compared with 2009

The reported loss before tax in Other was £116 million, compared with a loss of £410 million in 2009.

Other includes:

- the change in own credit spread on long-term debt which resulted in losses of £122 million in 2010 compared with losses of £439 million in 2009;
- the gain of £125 million on the sale and leaseback of the Paris headquarters building in February 2010; and
- the gain of £353 million on the sale of the Group’s London headquarters building in 2009.

Other information

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

	2011			2010			2009		
	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	**86,330**	**1,102**	**1.28**	76,665	1,111	1.45	61,378	1,307	2.13
Loans and advances to customers	**272,379**	**8,262**	**3.03**	244,544	7,891	3.23	242,776	8,720	3.59
Financial investments	**100,543**	**1,979**	**1.97**	97,264	2,101	2.16	91,624	2,604	2.84
Other interest-earning assets	**578**	**8**	**1.38**	642	7	1.09	1,006	12	1.19
Total interest-earning assets	**459,830**	**11,351**	**2.47**	419,115	11,110	2.65	396,784	12,643	3.19
Trading assets	**154,775**	**3,026**	**1.96**	138,639	2,492	1.80	150,491	3,548	2.36
Financial assets designated at fair value	**9,084**	**238**	**2.62**	7,558	253	3.35	8,763	285	3.25
Impairment provisions	**(3,402)**	**-**	**-**	(4,134)	-	-	(3,302)	-	-
Non-interest-earning assets	**341,685**	**-**	**-**	313,626	-	-	311,518	-	-
Total assets and interest income	**961,972**	**14,615**	**1.52**	874,804	13,855	1.58	864,254	16,476	1.91

Total equity and liabilities

	2011			2010			2009		
	Average balance £m	**Interest expense £m**	**Cost %**	Average balance £m	Interest expense £m	Cost %	Average balance £m	Interest expense £m	Cost %
Deposits by banks	**57,544**	**729**	**1.27**	62,060	553	0.89	62,187	928	1.49
Financial liabilities designated at fair value own debt issued	**20,999**	**396**	**1.89**	14,431	247	1.71	8,233	211	2.56
Customer accounts	**289,398**	**2,280**	**0.79**	268,034	1,834	0.68	283,204	2,412	0.85
Debt securities in issue	**48,948**	**672**	**1.37**	54,427	725	1.33	62,744	947	1.51
Other interest-bearing liabilities	**1,287**	**51**	**3.96**	1,423	57	4.01	1,245	54	4.34
Total interest-bearing liabilities	**418,176**	**4,128**	**0.99**	400,375	3,416	0.85	417,613	4,552	1.09
Trading liabilities	**106,364**	**2,081**	**1.96**	72,690	1,585	2.18	91,033	1,892	2.08
Financial liabilities designated at fair value (excluding own debt issued)	**10,847**	**187**	**1.72**	10,580	181	1.71	9,002	185	2.06
Non-interest bearing current accounts	**39,402**	**-**	**-**	36,831	-	-	32,520	-	-
Total equity and other non-interest-bearing liabilities	**387,183**	**-**	**-**	354,328	-	-	314,086	-	-
Total equity and liabilities	**961,972**	**6,396**	**0.66**	874,804	5,182	0.59	864,254	6,629	0.77

Net interest margin

	2011	2010	2009
	%	%	%
Net interest margin	**1.57**	1.84	2.04

Report of the Directors: Business Review (continued)

Analysis of changes in net interest income

The following table allocates changes in net interest income between volume and rate for 2011 compared to 2010, and for 2010 compared to 2009.

		Increase/(decrease) in 2011 compared with 2010			Increase/(decrease) in 2010 compared with 2009		
	2011	Volume	Rate	2010	Volume	Rate	2009
	£m	£m	£m	£m	£m	£m	£m
Interest income							
Short-term funds and loans and advances to banks	**1,102**	**140**	**(149)**	1,111	326	(522)	1,307
Loans and advances to customers	**8,262**	**899**	**(528)**	7,891	64	(893)	8,720
Financial investments	**1,979**	**71**	**(193)**	2,101	160	(663)	2,604
Interest expense							
Deposits by banks	**729**	**(40)**	**216**	553	(2)	(373)	928
Customer accounts	**2,280**	**146**	**300**	1,834	(129)	(449)	2,412
Financial liabilities designated at fair value – own debt issued	**396**	**112**	**37**	247	159	(123)	211
Debt securities in issue	**672**	**(73)**	**20**	725	(126)	(96)	947

Deposits

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.

	2011		2010		2009	
	Average balance	Average rate	Average balance	Average rate	Average balance	Average rate
	£m	%	£m	%	£m	%
Deposits by banks	**66,759**		80,944		66,330	
Demand and other – non-interest bearing	**4,791**		4,360		4,143	
Demand – interest bearing	**10,396**	**0.7**	8,913	0.6	9,019	1.0
Time	**12,542**	**2.2**	18,310	0.9	19,169	1.7
Other	**39,030**	**1.3**	49,361	0.7	33,999	1.5
Customer accounts	**334,471**		296,930		320,010	
Demand and other – non-interest bearing	**49,497**		43,419		36,806	
Demand – interest bearing	**146,641**	**0.4**	140,666	0.4	141,965	0.4
Savings	**35,784**	**1.7**	33,514	1.8	36,642	2.2
Time	**52,069**	**1.3**	49,017	1.1	56,013	1.3
Other	**50,480**	**0.8**	30,314	0.6	48,584	0.6
CDs and other money market instruments	**29,633**	**0.6**	37,006	0.4	41,564	1.0

Certificates of deposit and other time deposits

At 31 December 2011, the maturity analysis of CDs and other wholesale time deposits, by remaining maturity, was as follows:

	3 months or less	After 3 months but within 6 months	After 6 months but within 12 months	After 12 months	Total
	£m	£m	£m	£m	£m
Certificates of deposit	**9,444**	**3,908**	**122**	**–**	**13,474**
Time deposits					
- banks	**21,144**	**413**	**368**	**5,641**	**27,566**
- customers	**48,694**	**7,362**	**5,268**	**2,262**	**63,586**

Report of the Directors: Business Review (continued)

Contractual obligations

The table below provides details of selected known contractual obligations of the group as at 31 December 2011.

	Payments due by period			
	Total	Less than 1 year	1-5 years	More than 5 years
	£m	£m	£m	£m
Long-term debt obligations	**69,795**	**22,836**	**22,258**	**24,701**
Term deposits and certificates of deposit	**104,626**	**96,723**	**7,327**	**576**
Capital (finance) lease obligations	**291**	**8**	**56**	**227**
Operating lease obligations	**2,021**	**193**	**685**	**1,143**
Purchase obligations	**5**	**5**	**–**	**–**
Short positions in debt securities and equity shares	**30,485**	**21,087**	**1,875**	**7,523**
Current tax liability	**131**	**131**	**–**	**–**
Pension/healthcare obligation	**4,695**	**196**	**1,279**	**3,220**
	212,049	**141,179**	**33,480**	**37,390**

Risk Management

(Unaudited)

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 accountable to 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, the alignment of the Bank's risk appetite and 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.

Challenges and Uncertainties

(Unaudited)

Macro-economic and geopolitical

Eurozone – risk of sovereign and counterparty defaults

Exposures to the eurozone have received increasing focus given the continued instability in the area and the potential for contagion spreading from the periphery to core eurozone countries.

There is an increasing risk of sovereign defaults by the peripheral eurozone countries which will place further pressure on banks, within the core European countries, exposed to these. Although the group's exposure to the peripheral eurozone countries is relatively limited, exposure to counterparties in the core European countries can be impacted by any sovereign crisis. The group's eurozone exposures are described in more detail on pages 41 to 43. Potential impacts on the group are as follows:

- The group's exposures to European banks may come under stress, heightening the potential for credit and market risk losses, if the sovereign debt crisis in the region increases the need to recapitalise parts of the sector;
- trade and capital flows may contract as a result of banks deleveraging, protectionist measures being introduced in certain markets or on the emergence of geopolitical risks which in turn might curtail profitability;
- a prolonged period of low interest rates due to policy actions taken to address the eurozone crisis will constrain, for example, through spread compression and low returns on assets, the interest income we earn from investing excess deposits; and
- 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, for example in the event of contagion from stress in the peripheral eurozone sovereign and financial sectors.

Through the year the group actively managed, through reduction of exposures and other measures, to mitigate the risk of sovereign defaults.

Eurozone member departing from the currency union

The risk of a eurozone member departing from the currency union is a possible scenario. Should it materialise it would have a significant impact on the entire financial sector and the wider economy. It would crystallise sovereign risks and those to the bank and corporate sectors, and the disruption caused would affect consumer activity.

Potential losses to the group include:

- The group could incur significant losses stemming from the exit of one or more countries from the eurozone and the return to their local currencies.
- Should such an event occur in a disorderly manner, it could trigger defaults in companies with which we do business and have a knock-on effect on the global banking system.

Against this backdrop, in seeking to manage and mitigate this risk, the group has prepared and tested detailed operational contingency plans to deal with such a scenario. The group are keeping these plans under close review as events develop.

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

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 superequivalent manner and to differing timetables across regulatory regimes.

Regulatory developments affecting the business model and Group profitability

The key regulatory changes which are likely to have an effect on the activities of the group. These are set out below:

- *Basel III/Capital Requirements Directive IV (‘CRD IV’)*

  (i) Derivatives and central counterparty clearing measures have been introduced to give effect to the G20 commitments designed to reduce systemic risk and volatility relating to derivatives trading. The G20 agreed that all standardised over-the-counter (‘OTC’) derivatives were to be exchange traded where appropriate, reported to trade repositories and centrally cleared by the end of 2012. Higher capital requirements under Basel III will be imposed for bilateral (uncleared) transactions to incentivise the use of central clearing.

  (ii) Quality of capital: CRD IV requires a further strengthening and harmonisation of the criteria for eligibility of capital instruments with an emphasis on common equity as the principal component of tier 1 capital.

  (iii) Capital buffers: CRD IV proposals include a capital conservation buffer of 2.5 % of risk weighted assets to be built up during periods of economic growth, aimed at ensuring the capacity to absorb losses in stressed periods that may span a number of years.

  (iv) Counterparty credit risk requirements for managing and capitalising counterparty credit risk are to be strengthened. In particular, an additional capital charge for potential losses associated with the deterioration in the creditworthiness of individual counterparties, capital variation adjustment, will be introduced.

  (v) Liquidity and funding: a new minimum standard, the liquidity coverage ratio, designed to improve the short-term resilience of a bank’s liquidity risk profile, will be introduced after an observation and review period in 2015.

- *UK Independent Commission on Banking:* the forthcoming legislation arising from the report of the Independent Commission on Banking (‘ICB’) is likely to require the group to make major changes to its corporate structure and the business activities conducted in the UK through the bank. This includes the likelihood that the retail banking activities currently carried out within the bank may have to be spun-off into a ringfenced retail bank. These changes would take an extended period to implement with a significant impact on costs to both implement the changes and run the ongoing operations as restructured.

The proposals relating to capital and liquidity will impact the capital adequacy and liquidity frameworks under which financial institutions operate and result in increased capital and liquidity requirements, although the nature, timing and effect of many of the changes remain unclear. Increases in capital and liquidity requirements could have a material effect on the group’s future financial condition or the results of its operations.

The proposed leverage ratio could cause the bank as an institution with a relatively low-risk portfolio overall, to constrain business activity in areas which are well collateralised or possess sufficient risk mitigants.

If either the quality or amount of the group’s capital were to fall outside of the proposed regulations, it could be required to raise more capital or reduce its level of risk-weighted assets to meet these requirements. Such actions and any resulting transactions may not be within the operating plans of the group and may not be conducted on the most favourable terms. This could lead to lower returns on equity and cause some business activities and products to be less profitable and, in some instances, to fail to cover their cost of equity.

Proposed changes in regulations such as the rules relating to derivatives and central counterparties regulation, the UK ICB ‘Ring-fencing’ proposals and recovery and resolution plans 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. Due to the stage of development and implementation of these various regulations, it is not possible to estimate the impact on the group’s operations.

The group is ensuring that its 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 to drive appropriate risk management and mitigating actions.

Regulatory investigations and requirements relating to conduct of business and financial crime negatively impacting the brand

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.

It is inherently difficult to predict the outcome of the regulatory proceedings. An adverse outcome could lead to material adverse effect on the group's results and brand.

In response to this risk, the group is progressing a number of initiatives which seek to address the issues identified and enhance governance and oversight.

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.

The downturn may also put pressure on the group's ability to earn returns on equity 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.

Internet crime and fraud

The group is exposed to potentially fraudulent and criminal activities, in particular from a growing threat from internet crime which can result in the loss of customer data and sensitive information. The threat of external fraud may increase during adverse economic conditions especially 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 businesses arising from events that are wholly or partially beyond the group's control, such as internet crime and acts of terrorism.

Internet crime and fraud may give rise to losses in service to customers and/or economic loss to the group. These risks equally apply when the group relies on external suppliers or vendors to provide services to it and its customers.

The group has increased its monitoring and has implemented additional controls such as two-factor authentication to mitigate the possibility of losses arising from these risks.

Social media risk

The scale and profile of social media networks ('SMNs') have grown both in terms of customer demographic and geographical reach to represent a significant potential reputational risk to the group, given that these networks can be used as powerful broadcasting tools with the capability to reach large numbers of people in a very short time frame.

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.

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 our customers and stakeholders. Monitoring has also been implemented in some entities to protect the brand and to understand general sentiment towards the group and, in some cases, our 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 change driven by new banking regulation, the increased globalisation of the economy and business needs, new products and delivery channels, and organisational change.

Operational complexity has the potential to heighten all types of operational risk across our activities. This includes the risk of process errors, systems failures and fraud. Operational complexity can also increase operational costs across the group.

The implementation of the group's strategy, based on the application of strategic criteria, may involve the withdrawal from certain markets which presents disposal risks which must be carefully managed.

Critical systems failure, and a prolonged loss of service availability could cause serious damage to the group's ability to serve its clients, breach regulations under which it operates and cause long-term damage to our business, reputation and brand. The group seeks to ensure that its critical systems infrastructure is constantly monitored and properly resourced to mitigate against systems failures.

The potential effect of disposal risks include regulatory breaches, industrial action, loss of key personnel and interruption to systems and processes during business transformation, and can have both

financial and reputational implications. Management actions to manage these risks proactively include a close dialogue with regulators and customers and the proactive engagement with HR, legal, compliance and other functional experts.

Information security risk

The reliability and security of the group's information and technology infrastructure and customer databases and their ability, for example, to combat internet fraud are crucial to maintaining the group's banking applications and processes and to protecting the HSBC brand.

These risks give rise to potential 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 training to raise staff awareness of the requirements, enhanced controls around data access and heightened monitoring of information flows.

Regulation and Supervision

(Unaudited)

The group is subject to regulation and supervision by a large number of regulatory and other agencies. In addition to changes being pursued at a local level, changes are also being pursued globally through the actions of bodies such as the G-20, FSB and Basel Committee on Banking Supervision, as well as regionally through the European Union. Key areas include the work of the FSB on global systemically important financial institutions ('G-SIFI'), the Basel Committee's Basel III capital requirements, the EU's measures to implement Basel III (referred to as 'CRD IV'), and the EU's proposed Crisis Management Directive.

The FSB has been designated by the G-20 as the body responsible for co-ordinating the delivery of a global reform programme following the financial crisis, a key element of which is that no firm should be too big or too complicated to fail, and that taxpayers should not bear the cost of resolution. HSBC has been classified by FSB as a G-SIFI and therefore will be subject to what the FSB refers to as a 'multi-pronged and integrated set of policies'. These include proposals that would place an additional capital buffer on HSBC, impact the group and require enhanced reporting.

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'. This will be given effect across the EU via a recasting of CRD. The Proposals have been issued for a new Regulation and Directive, which collectively, are known as CRD IV. Finalised CRD IV rules are not expected until mid-2012 but draft proposals include:

- *Quality of capital:* CRD IV requires a further strengthening and harmonisation of the criteria for eligibility of capital instruments with an emphasis on common equity as the principal component of tier 1 capital;
- *Capital buffers:* proposals comprise a capital conservation buffer of 2.5 per cent of risk-weighted assets to be built up during periods of economic growth, aimed at ensuring the capacity to absorb losses in stressed periods that may span a number of years; and a countercyclical capital buffer of up to an additional 2.5 per cent to be built up in periods in which credit growth exceeds GDP growth;
- *Derivatives and central counterparty clearing:* higher capital requirements to be imposed for bilateral (uncleared) transactions, to incentivise the use of central clearing;
- *Counterparty credit risk:* requirements for managing and capitalising counterparty credit risk are to be strengthened. In particular, an additional capital charge for potential losses associated with the deterioration in the creditworthiness of individual counterparties (Credit Valuation Adjustment or CVA) will be introduced; and
- *Liquidity and funding:* a new minimum standard, the Liquidity Coverage Ratio, designed to improve the short-term resilience of a bank's liquidity risk profile, will be introduced after an observation and review period in 2015.

In addition, the EU continues to work on a Crisis Management Directive. This is intended to provide a harmonised framework for the resolution of credit institutions across the EU. It appears that the Directive has been delayed and recent communications from the EU suggest that publication will not now take place until later in 2012. The potential impact of this Directive cannot therefore presently be estimated. However, as with most of the initiatives already highlighted, there is some risk of inconsistency or duplication with other measures already in hand at the national level, both within and outside the EU. The EU also continues to work on its review of existing directives such as the Market Abuse Directive and the Markets in Financial Instruments Directive, the revisions to which may affect at least some of the investment markets in which the group operates and the instruments in which it trades.

The European Banking Authority, the European Insurance and Occupational Pensions Authority and the European Securities and Markets Authority, as new

European Supervisory Authorities since 2011 are also likely to have greater influence on regulatory approaches across the EU. This could lead to changes in how the group is regulated and supervised on a day-to-day basis as each of these authorities develops its powers having regard to some of the regulatory initiatives highlighted in this report.

UK Regulation and Supervision

The FSA is the supervisor of the bank and lead supervisor of the group. In addition, each operating bank, finance company or insurance operation within the group is regulated by local supervisors. UK banking and financial services institutions are subject to multiple regulations. The primary UK statute is the Financial Services and Markets Act 2000 ('FSMA'). Other UK financial services legislation includes that derived from EU directives relating to banking, securities, insurance, investments and sales of personal financial services.

The FSA is responsible for authorising and supervising the group's businesses in the UK which require authorisation under FSMA. These include deposit taking, retail banking, life and general insurance, pensions, investments, mortgages, custody and share dealing businesses, and treasury and capital markets activity. HSBC Bank plc is the group's principal authorised institution in the UK.

The UK financial services regulatory structure is currently in the process of substantial reform, with the UK Government's proposals to abolish the FSA and establish three new regulatory bodies by the end of 2012 now well advanced. These three bodies will comprise the Financial Policy Committee ('FPC'), 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 macro issues affecting economic and financial stability. The PRA and the FCA will inherit the majority of the FSA's existing functions and HSBC will be a 'dual regulated' firm, subject to prudential regulation by the PRA and to conduct regulation by the FCA.

FSMA will be substantially revised during the course of 2012 to reflect this regulatory reform.

There are a substantial number of other ongoing regulatory initiatives affecting the group and driven by or from the UK. These include the UK bank levy, ongoing rule making regarding remuneration and recovery and resolution plans ('RRP') and the implementation of the recommendations of the Independent Commission on Banking ('ICB'). Whilst not strictly a legislative or regulatory matter, certain banks in the UK, including HSBC, have established an accord with the UK Government, referred to as Project Merlin.

- The Financial Services Act 2010, amongst other things, empowered the FSA to make rules about remuneration requiring all authorised firms to operate a remuneration policy which is consistent with the effective management of risks and the Financial Stability Board's ('FSB') Implementation Standards for Principles for Sound Compensation Practices and requiring authorised firms to prepare and keep up-to-date RRP. The FSA has continued, during 2011, to consult on the rules made under these powers and HSBC continues to discuss RRP with the FSA. The Group expect the FSA's rules on RRP to be finalised and effective during 2012.
- In 2011, the FSA also implemented the requirements of CRD III, which requires certain financial institutions, including banks and investment firms, to have in place remuneration policies that are consistent with effective risk management. In addition to the rules required by the FSA for the group, individual legal entities may also be subject to their own local requirements.
- The ICB published its Final Report on 12 September 2011. The UK Government is now considering how it will implement the recommendations in the report. If the ICB's reform proposals were to be adopted as legislation in substantially the form presented, they would have wide ranging implications for the structure and costs of UK-headquartered globally systemically important banks ('G-SIBs'), and the UK banking industry.

  The ICB proposed that large G-SIBs (which would include HSBC) should have primary loss-absorbing capacity ('PLAC') equal to at least 17% of risk-weighted assets ('RWA's) calculated under Basel III. This capacity should be satisfied by issuance of additional equity and/or debt that is loss-absorbing at the point where the G-SIB is no longer viable. The UK supervisor would retain the power to increase this minimum loss-absorbing capacity to 20% of RWAs if it has concerns about the ability to restructure or liquidate the G-SIB at the point of failure. The Government have indicated that, where the activities outside the ring-fence of a large UK headquartered bank were demonstrably resolvable without adverse impact on UK financial stability, the higher PLAC ratio need not apply Group wide.

  The Chancellor of the Exchequer expressed broad approval of the ICB's Final Report and indicated that the UK Government endorses in principle the proposals to establish a ring-fenced bank and greater primary loss absorbing capacity. The Government is not, however, bound to adopt the Commission's recommendations and is proposing to undertake extensive consultation in two stages during 2012.

In respect of UK universal banks, including HSBC Bank plc, the ICB has proposed a separation of the UK retail and wholesale banking operations through the creation of a ring-fenced retail bank. The ICB recommends that a large ring-fenced bank should be required to maintain an equity 'ring-fence buffer' of at least 3 per cent of RWAs above the Basel III base requirement of 7 per cent of RWAs. Following on from this, the ICB also recommended that the minimum leverage ratio of equity-to-total assets should be adjusted from 3 per cent (as it is in the Basel III proposals) up to 4.06 per cent, increasing in the same proportion as the ring-fence buffer.

If the proposals described above are adopted substantially in the form prescribed, major changes to the corporate structure and business activities conducted in the UK through HSBC Bank plc might be required. The changes may include the spinning-out of the ring-fenced bank from the existing UK incorporated universal bank. The proposals, if adopted, would take an extended period of time to implement and would have a significant impact on costs, both to implement and to run the ongoing operations as restructured.

In February 2011, certain banks in the UK including HSBC exchanged letters with the UK's Chancellor of the Exchequer to establish an accord (referred to as Project Merlin) setting out the intentions of the banks on matters including lending, taxation, pay and other economic contributions. The intentions were, in large part, provided collectively and are not binding or enforceable on any member of the HSBC Group. In the accord, the banks:

- renewed their intention to implement the recommendations from the UK Business Finance Taskforce, established by the banks, which reported in October 2010, on improving customer relationships, ensuring better access to finance, providing better information and promoting understanding;
- agreed to provide the capacity for additional gross new lending to UK corporates, with HSBC providing at least £38.8 billion, with capacity to increase this to £44.1 billion, including a goal for UK small and medium sized enterprises ('SMEs') of £11.7 billion for the full year, with capacity for additional facilities of at least £1.2 billion if required, all subject to, inter alia, suitable demand and normal lending criteria;
- agreed to abide by the UK Code of Practice on Taxation for Banks and indicated that they expected to contribute some £8 billion to the total direct and indirect tax take in 2010 and some £10 billion in 2011 in the ordinary course of business;
- confirmed their intention to maintain their existing charitable contributions, in cash and in kind;
- agreed to make an additional contribution of up to £1 billion (up to £250 million for HSBC) to the Business Growth Fund plc (as established under the UK Business Finance Taskforce) for equity investment in SMEs subject to demand over the life of the business and an agreed risk-weighting for the investment; and
- agreed to contribute capital of £200 million (£50 million for HSBC) over two years to the Big Society Bank (now renamed Big Society Capital Limited) on commercial terms.

Additionally, the FSA continues to pursue a full agenda of regulatory development in relation to the conduct of business in the UK, with currently ongoing initiatives such as the Retail Distribution Review and the Mortgage Market Review which will affect those businesses (including HSBC) who provide investment and the provision of home finance in the UK.

Outlook

(Unaudited)

The bank expects UK GDP to rise by some 0.3 per cent in 2012. Uncertainty surrounding the eurozone and weak consumer confidence alongside the ongoing fiscal consolidation should constrain growth of domestic demand, while only modest growth is expected from net trade. With demand weak, consumer price inflation is expected to fall sharply through 2012 as the impact of 2011's VAT increase and fuel price rises drop out of the annual comparison.

Eurozone GDP is expected to contract by 1 per cent in 2012 but with large divergences between countries, as Spain and Italy experience deeper contractions than the core eurozone. The impact of fiscal austerity is likely to continue to be felt, especially in the eurozone periphery, and concerns surrounding the sovereign debt levels in these countries are likely to persist in 2012 as will the tight financial conditions. However, sentiment indicators suggest that the downturn that began in the second half of 2011 appears to be stabilising in early 2012 and a resumption of economic recovery can be expected in Germany, led by a firming of the global trade cycle and resilient domestic labour markets that will support consumer spending. Inflation appears to have peaked and, assuming stable energy prices, it is expected to slow to below 2 per cent in the course of 2012.

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 their 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;
- 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 RMMs, 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 its minimum credit regulatory capital requirement. For further details, see 'Credit quality of financial instruments' on page 43.

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 Risk Review team reviews the robustness and effectiveness of key measurement, 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

(Audited)

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

(Audited)

Concentrations of credit risk arise when a number of counterparties or exposure 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 and 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

(Audited)

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 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.

Report of the Directors: Risk (continued)

The group

	At 31 December 2011			At 31 December 2010		
	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	**56,460**	**–**	**56,460**	24,495	–	24,495
Items in the course of collection from other banks	**1,663**	**–**	**1,663**	1,932	–	1,932
Trading assets	**114,657**	**(2,303)**	**112,354**	135,047	(2,401)	132,646
treasury and other eligible bills	**1,301**	**–**	**1,301**	2,529	–	2,529
debt securities	**51,286**	**–**	**51,286**	73,771	–	73,771
loans and advances to banks	**30,335**	**–**	**30,335**	26,525	–	26,525
loans and advances to customers	**31,735**	**(2,303)**	**29,432**	32,222	(2,401)	29,821
Financial assets designated at fair value	**7,856**	**–**	**7,856**	7,717	–	7,717
treasury and other eligible bills	**5**	**–**	**5**	20	–	20
debt securities	**7,285**	**–**	**7,285**	7,161	–	7,161
loans and advances to banks	**70**	**–**	**70**	27	–	27
loans and advances to customers	**496**	**–**	**496**	509	–	509
Derivatives[1]	**176,993**	**(141,973)**	**35,020**	129,158	(86,254)	42,904
Loans and advances held at amortised cost[2]	**332,617**	**(52,881)**	**279,736**	342,245	(54,588)	287,657
loans and advances to banks	**44,603**	**(1,980)**	**42,623**	57,027	(1,996)	55,031
loans and advances to customers	**288,014**	**(50,901)**	**237,113**	285,218	(52,592)	232,626
Financial investments	**91,888**	**–**	**91,888**	100,660	–	100,660
treasury and other similar bills	**6,737**	**–**	**6,737**	9,354	–	9,354
debt securities	**85,151**	**–**	**85,151**	91,306	–	91,306
Other assets	**8,494**	**–**	**8,494**	7,837	–	7,837
endorsements and acceptances	**730**	**–**	**730**	494	–	494
accrued income and other	**7,764**	**–**	**7,764**	7,343	–	7,343
Financial guarantees	**12,410**	**–**	**12,410**	14,631	–	14,631
Loan commitments and other credit-related commitments	**120,881**	**–**	**120,881**	114,043	–	114,043
	923,919	**(197,157)**	**726,762**	877,765	(143,243)	734,522

Report of the Directors: Risk (continued)

The bank

	At 31 December 2011			At 31 December 2010		
	Maximum exposure	**Offset**	**Exposure to credit risk (net)**	Maximum exposure	Offset	Exposure to credit risk (net)
	£m	**£m**	**£m**	£m	£m	£m
Cash and balances at central banks	**44,967**	**–**	**44,967**	22,357	–	22,357
Items in the course of collection from other banks	**908**	**–**	**908**	1,030	–	1,030
Trading assets	**94,852**	**(2,303)**	**92,549**	102,704	(2,401)	100,303
treasury and other eligible bills	**709**	**–**	**709**	945	–	945
debt securities	**27,079**	**–**	**27,079**	39,202	–	39,202
loans and advances to banks	**36,407**	**–**	**36,407**	33,011	–	33,011
loans and advances to customers	**30,657**	**(2,303)**	**28,354**	29,546	(2,401)	27,145
Financial assets designated at fair value	**4,595**	**–**	**4,595**	4,505	–	4,505
debt securities	**4,595**	**–**	**4,595**	4,428	–	4,428
loans and advances to banks	**–**	**–**	**–**	77	–	77
Derivatives[1]	**145,424**	**(96,159)**	**49,265**	108,905	(93,503)	15,402
Loans and advances held at amortised cost[2]	**232,764**	**(41,163)**	**191,601**	236,408	(42,962)	193,446
loans and advances to banks	**22,203**	**–**	**22,203**	27,860	–	27,860
loans and advances to customers	**210,561**	**(41,163)**	**169,398**	208,548	(42,962)	165,586
Financial investments	**41,747**	**–**	**41,747**	40,788	–	40,788
treasury and other similar bills	**4,106**	**–**	**4,106**	3,296	–	3,296
debt securities	**37,641**	**–**	**37,641**	37,492	–	37,492
Other assets	**4,460**	**–**	**4,460**	3,880	–	3,880
endorsements and acceptances	**393**	**–**	**393**	231	–	231
accrued income and other	**4,067**	**–**	**4,067**	3,649	–	3,649
Financial guarantees	**8,531**	**–**	**8,531**	10,388	–	10,388
Loan commitments and other credit-related commitments	**81,801**	**–**	**81,801**	82,916	–	82,916
	660,049	**(139,625)**	**520,424**	613,881	(138,866)	475,015

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 2011, the total amount of such offsets was £142.0 billion (2010: £86.3 billion), of which £124.4 billion (2010: £75.2 billion) were offsets under a master netting arrangement, £17.4 billion (2010: £9.8 billion) were received in cash and £0.2 billion (2010: £1.3 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. However, 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

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. However, 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.

Report of the Directors: Risk (continued)

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 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 collaterals
(Audited)

	At 31 December 2011	At 31 December 2010
	£m	£m
Fully collateralised	**81,184**	74,526
Less than 25% loan to value ('LTV')	**6,392**	6,139
25% to 50% LTV	**20,410**	17,869
51% to 75% LTV	**34,008**	29,884
76% to 90% LTV	**15,448**	14,843
91% to 100% LTV	**4,926**	5,791
Partially collateralised		
greater than 100% LTV	**2,116**	2,677
collateral value	**1,822**	2,370
Total residential mortgages	**83,300**	77,203

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 products

(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	**Continental Europe**
	£m	**£m**
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 adjustable rate mortgages	**70**	**320**
Other	**63**	**–**
Total interest-only and affordability mortgages	**30,416**	**382**
As a percentage of total mortgage lending	**42.3%**	**6.3%**
At 31 December 2010		
Total residential mortgage lending	66,368	5,959
Total impairment allowances on residential mortgage lending	(177)	(37)
Interest-only (including endowment) mortgages	29,012	77
Affordability mortgages, including ARMs	644	210
Other	66	-
Total interest-only and affordability mortgages	29,722	287
As a percentage of total mortgage lending	44.8%	4.8%

Report of the Directors: Risk (continued)

Other personal lending

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

Corporate and commercial and financial (non-bank) lending

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 2011	At 31 December 2010
	£m	£m
Rated [CRR/EL 1 to 7]	**21,557**	20,738
Uncollateralised	**3,701**	3,964
Fully collateralised	**15,854**	14,754
Partially collateralised	**2,002**	2,020
- collateral value (partially collateralised)	**1,147**	1,160
Rated [CRR/EL 8 to 10]	**2,434**	1,810
Uncollateralised	**281**	160
Fully collateralised	**912**	750
Partially collateralised	**1,241**	900
- collateral value (partially collateralised)	**699**	558
Total commercial real estate loans and advances	**23,991**	22,548

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.

Other corporate and commercial and financial (non-bank) lending

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 (Audited)

	At 31 December 2011	At 31 December 2010
	£m	£m
Rated [CRR/EL 8 to 10]	**5,601**	7,565
Uncollateralised	**3,578**	5,246
Fully collateralised	**1,140**	1,226
Partially collateralised	**883**	1,093
- collateral value	**360**	404

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. Whilst such mitigants have value, often providing rights in insolvency, their assignable value is insufficiently certain and are 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 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.

Loans and advances to banks

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 2011 £m	At 31 December 2010 £m
Uncollateralised	**17,666**	21,069
Fully collateralised	**20,353**	32,399
Partially collateralised	**94**	59
- collateral value	**67**	41
Total loans and advances to banks	**38,113**	53,527

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

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

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.

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

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. Collateral accepted as security that the group is permitted to sell or repledge on reverse repos and stock borrowing is disclosed in Note 35 'Assets charged as security for liabilities and collateral accepted as security for assets'.

Report of the Directors: Risk (continued)

Collateral and other credit enhancements obtained

(Audited)

	The group		The bank	
	2011	2010	**2011**	2010
	£m	£m	**£m**	£m
Nature of assets				
Residential property[1]	**38**	29	**26**	22

1 The table presents the carrying amount of collateral and other credit enhancements obtained which are held at the reporting date. In previous years we presented the amount of collateral and other credit enhancements obtained during the year. This resulted from a change to the IFRS requirement.

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 2011		At 31 December 2010	
	Gross loans and advances to customers	**Gross loans by industry sector as a % of total gross loans**	Gross loans and advances to customers	Gross loans by industry sector as a % of total gross loans
	£m	**%**	£m	%
Personal				
Residential mortgages	**77,871**	**26.73%**	72,327	25.05%
Other personal	**33,571**	**11.52%**	35,008	12.12%
	111,442	**38.25%**	107,335	37.17%
Corporate and commercial				
Commercial, industrial and international trade	**71,098**	**24.40%**	72,006	24.94%
Commercial real estate	**21,034**	**7.22%**	19,970	6.92%
Other property-related	**4,908**	**1.68%**	4,125	1.43%
Government	**1,977**	**0.68%**	1,452	0.49%
Other commercial	**33,498**	**11.50%**	33,771	11.70%
	132,515	**45.48%**	131,324	45.48%
Financial				
Non-bank financial institutions	**43,881**	**15.06%**	46,087	15.96%
Settlement accounts	**440**	**0.15%**	612	0.21%
	44,321	**15.21%**	46,699	16.17%
Other	**3,085**	**1.06%**	3,390	1.18%
Total gross loans and advances	**291,363**	**100.00%**	288,748	100.00%

Report of the Directors: Risk (continued)

The bank

	At 31 December 2011		At 31 December 2010	
	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	**69,500**	**32.48%**	65,304	30.87%
Other personal	**9,276**	**4.34%**	9,894	4.68%
	78,776	**36.82%**	75,198	35.55%
Corporate and commercial				
Commercial, industrial and international trade	**50,103**	**23.42%**	52,115	24.64%
Commercial real estate	**12,675**	**5.92%**	12,090	5.71%
Other property-related	**3,201**	**1.50%**	3,120	1.47%
Government	**1,594**	**0.74%**	845	0.40%
Other commercial	**24,858**	**11.62%**	25,134	11.88%
	92,431	**43.20%**	93,304	44.10%
Financial				
Non-bank financial institutions	**39,616**	**18.52%**	39,616	18.73%
Settlement accounts	**41**	**0.02%**	50	0.02%
	39,657	**18.54%**	39,666	18.75%
Other	**3,085**	**1.44%**	3,390	1.60%
Total gross loans and advances	**213,949**	**100.00%**	211,558	100.00%

Area of special interest

Exposure to selected countries in the eurozone

(Unaudited)

2011 was a turbulent year for the global markets, dominated by the continuing eurozone debt crisis that started with the global financial crisis in 2007 and, by 2011, had developed into a severe sovereign debt crisis. The measures taken by governments to avoid a financial collapse resulted in higher debt levels, large fiscal deficits and, in certain cases, social and political disruption. During 2011, a number of eurozone countries came under severe financial pressure and their ability to raise, refinance and service their debt was put into question by markets, as demonstrated by the record high spreads during most of the year. Greece, Ireland and Portugal were forced to seek bail out packages from the European Central Bank ('ECB') and the International Monetary Fund ('IMF') under strict conditions, while fear of contagion to other eurozone countries forced governments to reduce debt levels through austerity measures that, at least in the short term, are seen as the cause of slow growth for some countries and stagnation in others.

Despite a number of high profile summits and meetings the EU was unable to agree and implement a strong coherent policy response to the crisis, prompting fear of default or the exit from the euro of one or more members. Under pressure during most of 2011, EU members showed an increasing willingness to agree a structured common approach, but they also demonstrated divergent opinions on the way forward and on the measures to be taken. This resulted in the three major rating agencies either downgrading, or putting on the watch list for possible downgrade, a number of sovereigns, which intensified the pressure, even on the stronger eurozone countries.

The ongoing sovereign debt crisis, slow economic growth, dearth of market financing for banks and private sector deleveraging severely affected the eurozone financial system, increasing the possibility of further banking stress in the region. The banking sector within the peripheral eurozone countries was particularly under threat as the credit risk of domestic and cross-border exposures increased significantly. This prompted calls from the European Banking Authority ('EBA') and the IMF for funding and liquidity support and/or the recapitalisation of certain European banks.

The ratings downgrade of a number of eurozone countries by major rating agencies in 2011 and January 2012 was generally anticipated and was, in most cases, not as large as feared, with the exception of Portugal which like Greece is now rated below investment grade. The downgrades have implications for the ratings of European banks and government guaranteed securities, as evidenced by the immediate downgrade of the European Financial Stability Fund ('EFSF').

Report of the Directors: Risk (continued)

Exposure to selected eurozone countries

(Audited)

	At 31 December 2011					
	Greece	Ireland	Italy	Portugal	Spain	Total
	£bn	£bn	£bn	£bn	£bn	£bn
Total						
Held for trading	0.5	0.6	1.3	0.4	1.4	4.2
Not held for trading	0.3	0.6	1.3	0.3	1.3	3.8
	0.8	**1.2**	**2.6**	**0.7**	**2.7**	**8.0**
Sovereign & 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
	0.3	**0.2**	**1.5**	**0.3**	**0.8**	**3.1**
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
	0.5	**1.0**	**1.1**	**0.4**	**1.9**	**4.9**

The table above summarises the group's exposures to governments and central banks of selected eurozone countries, and near/ quasi-government agencies and banks domiciled in these countries.

The category 'Held for trading' comprises trading assets. The category 'Not held for trading' comprises financial assets designated at fair value, derivatives, loans and advances to banks, loans and advances to customers and financial investments.

The group has no significant net open positions in the credit default swap contracts of any eurozone countries above apart from Greece, where the group has net open protection against its Greek exposures on a net notional of £447 million (fair value: £298 million).

Eurozone sovereigns and agencies
(Unaudited)

During 2011, Portugal joined Greece and Ireland in the list of the eurozone countries requiring rescue packages to remain solvent. Greece required a second support package, which was formalised as EU leaders announced a 3-year programme totalling €146 billion. In addition, the EFSF rules were changed to allow it to buy bonds on the secondary market, finance the recapitalisation of banks and provide pre-emptive credit lines to eurozone countries under pressure in debt markets. Conditions stabilised somewhat in October on growing optimism that the EU summit would propose comprehensive measures to tackle the crisis. By December, neither measures nor an implementation plan had been agreed and uncertainty and volatility returned as markets grew sceptical about the adequacy of the political response; fears of contagion to other eurozone countries intensified.

Concerns of contagion of the debt crisis in Greece, Ireland and Portugal to other countries, notably Italy and Spain, are likely to persist, causing the risk premium on most European countries' sovereign debt to remain high. The German economy has shown positive signs of stabilisation and has experienced positive growth during the year while the French economy has shown modest growth but is expected to stay resilient should the crisis spread to other peripheral eurozone countries.

At 31 December 2011, the group's exposure to the sovereign and agency debt of Greece, Ireland, Italy, Portugal and Spain was £3.1 billion, £0.5 billion lower than at the end of 2010.

During 2011, an impairment charge of £137 million was recognised in respect of Greek sovereign and agency exposures classified as available for sale, reflecting the further deterioration in Greece's fiscal position and the expected impact of recently announced support measures. The amount of the impairment charge represented the cumulative fair value loss on these securities as at the end of 2011, and does not necessarily represent the expectation of future cash losses. The impairment charge was recycled from the available-for-sale reserve to the income statement.

The group's sovereign exposures to Ireland, Italy, Portugal, and Spain are not considered to be impaired at 31 December 2011 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.

Eurozone banks
(Unaudited)

As a direct result of the eurozone sovereign debt crisis, economic slowdown, uncertain property market and low credit growth, banks in the eurozone area are continuing to face severe stress.

Report of the Directors: Risk (continued)

During the year, banks with direct exposure to eurozone sovereigns saw their costs and access to funding deteriorate. The concern about solvency of weaker banks intensified further following the rescue of Dexia in Belgium and the failure of MF Global in the US, which lost access to the funding markets due to its significant exposures to eurozone sovereign debt. Market volatility and funding issues were further exacerbated due to downgrades of European banks by the major credit rating agencies, citing concerns over their ability to absorb losses due to possible sovereign debt default, reliance on volatile wholesale funding markets and weakening of perceived government support. A crisis of confidence surfaced and banks became increasingly reluctant to lend to each other through the inter-bank market, prompting the ECB to take a number of extraordinary measures to ease funding pressures in the banking system. These included two unlimited liquidity operations with a 3-year maturity, the widening of eligibility criteria for collateral, assistance in providing access to liquidity for more (medium-sized) banks and lowering reserve requirements from 2 per cent to 1 per cent. The slowdown in the inter-bank funding market and the ECB's liquidity measures resulted in transferring a large part of market liquidity to Central Banks of highly rated countries, which is a further sign of ongoing derisking by banks in the eurozone. These measures have helped to ease the liquidity crisis in the short term, though medium-term funding challenges remain.

The group's overall exposure within the eurozone is largely to the banks in stronger countries. Management continue to closely monitor and manage eurozone bank exposures in the peripheral eurozone countries, and are cautious in lending to this sector. The group regularly updates its assessment of higher-risk eurozone banks and adjust its risk appetite accordingly. Where possible, the group also seeks to play a positive role in maintaining credit and liquidity supply.

At 31 December 2011, the group's exposure to the banks in Greece, Ireland, Italy, Portugal and Spain was £4.9 billion, £0.3 billion higher than at the end of 2010.

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

Summary exposures to non-distressed eurozone countries (Audited)

At 31 December 2011, the group's exposure to the sovereign and agency debt and banks of Germany, France and Netherlands were £52 billion and £48 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 our operations.

Exposure to non-distressed eurozone countries

(Audited)

	At 31 December 2011			
	France	**Germany**	**Netherlands**	**Total**
	£bn	**£bn**	**£bn**	**£bn**
Sovereign & Agencies	15.1	11.1	25.9	52.1
Banks	28.4	11.9	7.4	47.7
	43.5	**23.0**	**33.3**	**99.8**

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.

Credit quality

	Debt securities and other bills	**Wholesale lending and derivatives**		**Retail lending**	
Quality classification	**External credit rating**	**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.

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'). The 23-grade scale was introduced in September 2010 following the harmonisation of PDs for three asset classes (banks, sovereigns and corporate) into one scale which required an additional PD band. 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 2011							
	Neither past due nor impaired							
		Medium						
	Strong	Good	Satisfactory	Sub-Standard	Past due not impaired	Impaired	Impairment allowances	Total
	£m	£m	£m	£m	£m	£m	£m	£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 group

	31 December 2010							
	Neither past due nor impaired							
		Medium						
	Strong	Good	Satisfactory	Sub-Standard	Past due not impaired	Impaired	Impairment allowances	Total
	£m	£m	£m	£m	£m	£m	£m	£m
Cash and balances at central banks	24,495	–	–	–	–	–	–	24,495
Items in the course of collection from other banks	1,932	–	–	–	–	–	–	1,932
Trading assets	107,068	12,142	15,411	426				135,047
– treasury and other eligible bills	2,278	127	124	–				2,529
– debt securities	65,242	2,398	5,715	416				73,771
– loans and advances to banks	19,245	4,270	3,000	10				26,525
– loans and advances to customers	20,303	5,347	6,572	–				32,222
Financial assets designated at fair value	3,530	260	3,927	–				7,717
– treasury and other eligible bills	20	–	–	–				20
– debt securities	2,977	260	3,924	–				7,161
– loans and advances to banks	24	–	3	–				27
– loans and advances to customers	509	–	–	–				509
Derivatives	103,241	18,840	6,675	402				129,158
Loans and advances held at amortised cost	207,339	69,053	50,281	10,855	1,514	6,783	(3,580)	342,245
– loans and advances to banks	51,290	5,170	366	180	–	71	(50)	57,027
– loans and advances to customers	156,049	63,883	49,915	10,675	1,514	6,712	(3,530)	285,218
Financial investments	91,289	2,559	3,040	2,134	–	1,638	–	100,660
– treasury and other eligible bills	9,250	–	74	25	–	5	–	9,354
– debt securities	82,039	2,559	2,966	2,109	–	1,633	–	91,306
Other assets	4,459	520	2,338	503	12	5	–	7,837
– endorsements and acceptances	436	14	44	–	–	–	–	494
– accrued income and other	4,023	506	2,294	503	12	5	–	7,343

Report of the Directors: Risk (continued)

The bank

	31 December 2011							
	Neither past due nor impaired							
		Medium						
	Strong	Good	Satisfactory	Sub-Standard	Past due not impaired	Impaired	Impairment allowances	Total
	£m	£m	£m	£m	£m	£m	£m	£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)

The bank

	31 December 2010							
	Neither past due nor impaired							
		Medium						
	Strong	Good	Satisfactory	Sub-Standard	Past due not impaired	Impaired	Impairment allowances	Total
	£m	£m	£m	£m	£m	£m	£m	£m
Cash and balances at central banks	22,357	–	–	–	–	–	–	22,357
Items in the course of collection from other banks	1,030	–	–	–	–	–	–	1,030
Trading assets	79,973	10,734	11,582	415				102,704
– treasury and other eligible bills	831	–	114	–				945
– debt securities	33,801	1,731	3,255	415				39,202
– loans and advances to banks	26,450	3,803	2,758	–				33,011
– loans and advances to customers	18,891	5,200	5,455	–				29,546
Financial assets designated at fair value	602	77	3,826	–				4,505
– debt securities	602	–	3,826	–				4,428
– loans and advances to banks	–	77	–	–				77
Derivatives	88,490	14,859	5,196	360				108,905
Loans and advances held at amortised cost	148,707	45,098	30,636	9,343	702	4,953	(3,031)	236,408
– loans and advances to banks	22,998	2,801	362	951	–	769	(21)	27,860
– loans and advances to customers	125,709	42,297	30,274	8,392	702	4,184	(3,010)	208,548
Financial investments	39,561	189	594	288	–	156	–	40,788
– treasury and other similar bills	3,222	–	74	–	–	–	–	3,296
– debt securities	36,339	189	520	288	–	156	–	37,492
Other assets	3,019	497	358	6	–	–	–	3,880
– endorsements and acceptances	182	13	36	–	–	–	–	231
– accrued income and other	2,837	484	322	6	–	–	–	3,649

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 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**
At 31 December 2010						
Loans and advances held at amortised cost	944	290	239	19	22	1,514
Other assets	3	4	–	3	2	12
	947	294	239	22	24	1,526

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 2011						
Loans and advances held at amortised cost	**349**	**141**	**96**	**15**	**1**	**602**
At 31 December 2010						
Loans and advances held at amortised cost	399	171	125	7	–	702

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 concessions granted which the 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 it typically no less that 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.

In previous periods, the group's impaired loan disclosure convention did not explicitly require loans that are renegotiated for credit purposes to be presented as impaired. In the *2011 Annual Report and Accounts*, the group has separately presented all renegotiated loans, as defined above, by credit quality classification and has simultaneously adopted a more stringent impaired loan disclosure convention for portfolios with significant levels of forbearance. The topic of renegotiated loans and forbearance is subject to evolving industry practice and regulatory pronouncements.

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 2011				At 31 December 2010			
	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	**341**	**88**	**624**	**1,053**	260	103	578	941
Other personal	**263**	**47**	**103**	**413**	304	61	195	560
Commercial real estate	**1,444**	**–**	**1,615**	**3,059**	1,479	1	1,175	2,655
Corporate and commercial	**1,185**	**46**	**1,171**	**2,402**	1,446	42	665	2,153
Financial	**8**	**–**	**306**	**314**	5	–	361	366
Governments	**–**	**–**	**–**	**–**	–	–	–	–
Total renegotiated loans and advances to customers	**3,241**	**181**	**3,819**	**7,241**	3,494	207	2,974	6,675
Impairment allowances:								
Collectively assessed				**(69)**				(92)
Individually assessed				**(1,137)**				(822)
Total impairment allowance on renegotiated loans				**(1,206)**				(914)

Report of the Directors: Risk (continued)

Impaired loans

(Audited)

During the year the group adopted a revised disclosure convention for impaired loans and advances. The revision introduces a more stringent approach to the presentation of renegotiated loans as impaired. Management believes that this revised approach better reflects the nature of risks and inherent credit quality in the loan portfolio as it is more closely calibrated to the types of forbearance concession granted and applies stricter requirements for the performance of renegotiated loans before they may be considered as not impaired. It also reflects developments in industry best practice disclosure. The revised disclosure convention affects the disclosure presentation of impaired loans but does not affect the accounting policy for the recognition of impairment allowances.

Impaired loans and advances to customers and banks by industry sector

(Audited)

	Impaired loans and advances at 31 December 2011			Impaired loans and advances at 31 December 2010		
	Individually assessed £m	**Collectively assessed £m**	**Total £m**	Individually assessed £m	Collectively assessed £m	Total £m
Banks	**47**	**–**	**47**	71	–	71
Customers	**6,775**	**692**	**7,467**	5,651	1,061	6,712
Personal	**1,034**	**662**	**1,696**	895	1,010	1,905
Corporate and commercial	**5,198**	**30**	**5,228**	4,174	51	4,225
Financial	**543**	**–**	**543**	582	–	582
	6,822	**692**	**7,514**	5,722	1,061	6,783

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 2011 £m	2010 £m
Gross loans and advances		
Individually assessed impaired loans[1]	**6,775**	5,651
Collectively assessed[2]	**284,588**	283,097
Impaired loans[1]	**692**	1,061
Non-Impaired loans[3]	**283,896**	282,036
Total gross loans and advances	**291,363**	288,748
Impairment allowances		
Individually assessed	**2,429**	2,248
Collectively assessed	**920**	1,282
Total impairment allowances	**3,349**	3,530
Individually assessed allowances as a percentage of individually assessed loans and advances	**35.9%**	39.8%
Collectively assessed allowances as a percentage of collectively assessed loans and advances	**0.32%**	0.45%

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 2011			At 31 December 2010		
	Individually assessed allowances £m	**Collectively assessed allowances £m**	**Total allowances £m**	Individually assessed allowances £m	Collectively assessed allowances £m	Total allowances £m
Banks	**32**	**–**	**32**	50	–	50
Customers	**2,429**	**920**	**3,349**	2,248	1,282	3,530
Personal	**351**	**615**	**966**	313	1,005	1,318
Corporate and commercial	**1,804**	**298**	**2,102**	1,665	271	1,936
Financial	**274**	**7**	**281**	270	6	276
	2,461	**920**	**3,381**	2,298	1,282	3,580

Impairment allowances as a percentage of gross loans and advances[1]

(Audited)

The group

	At 31 December	
	2011 %	2010 %
Banks		
Individually assessed impairment allowances	**0.13**	0.19
Customers		
Individually assessed impairment allowances	**0.91**	0.87
Collectively assessed impairment allowances	**0.34**	0.50
	1.38	1.56

The bank

	At 31 December	
	2011 %	2010 %
Banks		
Individually assessed impairment allowances	**0.13**	0.08
Customers		
Individually assessed impairment allowances	**1.35**	1.19
Collectively assessed impairment allowances	**0.29**	0.31
	1.77	1.58

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		
	Individually assessed £m	Individually assessed £m	Collectively assessed £m	Total £m
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**
At 1 January 2010	57	2,312	1,280	3,649
Amounts written off	(6)	(933)	(885)	(1,824)
Recoveries of loans and advances written off in previous years	1	21	137	159
Charge to income statement	2	877	754	1,633
Foreign exchange and other movements	(4)	(29)	(4)	(37)
At 31 December 2010	50	2,248	1,282	3,580

The bank

	Banks	Customers		
	Individually assessed £m	Individually assessed £m	Collectively assessed £m	Total £m
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**
At 1 January 2010	28	2,267	608	2,903
Amounts written off	(6)	(826)	(707)	(1,539)
Recoveries of loans and advances written off in previous years	1	19	132	152
Charge to income statement	(1)	951	588	1,538
Foreign exchange and other movements	(1)	(22)	–	(23)
At 31 December 2010	21	2,389	621	3,031

Report of the Directors: Risk (continued)

Movement in impairment allowances by industry sector

(Unaudited)

	2011 £m	2010 £m	2009 £m	2008 £m	2007 £m
Impairment allowances at 1 January	**3,580**	3,649	2,545	1,796	1,766
Amounts written off	**(1,627)**	(1,824)	(1,580)	(1,150)	(1,297)
Personal	**(996)**	(834)	(1,012)	(859)	(1,031)
– residential mortgages	**(15)**	(31)	(25)	(2)	(1)
– other personal	**(981)**	(803)	(987)	(857)	(1,030)
Corporate and commercial	**(612)**	(980)	(508)	(280)	(264)
– commercial, industrial and international trade	**(345)**	(247)	(275)	(200)	(183)
– commercial real estate and other property-related	**(165)**	(648)	(93)	(42)	(36)
– other commercial	**(102)**	(85)	(140)	(38)	(45)
Financial[1]	**(19)**	(10)	(60)	(11)	(2)
Recoveries of amounts written off in previous years	**297**	159	170	157	268
Personal	**268**	136	133	150	231
– residential mortgages	**13**	19	17	–	–
– other personal	**255**	117	116	150	231
Corporate and commercial	**27**	22	32	7	34
– commercial, industrial and international trade	**11**	11	30	4	8
– commercial real estate and other property-related	**5**	4	2	3	9
– other commercial	**11**	7	–	–	17
Financial[1]	**2**	1	5	–	3
Charge to income statement	**1,222**	1,633	2,619	1,716	1,043
Personal	**415**	803	1,130	876	789
– residential mortgages	**60**	99	100	11	4
– other personal	**355**	704	1,030	865	785
Corporate and commercial	**798**	709	1,329	749	248
– commercial, industrial and international trade	**261**	322	543	304	176
– commercial real estate and other property-related	**310**	232	626	304	60
– other commercial	**227**	155	160	141	12
Financial[1]	**9**	121	160	91	7
Governments	–	–	–	–	(1)
Exchange and other movements	**(91)**	(37)	(105)	26	16
Impairment allowances at 31 December	**3,381**	3,580	3,649	2,545	1,796
Impairment allowances against banks:					
– individually assessed	**32**	50	57	43	3
Impairment allowances against customers					
– individually assessed	**2,429**	2,248	2,312	1,380	920
– collectively assessed	**920**	1,282	1,280	1,122	873
Impairment allowances at 31 December	**3,381**	3,580	3,649	2,545	1,796
Impairment allowances against customers as a percentage of loans and advances to customers	**%**	%	%	%	%
– individually assessed	**0.84**	0.78	0.84	0.46	0.40
– collectively assessed	**0.32**	0.45	0.47	0.38	0.38
At 31 December	**1.16**	1.23	1.31	0.84	0.78

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)

	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**

	2010		
	Individually assessed £m	Collectively assessed £m	Total £m
Banks	1	–	1
Personal	98	705	803
– Residential mortgages	60	39	99
– Other personal	38	666	704
Corporate and commercial	662	47	711
– Commercial, industrial and international trade	286	36	322
– Commercial real estate and other property-related	213	19	232
– Other commercial	163	(8)	155
Financial	118	2	120
Total charge to income statement	879	754	1,633

Net loan impairment charge to the income statement

(Unaudited)

	2011 £m	2010 £m	2009 £m	2008 £m	2007 £m
Individually assessed impairment allowances					
New allowances	**1,042**	1,157	1,654	893	390
Release of allowances no longer required	**(236)**	(256)	(167)	(180)	(194)
Recoveries of amounts previously written off	**(19)**	(22)	(44)	(22)	(21)
	787	879	1,443	691	175
Collectively assessed impairment allowances					
New allowances net of allowance required	**881**	1,008	1,445	1,266	1,228
Release of allowances no longer required	**(168)**	(117)	(143)	(106)	(113)
Recoveries of amounts previously written off	**(278)**	(137)	(126)	(135)	(247)
	435	754	1,176	1,025	868
Total charge for impairment losses	**1,222**	1,633	2,619	1,716	1,043
Banks	**(7)**	2	35	35	–
Customers	**1,229**	1,631	2,584	1,681	1,043
Charge for impairment losses as a percentage of closing gross loans and advances	**0.36**	0.47	0.81	0.49	0.36
At 31 December	**£m**	£m	£m	£m	£m
Impaired loans	**7,514**	6,783	6,623	3,744	2,959
Impairment allowances	**3,381**	3,580	3,649	2,545	1,796

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

(Unaudited)

	2011 %	2010 %	2009 %	2008 %	2007 %
Net allowances net of allowances releases	**0.53**	0.72	1.11	0.78	0.72
Recoveries	**(0.10)**	(0.06)	(0.07)	(0.07)	(0.15)
Total charge for impairment losses	**0.43**	0.66	1.04	0.71	0.57
Amount written off net of recoveries	**0.46**	0.67	0.63	0.48	0.71

Securitisation exposures and other structured products

(Audited)

Analysis of asset-backed securities

During the period a total valuation decrease of £341 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).

Asset Backed Securities

	31 December 2011				31 December 2010			
	Gross principal[2]	**CDS gross protection[3]**	**Net Principal exposure[4,6]**	**Carrying Amount[5,6]**	Gross principal	CDS gross protection	Net Principal exposure[6]	Carrying Amount[6]
	£m	**£m**	**£m**	**£m**	£m	£m	£m	£m
High grade[1]	**17,858**	**4,609**	**13,249**	**12,402**	22,313	4,145	18,168	15,631
rated C to A	**16,714**	**435**	**16,279**	**10,536**	16,295	141	16,154	9,850
not publicly rated	**788**	**–**	**788**	**261**	493	–	493	215
Total asset-backed securities	**35,360**	**5,044**	**30,316**	**23,199**	39,101	4,286	34,815	25,696

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 *A CDS is a credit default swap. CDS protection principal is the gross principal of the underlying instrument that is protected by CDSs.*
4 *Net principal exposure is the gross principal amount of assets that are not protected by CDSs. 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 (2011: 1GBP:USD 1.548; 2010: 1GBP:USD 1.552).*

Included in the above table is carrying amount of £7,575 million (2010: £8,752 million) held through 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 £202 million for the year ended 31 December 2011 (2010: decreased by impairment charges of £265 million).

Special purpose entities

(Audited)

The group enters into certain transactions with customers in the ordinary course of business which involve the establishment of special purpose entities ('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.

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.

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 38.

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

(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 thereto;
- monitoring balance sheet liquidity and advances to core funding ratios 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
- 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 2011

(Audited)

The liquidity position of the group strengthened further in 2011. The group continued to enjoy strong inflows of customer deposits and maintained good access to wholesale markets. During 2011, core funding grew by 7.5 per cent while advances grew by 2.3 per cent, resulting in a decrease in our advances-to-core funding ratio to 91 per cent.

Market conditions

Developments in the eurozone sovereign debt crisis continued to dominate the agenda. In May 2011, Portugal became the third eurozone country to seek financial support from the ECB and the IMF. Conditions deteriorated markedly over the summer with sharp increases in credit default swap premia for eurozone peripheral countries. This prompted European authorities to propose a package of measures in October, including a near doubling of the capacity of the European Financial Stability Facility.

In December 2011, with the crisis reaching systemic levels, the ECB injected liquidity into the European banking sector via an unprecedented €489 billion (£409 billion) 3-year Long-Term Refinancing Operation ('LTRO'), and committed to conduct a similar operation in February 2012. This intervention by the ECB had a positive effect on bank CDS levels, as well as on general funding conditions. The group supports the ECB in its efforts to stabilise the capital markets. Given the lack of stigma in participating and the attractive pricing, and with the outlook for capital markets remaining uncertain, we considered it prudent for the group's Continental Europe operations, to anticipate future funding requirements by participating in the LTRO, receiving €5.2 billion in total, mainly in France.

Encumbered assets

Encumbered assets are assets which have been pledged or used as collateral or which legally the group may not be able to use to secure funding. It remains a strength that only a small percentage of the group's assets are encumbered and that the majority of the group's assets are available as security for creditors. The encumbrance arises mainly due to repo activity within Global Banking and Markets, which is largely self-funding.

Encumbered assets are disclosed in Note 35 'Assets charged as security for liabilities and collateral accepted as security for assets'. Assets not included in Note 35 but which would generally not be used to secure funding include assets backing insurance and investment contracts.

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, but 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. In aggregate, the banking entities of the group are liquidity providers to the interbank market, placing significantly more short-term funds with other banks than they borrow.

Of total liabilities of £796 billion at 31 December 2011, funding from customers amounted to £346 billion, of which £342 billion was contractually repayable within one year.

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 33 'Maturity analysis of assets and liabilities'.

Assets available to meet these liabilities, and to cover outstanding commitments to lend (£828 billion), included cash, central bank balances, items in the course of collection and treasury and other bills (£66 billion); loans to banks (£45 billion, including £43 billion repayable within one year); and loans to customers (£288 billion, including £137 billion repayable within one year). In the normal course of business, a proportion of customer loans contractually repayable within one year will be extended. In addition, the group held debt securities marketable at a value of £144 billion. Of these assets, £103 billion of debt securities and treasury and other bills had been pledged to secure liabilities.

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 ratio

(Audited)

The group emphasises the importance of core customer deposits as a source of funds to finance lending to customers, and discourages reliance on short-term professional funding. This is achieved by placing limits on banking entities which restrict their ability to increase loans and advances to customers without corresponding growth in core customer deposits or long term debt funding. This measure is referred to as the 'advances to core funding' ratio. Advances to core funding ratio limits are set by the RMM. The ratio describes current 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. Loans and advances to customers which are part of reverse repurchase arrangements, and where the group receives securities which are deemed to be liquid, are excluded from the advances to core funding ratio.

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.

Stressed one month coverage ratio

(Unaudited)

The stressed one month coverage ratios tabulated below are derived from projected cashflow scenario analyses, and express the stressed cash inflows as a percentage of stressed cash outflows over a one month time horizon. Entities of the group are required to target a ratio of 100 per cent or greater.

Advances to core funding ratios

(Audited)

	The group		The bank	
	2011	2010	**2011**	2010
	(%)	(%)	**(%)**	(%)
Year end	**91.2**	95.7	**99.8**	103.0
Maximum	**96.3**	97.9	**103.4**	109.7
Minimum	**91.2**	94.5	**98.4**	102.6
Average	**94.1**	96.3	**100.8**	106.0

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

Stressed one month coverage ratio

(Unaudited)

	The group		The bank	
	2011	2010	**2011**	2010
	(%)	(%)	**(%)**	(%)
Year end	**115.2**	111.7	**116.2**	111.1
Maximum	**115.3**	114.3	**118.1**	111.3
Minimum	**110.9**	106.7	**109.4**	103.2
Average	**112.1**	110.9	**112.5**	108.2

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

Projected cash flow scenario analyses

(Audited)

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.

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

Report of the Directors: Risk (continued)

Both ratio and cash flow limits reflect the local market place, the diversity of funding sources available and the concentration risk from large depositors. Compliance with entity level limits is monitored and reported regularly to the RMM.

Contingent Liquidity risk

(*Audited)*

In the normal course of business, 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's contractual exposures as at 31 December monitored under the contingent liquidity risk limit structure
(Audited)

	The group		The bank	
	2011	2010	**2011**	2010
	£bn	£bn	**£bn**	£bn
Conduits				
Client-originated assets[1]				
– total lines	**8.3**	5.1	**7.4**	3.5
– largest individual lines	**0.4**	0.4	**0.4**	0.4
Assets managed by the group[2]	**14.3**	16.5	**14.3**	16.5
Single-issuer liquidity facilities				
– five largest[3]	**2.2**	2.7	**2.2**	2.7
– largest market sector[4]	**4.9**	5.4	**4.9**	5.4

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 2011, a committed line of £2.1 billion was provided to Bryant Park by the bank (transferred from HSBC Bank USA)*
2 *These 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. The group has a total contingent liquidity risk of £14.3 billion (31 December 2010: £16.5 billion) of which Solitaire represents £6.0 billion already funded on-balance sheet as at 31 December 2011 (31 December 2010: £5.2 billion) leaving a net contingent exposure of £8.3 billion (31 December 2010 : £11.3 billion). As at 31 December 2011 £4.0 billion (31 December 2010 : £5.4 billion) is on a zero balance liquidity exposure as all the Commercial Paper is funded by HSBC.*
3 *These figures represent the undrawn balance for the five largest committed liquidity facilities provided to customers, other than those facilities to conduits.*
4 *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.*

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 include positions arising from market-making, position-taking and others designated as marked-to-market.

Non-trading portfolios include 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 69.

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 our status as one of the world's largest banking and financial services organisations.

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 its business and to transfer them to either its 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, simulation modelling is used to identify the impact of varying scenarios on valuations and net interest income.

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

Value at risk ('VAR')

(Audited)

VAR is a technique that estimates the potential losses that could occur on risk positions as a result of movements in market rates and prices over a specified time horizon and to a given level of confidence.

The VAR models used by the group are predominantly based 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 by the group assess potential market movements with reference to data from the past two years and calculate VAR to a 99 per cent confidence level and for a one-day holding period.

The group routinely validates the accuracy of its VAR models by back-testing the actual daily profit and loss results, adjusted to remove non-modelled items such as fees and commissions, against the corresponding VAR numbers. Statistically, the group would expect to see losses in excess of VAR only 1 per cent of the time over a one-year period. The actual number of excesses over this period can therefore be used to gauge how well the models are performing.

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

- 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.

Sensitivity analysis

(Unaudited)

Sensitivity measures are used to monitor the market risk positions within each risk type, for example, the present 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 VAR's limitations, the group augments VAR with stress testing to evaluate the potential impact on portfolio values of more extreme, though plausible, events or movements in a set of financial variables. The process is governed by the 'Stress Testing Review Group' forum which, in conjunction with regional risk managers determines the scenarios to be applied at portfolio and consolidated level, as follows:

- sensitivity scenarios consider the impact of any single risk factor or a set of factors 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 reflecting current market concerns around the US treasuries

Report of the Directors: Risk (continued)

downgrade and the potential effects of a sovereign debt default, including its wider contagion effects; and

- historical scenarios incorporate historical observations of market movement during previous periods of stress which would not be captured within VAR.

Stress testing results provide senior management with an assessment of the financial impact such events would have on the profit of the bank.

Trading and non-trading portfolios

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

	Portfolio	
	Trading	Non-trading
Risk type		
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)

	2011 £m	2010 £m
At 31 December (including non-trading credit spread VAR)	**191.3**	**169.2**

Despite a reduction of the exposures versus December 2010, the relative increase in rates and credit spread volatility towards the end of the year materially increased the 31 December 2011 total VAR.

With effect from 21 May 2010, the basis of the VAR computation was changed to include non-trading credit spread VAR. The 2010 average, minimum and maximum calculations, included in the table below are therefore based on the VAR from this point onwards.

	2011 £m	2010 £m
Average	161.7	211.3
Minimum	131.4	147.5
Maximum	233.0	279.4

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 2011 was £69.2 million (2010: £43.0 million). This is analysed below by risk type:

Total trading VAR by risk type

	Foreign exchange and commodity £m	Interest rate £m	Equity £m	Credit £m	Portfolio diversification £m	Total[1] £m
At 31 December 2011	9.5	28.1	4.4	45.4	-18.3	69.1
At 31 December 2010	12.0	27.6	7.5	20.8	-24.9	43.0
Average						
2011	9.3	31.4	5.0	30.6	-18.4	57.9
2010	16.4	31.5	5.5	26.6	-23.3	56.7
Minimum						
2011	4.4	17.3	1.6	15.1		35.5
2010	3.6	18.3	1.6	14.7		26.3
Maximum						
2011	20.3	45.9	10.7	63.0		84.8
2010	41.0	53.2	12.8	41.3		85.1

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*

Report of the Directors: Risk (continued)

Despite a reduction of the exposures versus December 2010, the relative increase in rates and credit spread volatility towards the end of the year materially increased the 31 December 2011 trading VAR.

Credit spread risk

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 2011, the credit VAR on these transactions was £4.1 million (2010: £7.7 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 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 2011 gap risk continued to be managed down. We did not incur any material gap loss in respect of such transactions in 2011.

Non-trading portfolios

(Audited)

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 2011, 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 £171.3 million (2010: £157.1 million). The sensitivity was calculated on the same basis as for the trading portfolio. It increased to £222.8 million (2010: £181.3 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 2011, the capital note holders can absorb the first US$2.3 billion (2010: US$2.2 billion) of any losses incurred by the SICs prior to us 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 £34.5 million at 31 December 2011 (2010: £26.2 million); whilst the average, minimum and maximum during the year was £25.9 million, £13.2 million and £35.0 million respectively (2010: £31.4 million, £19.0 million and £36.8 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 2011 was £1,224 million (2010: £1,426 million).

The fair value of the constituents of equity securities held as available-for-sale can fluctuate considerably. A 10 per cent reduction in the value of the available-for-sale equities at 31 December 2011 would have reduced equity by £122 million (2010: £143 million). 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 the 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 to be significantly overvalued 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 34 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.

For simulation modelling, businesses use a combination of scenarios relevant to them and their 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 £16.7 billion at 31 December 2011 compared with £15.6 billion at 31 December 2010. Assets of the defined benefit schemes at 31 December 2011 comprised: equity investments 13 per cent (16 per cent at 31 December 2010); debt securities 76 per cent (69 per cent at 31 December 2010) and other (including property) 11 per cent (15 per cent at 31 December 2010).

Report of the Directors: Risk (continued)

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 within their respective countries.

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 £6.5 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, Europe 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 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.

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.

Data security

In connection with a significant data theft which occurred in 2010 in Switzerland, HSBC Private Bank (Suisse) SA has implemented various measures to strengthen information security and provided the Swiss Financial Market Supervisory Authority ('FINMA') with regular updates on implementation in compliance with its declaratory ruling dated 22 February 2011.

In 2011, it emerged that German authorities have client related data of HSBC Trinkaus & Burkhardt (International) SA. HSBC Trinkaus & Burkhardt (International) SA continues to seek to clarify the background of this incident and to further strengthen information security.

Risk management of insurance operations

(Audited)

The group operates a bancassurance model which provides insurance products for customers with whom the group has a banking relationship. Insurance products are sold through all global businesses, mainly utilising retail branches, the internet and phone centres. RBWM customers attract the majority of sales and comprise the majority of policyholders.

Many of these insurance products are manufactured by group subsidiaries. This allows the group to retain the risks and rewards associated with writing insurance contracts, which includes both the underwriting profit and the commission paid by the manufacturer to the bank distribution channel within the group.

Where it is considered operationally more effective, third parties are engaged to manufacture insurance products for sale through the group's banking network. The group works with a limited number of market-leading partners to provide the products. These arrangements earn the group a commission.

The majority of the risk in the group's insurance business derives from manufacturing activities and can be categorised as insurance risk and financial risks. 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 UK, European and Middle East Insurance Regional Risk Committee, which oversees the status of the significant risk categories in the insurance operations. Four subcommittees of this Committee focus on products and pricing, market, liquidity risk and 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 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. Approval is provided by the UK, European and Middle East Regional Insurance Head Office or Group Insurance Head Office 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.

Insurance risk of insurance operations

(Audited)

Insurance risk is the risk, other than financial risk, transferred from the holder of the insurance contract to the issuer (the group). 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 ('DPF') within the policy.

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 centrally, 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, supplemented with stress testing.

As well as exercising underwriting controls, reinsurance is also used as a means of mitigating exposure, in particular to aggregation of catastrophe risk. When we manage our exposure to insurance risk through the use of third-party reinsurers, the associated revenue and manufacturing profit is ceded to them. 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 71).

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. Of particular importance is the need to match the expected pattern of cash inflows with the benefits payable on the underlying contracts, which can extend for many years.

The following tables analyse the group's insurance risk exposures by type of business.

Analysis of life insurance risk – liabilities to policyholders

(Audited)

	2011 £m	2010 £m
Life (non-linked)		
– Insurance contracts with DPF [1]	**216**	211
– Credit life	**141**	169
– Annuities	**334**	304
Term assurance and other long-term contracts	**60**	204
Total life (non-linked)	**751**	888
Life (linked)	**1,620**	1,464
Investment contracts with DPF [1, 2]	**13,872**	14,205
Insurance liabilities to policyholders	**16,243**	16,557

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

(Audited)

Non-life insurance contracts include accident and health, fire and other damage to property, and repayment protection. The UK motor book continued to run-off and the business was sold in September 2011. Credit non-life insurance is originated in conjunction with the provision of loans.

Net written insurance premiums amounted to: Accident and health: £15 million (2010: £53 million), Fire and other damage: £5 million (2010: £25 million), Credit: £4 million (2010: £16 million) and Marine, aviation and other: £5 million (2010: £14 million).

Financial risks of insurance operations

(Audited)

The group's insurance businesses are exposed to a range of financial risks, including market risk, credit risk and liquidity risk. Market risk includes interest rate risk, equity

risk and foreign exchange risk. The nature and management of these risks is described below.

Manufacturing subsidiaries are exposed to financial risk when, for example, the proceeds from financial assets are not sufficient to fund the obligations arising from non-linked insurance and investment contracts.

Local regulatory requirements prescribe the type, quality and concentration of assets that the group's insurance manufacturing subsidiaries 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 subsidiaries 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, we typically designate assets at fair value; for non-linked contracts, the classification of the assets is driven by the nature of the underlying contract.

Financial assets held by insurance manufacturing subsidiaries
(Audited)

	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**
	5,713	**3,768**	**–**	**583**	**10,064**
Financial investments - available-for-sale					
Other eligible bills	**–**	**–**	**–**	**32**	**32**
Debt securities	**–**	**8,973**	**14**	**761**	**9,748**
Equity securities	**–**	**–**	**–**	**11**	**11**
	–	**8,973**	**14**	**804**	**9,791**
Derivatives	**5**	**148**	**–**	**4**	**157**
Other financial assets	**400**	**835**	**13**	**237**	**1,485**
	6,118	**13,724**	**27**	**1,628**	**21,497**

	At 31 December 2010				
	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	8	5	–	6	19
Debt securities	1,679	730	–	220	2,629
Equity securities	4,082	3,280	–	383	7,745
	5,769	4,015	–	609	10,393
Financial investments - available-for-sale					
Other eligible bills	–	23	90	140	253
Debt securities	–	9,454	86	757	10,297
Equity securities	–	–	–	16	16
	–	9,477	176	913	10,566
Derivatives	5	147	–	2	154
Other financial assets	427	710	278	244	1,659
	6,201	14,349	454	1,768	22,772

Approximately 57 per cent of financial assets were invested in debt securities at 31 December 2011 (2010: 57 per cent), with 35 per cent invested in equity securities (2010: 34 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 28 per cent of the total financial assets of the group's insurance manufacturing subsidiaries at the end of 2011 (2010: 27 per cent).

Market risk of insurance operations
(Audited)

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 subsidiaries which generate market risk, and the market risk to which these features expose the subsidiaries, are discussed below.

Long-term insurance or investment products may incorporate either investment return or capital repayment guarantees or both. Subsidiaries 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 the market value of the linked assets influences the fees earned for managing them.

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;
- as far as possible, matching assets to 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 subsidiaries monitor exposures against mandated limits regularly and report these quarterly to the Regional Insurance Head Office. Exposures are aggregated and reported to senior risk management forums, including the Regional Insurance Market, Liquidity and Credit Risk Committee, the Regional Insurance Risk Committee and the Regional Stress Testing Committee.

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 subsidiaries after taking into consideration tax and accounting treatments where material and relevant. The results of these stress tests are reported to the Regional 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 values of certain assets and liabilities and the risk factors may be non-linear and, therefore, the results disclosed cannot 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.

Sensitivity of the group's insurance subsidiaries to risk factors
(Audited)

	2011		2010	
	Effect on profit for the year	**Effect on total equity**	Effect on profit for the year	Effect on total equity
	£m	**£m**	£m	£m
+ 100 basis points parallel shift in yield curves	**(19)**	**(30)**	12	(6)
– 100 basis points parallel shift in yield curves	**7**	**19**	(17)	2
10 per cent increase in equity prices	**16**	**16**	10	10
10 per cent decrease in equity prices	**(16)**	**(16)**	(10)	(10)
Sensitivity to credit spread increases	**(1)**	**(4)**	(1)	(5)

Credit risk of insurance operations
(Audited)

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 £10.6 billion (2010: £11.5 billion) non-linked bond portfolio.

As tabulated above, the exposure of the income statement to the effect of changes in credit spreads is a fall of £1 million (2010: £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 subsidiaries are 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 by the Regional Insurance Head Office and reported to the Regional Insurance Market, Liquidity and Credit Risk Committee and the Regional Insurance Risk Committee. Stress testing is performed by the Regional Insurance Head Office on the investment credit exposures using credit spread sensitivities and default probabilities. The stresses are reported to the Regional Insurance Market, Liquidity and Credit Risk Committee.

A number of tools are used to manage and monitor credit risk. These include an Early Warning Report and a watch list of investments with current credit concerns which are circulated fortnightly to senior management in the Regional Insurance Head Office and to the Regional Chief Risk Officer to identity investments which may be at risk of future impairment.

Credit quality
(Audited)

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 43. 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. 93 per cent (2010: 96.5 per cent) of the assets included in the table are invested in investments rated as 'Strong'.

Report of the Directors: Risk (continued)

Treasury bills, other eligible bills and debt securities in the group's insurance manufacturing subsidiaries

(Audited)

	At 31 December 2011			At 31 December 2010		
	Strong £m	Good/ Satisfactory £m	Total[2] £m	Strong £m	Good/ Satisfactory £m	Total[2] £m
Financial assets designated at fair value[1]	**731**	**109**	**840**	840	123	963
– treasury and other eligible bills	**3**	**-**	**3**	13	–	13
– debt securities	**728**	**109**	**837**	827	123	950
Financial investments	**9,160**	**620**	**9,780**	10,273	277	10,550
– treasury and other similar bills	**32**	**-**	**32**	253	–	253
– debt securities	**9,128**	**620**	**9,748**	10,020	277	10,297
	9,891	**729**	**10,620**	11,113	400	11,513

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 subsidiaries.*

Credit risk also arises when part of the insurance risk incurred by the group is assumed by 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.

Reinsurers' share of liabilities under insurance contracts

(Audited)

	Neither past due nor impaired				
	Strong £m	Good/ Satisfactory £m	Sub-standard £m	Past due not impaired £m	Total[1,2] £m
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**
At 31 December 2010					
Linked insurance contracts	28	–	–	–	28
Non-linked insurance contracts	395	4	5	–	404
Total	423	4	5	–	432
Reinsurance debtors	14	–	–	–	14

1 *No amounts reported within Reinsurers' share of liabilities under insurance contracts were classified as 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

(Audited)

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 around the market price. Finally, standby liquidity risk refers to the capacity to meet payment terms in abnormal conditions.

The group's insurance manufacturing subsidiaries 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

Report of the Directors: Risk (continued)

- 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 subsidiaries are required to complete and submit liquidity risk reports to the Regional Insurance Head Office for collation and review by the Regional Insurance Market Liquidity and Credit 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 2011 remained comparable with 2010.

Expected maturity of insurance contract liabilities

(Audited)

	Expected cash flows (undiscounted)				
	Within 1 year	1-5 years	5-15 years	Over 15 years	Total
	£m	£m	£m	£m	£m
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**
At 31 December 2010					
Non-life insurance	235	270	12	42	559
Life insurance (non-linked)	123	197	458	181	959
Life insurance (linked)	35	205	614	617	1,471
Total	393	672	1,084	840	2,989

Remaining contractual maturity of investment contract liabilities

(Audited)

	Liabilities under investment contracts by insurance underwriting subsidiaries					
	Within 1 year	1-5 years	5-10 years	Over 10 years	Undated[1]	Total
	£m	£m	£m	£m	£m	£m
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**
At 31 December 2010						
Linked investment contracts	249	606	735	1,374	1,777	4,741
Investment contracts with DPF	–	–	–	–	14,205	14,205
Total	249	606	735	1,374	15,982	18,946

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
(Audited)

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 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 21 of the Notes on the Financial Statements.

During 2011 the calculation of the PVIF asset was refined to bring greater comparability and consistency across the Group's insurance operations. This was achieved by incorporating explicit margins and allowances for certain risks and uncertainties in place of implicit adjustments to the risk discount rate.

The change in calculation reflected explicit risk margins for non-economic risks in the projection assumptions, and explicit allowances for financial options and guarantees using stochastic methods. Risk discount rates were reduced as a result of removing the implicit adjustments.

It should be noted that refinements made to the PVIF calculation during 2011 will introduce greater volatility within reported results.

Other material risks

Pension risk

(Unaudited)

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. However, 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
- 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 our 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 at that time, at the last year end 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 reminder in a more diverse range of investments, and includes a commitment to undertake a programme of swap arrangements (see Note 41 on the Financial Statements) 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.

	2011	**2010**	2006
	%	**%**	%
Equities	**15.5**	15.5	15.0
Bonds	**60.5**	56.5	50.0
Alternative assets[1]	**9.5**	10.5	10.0
Property	**9.0**	9.0	10.0
Cash	**5.5**	8.5	15.0
	100.0	100.0	100.0

1 *In 2010 and 2011, alternative assets include ABSs, MBSs and infrastructure assets. In 2006, alternative assets included loans and infrastructure assets.*

Reputational risk

(Unaudited)

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.

A Reputational Risk Committee ('HRCC') exists to manage reputational risks across HSBC Bank plc. The HRRC 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 HRRC 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.

Report of the Directors: Capital Management

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 at all times. 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 indentified 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.

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 2011.

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 of the Basel Committee on Banking Supervision. Basel II is structured around three 'pillars': Pillar 1: minimum capital requirements, Pillar 2: Supervisory Review and Evaluation Process and Pillar 3: market discipline. 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.

There were no material changes to the group's policies except the introduction of CRD III regulations, commonly known as Basel 2.5, which took effect as of 31 December 2011. The implementation of CRD III increased the group's credit risk RWAs by £5 billion and was the main reason for the £16 billion increase in market risk RWAs at the end of 2011.

Regulatory capital

The group's capital is comprised of 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.

Report of the Directors: Capital Management (continued)

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 99 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.

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. Its 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.

Following the implementation of CRDIII, the majority of securitisation positions in the trading book are treated for capital purposes as if they are held in the non-trading book at fair value. 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.

Report of the Directors: Capital Management (continued)

Following the implementation of CRDIII, the bank's internal 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.

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.

Future developments

The regulation and supervision of financial institutions continues to undergo significant change in response to the global financial crisis. In December 2010, the Basel Committee issued final rules in 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 requirement of 4.5 per cent and 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 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 will be subject to a supervisory monitoring period, which commenced on 1 January 2011, and a parallel run period which will run 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 met. The capital treatment of securities issued prior to this date will be phased out over a 10-year period commencing on 1 January 2013.

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 majority of the Basel III proposals are in the Regulation, removing national discretion, with the exception of countercyclical and capital buffers which are in the Directive.

The Regulation additionally sets out provisions to harmonise regulatory and financial reporting in the EU. In December 2011, the European Banking Authority published a consultative document, *Implementing Technical Standards on Supervisory Reporting Requirements*. The proposed measures specify uniform formats, frequencies and dates of prudential reporting to the regulator. The new requirements are due to take effect as of 1 January 2013.

The CRD IV measures are subject to agreement by the European Parliament, the Council and EU member states.

In September 2011 the UK Independent Commission on Banking ('ICB') recommended measures on capital requirements for UK banking groups. For further details on these proposals see page 31.

Report of the Directors: Capital Management (continued)

Capital structure at 31 December

	31 Dec 2011 £m	31 Dec 2010 £m
Composition of regulatory capital (Audited)		
Shareholders' equity [1]	**32,449**	31,379
Shareholders' equity per balance sheet	**31,090**	31,825
Preference share & related premium	**(431)**	(431)
Other equity instruments	**–**	(1,750)
Deconsolidation of special purpose entities [2, 4]	**1,790**	1,735
Non controlling interests	**364**	382
Non-controlling interests per balance sheet	**514**	532
Of which representing non-controlling interests in preference shares	**(150)**	(150)
Regulatory adjustments to the accounting basis	**(1,032)**	748
Unrealised (gains)/losses on available-for-sale debt securities [3, 4]	**1,261**	1,545
Own credit spread	**(706)**	(170)
Defined benefit pension fund adjustment [5, 6]	**(1,058)**	288
Cash flow hedging reserve	**(236)**	(190)
Reserves arising from revaluation of property & unrealised gains on available-for-sale equities	**(272)**	(373)
Other regulatory adjustments	**(21)**	(352)
Deductions	**(11,051)**	(11,428)
Goodwill capitalised & intangible assets	**(10,274)**	(10,436)
50% of securitisation positions	**(570)**	(679)
50% of excess expected losses over impairment allowances	**(286)**	(439)
50% of tax credit adjustment for excess expected losses	**79**	126
Core tier 1 capital	**20,730**	21,081
Other tier 1 capital before deductions	**2,377**	2,374
Preference shares & related premium	**581**	581
Hybrid capital securities	**1,796**	1,793
Deductions	**(368)**	(500)
Unconsolidated investments [7]	**(447)**	(626)
50% of tax credit adjustment for excess expected losses	**79**	126
Tier 1 capital	**22,739**	22,955
Total qualifying tier 2 capital before deductions	**11,837**	11,758
Reserves arising from unrealised gains on revaluation of property & available-for-sale equities	**272**	373
Collective impairment allowances [8]	**235**	338
Perpetual subordinated debt	**2,863**	2,762
Term subordinated debt	**8,467**	8,285
Total deductions other than from tier 1 capital	**(1,908)**	(2,302)
Unconsolidated investments [7]	**(1,045)**	(1,177)
50% of securitisation positions	**(570)**	(679)
50% of excess expected losses over impairment allowances	**(286)**	(439)
Other deductions	**(7)**	(7)
Total regulatory capital	**32,668**	32,411
Risk-weighted assets (Unaudited)		
Credit and counterparty risk	**173,693**	164,372
Market risk	**28,605**	12,762
Operational risk	**25,381**	24,586
Total	**227,679**	201,720
Capital ratios (Unaudited)		%
Core tier 1 ratio	**9.1**	10.5
Tier 1 ratio	**10.0**	11.4
Total capital ratio	**14.4**	16.1

1 *Includes externally verified profits for the year to 31 December 2011. Does not include the interim dividend of £200 million declared by the Board of Directors after 31 December 2011.*
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 *In December 2010, the bank agreed with the FSA that for regulatory purposes it would consolidate one of its special purpose entities.*
5 *FSA rules require banks to exclude from capital resources any surplus in a defined benefit pension scheme.*
6 *FSA rules permit banks to replace a liability in a defined benefit pension scheme by the additional funding that will be paid into the scheme over the following five year period.*
7 *Mainly comprise investments in insurance entities.*
8 *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 79 to 86 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

A A Flockhart, Chairman, 60

Chairman since January 2011 and a Director since July 2010. An executive Director of HSBC Holdings plc and Chairman, Europe, Middle East, Latin America and Commercial Banking. Joined HSBC in 1974.

B Robertson, Chief Executive, 57

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, 51

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.

P W Boyles, Chief Executive Officer, Continental Europe, 56

A Director since July 2010. A Group General Manager since 2006. Joined HSBC in 1975.

J D Garner, Deputy Chief Executive and Head of UK Bank, 42

A Director since December 2010. A Group General Manager since 2006. Formerly Head of Personal Financial Services, UK Banking. Joined HSBC in 2004.

Dame Denise Holt, Independent Non-Executive Director, 62

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.

P J C Houzé, Independent Non-Executive Director, 64

A Director since October 2010. Chief Executive Officer of Galeries Lafayette Group and Chief Executive of Monoprix SA. A Director and Chairman of the Nomination and Remuneration Committees of HSBC France.

J W Leng, Non-Executive Director, 66

A Director since October 2010. A member of the HSBC European Advisory Council. 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.

Dame Mary Marsh, Independent Non-Executive Director, 65

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, 51

A Director since 2005. General Counsel & Company Secretary, Vodafone Group plc.

A R D Monro-Davies, Independent Non-Executive Director, 71

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, 61

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, Head of Retail Banking and Wealth Management, Europe, 36

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, 69

Chairman of the Audit and Risk Committees.

A Director since 2004. Formerly Deputy Chairman of S G Warburg & Co.

Secretary

J H McKenzie, 58

Joined HSBC in 1987.

Registered Office: 8 Canada Square, London E14 5HQ

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 79.

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.

A P Simoes was appointed as a Director on 1 February 2012. Dame Denise Holt was appointed as an independent non-executive Director on 1 February 2011. P Antika was appointed as a non-executive Director on 1 July 2011.

S P O'Sullivan, D C Budd and P A Thurston resigned as Directors on 31 January 2011, 24 February 2011 and 31 December 2011 respectively.

Directors' emoluments

Details on the emoluments of the Directors of the bank for 2011, disclosed in accordance with the Companies Act, are shown in Note 7 'Employee compensation and benefits' in the Notes on the Financial statements.

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), A R D Monro-Davies, and P M Shawyer. All of the members of the Audit Committee who served during 2011 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), A R D Monro-Davies, and P M Shawyer. All of the members of the Risk Committee who served during 2011 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: A A Flockhart (Committee Chairman), B Robertson, P W Boyles and J D Garner.

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 disposition; 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 that the Directors have established 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 up to 27 February 2012, the date of approval of the *Annual Report and Accounts 2011*. In the case of companies acquired during the year, the internal controls in place are being reviewed against the group's benchmarks and integrated into the group's processes.

Key internal control procedures include the following:

- Authority to operate the bank and responsibility for financial performance against plans and capital expenditure, is delegated to the Chairman 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.
- Functional, operating, financial reporting and certain management reporting standards are established by the HSBC Holdings global function management committees, for application across the whole of HSBC. These are supplemented by operating standards set by the bank as required.
- 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 security, security and fraud, systems and people risk). Exposure to these risks is monitored by the bank's or other major subsidiaries' risk management committees, asset and liability committees and executive committees in subsidiaries. The bank's Risk Management Meeting ('RMM') is held monthly to address asset, liability and risk management issues. The minutes of this meeting are submitted to the Group RMM.
- The group's financial reporting process for preparing the consolidated Annual Report and Accounts 2011 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.
- 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. During 2011, attention was focused on:
  - embedding further Risk Appetite and Stress Testing into the business of HSBC through refining processes around risk identification and forward looking risks;
  - a number of reviews and special papers on key risks prompted by the top and emerging risk process, which were presented to Risk Management Meeting, the Risk Committee and Board;
  - managing geopolitical risks and ongoing instability in the Eurozone;
  - managing and mitigating the uncertain economic risks within major markets, particularly in the US;
  - extending a Single Name Concentration risk process with respect to HSBC's larger corporate exposures;
  - implementing the Group's global wholesale risk aggregation system;
  - the mitigation of information risks; and
  - enhancing policies and practices relevant to the prevention of financial crimes
- Periodic strategic plans are prepared for global businesses, support functions and certain geographies within the framework of the Group Strategic Plan. The group prepares rolling operating plans which set out the key business initiatives and the likely financial effects of those initiatives, which are informed by detailed analysis of risk appetite describing the types and quantum of risk that the group is prepared to take in executing its strategy.
- Governance arrangements are in place to provide oversight of, and advice to the Board on, material risk-related matters including assurance that risk analytical models are fit for purpose, used accordingly and complemented by both model-specific and enterprise-wide stress tests that evaluate the impact of severe yet plausible events and other unusual circumstances not fully captured by quantitative models.
- Centralised functional control is exercised over all IT developments and operations. Common systems are employed for similar business processes wherever practicable.
- HSBC Holdings sets policies, procedures and standards for the following risks to which the group adheres: 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). Responsibility for exposure to market risk and to credit risk with specified risk characteristics is delegated with limits to line management. Credit and market risks are measured and reported on in subsidiaries and aggregated for review of risk concentrations on a HSBC Group-wide basis.

- Policies have been established to guide the bank, subsidiary companies and management at all levels in the conduct of business to avoid reputational risks which can arise from environmental, social or governance issues, or as a consequence of operational risk events, or as a result of employees acting in a manner inconsistent with the Group's 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 establishment and maintenance of appropriate systems of internal control is primarily the responsibility of business management. The Internal Audit function, which is centrally controlled, monitors the effectiveness of internal control structures across the whole of the HSBC Group focusing on the areas of greatest risk to HSBC as determined by a risk-based grading approach.
- 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. Executive management must also confirm annually as part of the Internal Audit process that officers under their control have taken, or are in the process of taking, the appropriate actions to deal with all significant recommendations made by external auditors in management letters or by regulators following regulatory inspections.

The Audit Committee has kept under review the effectiveness of this system of internal control and has reported regularly to the Board of Directors. The key processes used by the Committee in carrying out its reviews include: regular business and operational risk assessments; regular reports from the heads of key risk functions; the production annually of reviews of key internal controls measured against group benchmarks, 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 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 Audit 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 Committee, 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 issuer's accounting and financial reporting function, and their training programmes and budget. The Audit Committee has 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.

Health and safety

The maintenance of appropriate health and safety standards throughout the bank remains a key responsibility of all managers and the bank is committed actively to managing all health and safety risks associated with its business. The bank's objectives are to identify, remove, reduce or control material risks of fires and of accidents or injuries to employees and visitors, and to minimise the effects of incidents on business operations.

Group standards, instructions and related policies and procedures are set by the Group Corporate Real Estate function of HSBC Holdings plc and are implemented by Health, Safety and Fire (HSF) Coordinators based in each country in which the Group operates, supported by a Regional HSF Coordinator.

Despite the considerable international pressure on terrorist networks over the past few years, the global threat from terrorism persists. HSBC remains committed to maintaining its preparedness and to ensuring the highest standards of health and safety wherever in the world it operates.

HSBC Group Security provides regular risk assessments in areas of increased risk to assist management in judging the level of terrorist threat. In addition, Regional Security functions conduct regular security reviews to ensure measures to protect HSBC staff, buildings, assets and information are appropriate for the level of threat.

Report of the Directors: Governance (continued)

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 our Diversity & Inclusion Index which is part of our Global People Survey. All survey items in the Diversity & Inclusion Index performed above the UK and Ireland external 'Best in Class' average and the Financial Services norm.

The latest survey, undertaken in July 2011, indicated that 84 per cent of bank staff feel they are treated with respect and dignity at work, and that 80 per cent feel that they work in an environment where people from diverse perspectives can succeed.

Employees with disabilities

The group continues to recruit, train and develop disabled employees and make reasonable adjustments where employees 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 our employees.

Employee engagement

'Employee engagement' describes employees' emotional 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 level to improve the working experience and engagement.

In the HSBC Group the annual employee engagement survey was last undertaken in July 2011. The UK bank achieved a response rate of 74 per cent. The UK employee

engagement score rose from 68 per cent in 2010 to 72 per cent in 2011. The UK bank remains above the UK and Ireland external 'Best in Class' average. Improvements have been seen in all areas of the employee experience with particular gains regarding reward, communication and the valuing of contributions.

Customer Orientation and the working experience remain strong and are improving.

In 2012 a new approach to measure '***employee experience'*** is proposed. Quarterly pulse surveys will focus on behaviours that drive high performance rather then driving up a measure of engagement. This will allow HSBC to:

- improve alignment to HSBC strategy
- provide more regular and timely feedback/ respond to emerging issues
- identify and share good practice Group-wide
- reduce complexity of data collection and reporting

The aim is to alternate the employee engagement surveys with the employee experience pulse surveys that are conducted on an annual basis.

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

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.

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 one or more of 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 them. When setting strategy, HSBC considers factors such as population growth; increased longevity; urbanisation and the resulting resource constraints and rising atmospheric CO_2 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.

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 development of communities and are prerequisites for economic growth. These philanthropic programmes aim to involve employees in the work of local NGOs and charities.

During 2011, the bank supported community activities in the UK through charitable donations, and UK employees volunteered around 60,000 hours in work time.

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; in effect this risk arises when the environmental and social effects outweigh economic benefits. 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

Report of the Directors: Governance (continued)

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 is also a signatory to 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.

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 business function, with senior executives charged with implementing sustainable business practice in all major regions, through inclusion in the HSBC Group Standards Manuals, and through induction and developmental training. Local teams are in charge of embedding corporate sustainability strategies within banking activities. In the UK, the head of Corporate Sustainability sits on the UK Bank Management Committee and reports to the Deputy CEO and Head of UK Retail Bank. In France, the head of Corporate Sustainability reports to the Chief Executive of HSBC France and sits on the executive management board.

As a whole, 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. The *HSBC Sustainability Report 2011* will be issued on 25 May 2012 and will be available at www.hsbc.com/sustainability.

Valuation of freehold and leasehold land and buildings

The group's freehold and long leasehold properties were valued in 2011. The value of these properties was £253 million in excess of their carrying amount in the consolidated balance sheet. The group no longer revalues freehold and long leasehold properties under IFRSs.

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 2011 represented 28 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 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

27 February 2012

Statement of Directors' Responsibilities in Respect of the *Annual Report and Accounts 2011* 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 Auditors 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 law 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 the Directors: Governance' section on page 79 of this Annual Report, confirm to the best of their knowledge:

- in accordance with rule 4.1.12(3)(a) of the Disclosure Rules and Transparency Rules, the consolidated financial statements, which have been prepared in accordance with IFRSs as issued by the IASB and as endorsed 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 Rules 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 taken 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* — 27 February 2012

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 2011 set out on pages 89 to 203. 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 87, 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 APB's web-site at www.frc.org.uk/apb/scope/private.cfm.

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 2011 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

27 February 2012

Financial Statements

Consolidated income statement for the year ended 31 December 2011

	Notes	2011 £m	2010 £m
Interest income		**11,351**	11,110
Interest expense		**(4,128)**	(3,416)
Net interest income		**7,223**	7,694
Fee income		**5,193**	5,311
Fee expense		**(1,293)**	(1,271)
Net fee income		**3,900**	4,040
Trading income excluding net interest income		**591**	1,210
Net interest income on trading activities		**945**	907
Net trading income		**1,536**	2,117
Net income from financial instruments designated at fair value		**433**	276
Gains less losses from financial investments		**292**	537
Dividend income		**16**	18
Net earned insurance premiums	*4*	**2,580**	2,635
Other operating income		**225**	782
Total operating income		**16,205**	18,099
Net insurance claims incurred and movement in liabilities to policyholders	*5*	**(2,182)**	(3,023)
Net operating income before loan impairment charges and other credit risk provisions		**14,023**	15,076
Loan impairment charges and other credit risk provisions	*6*	**(1,623)**	(1,951)
Net operating income	*6*	**12,400**	13,125
Employee compensation and benefits	*7*	**(4,581)**	(4,961)
General and administrative expenses		**(4,158)**	(3,536)
Depreciation and impairment of property, plant and equipment	*22*	**(353)**	(460)
Amortisation and impairment of intangible assets	*21*	**(196)**	(162)
Total operating expenses		**(9,288)**	(9,119)
Operating profit		**3,112**	4,006
Share of profit in associates and joint ventures		**(1)**	5
Profit before tax		**3,111**	4,011
Tax expense	*10*	**(734)**	(996)
Profit for the year		**2,377**	3,015
Profit attributable to shareholders of the parent company		**2,329**	2,959
Profit attributable to non-controlling interests		**48**	56

The accompanying notes on pages 99 to 203 and the audited sections of 'Report of the Directors: Risk' on pages 27 to 74 and 'Report of the Directors: Capital Management' on pages 75 to 78 form an integral part of these financial statements.

Financial Statements (continued)

Consolidated statement of comprehensive income for the year ended 31 December 2011

	2011 £m	2010 £m
Profit for the year	**2,377**	3,015
Other comprehensive income		
Available-for-sale investments		
– fair value (losses)/gains	**(341)**	2,914
– fair value gains transferred to the income statement on disposal	**(100)**	(419)
– amounts transferred to the income statement in respect of impairment losses	**369**	721
– income taxes	**225**	(254)
Cash flow hedges		
– fair value gains	**369**	307
– fair value gains transferred to the income statement	**(300)**	(530)
– income taxes	**(23)**	63
Actuarial gains on defined benefit plans		
– before income taxes	**1,141**	179
– income taxes	**(316)**	(63)
Exchange differences and other	**(536)**	(114)
Other comprehensive income for the year, net of tax	**488**	2,804
Total comprehensive income for the year	**2,865**	5,819
Total comprehensive income for the year attributable to:		
– shareholders of the parent company	**2,836**	5,777
– non-controlling interests	**29**	42
	2,865	5,819

The accompanying notes on pages 99 to 203 and the audited sections of 'Report of the Directors: Risk' on pages 27 to 74 and 'Report of the Directors: Capital Management' on pages 75 to 78 form an integral part of these financial statements.

Financial Statements (continued)

Consolidated statement of financial position at 31 December 2011

	Notes	2011 £m	2010 £m
ASSETS			
Cash and balances at central banks		**56,460**	24,495
Items in the course of collection from other banks		**1,663**	1,932
Trading assets	*15*	**126,598**	159,552
Financial assets designated at fair value	*16*	**15,332**	15,467
Derivatives	*17*	**176,993**	129,158
Loans and advances to banks	*32*	**44,603**	57,027
Loans and advances to customers	*32*	**288,014**	285,218
Financial investments	*18*	**93,112**	102,086
Other assets	*24*	**7,137**	6,118
Current tax assets		**262**	216
Prepayments and accrued income		**2,937**	3,568
Interests in associates and joint ventures	*20*	**76**	76
Goodwill and intangible assets	*21*	**10,995**	11,143
Property, plant and equipment	*22*	**2,204**	2,108
Deferred tax assets	*10*	**140**	330
Retirement benefit assets	*7*	**1,444**	-
Total assets		**827,970**	798,494
LIABILITIES AND EQUITY			
Liabilities			
Deposits by banks	*32*	**41,032**	48,287
Customer accounts	*32*	**346,129**	344,123
Items in the course of transmission to other banks		**1,154**	1,411
Trading liabilities	*25*	**119,211**	132,360
Financial liabilities designated at fair value	*26*	**31,992**	27,935
Derivatives	*17*	**178,121**	129,204
Debt securities in issue	*32*	**42,688**	48,119
Other liabilities	*27*	**4,570**	4,860
Current tax liability		**131**	153
Liabilities under insurance contracts issued	*28*	**16,347**	17,116
Accruals and deferred income		**3,509**	3,950
Provisions	*29*	**820**	425
Deferred tax liabilities	*10*	**266**	54
Retirement benefit liabilities	*7*	**398**	733
Subordinated liabilities	*30*	**9,998**	7,407
Total liabilities		**796,366**	766,137
Equity			
Called up share capital	*36*	**797**	797
Share premium account		**20,025**	20,025
Other equity instruments	*36*	**–**	1,750
Other reserves		**(537)**	(220)
Retained earnings		**10,805**	9,473
Total equity attributable to shareholders of the parent company		**31,090**	31,825
Non-controlling interests		**514**	532
Total equity		**31,604**	32,357
Total equity and liabilities		**827,970**	798,494

The accompanying notes on pages 99 to 203 and the audited sections of 'Report of the Directors: Risk' on pages 27 to 74 and 'Report of the Directors: Capital Management' on pages 75 to 78 form an integral part of these financial statements.

A A Flockhart, Chairman 27 February 2012

Financial Statements (continued)

Consolidated cash flow statement for the year ended 31 December 2011

	Notes	2011 £m	2010 £m
Cash flows from operating activities			
Profit before tax		**3,111**	4,011
Adjustments for:			
– non-cash items included in profit before tax	37	**3,090**	2,837
– change in operating assets	37	**20,932**	17,225
– change in operating liabilities	37	**(8,348)**	20,868
– elimination of exchange differences[1]		**1,726**	(3,613)
– net gain from investing activities		**(327)**	(925)
– share of loss/(profits) in associates and joint ventures		**1**	(5)
– contributions paid to defined benefit plans		**(397)**	(1,985)
– tax paid		**(486)**	(1,087)
Net cash (used in)/generated from operating activities		**19,302**	37,326
Cash flows from investing activities			
Purchase of financial investments		**(67,343)**	(68,653)
Proceeds from the sale and maturity of financial investments		**74,328**	57,569
Purchase of property, plant and equipment		**(391)**	(511)
Proceeds from the sale of property, plant and equipment		**34**	141
Purchase of intangible assets		**(281)**	(184)
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		**–**	517
Proceeds from disposal of associates		**14**	–
Purchases of HSBC Holdings plc shares to satisfy share-based payment transactions		**(32)**	–
Net cash generated from/(used in) investing activities		**6,188**	(11,118)
Cash flows from financing activities			
Issue of preference share capital		**–**	25
Subordinated liabilities issued, net of perpetual subordinated debt classified as equity repaid		**1,602**	633
Subordinated loan capital repaid		**(704)**	–
Net cash outflow from increase in stake of subsidiaries		**(50)**	(194)
Dividends paid to shareholders		**(1,819)**	(1,874)
Dividends paid to non-controlling interests		**(31)**	(22)
Net cash generated from financing activities		**(1,002)**	(1,432)
Net increase in cash and cash equivalents		**24,488**	24,776
Cash and cash equivalents at 1 January		**86,005**	60,806
Effect of exchange rate changes on cash and cash equivalents		**(2,053)**	423
Cash and cash equivalents at 31 December	37	**108,440**	86,005

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 99 to 203 and the audited sections of 'Report of the Directors: Risk' on pages 27 to 74 and 'Report of the Directors: Capital Management' on pages 75 to 78 form an integral part of these financial statements.

Consolidated statement of changes in equity for the year ended 31 December 2011

	2011									
					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[5] £m	Foreign exchange reserve £m	Total share-holders' equity £m	Non-controlling interests £m	Total equity £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[2]	–	–	**(1,750)**	**(6)**	–	–	–	**(1,756)**	–	**(1,756)**
Other movements	–	–	–	–	–	–	**3**	**3**	–	**3**
Acquisition of subsidiaries[3]	–	–	–	**(108)**	–	–	–	**(108)**	–	**(108)**
Change in ownership interest in subsidiaries that did not result in loss of control[4]	–	–	–	**(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 *In March 2011, the bank repaid to HSBC Holdings plc £1,750 million of perpetual subordinated debt. At the same time, the bank issued US dollar denominated perpetual subordinated debt of $2,862 million to HSBC Holdings plc, which is included in 'Subordinated liabilities'. See Note 41 for further details.*
3 *Relates to the purchase of HSBC International Trustee Limited from a fellow subsidiary of HSBC Holdings plc. See Note 41 for further details.*
4 *Relates to the purchase of the non-controlling interest in HSBC Investment Holdings (Guernsey) Limited. See Note 41 for further details.*
5 *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 99 to 203 and the audited sections of 'Report of the Directors: Risk' on pages 27 to 74 and 'Report of the Directors: Capital Management' on pages 75 to 78 form an integral part of these financial statements.

	2010									
					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	1,750	8,135	(5,911)	350	2,641	27,787	641	28,428
Profit for the year	–	–	–	2,959	–	–	–	2,959	56	3,015
Other comprehensive income (net of tax)	–	–	–	118	2,962	(160)	(102)	2,818	(14)	2,804
Available-for-sale investments	–	–	–	–	2,962	–	–	2,962	–	2,962
Cash flow hedges	–	–	–	–	–	(160)	–	(160)	–	(160)
Actuarial gains/(losses) on defined benefit plans	–	–	–	118	–	–	–	118	(2)	116
Exchange differences and other	–	–	–	–	–	–	(102)	(102)	(12)	(114)
Total comprehensive income for the year	–	–	–	3,077	2,962	(160)	(102)	5,777	42	5,819
Dividends to shareholders	–	–	–	(1,868)	–	–	–	(1,868)	(22)	(1,890)
Net impact of equity-settled share-based payments[1]	–	–	–	163	–	–	–	163	–	163
Other movements	–	–	–	–	–	–	–	–	–	–
Change in ownership interest in subsidiaries that did not result in loss of control[2]	–	–	–	(56)	–	–	–	(56)	(129)	(185)
Tax on items taken directly to equity - current	–	–	–	22	–	–	–	22	–	22
At 31 December	797	20,025	1,750	9,473	(2,949)	190	2,539	31,825	532	32,357

1 *Includes deferred tax of £(10) million.*
2 *Relates to the purchase of non-controlling interest in HSBC Europe B.V. See Note 41 for further details.*
3 *Movements in the cash flow hedging reserve include amounts transferred to the income statement of £530 million comprising a £514 million loss taken to 'Net interest income' and a £16 million gain taken to 'Net trading income'.*

The accompanying notes on pages 99 to 203 and the audited sections of 'Report of the Directors: Risk' on pages 27 to 74 and 'Report of the Directors: Capital Management' on pages 75 to 78 form an integral part of these financial statements.

Financial Statements (continued)

HSBC Bank plc statement of financial position at 31 December 2011

	Notes	2011 £m	2010 £m
ASSETS			
Cash and balances at central banks		**44,967**	22,357
Items in the course of collection from other banks		**908**	1,030
Trading assets	*15*	**106,339**	126,493
Financial assets designated at fair value	*16*	**4,595**	4,505
Derivatives	*17*	**145,424**	108,905
Loans and advances to banks	*32*	**22,203**	27,860
Loans and advances to customers	*32*	**210,561**	208,548
Financial investments	*18*	**42,240**	41,338
Other assets	*24*	**4,016**	3,354
Current tax assets		**308**	216
Prepayments and accrued income		**1,249**	1,557
Interests in associates and joint ventures	*20*	**65**	63
Investments in subsidiary undertakings	*23*	**15,047**	15,459
Goodwill and intangible assets	*21*	**799**	686
Property, plant and equipment	*22*	**1,347**	1,343
Deferred tax assets	*10*	**55**	617
Retirement benefit assets	*7*	**1,444**	-
Total assets		**601,567**	564,331
LIABILITIES AND EQUITY			
Liabilities			
Deposits by banks	*32*	**32,324**	38,873
Customer accounts	*32*	**237,654**	230,795
Items in the course of transmission to other banks		**446**	577
Trading liabilities	*25*	**94,584**	98,412
Financial liabilities designated at fair value	*26*	**22,861**	18,334
Derivatives	*17*	**147,251**	108,786
Debt securities in issue	*32*	**25,705**	29,417
Other liabilities	*27*	**2,380**	2,221
Current taxation		**25**	11
Accruals and deferred income		**1,769**	1,955
Provisions	*29*	**565**	229
Deferred tax liability	*10*	**2**	2
Retirement benefit liabilities	*7*	**172**	575
Subordinated liabilities	*30*	**9,893**	7,562
Total liabilities		**575,631**	537,749
Equity			
Called up share capital	*36*	**797**	797
Share premium account		**20,025**	20,025
Other equity instruments	*36*	**–**	1,750
Other reserves		**(340)**	42
Retained earnings		**5,454**	3,968
Total equity		**25,936**	26,582
Total equity and liabilities		**601,567**	564,331

The accompanying notes on pages 99 to 203 and the audited sections of 'Report of the Directors: Risk' on pages 27 to 74 and 'Report of the Directors: Capital Management' on pages 75 to 78 form an integral part of these financial statements.

A A Flockhart, Chairman — 27 February 2012

Financial Statements (continued)

HSBC Bank plc cash flow statement for the year ended 31 December 2011

	Notes	2011 £m	2010 £m
Cash flows from operating activities			
Profit before tax		**2,770**	3,396
Adjustments for:			
– non-cash items included in profit before tax	*37*	**1,956**	2,215
– change in operating assets	*37*	**22,991**	(5,523)
– change in operating liabilities	*37*	**1,033**	28,734
– elimination of exchange differences[1]		**(617)**	(1,189)
– net gain from investing activities		**(239)**	(329)
– contributions paid to defined benefit plans		**(379)**	(1,933)
– tax paid		**(133)**	(674)
Net cash (used in)/generated from operating activities		**27,382**	24,697
Cash flows from investing activities			
Purchase of financial investments		**(31,107)**	(27,066)
Proceeds from the sale of financial investments		**30,585**	14,849
Purchase of property, plant and equipment		**(272)**	(316)
Proceeds from the sale of property, plant and equipment		**24**	5
Purchase of goodwill and intangible assets		**(245)**	(163)
Proceeds from disposal of associates		**1**	2
Net cash generated from/(used in) investing activities		**(1,014)**	(12,689)
Cash flows from financing activities			
Subordinated loan capital repaid		**(684)**	–
Subordinated liabilities issued, net of perpetual subordinated debt classified as equity repaid		**1,326**	633
Net cash outflow from acquisition of and increase in stake of subsidiaries		**–**	(442)
Dividends paid		**(1,815)**	(1,868)
Net cash generated from financing activities		**(1,173)**	(1,677)
Net increase in cash and cash equivalents		**25,195**	10,331
Cash and cash equivalents at 1 January		**51,359**	40,702
Effect of exchange rate changes on cash and cash equivalents		**(1,198)**	326
Cash and cash equivalents at 31 December	*37*	**75,356**	51,359

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 99 to 203 and the audited sections of 'Report of the Directors: Risk' on pages 27 to 74 and 'Report of the Directors: Capital Management' on pages 75 to 78 form an integral part of these financial statements.

HSBC Bank plc statement of changes in equity for the year ended 31 December 2011

	2011							
					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 equity £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 *In March 2011, the bank repaid to HSBC Holdings plc £1,750 million of perpetual subordinated debt. At the same time, the bank issued US dollar denominated perpetual subordinated debt of $2,862 million to HSBC Holdings plc, which is included in 'Subordinated liabilities'. See Note 41 for further details.*
3 *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 99 to 203 and the audited sections of 'Report of the Directors: Risk' on pages 27 to 74 and 'Report of the Directors: Capital Management' on pages 75 to 78 form an integral part of these financial statements.

	2010							
					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[2] £m	Foreign exchange reserve £m	Total equity £m
At 1 January	797	20,025	1,750	2,715	(664)	332	(24)	24,931
Profit for the year	–	–	–	2,858	–	–	–	2,858
Other comprehensive income (net of tax)	–	–	–	140	596	(202)	4	538
Available-for-sale investments	–	–	–	–	596	–	–	596
Cash flow hedges	–	–	–	–	–	(202)	–	(202)
Actuarial gains on defined benefit plans	–	–	–	140	–	–	–	140
Exchange differences and other	–	–	–	–	–	–	4	4
Total comprehensive income for the year	–	–	–	2,998	596	(202)	4	3,396
Dividends to shareholders	–	–	–	(1,868)	–	–	–	(1,868)
Net impact of equity-settled share-based payments[1]	–	–	–	101	–	–	–	101
Tax on items taken directly to equity - current	–	–	–	22	–	–	–	22
At 31 December	797	20,025	1,750	3,968	(68)	130	(20)	26,582

1 *Includes deferred tax of £(10) million.*
2 *Movements in the cash flow hedging reserve include an amount transferred to the income statement of a £148 million loss taken to 'Net interest income'.*

The accompanying notes on pages 99 to 203 and the audited sections of 'Report of the Directors: Risk' on pages 27 to 74 and 'Report of the Directors: Capital Management' on pages 75 to 78 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 2011, there were no unendorsed standards effective for the year ended 31 December 2011 affecting these consolidated and separate financial statements, and there was no 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 2011 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.

During 2011, 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 66 to 73.

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 75 to 78.

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 56 to 57.

In accordance with the group's policy to provide meaningful disclosures that help investors and other stakeholders understand the group's performance, financial position and changes thereto, the information provided in the Notes on the Financial Statements and the Report of the Directors goes beyond the minimum levels required by accounting standards, statutory and regulatory requirements. In particular, the group has adopted the British Bankers' Association Code for Financial Reporting Disclosure ('the BBA Code'). The BBA Code aims to increase the quality and comparability of banks' disclosures and sets out five disclosure principles together with supporting guidance. In line with the principles of the BBA Code, the group assesses good practice recommendations issued from time to time by relevant regulators and standard setters, and will assess the applicability and relevance of such guidance, enhancing disclosures where appropriate.

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.

(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 2011, 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 2011. 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 from 2013.

Standards and Interpretations issued by the IASB but not endorsed by the EU

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'). The standards are effective for annual periods beginning on or after 1 January 2013 with early adoption permitted. IFRSs 10 and 11 are 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.

The group is currently assessing the impact of IFRS 10 and 11, but it is impracticable to quantify their effect as at the date of publication of these financial statements.

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 group is currently assessing the impact of IFRS 13 and it is not practical to quantify the effect as at the date of publication of these financial statements, which will depend on final interpretations of the standard, market conditions and the group's holdings of financial instruments at 1 January 2013. However, based on the analysis performed to date, the most significant potential effect from applying IFRS 13 is considered to be on the methodologies for the calculation of credit valuation adjustments in valuing certain financial instruments. See Note 31 for further information on credit valuation adjustment methodologies.

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 must 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 2011 consolidated financial statements, the change would decrease pre-tax profit, with no effect on the pension liability. The effect on total operating expenses and pre-tax profit is not expected to be material. The effect at the date of adoption will depend on market interest rates, rates of return and the actual mix of scheme assets at that time.

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 with early adoption permitted and are required to be applied retrospectively.

The group is currently assessing the impact of these clarifications but it is impracticable to quantify their effect as at the date of publication of these 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 relating to 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 did not finalise the replacement of IAS 39 by its stated target of June 2011, and the IASB and the US Financial Accounting Standards Board have agreed to extend the timetable beyond this date to permit further work and consultation with stakeholders, including reopening IFRS 9 to address practice and other issues. The EU is not expected to endorse IFRS 9 until the completed standard is available. Therefore, the group remains unable to provide a date by which it plans to apply IFRS 9 and it remains impracticable to quantify the impact of IFRS 9 as at the date of publication of these consolidated financial statements

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
- 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 31 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.

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 borrower repays their 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:

- 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
- 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.

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 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.

(i) 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.

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-sake 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

Notes on the Financial Statements (continued)

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.

(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.

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 are 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.

(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 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 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 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 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 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:

Premiums

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.

Premiums for life assurance are accounted for when receivable, except in unit-linked insurance contracts where premiums are accounted for when liabilities are established.

Reinsurance premiums are accounted for in the same accounting period as the premiums for the direct insurance contracts to which they relate.

Claims and reinsurance recoveries

Gross insurance claims for non-life insurance contracts include paid claims and movements in outstanding claims liabilities.

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.

Reinsurance recoveries are accounted for in the same period as the related claim.

Liabilities under insurance contracts

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.

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.

Notes on the Financial Statements (continued)

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.

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 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.

Future profit participation

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.

In the case of net unrealised investment gain on contracts whose discretionary benefit principally reflect the actual performance of the 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. Movement in the liabilities arising from realised gains and losses on relevant assets are recognised in the income statement.

Investment contracts

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 expense/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.

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.

(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.

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 method involve the use of statistically assessed historical information 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.

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.

In addition to the annual impairment test, which was performed as at 1 July 2011, management reviewed the current and expected performance of the CGUs as at 31 December 2011 and determined that there was no indication of potential impairment of the goodwill allocated to them, except for Global Banking and Markets, which experienced significantly reduced profitability in the second half of 2011. This reduced profitability resulted in a reduction in the recoverable amount of the CGU when compared to its carrying amount. Consequently, the results of the goodwill impairment testing for this CGU are more sensitive to key assumptions used. Management retested the goodwill for this CGU and concluded that there was no impairment.

Note 21 includes details of the CGUs with significant balances of goodwill, states the key assumptions used to assess the goodwill in each CGU for impairment, and provides a discussion of the sensitivity of the carrying value of goodwill to changes in key assumptions.

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 31. 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 usually governed by 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. Management bases the determination of this rate on its 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 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 31. 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 31. 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.

Impairment of available-for-sale financial assets

The group's accounting policy for impairment on available-for-sale financial assets is described in Note 2(j) on the Financial Statements.

Management is required to exercise judgement in determining whether there is objective evidence that an impairment loss has occurred. Once an impairment has been identified, the amount of impairment is measured in relation to the fair value of the asset. More information on assumptions and estimates requiring management judgement relating to the determination of fair values of financial instruments is provided above in 'Valuation of financial instruments'.

Deciding whether an available-for-sale debt security is impaired requires objective evidence of both the occurrence of a loss event and a related decrease in estimated future cash flows. The degree of judgment involved is less when cash flows are readily determinable, but increases when estimating future cash flows requires consideration of a number of variances, some of which may be unobservable in current market conditions.

The most significant judgements concern more complex instruments, such as asset-backed securities ('ABSs'), where it is necessary to consider factors such as the estimated future cash flows on underlying pools of collateral, the extent and depth of market price declines and changes in credit ratings. The review of estimated future cash flows on underlying collateral is subject to estimation uncertainties where the assessment is based on historical information on pools of assets, and judgement is required to determine whether historical performance is likely to be representative of current economic and credit conditions.

There is no single factor to which the group's charge for impairment of available-for-sale debt securities is particularly sensitive, because of the range of different types of securities held, the range of geographical areas in which those securities are held, and the wide range of factors which can affect the occurrence of loss events and the cash flows of securities, including different types of collateral.

It is reasonably possible that outcomes in the next financial year could be different from the assumptions and estimates used in identifying impairment on available-for-sale debt securities, as a result of which, evidence of impairment may be identified in available-for-sale debt securities which had previously been determined not to be impaired. It is possible that this could result in the recognition of material impairment losses in the next financial year.

Notes on the Financial Statements (continued)

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 asset returns in the next financial year, and 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.

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
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**
2010					
Gross written premiums	113	339	257	1,910	2,619
Movement in unearned premiums	93	78	–	–	171
Gross earned premiums	206	417	257	1,910	2,790
Gross written premiums ceded to reinsurers	(5)	(125)	(5)	–	(135)
Reinsurers' share of movement in unearned premiums	(5)	(15)	–	–	(20)
Reinsurers' share of gross earned premiums	(10)	(140)	(5)	–	(155)
Net earned insurance premiums	196	277	252	1,910	2,635

Notes on the Financial Statements (continued)

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
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**

	Non-life insurance £m	Life insurance (non-linked) £m	Life insurance (linked) £m	Investment contracts with discretionary participation features £m	Total £m
2010					
Claims, benefits and surrenders paid	229	256	133	1,299	1,917
Movement in liabilities	(93)	(20)	273	1,096	1,256
Gross claims incurred and movement in liabilities	136	236	406	2,395	3,173
Reinsurers' share of claims, benefits and surrenders paid	(24)	(78)	(4)	–	(106)
Reinsurers' share of movement in liabilities	(3)	(29)	(12)	–	(44)
Reinsurers' share of claims incurred and movement in liabilities	(27)	(107)	(16)	–	(150)
Net insurance claims incurred and movement in liabilities to policyholders	109	129	390	2,395	3,023

Notes on the Financial Statements (continued)

6 Net operating income

Net operating income is stated after the following items of income, expense, gains and losses:

	2011 £m	2010 £m
Income		
Interest recognised on impaired financial assets	**45**	39
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	**2,836**	2,926
Fees earned on trust and other fiduciary activities where the group holds or invests assets on behalf of its customers	**723**	730
Expense		
Interest on financial instruments, excluding interest on financial liabilities held for trading or designated at fair value	**3,727**	3,158
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**	536
Fees payable on trust and other fiduciary activities where the group holds or invests assets on behalf of its customers	**2**	2
Gains/(losses)		
Gain on disposal or settlement of loans and advances	**18**	34
Gain/(loss) on financial liabilities measured at amortised cost	**5**	(1)
Impairment of available-for-sale equity shares	**(18)**	(8)
Gain on disposal of assets held for sale	**8**	–
Gains on disposal of property, plant and equipment, intangible assets and non-financial investments:		
– Gain on disposal of HSBC Asset Finance (UK) Ltd Rail subsidiaries	–	163
– Gain on disposal of HSBC France headquarters	–	125
– Other	**17**	89
Loan impairment charges and other credit risk provisions		
Net impairment charge on loans and advances	**(1,222)**	(1,633)
Net impairment of available-for-sale debt securities	**(393)**	(317)
Net impairment in respect of other credit risk provisions	**(8)**	(1)
	(1,623)	(1,951)

7 Employee compensation and benefits

Total employee compensation

	2011 £m	2010 £m
Wages and salaries	**4,053**	3,804
Social security costs	**557**	535
Post-employment benefits	**(29)**	404
One-off bonus tax	–	218
	4,581	4,961

Average number of persons employed by the group during the year

	2011	2010
UK Retail	**41,279**	40,110
Continental Europe Retail	**13,968**	13,059
Global Banking and Markets	**9,343**	9,724
Private Banking	**5,302**	4,776
Other[1]	**10,121**	10,263
Total	**80,013**	77,932

1 *Employees included within 'Other' are employees of central functions who provide services to a number of the group business segments.*

In December 2009, the governments of the UK and France introduced one-off taxes in respect of certain bonuses payable by banks and banking groups. In both countries the tax was levied at 50 per cent on bonuses awarded during a certain period and over a threshold amount. The taxes were liabilities of the employer and were payable on awards

Notes on the Financial Statements (continued)

of both cash and shares. The amount payable and paid in 2010 in respect of the relevant taxes was £218 million (£191 million in the UK and £27 million in France).

Post-employment benefit plans

Income statement charge

	2011 £m	2010 £m
Defined benefit pension plans		
- HSBC Bank (UK) Pension Scheme	**(261)**	200
- Other plans	**35**	32
Defined contribution pension plans	**190**	165
	(36)	397
Defined benefit healthcare plans	**7**	7
	(29)	404

Defined benefit post-employment benefit plans

Net assets/(liabilities) recognised on balance sheet in respect of defined benefit plans

	2011 £m	2010 £m
Defined benefit pension plans	**1,204**	(569)
– HSBC Bank (UK) Pension Scheme	**1,444**	(395)
Fair value of plan assets	**17,183**	14,317
Present value of defined benefit obligations	**(15,739)**	(14,712)
– Other plans	**(240)**	(174)
Fair value of plan assets	**728**	738
Present value of defined benefit obligations	**(972)**	(912)
Effect of limit on plan surpluses	**–**	(5)
Unrecognised past service cost	**4**	5
Defined benefit healthcare plans	**(158)**	(164)
Fair value of plan assets	**–**	–
Present value of defined benefit obligations	**(158)**	(164)
Unrecognised past service cost	**–**	–
Fair value of plan assets	**17,911**	15,055
Present value of defined benefit obligations	**(16,869)**	(15,788)
Effect of limit on plan surpluses	**–**	(5)
Unrecognised past service cost	**4**	5
	1,046	(733)
Retirement benefit liabilities	**(398)**	(733)
Retirement benefit assets	**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 (2010: £7 million).

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 %
2011	4.80	3.20	3.10	2.25	3.70	7.20
2010	5.40	3.70	3.50	3.70	4.20	7.70

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
2011	SAPS MC[1]	22.5	24.3	23.5	25.3
2010	SAPS MC[1]	22.4	24.3	23.4	25.3

1 *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. (Standard table with 1.08 rating for male dependants and light table with 1.10 rating for female dependants.)*

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	
	2011	2010
	£m	£m
Discount rate		
Change in pension obligation at year end from a 25bps increase	**(633)**	(606)
Change in pension obligation at year end from a 25bps decrease	**675**	646
Change in following year pension cost from a 25bps increase	**1**	(6)
Change in following year pension cost from a 25bps decrease	**(1)**	6
Rate of inflation		
Change in pension obligation at year end from a 25bps increase	**663**	663
Change in pension obligation at year end from a 25bps decrease	**(632)**	(630)
Change in following year pension cost from a 25bps increase	**37**	43
Change in following year pension cost from a 25bps decrease	**(35)**	(41)
Rate of increase for pensions in payment and deferred revaluation		
Change in pension obligation at year end from a 25bps increase	**566**	524
Change in pension obligation at year end from a 25bps decrease	**(543)**	(499)
Change in following year pension cost from a 25bps increase	**28**	31
Change in following year pension cost from a 25bps decrease	**(27)**	(29)
Rate of pay increase		
Change in pension obligation at year end from a 25bps increase	**160**	139
Change in pension obligation at year end from a 25bps decrease	**(155)**	(131)
Change in following year pension cost from a 25bps increase	**12**	13
Change in following year pension cost from a 25bps decrease	**(10)**	(11)
Investment return		
Change in following year pension cost from a 25bps increase	**(42)**	(35)
Change in following year pension cost from a 25bps decrease	**43**	35
Mortality		
Change in pension obligation from each additional year of longevity assumed	**400**	320

The following table shows the effect of changes in the mortality rates on defined benefit pension plans other than the principal plan:

	Other Plans	
	2011	2010
	£m	£m
Change in pension obligation from each additional year of longevity assumed	**9**	15

Defined benefit pension plans

Value recognised on the balance sheet

	HSBC Bank (UK) Pension Scheme			
	2011		**2010**	
	Expected rates of return	**Value**	**Expected rates of return**	**Value**
	%	**£m**	**%**	£m
Fair value of plan assets		**17,183**		14,317
Equities	**7.2**	**2,061**	8.4	2,200
Bonds	**4.1**	**13,351**	5.3	10,067
Property	**6.7**	**985**	7.6	926
Other	**2.8**	**786**	4.0	1,124
Defined benefit obligation		**(15,739)**		(14,712)
Net asset/(liability)[1]		**1,444**		(395)

Notes on the Financial Statements (continued)

	Other plans			
	2011		2010	
	Expected rates of return	Value	Expected rates of return	Value
	%	£m	%	£m
Fair value of plan assets		**728**		738
Equities	**7.0**	**176**	7.2	239
Bonds	**3.5**	**307**	3.7	305
Property	**5.1**	**34**	5.2	30
Other	**5.5**	**211**	5.3	164
Defined benefit obligation (funded)		**(972)**		(912)
Present value of funded obligations		**(845)**		(797)
Present value of unfunded obligations		**(127)**		(115)
Effect of limit on plan surpluses		**-**		(5)
Unrecognised past service cost		**4**		5
Net liability[1]		**(240)**		(174)

1 *£1,430 million of the net asset for defined benefit pension plans relates to the bank (2010: net liability of £411 million).*
2 *The expected rates of return are weighted on the basis of the fair value of the plan assets.*

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 41 'Related party transactions'.

In December 2010, the HSBC Insurance Pension Scheme was merged into the HSBC Bank (UK) Pension Scheme, resulting in assets of £30 million and liabilities of £26 million being transferred out of Other plans and into the HSBC Bank (UK) Pension Scheme. Also, in December 2010, the HFC Bank Limited defined benefit pension plans, the HFC Beneficial Bank Retirement Benefit Plan and the HFC Pension Plan (defined benefit section) were merged into the HSBC Bank (UK) Pension Scheme, resulting in assets of £58 million and liabilities of £62 million being transferred into the HSBC Bank (UK) Pension Scheme. These transfers are recognised in the transfers line in the table below, along with other smaller scheme mergers and transfers.

Notes on the Financial Statements (continued)

Net liability under defined benefit pension plans

	2011		2010	
	HSBC Bank (UK) Pension Scheme	**Other plans**	HSBC Bank (UK) Pension Scheme	Other plans
Fair value of plan assets	**£m**	**£m**	£m	£m
At 1 January	**14,317**	**738**	10,908	649
Expected return on plan assets	**827**	**36**	706	32
Normal contributions by the group	**194**	**19**	173	52
Special contributions by the group	**184**	**–**	1,760	–
Contributions by employees	**21**	**12**	15	9
Experience gains/(losses)	**2,146**	**(39)**	1,150	(4)
Benefits paid	**(506)**	**(29)**	(483)	(26)
Assets distributed on settlements	**–**	**–**	–	(7)
Transfers	**–**	**–**	88	(7)
Exchange differences	**–**	**(9)**	–	40
At 31 December	**17,183**	**728**	14,317	738
Present value of defined benefit obligations				
At 1 January	**14,712**	**912**	13,262	805
Current service cost	**157**	**38**	163	30
Interest cost	**769**	**30**	743	31
Contributions by employees	**21**	**12**	15	9
Actuarial (gains)/losses	**946**	**32**	924	50
Benefits paid	**(506)**	**(43)**	(483)	(40)
Past service (credit)/cost - vested immediately	**(360)**	**3**	–	3
Liabilities extinguished on settlements	**–**	**–**	–	(7)
Transfers	**–**	**–**	88	(5)
Exchange differences	**–**	**(12)**	–	36
At 31 December	**15,739**	**972**	14,712	912

The actual return on plan assets for the year ended 31 December 2011 was a positive return £2,970 million (2010: positive return of £1,883 million). The group expects to make £189 million of contributions to defined benefit pension plans during 2012.

Total expense recognised in the income statement in 'Employee compensation and benefits'

	2011		2010	
	HSBC Bank (UK) Pension Scheme	**Other plans**	HSBC Bank (UK) Pension Scheme	Other plans
	£m	**£m**	£m	£m
Current service cost	**157**	**38**	163	30
Interest cost	**769**	**30**	743	31
Expected return on plan assets	**(827)**	**(36)**	(706)	(32)
Past service (credit)/cost	**(360)**	**3**	–	3
Total (gain)/ expense	**(261)**	**35**	200	32

Total net actuarial gains/(losses)

Total net actuarial losses recognised in other comprehensive income since transition to IFRSs are £482 million. The total effect of the limit on plan surpluses recognised within actuarial losses in other comprehensive income during 2011 was a gain of £5 million (2010: gain of £16 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 2008. At that date, the market value of the Scheme's assets was £10.2 billion. The market value of the plan represented 76 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 the resulting deficit amounted to £3.2 billion. 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 2008. 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 2008 plus a margin for the expected return on the investment strategy of 190 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 this, 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 minimum improvements of 1.75 per cent for males and 1.25 per cent for females.

In February 2010, the bank agreed with the Trustee of the Scheme to reduce the deficit of the plan by meeting a schedule of future funding payments, On 17 June 2010, the bank agreed with the Trustee to accelerate the reduction of the deficit of the plan with a special contribution of £1,760 million in 2010 followed by a revised payment schedule in the following years, as shown below:

Additional future funding payments to the principal plan

	Original plan	Revised plan
	£m	£m
2010	-	1,760
2011	-	-
2012	465	-
2013	465	-
2014	465	-
2015	630	-
2016	630	495
2017	630	630
2018	630	630

On the same day, the bank made the £1,760 million contribution and the Scheme used the contribution to acquire debt securities with a fair value of £1,760 million from the bank in a transaction at an arm's length value determined by the Scheme's independent third party advisors. The debt securities sold comprised supranational, agency and government-guaranteed securities, asset-backed securities, corporate subordinated debt, and auction rate securities.

The group considers that the contribution set out above, 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. At each subsequent actuarial valuation, the group has agreed with the Trustees that any shortfall in investment returns relative to this expected level, subject to a maximum of 50 basis points per annum, will be eliminated by payment of equal cash instalments over the remaining years to the end of this recovery plan period.

The bank is also making ongoing contributions to the Scheme in respect of future benefit accrual for defined benefit section members at the rate of 34 per cent of pensionable salaries from April 2010 until the completion of the next actuarial valuation, to be calculated as at 31 December 2011. During 2009 and the first quarter of 2010, the bank paid contributions at the rate of 38 per cent of pensionable salaries.

As part of the 31 December 2008 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

Notes on the Financial Statements (continued)

run the plan without the support of the bank. The amount required under this approach was estimated to be £19,400 million as at 31 December 2008. 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.

Move to using the Consumer Prices Index

The expected cash flows of the principal plan were projected by reference to the Retail Prices Index ('RPI') swap curve in calculating the liability recognised. The Occupational Pensions (Revaluation) Order 2010 confirmed the UK government's intention to move to using the Consumer Prices Index ('CPI') rather than RPI as the inflation measure for determining the minimum pension increases to be applied to the statutory index-linked features of retirement benefits. Historical annual CPI increases have generally been lower than annual RPI increases. The rules of the principal plan prescribe that annual increases for pensions in payment are in line with RPI, but for deferred pensions, i.e. pensions for members of the Scheme who have left HSBC employment but whose pensions are yet to commence, are linked to the statutory index prior to retirement. However, consistent with communications to Scheme members, the bank has historically used RPI in calculating the pension liability for deferred pensions.

In May 2011, the Trustee communicated to Scheme members the impact on Scheme benefits of the UK government's announcement. At 30 June 2011, the bank used CPI in calculating the pension liability recognised which resulted in a reduction of the Scheme's liabilities, in respect of deferred pensioners, of £360 million. A corresponding gain was recognised in the income statement, as a credit within 'Employee compensation and benefits'.

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.

The additional future funding payments to the principal plan, set out in the table above, were not amended as a result of this transaction.

Summary

	HSBC Bank (UK) Pension Scheme				
	2011	2010	2009	2008	2007
	£m	£m	£m	£m	£m
Defined benefit obligation	**(15,739)**	(14,712)	(13,262)	(10,460)	(11,719)
Fair value of plan assets	**17,183**	14,317	10,908	10,191	11,316
Net surplus/(deficit)	**1,444**	(395)	(2,354)	(269)	(403)
Experience losses on plan liabilities	**(240)**	(207)	(143)	(7)	(30)
Experience gains/(losses) on plan assets	**2,146**	1,150	424	(1,643)	6
(Losses)/gains from changes in actuarial assumptions	**(706)**	(717)	(2,718)	1,671	1,238
Total net actuarial gains/(losses)	**1,200**	226	(2,437)	21	1,214

	Other plans				
	2011	2010	2009	2008	2007
	£m	£m	£m	£m	£m
Defined benefit obligation	**(972)**	(912)	(805)	(889)	(643)
Fair value of plan assets	**728**	738	649	617	557
Effect of limit on plan surpluses	**–**	(5)	(21)	–	(21)
Net deficit	**(244)**	(179)	(177)	(272)	(107)
Experience gains/(losses) on plan liabilities	**(6)**	11	15	(6)	(4)
Experience (losses)/gains on plan assets	**(39)**	(4)	41	(130)	3
(Losses)/gains from changes in actuarial assumptions	**(26)**	(61)	25	(47)	53
Total net actuarial gains/(losses)	**(71)**	(54)	81	(183)	52

Notes on the Financial Statements (continued)

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:

	2011 £000	2010 £000
Fees	**652**	334
Salaries and other emoluments	**2,091**	1,317
Bonuses	**5,733**[1]	2,608[2]
	8,476	4,259
Vesting of Restricted Share Plan awards	**1,528**	265

1 *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, 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.*

2 *The awards made to executive Directors in respect of 2010 performance were 60 per cent deferred. 50 per cent of both the deferred and non-deferred components was in the form of Restricted Shares issued under the HSBC Share Plan. The remaining 50 per cent was delivered as cash.*

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 2011 (2010: five Directors). During 2011, five Directors received shares in respect of awards under long-term incentive plans that vested during the year (2010: one Director).

Retirement benefits are not accruing to any Directors under a defined benefit scheme and are accruing to four Directors under money purchase schemes in respect of Directors' qualifying services. Contributions of £202,942 were made during the year to money purchase arrangements in respect of Directors' qualifying services (2010: £nil).

In addition, there were payments under retirement benefit agreements with former Directors of £795,269 (2010: £763,666), including payments in respect of unfunded pension obligations to former Directors of £666,152 (2010: £644,954). The provision as at 31 December 2011 in respect of unfunded pension obligations to former Directors amounted to £10,682,217 (2010: £10,870,922).

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 and the HSBC Share Plan 2011 ('the Plans') 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:

	2011 £000	2010 £000
Fees	**–**	–
Salaries and other emoluments	**665**	501
Bonuses	**2,768**[1]	1,208[2]

1 *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, and £975,000 in deferred Restricted Shares issued under schedule 4 of the HSBC Share Plan 2011 (Group Performance Share Plan).*

2 *The awards made to the highest paid Director in respect of 2010 performance were 60 per cent deferred and 40 per cent non-deferred. 50 per cent of both the deferred and non-deferred components was in the form of Restricted Shares issued under the HSBC Share Plan. The remaining 50 per cent was delivered as cash.*

The highest paid Director received 51,794 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 did not exercise any share options over HSBC Holdings plc ordinary shares during the year.

Pension contributions of £150,750 were made by the bank in respect of services by the highest paid Director during the year.

Notes on the Financial Statements (continued)

8 Auditors' remuneration

Auditors' remuneration in relation to the statutory audit amounted to £10.2 million (2010: £9.5 million).

The following fees were payable by the group to the group's principal auditor, KPMG Audit Plc and its associates (together 'KPMG'):

	2011	2010
	£m	£m
Audit fees for HSBC Bank plc statutory audit:		
– fees relating to current year	**2.4**	2.5
– fees relating to prior year	**0.7**	0.3
	3.1	2.8
Fees payable to KPMG for other services provided to the group		
Audit-related services:		
– audit of the group's subsidiaries	**6.8**	6.9
– audit of pension schemes associated with the group	**–**	0.1
– other services	**6.7**	4.6
Tax services	**0.7**	0.4
Other services:		
– services relating to information technology	**0.1**	–
– all other services	**1.0**	1.0
	15.3	13.0
Total fees payable	**18.4**	15.8

'Audit fees for HSBC Bank plc statutory audit' is fees payable to KPMG Audit plc for the statutory audit of the consolidated financial statements of the group and the separate financial statements of HSBC Bank plc. It excludes amounts payable for the statutory audit of HSBC Bank plc's subsidiaries, which have been included in 'Fees payable to KPMG for other services provided to the group'.

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

	2011	2010
	£m	£m
Share awards	**298**	213
Savings-related share option plans	**30**	33
Equity-settled share-based payments[1]	**328**	246

1 *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 £311m relating to deferred share awards (2010: £226m). 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.

Notes on the Financial Statements (continued)

Income statement impact of deferred share awards on current and future years

	Charge recognised in 2011 in respect of performance year:			**Charge expected to be recognised in 2012 or later in respect of performance year:**		
	2011[1]	**Pre-2011**	**Total**	**2011[1]**	**Pre-2011**	**Total**
	£m	**£m**	**£m**	**£m**	**£m**	**£m**
HSBC deferred share awards	**20**	**291**	**311**	**83**	**193**	**276**

	Charge recognised in 2010 in respect of performance year:			Charge expected to be recognised in 2011 or later in respect of performance year:		
	2010[1]	Pre-2010	Total	2010[1]	Pre-2010	Total
	£m	£m	£m	£m	£m	£m
HSBC deferred share awards	–	226	226	–	287	287

1 *Regulatory and best practice guidance has clarified the required structure and terms of deferred bonus arrangements awarded to employees, who now have a better understanding of the likely nature of the awards to be granted. As a result, the vesting period for deferred share awards expected to be granted in 2012 in respect of the 2011 performance year was determined to have started on 1 January 2011 and a charge was recognised from that date. Previously, the charge was recognised from the grant date.*

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 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 awards[1]**	
	2011 Number (000s)	2010 Number (000s)	**2011 Number (000s)**	2010 Number (000s)
Outstanding at 1 January	**95,007**	71,780	**99**	200
Additions during the year	**36,947**	51,434	**80**	58
Released in the year	**(14,751)**	(19,143)	**(42)**	(21)
Forfeited in the year	**(5,873)**	(9,064)	**(137)**	(138)
Outstanding at 31 December	**111,330**	95,007	**–**	99
Weighted average fair value of awards granted (£)	**6.19**	6.81	**6.47**	6.47

1 *Additions during the year comprised reinvested dividend equivalents.*

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% (2010: 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 136 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**
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**

	Savings-Related Share Option Plans		
	1-year plan	**3-year plans**	**5-year plans**
2010			
Risk-free interest rate[1] (%)	0.7	1.9	2.9
Expected life[2] (years)	1	3	5
Expected volatility[3] (%)	30	30	30
Share price at grant date (£)	6.82	6.82	6.82

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.*

The expected US dollar denominated dividend yield was determined to be 4.5 per cent per annum in line with consensus analyst forecasts (2010: 4.5 per cent).

Notes on the Financial Statements (continued)

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] £
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**		–
2010				
Outstanding at 1 January	77,340	5.24	44,392	6.85
Granted during the year	7,084	5.43	–	–
Exercised during the year	(4,795)	5.46	(679)	6.05
Transferred during the year	(113)	4.00	(320)	7.08
Forfeited and expired during the year	(8,980)	5.58	(695)	6.95
Outstanding at 31 December	70,536	3.77	42,698	6.86
Weighted average fair value of options granted during the year (£)		1.64		–
Weighted average share price at the date the options were exercised (£)		6.65		6.86
At 31 December 2010				
Exercise price range (£):				
3.00 – 4.50	57,275	3.30	–	–
4.51 – 6.00	10,306	5.60	–	–
6.01 – 7.50	2,871	6.37	42,536	6.85
7.51 – 9.00	68	7.83	162	7.72
9.01 – 10.50	16	9.08		
Of which exercisable:	868	6.14	–	–
Weighted average remaining contractual life (years)		2.51		–

1 *Weighted Average Exercise Price.*

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

	2011		2010	
	Number (000's)	**Weighted average exercise price £**	Number (000's)	Weighted average exercise price £
Outstanding at 1 January	**29,135**	**7.44**	32,162	7.38
Exercised in the year	**–**	**–**	(1,414)	6.50
Transferred in the year	**(36)**	**6.91**	(125)	7.51
Expired in the year	**(14,077)**	**7.59**	(1,488)	7.04
Outstanding at 31 December[1,2]	**15,022**	**7.31**	29,135	7.44

1 *The above includes the bank employee awards of 14,767,030 options outstanding at 1 January 2011 (2010: 17,324,442), and 7,692,481 options outstanding at 31 December 2010 (2010: 14,767,030).*
2 *The weighted average exercise price for bank employees was £7.45 at 1 January 2011 (2010: £7.35) and £7.32 at 31 December 2011 (2010: £7.45).*

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

	2011		2010	
Exercise price range (£)	**£5.56-£6.50**	**£6.51-£8.40**	£5.56-£6.50	£6.51-£8.40
Number (000's)	**315**	**14,707**	320	28,816
Weighted average exercise price (£)	**6.50**	**7.32**	6.50	7.45
Of which exercisable:				
– number (000's)	**315**	**14,707**	320	28,816
– weighted average exercise price (£)	**6.50**	**7.32**	6.50	7.45

The bank

	2011		2010	
Exercise price range (£)	**£5.56-£6.50**	**£6.51-£8.40**	£5.56-£6.50	£6.51-£8.40
Number (000's)	**35**	**7,657**	42	14,725
Weighted average exercise price (£)	**6.50**	**7.32**	6.50	7.45
Of which exercisable:				
– number (000's)	**35**	**7,657**	42	14,725
– weighted average exercise price (£)	**6.50**	**7.32**	6.50	7.45

10 Tax expense

	2011 £m	2010 £m
Current taxation		
UK corporation tax charge – on current year profit	**232**	536
UK corporation tax charge – adjustments in respect of prior years	**18**	6
Overseas tax – on current year profit	**330**	371
Overseas tax – adjustment in respect of prior years	**1**	37
	581	950
Deferred taxation		
Origination and reversal of temporary differences	**154**	29
Effect of changes in the tax rates	**(18)**	–
Adjustment in respect of prior years	**17**	17
	153	46
Tax expense	**734**	996

The UK corporation tax rate applying to HSBC Bank plc and its subsidiaries was 26.5 per cent (2010: 28 per cent). Other overseas subsidiaries and overseas branches provided for taxation at the appropriate rates in the countries in which they operate.

Notes on the Financial Statements (continued)

The following table reconciles the tax expense which would apply if all profits had been taxed at the UK corporation tax rate:

	2011		2010	
		Percentage of overall tax charge		Percentage of overall tax charge
	£m	**%**	£m	%
Taxation at UK corporation tax rate of 26.5% (2010: 28%)	**824**	**26.5**	1,123	28.0
Effect of taxing overseas profit at different rates	**(4)**	**(0.1)**	(47)	(1.2)
Gains subject to tax at a lower rate	**(4)**	**(0.1)**	(133)	(3.4)
Adjustment in respect of prior years	**36**	**1.1**	60	1.5
Effect of profits in associates and joint ventures	**–**	**–**	(1)	–
Deferred tax temporary differences not provided	**11**	**0.4**	16	0.4
Release of deferred tax consequent on the disposal of group properties			(18)	(0.4)
Non taxable income	**(114)**	**(3.6)**	(56)	(1.4)
Effect of UK bank payroll tax (disallowable)			53	1.3
Permanent disallowables	**17**	**0.5**	23	0.6
Changes in tax rates	**(18)**	**(0.6)**	–	–
Local taxes and overseas withholding taxes	**27**	**0.9**	17	0.4
Other items	**(41)**	**(1.4)**	(41)	(1.0)
Tax expense	**734**	**23.6**	996	24.8

The UK Government has announced that the main rate of corporation tax for the year beginning 1 April 2011 will reduce from 28 per cent to 26 per cent, to be followed by further 1 per cent reductions per annum to 23 per cent for the year beginning 1 April 2014. While the reduction in the corporate tax rate to 25% has already been enacted, the further announced reductions are expected to be enacted through the 2012 and 2013 Finance Acts. This results in a weighted average rate of 26.5 per cent for 2011 (2010: 28 per cent). It is not expected that the proposed future rate changes will have a significant effect on the net UK deferred tax position.

HSBC Bank plc provides for potential tax liabilities that may arise on the basis of the amounts expected to be paid to the tax authorities. The amounts ultimately paid may differ materially from the amounts provided, depending on the ultimate resolution of such matters.

Movement of net deferred tax 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 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	735	116	–	76	13	10	63	–	–	298	1,311
Liabilities	–	(30)	–	(2)	(16)	(131)	(7)	(438)	(78)	(412)	(1,114)
At 1 January 2010	735	86	–	74	(3)	(121)	56	(438)	(78)	(114)	197
Income statement	(134)	(24)	–	(15)	–	–	31	133	55	(92)	(46)
Other comprehensive income:											
- available-for-sale investments	–	–	–	–	9	–	–	–	–	–	9
- cash flow hedges	–	–	–	–	–	63	–	–	–	–	63
- actuarial movements	(67)	–	–	–	–	–	–	–	–	–	(67)
Equity:											
- share-based payments	–	–	–	–	–	–	(10)	–	–	–	(10)
Acquisitions and disposals	–	–	–	–	(6)	–	–	99	–	15	108
Foreign exchange and other adjustments	–	(10)	4	–	(4)	(1)	(1)	12	1	21	22
	(201)	(34)	4	(15)	(1)	62	20	244	56	(56)	79
Assets	534	52	4	60	7	–	76	–	–	–	733
Liabilities	–	–	–	(1)	(11)	(59)	–	(194)	(22)	(170)	(457)
At 31 December 2010	534	52	4	59	(4)	(59)	76	(194)	(22)	(170)	276

Movement of net deferred tax assets 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	**(258)**	**(9)**	**44**	–	–	**(8)**	**(18)**	**(249)**
Other comprehensive income:								
- 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**

Movement of net deferred tax assets 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	Revaluation of property £m	Other £m	Total £m
Assets	698	44	65	–	–	46	–	69	922
Liabilities	–	–	–	(1)	(131)	–	(11)	(2)	(145)
At 1 January 2010	698	44	65	(1)	(131)	46	(11)	67	777
Income statement	(172)	(9)	3	–	–	35	–	(14)	(157)
Other comprehensive income:									
- cash flow hedges	–	–	–	–	81	–	–	–	81
- actuarial movements	(77)	–	–	–	–	–	–	–	(77)
Equity:									
- share-based payments	–	–	–	–	–	(10)	–	–	(10)
Foreign exchange and other adjustments	–	–	(10)	–	–	–	11	–	1
	(249)	(9)	(7)	–	81	25	11	(14)	(162)
Assets	449	35	58	–	–	71	–	55	668
Liabilities	–	–	–	(1)	(50)	–	–	(2)	(53)
At 31 December 2010	449	35	58	(1)	(50)	71	–	53	615

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	
	2011	2010	**2011**	2010
	£m	£m	**£m**	£m
Deferred tax assets	**140**	330	**55**	617
Deferred tax liabilities	**(266)**	(54)	**(2)**	(2)
	(126)	276	**53**	615

For the group, the amount of temporary differences for which no deferred tax asset is recognised in the balance sheet is £628 million (2010: £576 million). This amount is in respect of losses where the recoverability of potential benefits is not considered likely.

For the bank, there are no temporary differences for which no deferred tax asset is recognised in the balance sheet (2010: 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 (2010: 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:

	2011		2010	
Dividends declared on ordinary shares	**£ per share**	**Total £m**	£ per share	Total £m
Second interim dividend in respect of previous year	**1.15**	**915**	–	–
Third interim dividend in respect of previous year	–	–	1.07	850
First interim dividend in respect of current year	**1.00**	**800**	1.13	900
	2.15	**1,715**	2.20	1,750

	2011		2010	
Dividends on preference shares classified as equity	**£ per share**	**Total £m**	£ per share	Total £m
Dividend on HSBC Bank plc non-cumulative third dollar preference shares	**1.17**	**41**	1.18	41
	1.17	**41**	1.18	41

	2011	2010
Coupons on capital securities classified as equity[1]	**£m**	£m
Coupon in respect of the first quarter of the year	**59**	4
Coupon in respect of the second quarter of the year	–	63
Coupon in respect of the third quarter of the year	–	5
Coupon in respect of the fourth quarter of the year	–	5
	59	77

1 *In March 2011, the bank repaid to HSBC Holdings plc £1,750 million of perpetual subordinated debt. At the same time, the bank issued US dollar denominated perpetual subordinated debt of $2,862 million to HSBC Holdings plc, which is included in 'Subordinated liabilities'. See Note 41 for further details.*

Notes on the Financial Statements (continued)

12 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 2011						
	UK Retail £m	Continental Europe Retail £m	Global Banking and Markets £m	Private Banking £m	Other[2] £m	Inter-segment £m	Total £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[1]	(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[2]	(2,020)	(1,196)	(1,558)	(404)	951	69	(4,158)
Depreciation and impairment of property, plant and equipment[1]	(4)	(39)	(10)	(19)	(281)	–	(353)
Amortisation and impairment of intangible assets[1]	(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 *Significant non-cash item.*
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 2010						
	UK Retail £m	Continental Europe Retail £m	Global Banking and Markets £m	Private Banking £m	Other £m	Inter-segment £m	Total £m
Net interest income	3,536	1,726	1,913	724	(100)	(105)	7,694
Net fee income	1,866	684	820	650	20	–	4,040
Net trading income	10	21	1,711	253	(8)	130	2,117
Other income	255	14	909	22	73	(48)	1,225
Net operating income before loan impairment charges and other credit risk provisions	5,667	2,445	5,353	1,649	(15)	(23)	15,076
Loan impairment charges and other credit risk provisions[1]	(1,221)	(195)	(518)	(17)	–	–	(1,951)
Net operating income	4,446	2,250	4,835	1,632	(15)	(23)	13,125
Employee compensation and benefits	(1,212)	(702)	(1,506)	(656)	(885)	–	(4,961)
General and administrative expenses[2]	(1,788)	(1,102)	(1,376)	(338)	1,045	23	(3,536)
Depreciation and impairment of property, plant and equipment[1]	(23)	(58)	(108)	(22)	(249)	–	(460)
Amortisation and impairment of intangible assets[1]	(105)	(14)	(31)	–	(12)	–	(162)
Total operating expenses	(3,128)	(1,876)	(3,021)	(1,016)	(101)	23	(9,119)
Operating profit	1,318	374	1,814	616	(116)	–	4,006
Share of profit in associates and joint ventures	3	–	2	–	–	–	5
Profit before tax	1,321	374	1,816	616	(116)	–	4,011

1 *Significant non-cash item*
2 *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	Private Banking £m	Other £m	Inter-segment £m	Total £m
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)**	**–**
Year ended 31 December 2010							
Net operating income:	4,446	2,250	4,835	1,632	(15)	(23)	13,125
External	4,355	2,269	5,165	1,427	(91)	–	13,125
Inter-segment	91	(19)	(330)	205	76	(23)	–

Performance ratios

	UK Retail £m	Continental Europe Retail £m	Global Banking and Markets £m	Private Banking £m	Other £m	Inter-segment £m	Total £m
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%**
Year ended 31 December 2010							
Share of the group's profit before tax	1,321	374	1,816	616	(116)	–	4,011
Cost efficiency ratio	55.20%	76.73%	56.44%	61.61%	–	–	60.49%

Notes on the Financial Statements (continued)

Balance sheet information

	UK Retail £m	Continental Europe Retail £m	Global Banking and Markets £m	Private Banking £m	Other £m	Inter-segment £m	Total £m
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**
Year ended 31 December 2010							
Loans and advances to customers (net)	115,953	35,505	110,688	22,436	636	–	285,218
Investment in associates and joint venture	28	4	34	1	9	–	76
Total assets	169,683	62,275	607,278	69,748	12,007	(122,497)	798,494
Customer accounts	139,191	31,907	117,704	55,321	–	–	344,123
Total liabilities	145,301	56,366	601,237	64,320	17,574	(118,661)	766,137

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	Private Banking £m	Other £m	Inter-segment £m	Total £m
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)	–
Year ended 31 December 2010							
Net operating income:	4,369	2,327	4,835	1,632	(15)	(23)	13,125
External	4,360	2,266	5,163	1,427	(91)	–	13,125
Inter-segment	9	61	(328)	205	76	(23)	–

Information by country

	31 December 2011		31 December 2010	
	External net operating income[1] £m	**Non-current assets[2] £m**	External net operating income[1] £m	Non-current assets[2] £m
United Kingdom	**8,059**	**3,455**	8,381	3,596
France	**1,600**	**6,350**	2,072	6,385
Switzerland	**509**	**2,597**	514	2,612
Other countries	**2,232**	**918**	2,158	1,003
Total	**12,400**	**13,320**	13,125	13,596

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.*

13 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 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 group

	At 31 December 2010								
	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	–	–	–	–	–	24,495	–	–	24,495
Items in the course of collection from other banks	–	–	–	–	–	1,932	–	–	1,932
Trading assets	159,552	–	–	–	–	–	–	–	159,552
Financial assets designated at fair value	–	15,467	–	–	–	–	–	–	15,467
Derivatives	127,823	–	–	–	–	–	180	1,155	129,158
Loans and advances to banks	–	–	–	57,027	–	–	–	–	57,027
Loans and advances to customers	–	–	–	285,218	–	–	–	–	285,218
Financial investments	–	–	4,281	–	97,805	–	–	–	102,086
Other assets	–	–	–	–	–	4,502	–	–	4,502
Accrued income	–	–	–	–	–	3,335	–	–	3,335
Total financial assets	287,375	15,467	4,281	342,245	97,805	34,264	180	1,155	782,772
Total non-financial assets									15,722
Total assets									798,494
Financial liabilities									
Deposits by banks	–	–	–	–	–	48,287	–	–	48,287
Customer accounts	–	–	–	–	–	344,123	–	–	344,123
Items in the course of transmission to other banks	–	–	–	–	–	1,411	–	–	1,411
Trading liabilities	132,360	–	–	–	–	–	–	–	132,360
Financial liabilities designated at fair value	–	27,935	–	–	–	–	–	–	27,935
Derivatives	127,852	–	–	–	–	–	705	647	129,204
Debt securities in issue	–	–	–	–	–	48,119	–	–	48,119
Other liabilities	–	–	–	–	–	4,334	–	–	4,334
Accruals	–	–	–	–	–	3,630	–	–	3,630
Subordinated liabilities	–	–	–	–	–	7,407	–	–	7,407
Total financial liabilities	260,212	27,935	–	–	–	457,311	705	647	746,810
Total non-financial liabilities									19,327
Total liabilities									766,137

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

The bank

	At 31 December 2010								
	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	–	–	–	–	–	22,357	–	–	22,357
Items in the course of collection from other banks	–	–	–	–	–	1,030	–	–	1,030
Trading assets	126,493	–	–	–	–	–	–	–	126,493
Financial assets designated at fair value	–	4,505	–	–	–	–	–	–	4,505
Derivatives	107,991	–	–	–	–	–	133	781	108,905
Loans and advances to banks	–	–	–	27,860	–	–	–	–	27,860
Loans and advances to customers	–	–	–	208,548	–	–	–	–	208,548
Financial investments	–	–	–	–	41,338	–	–	–	41,338
Other assets	–	–	–	–	–	2,436	–	–	2,436
Accrued income	–	–	–	–	–	1,444	–	–	1,444
Total financial assets	234,484	4,505	–	236,408	41,338	27,267	133	781	544,916
Total non-financial assets									19,415
Total assets									564,331
Financial liabilities									
Deposits by banks	–	–	–	–	–	38,873	–	–	38,873
Customer accounts	–	–	–	–	–	230,795	–	–	230,795
Items in the course of transmission to other banks	–	–	–	–	–	577	–	–	577
Trading liabilities	98,412	–	–	–	–	–	–	–	98,412
Financial liabilities designated at fair value	–	18,334	–	–	–	–	–	–	18,334
Derivatives	108,028	–	–	–	–	–	382	376	108,786
Debt securities in issue	–	–	–	–	–	29,417	–	–	29,417
Other liabilities	–	–	–	–	–	2,024	–	–	2,024
Accruals	–	–	–	–	–	1,748	–	–	1,748
Subordinated liabilities	–	–	–	–	–	7,562	–	–	7,562
Total financial liabilities	206,440	18,334	–	–	–	310,996	382	376	536,528
Total non-financial liabilities									1,221
Total liabilities									537,749

14 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 2011		At 31 December 2010	
	Carrying amount	**Fair value**	Carrying amount	Fair value
	£m	**£m**	£m	£m
Reclassification to loans and receivables	**4,587**	**3,889**	5,728	5,019
Reclassification to available-for-sale	**22**	**22**	59	59
	4,609	**3,911**	5,787	5,078

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 2011 would have been decreased by £30 million from £3,111 million to £3,081 million (2010: an increase of £367 million from £4,011 million to £4,378 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:

	2011	2010	2009	2008
	£m	£m	£m	£m
Reclassification to loans and receivables				
Recorded in the income statement	**180**	316	427	255
Assuming no reclassification	**152**	682	910	(1,405)
Net income statement effect of reclassification	**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	**30**	(367)	(587)	1,793

Notes on the Financial Statements (continued)

15 Trading assets

	The group		The bank	
	2011	2010	**2011**	2010
	£m	£m	**£m**	£m
Trading assets:				
– which may be repledged or resold by counterparties	**53,296**	55,281	**39,350**	27,466
– not subject to repledge or resale by counterparties	**73,302**	104,271	**66,989**	99,027
	126,598	159,552	**106,339**	126,493
Treasury and other eligible bills	**1,301**	2,529	**709**	945
Debt securities	**51,286**	73,771	**27,079**	39,202
Equity securities	**11,941**	24,505	**11,487**	23,789
Loans and advances to banks	**30,335**	26,525	**36,407**	33,011
Loans and advances to customers	**31,735**	32,222	**30,657**	29,546
	126,598	159,552	**106,339**	126,493

Included within the above figures for the group are debt securities issued by banks and other financial institutions of £12,571 million (2010: £19,307 million), of which £2,967 million (2010: £4,733 million) are guaranteed by various governments.

Included within the above figures for the bank are debt securities issued by banks and other financial institutions of £5,487 million (2010: £9,795 million), of which £1 million (2010: £1,244 million) are guaranteed by various governments.

16 Financial assets designated at fair value through profit or loss

	The group		The bank	
	2011	2010	**2011**	2010
	£m	£m	**£m**	£m
Financial assets designated at fair value:				
– not subject to repledge or resale by counterparties	**15,332**	15,467	**4,595**	4,505
Treasury and other eligible bills	**5**	20	**–**	–
Debt securities	**7,285**	7,161	**4,595**	4,428
Equity securities	**7,476**	7,750	**–**	–
Loans and advances to banks	**70**	27	**–**	77
Loans and advances to customers	**496**	509	**–**	–
	15,332	15,467	**4,595**	4,505

Notes on the Financial Statements (continued)

17 Derivatives

Fair values of derivatives by product contract type held

The group

	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			**176,993**			**(178,121)**

	At 31 December 2010					
	Assets			Liabilities		
	Trading £m	Hedging £m	Total £m	Trading £m	Hedging £m	Total £m
Foreign exchange	30,390	8	30,398	(31,609)	(19)	(31,628)
Interest rate	161,975	1,327	163,302	(160,428)	(1,333)	(161,761)
Equity	8,235	–	8,235	(8,831)	–	(8,831)
Credit	6,478	–	6,478	(6,084)	–	(6,084)
Commodity and other	409	–	409	(564)	–	(564)
Gross total fair values	207,487	1,335	208,822	(207,516)	(1,352)	(208,868)
Netting			(79,664)			79,664
Total			129,158			(129,204)

The bank

	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			**145,424**			**(147,251)**

	At 31 December 2010					
	Assets			Liabilities		
	Trading £m	Hedging £m	Total £m	Trading £m	Hedging £m	Total £m
Foreign exchange	29,987	–	29,987	(31,246)	–	(31,246)
Interest rate	116,490	914	117,404	(114,537)	(757)	(115,294)
Equity	7,331	–	7,331	(8,363)	–	(8,363)
Credit	6,478	–	6,478	(6,012)	–	(6,012)
Commodity and other	388	–	388	(554)	–	(554)
Gross total fair values	160,674	914	161,588	(160,712)	(757)	(161,469)
Netting			(52,683)			52,683
Total			108,905			(108,786)

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. 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	
	2011	2010	**2011**	2010
	£m	£m	**£m**	£m
Foreign exchange	**1,586,377**	1,617,429	**1,586,934**	1,590,774
Interest rate	**10,380,838**	9,723,176	**7,019,421**	6,491,919
Equity	**135,985**	171,061	**129,080**	163,737
Credit	**335,765**	317,373	**335,755**	317,378
Commodity	**40,766**	41,696	**40,641**	40,834
Total derivatives	**12,479,731**	11,870,735	**9,111,831**	8,604,642

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.

Notes on the Financial Statements (continued)

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	
	2011	2010	**2011**	2010
	£m	£m	**£m**	£m
Unamortised balance at 1 January	**130**	101	**123**	94
Deferral on new transactions	**118**	199	**115**	198
Recognised in the income statement during the period:				
– amortisation	**(79)**	(60)	**(79)**	(60)
– subsequent to unobservable inputs becoming observable	**(43)**	(7)	**(41)**	(6)
– maturity or termination, or offsetting derivative	**(29)**	(103)	**(27)**	(102)
Exchange differences	**–**	–	**–**	(1)
Unamortised balance at 31 December[1]	**97**	130	**91**	123

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 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 2011		At 31 December 2010	
	Cash flow hedge	**Fair value hedge**	Cash flow hedge	Fair value hedge
	£m	**£m**	£m	£m
Exchange rate	**716**	**68**	351	86
Interest rate	**93,203**	**25,011**	123,244	18,920

	The bank			
	At 31 December 2011		At 31 December 2010	
	Cash flow hedge	**Fair value hedge**	Cash flow hedge	Fair value hedge
	£m	**£m**	£m	£m
Exchange rate	**214**	**–**	–	–
Interest rate	**35,138**	**18,927**	53,475	11,326

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.

Notes on the Financial Statements (continued)

Fair value of derivatives designated as fair value hedges

The group

	At 31 December 2011		At 31 December 2010	
	Assets	**Liabilities**	Assets	Liabilities
	£m	**£m**	£m	£m
Foreign exchange	**–**	**(1)**	3	–
Interest rate	**197**	**(1,578)**	177	(705)
	197	**(1,579)**	180	(705)

The bank

	At 31 December 2011		At 31 December 2010	
	Assets	**Liabilities**	Assets	Liabilities
	£m	**£m**	£m	£m
Interest rate	**179**	**(1,557)**	133	(381)
	179	**(1,557)**	133	(381)

Gains or losses arising from the change in fair value of fair value hedges

	The group		The bank	
	2011	2010	**2011**	2010
	£m	£m	**£m**	£m
Gains/ (losses)				
– on hedging instruments	**(1,231)**	(255)	**(1,122)**	(231)
– on hedged items attributable to the hedged risk	**1,143**	248	**1,047**	236

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 2011		At 31 December 2010	
	Assets	**Liabilities**	Assets	Liabilities
	£m	**£m**	£m	£m
Foreign exchange	**115**	**(7)**	5	(19)
Interest rate	**977**	**(600)**	1,150	(628)
	1,092	**(607)**	1,155	(647)

The bank

	At 31 December 2011		At 31 December 2010	
	Assets	**Liabilities**	Assets	Liabilities
	£m	**£m**	£m	£m
Interest rate	**403**	**(180)**	781	(376)

Notes on the Financial Statements (continued)

Forecast principal balances on which interest cash flows are expected to arise

The group

	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**

	At 31 December 2010			
	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	68,844	45,548	28,345	97
Liabilities	(33,808)	(19,057)	(12,968)	(760)
Net cash inflow/(outflow) exposure	35,036	26,491	15,377	(663)

The bank

	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)**

	At 31 December 2010			
	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	42,600	35,332	21,112	–
Liabilities	(12,324)	(11,634)	(11,125)	(210)
Net cash inflow/(outflow) exposure	30,276	23,698	9,987	(210)

The gains and losses on ineffective portions of such derivatives are recognised immediately in 'Net trading income'. During the year to 31 December 2011, a gain of £6 million (2010: loss of £4 million) was recognised due to hedge ineffectiveness.

Notes on the Financial Statements (continued)

18 Financial investments

	The group		The bank	
	2011	2010	**2011**	2010
	£m	£m	**£m**	£m
Financial investments:				
– which may be repledged or resold by counterparties	**12,555**	11,266	**9,025**	9,930
– not subject to repledge or resale by counterparties	**80,557**	90,820	**33,215**	31,408
	93,112	102,086	**42,240**	41,338

	The group		The bank	
	2011	2010	**2011**	2010
	£m	£m	**£m**	£m
Treasury and other eligible bills	**6,737**	9,354	**4,106**	3,296
– available-for-sale	**6,737**	9,354	**4,106**	3,296
– held-to-maturity	**-**	–	**-**	–
Debt securities	**85,151**	91,306	**37,641**	37,492
– available-for-sale	**81,000**	87,025	**37,641**	37,492
– held-to-maturity	**4,151**	4,281	**-**	–
Equity securities	**1,224**	1,426	**493**	550
– available-for-sale	**1,224**	1,426	**493**	550
Total financial investments	**93,112**	102,086	**42,240**	41,338

For the group, £6,193 million (2010: £10,067 million), and for the bank, £666 million (2010: £3,707 million), of the debt securities issued by banks and other financial institutions are guaranteed by various governments.

19 Repurchase agreements and securities lending agreements

The group enters into transactions in the normal course of business by which it transfers recognised financial assets directly to third parties or to special purpose entities. These transfers may give rise to full or partial derecognition of the financial assets concerned.

Transfers that do not qualify for derecognition

The majority of financial assets that do not qualify for derecognition are (i) debt securities held by counterparties under repurchase agreements or (ii) equity securities lent under securities lending agreements. The following tables analyse the carrying amount of such financial assets as at 31 December that did not qualify for derecognition during the year and their associated financial liabilities:

The group

	2011		2010	
	Carrying amount of transferred assets £m	**Carrying amount of associated liabilities £m**	Carrying amount of transferred assets £m	Carrying amount of associated liabilities £m
Nature of transaction				
Repurchase agreements	**61,861**	**61,820**	62,101	60,774
Securities lending agreements	**3,991**	**3,971**	4,173	4,203
Total	**65,852**	**65,791**	66,274	64,977

Notes on the Financial Statements (continued)

The bank

	2011		2010	
	Carrying amount of transferred assets	**Carrying amount of associated liabilities**	Carrying amount of transferred assets	Carrying amount of associated liabilities
	£m	**£m**	£m	£m
Nature of transaction				
Repurchase agreements	**44,404**	**44,350**	33,471	32,144
Securities lending agreements	**3,971**	**3,971**	4,173	4,203
Total	**48,375**	**48,321**	37,644	36,347

A small proportion of financial assets that do not qualify for derecognition relate to loans, credit cards, debt securities and trade receivables that have been securitised under arrangements by which the group retains a continuing involvement in such transferred assets. Continuing involvement may entail retaining the rights to future cash flows arising from the assets after investors have received their contractual terms (for example, interest rate strips); providing subordinated interest; liquidity support; continuing to service the underlying asset; or entering into derivative transactions with the securitisation vehicles. As such, the group continues to be exposed to risks associated with these transactions.

The rights and obligations that the group retains from its continuing involvement in securitisations are initially recorded as an allocation of the fair value of the financial asset between the part that is derecognised and the part that continues to be recognised on the date of transfer. The following table analyses the carrying amount of financial assets that qualified for partial derecognition, the extent of the group's continuing involvement and the associated liabilities.

Continuing involvement in financial assets qualifying for partial derecognition

The group

	Securitisations at 31 December	
	2011	2010
	£m	£m
Carrying amount of assets (original)	**8,359**	8,359
Carrying amount of assets (currently recognised)	**14**	20
Carrying amount of associated liabilities (currently recognised)	**7**	10

The bank

	Securitisations at 31 December	
	2011	2010
	£m	£m
Carrying amount of assets (original)	**8,359**	8,359
Carrying amount of assets (currently recognised)	**14**	20
Carrying amount of associated liabilities (currently recognised)	**7**	10

20 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.

In 2011, the group purchased, at the carrying value of £1.7 million, the 0.69% shareholding in VocaLink held by HFC Ltd, a fellow subsidiary of HSBC Holdings plc. At 31 December 2011, the group had a 15.91% interest in the £133 million issued equity capital of VocaLink (2010: 15.22%). The carrying amount of the group's interest of £52 million at 31 December 2011 (2010: £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.

Notes on the Financial Statements (continued)

Summarised financial information on associates

The group's share of:

	2011 £m	2010 £m
Assets	**117**	115
Liabilities	**62**	58
Revenue	**46**	42
Profit after tax	**(1)**	4

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 2011 and 31 December 2010, the group had a 50% interest in the £10 million issued equity capital.

Holmwood Termtime Credit Limited was disposed of as part of the sale of HSBC Insurance Brokers Limited. The sale was completed in April 2010.

Summarised financial information on joint ventures

The group's share of:

	2011 £m	2010 £m
Current assets	**123**	91
Non current assets	**14**	12
Current liabilities	**121**	85
Non current liabilities	**10**	11
Income	**43**	46
Expense	**(43)**	(45)

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.

21 Goodwill and intangible assets

	The group		The bank	
	2011 £m	2010 £m	2011 £m	2010 £m
Goodwill	**9,629**	9,860	**298**	298
Present value of in-force long-term assurance business ('PVIF')	**708**	710	**–**	–
Other intangible assets	**658**	573	**501**	388
	10,995	11,143	**799**	686

Goodwill

The group

	2011 £m	2010 £m
Gross amount and Carrying amount		
At 1 January	**9,860**	10,015
Disposals	**(3)**	–
Exchange differences	**(228)**	(140)
Other changes	**–**	(15)
At 31 December	**9,629**	9,860

Notes on the Financial Statements (continued)

The bank

	2011 £m	2010 £m
Gross amount and Carrying amount		
At 1 January	**298**	299
Other changes	**–**	(1)
At 31 December	**298**	298

During 2011, no goodwill impairment was recognised (2010: 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 2011 based on a value in use calculation. In line with the accounting policy set out in Note 2, goodwill is also retested for impairment whenever there is an indication that goodwill may be impaired. The Global Banking and Markets CGU experienced significantly reduced profitability for the second half of 2011 and, as a result, goodwill allocated to this CGU was reassessed for impairment at 31 December.

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 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. These CGUs do not carry on their balance sheet any intangible assets with indefinite useful lives, other than goodwill.

	Goodwill at 1 July 2011 £m	**Discount rate %**	**Nominal growth rate beyond initial cash flow projections %**	Goodwill at 1 July 2010 £m	Discount rate %	Nominal growth rate beyond initial cash flow projections %
Global Banking and Markets	**5,915**	**10%**	**4.4%**	5,368	11%	3.3%
Private Banking	**3,048**	**7%**	**5.4%**	2,980	11%	2.6%
Total goodwill in the CGUs listed above	**8,963**			8,348		

As at 1 July 2011, aggregate goodwill of £1,235 million (1 July 2010: £1,175 million) had been allocated to 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 2010 and 2011 do not exceed the long-term growth rate for the countries within which the CGU operates.

Discount rate: the 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 2011 and 2010, internal costs of capital rates were consistent with externally-sourced rates. The decrease in European discount rates was largely driven by deleveraging within the financial services sector, including the group and a fall in the risk free rate.

Global Banking and Markets: the key assumption included in the cash flow projection for Global Banking and Markets is that European markets will stabilise and begin to recover in 2012. Accordingly, European revenues are forecast to recover partially in 2012 and the anticipated recovery is assumed to continue over the projection period such that 2014 overall revenue recovers to a level broadly in line with 2010. The group's ability to achieve the forecast cash flows for Global Banking and Markets could be adversely impacted by regulatory change during the projection period including but not limited to the impact of the recommendations set out in the 'Final Report by the Independent Commission on Banking'.

Based on management's value in use calculation, Global Banking and Markets has an excess of recoverable amount over carrying amount ('headroom') of £4.1 billion. In order to reduce the headroom to nil, the discount rate used to discount the cash flows would need to increase by 160 basis points or the nominal growth rate, beyond the initial cash flow projection, would need to decrease by 180 basis points.

The present value of in-force long-term assurance business

Movement in PVIF

The group

	2011	2010
	£m	£m
At 1 January	**710**	630
Addition from current year new business	**120**	102
Movement from in-force business (including investment return variances and changes in investment assumptions)	**(150)**	(9)
Exchange differences and other movements	**28**	(13)
At 31 December	**708**	710

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.

During 2011 the calculation of the PVIF asset was refined to bring greater comparability and consistency across the Group's insurance operations. This was achieved by incorporating explicit margins and allowances for certain risks and uncertainties in place of implicit adjustments to the risk discount rate.

The change in calculation reflected explicit risk margins for non-economic risks in the projection assumptions, and explicit allowances for financial options and guarantees using stochastic methods. Risk discount rates have been reduced as a result of removing the implicit adjustments.

In certain circumstances, the implicit adjustments were different from explicit amounts, resulting in a one-off gain of £59m which is included in 'Exchange differences and other movements' in the table above.

Additionally, it should be noted that refinements made to the PVIF calculation during 2011 will introduce greater volatility within reported results.

PVIF-specific assumptions

The key assumptions used in the computation of PVIF for the group's main life insurance operations were:

	2011		2010	
	France	**UK Life**	France	UK Life
Risk free rate	**2.77%**	**2.24%**	3.15%	3.46%
Risk discount rate	**5.95%**	**2.74%**	8.00%	7.00%
Expenses inflation	**2.00%**	**3.45%**	2.00%	3.76%

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	
	2011	2010
	£m	£m
+ 100 basis points shift in risk-free rate	**(16)**	11
– 100 basis points shift in risk-free rate	**5**	(19)
+ 100 basis points shift in risk discount rate	**(15)**	(29)
– 100 basis points shift in risk discount rate	**19**	33

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 2011 and total equity at 31 December 2011 to reasonably possible changes in these non-economic assumptions at that date across all our insurance manufacturing subsidiaries, with comparatives for 2010.

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	
	2011	2010	**2011**	2010
	£m	£m	**£m**	£m
20% increase in claims costs	**(4)**	(48)	**(4)**	(48)
20% decrease in claims costs	**4**	48	**4**	48
10% increase in mortality and/or morbidity rates	**(19)**	(14)	**(19)**	(14)
10% decrease in mortality and/or morbidity rates	**17**	13	**17**	13
50% increase in lapse rates	**(142)**	(110)	**(142)**	(110)
50% decrease in lapse rates	**234**	173	**234**	173
10% increase in expense rates	**(27)**	(21)	**(27)**	(21)
10% decrease in expense rates	**27**	21	**27**	21

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 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**
Cost						
At 1 January 2010	15	1,071	162	207	21	1,476
Additions[1]	–	172	12	–	–	184
Disposals	–	–	(3)	–	–	(3)
Amounts written off	–	(1)	(1)	–	–	(2)
Exchange differences	–	(3)	(4)	–	–	(7)
Other changes	1	8	(5)	–	(18)	(14)
At 31 December 2010	16	1,247	161	207	3	1,634
Accumulated amortisation and impairment						
At 1 January 2010	(11)	(712)	(105)	(91)	(3)	(922)
Amortisation charge for the year[2]	(2)	(121)	(17)	(23)	1	(162)
Disposals	–	(1)	2	–	–	1
Amounts written off	–	1	1	–	–	2
Exchange differences	–	4	3	–	–	7
Other changes	–	6	5	–	2	13
At 31 December 2010	(13)	(823)	(111)	(114)	–	(1,061)
Net carrying amount at 31 December 2010	3	424	50	93	3	573

1 *At 31 December 2011, the group did not have any contractual commitments to acquire intangible assets (2010: 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 2011	**1,059**	**6**	**1,065**
Additions[1]	**242**	**3**	**245**
Disposals	**–**	**(4)**	**(4)**
Amounts written off	**(27)**	**–**	**(27)**
Other changes	**–**	**–**	**–**
At 31 December 2011	**1,274**	**5**	**1,279**
Accumulated amortisation and impairment			
At 1 January 20011	**(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**
Other changes	**–**	**–**	**–**
At 31 December 2011	**(777)**	**(1)**	**(778)**
Net carrying amount at 31 December 2011	**497**	**4**	**501**
Cost			
At 1 January 2010	902	5	907
Additions[1]	162	1	163
Other changes	(5)	–	(5)
At 31 December 2010	1,059	6	1,065
Accumulated amortisation and impairment			
At 1 January 2010	(570)	(4)	(574)
Amortisation charge for the year[2]	(108)	–	(108)
Other changes	6	(1)	5
At 31 December 2010	(672)	(5)	(677)
Net carrying amount at 31 December 2010	387	1	388

1 *At 31 December 2011, the bank did not have any contractual commitments to acquire intangible assets (2010: 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)

22 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 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 £23 million (2010: £21 million).*
2 *Including assets with a carrying amount of £21 million (2010: £20 million) pledged as security for liabilities.*
3 *At 31 December 2011, the group had £5 million (2010: £3 million) of contractual commitments to acquire property, plant and equipment.*
4 *Including the investment properties on page 168.*

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 2010	842	26	492	3,251	3,227	7,838
Additions at cost[3]	69	6	30	364	42	511
Reclassified to held for sale	(32)	–	–	2	–	(30)
Fair value adjustments	4	–	–	–	–	4
Disposals	(10)	–	(15)	(56)	(3,235)	(3,316)
Exchange differences	(8)	1	(6)	(10)	1	(22)
At 31 December 2010	865	33	501	3,551	35	4,985
Accumulated depreciation and impairment						
At 1 January 2010	(119)	(11)	(237)	(2,225)	(1,156)	(3,748)
Depreciation charge for the year	(13)	(5)	(40)	(298)	(98)	(454)
Reclassified to held for sale	10	–	–	(1)	–	9
Disposals	3	–	14	53	1,237	1,307
Impairment losses recognised	(6)	–	–	–	–	(6)
Exchange differences	5	–	(1)	9	2	15
At 31 December 2010	(120)	(16)	(264)	(2,462)	(15)	(2,877)
Net carrying amount at 31 December 2010	745	17	237	1,089	20	2,108

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 2011	**445**	**34**	**402**	**2,649**	**3,530**
Additions at cost[1]	**15**	**37**	**40**	**180**	**272**
Reclassified from held for sale	**(15)**	**(1)**	**–**	**(9)**	**(25)**
Disposals	**(37)**	**(2)**	**(119)**	**(225)**	**(383)**
Transfers	**–**	**(23)**	**23**	**–**	**–**
Exchange and other 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 from held for sale	**5**	**–**	**–**	**5**	**10**
Disposals	**29**	**1**	**117**	**210**	**357**
Transfers	**–**	**23**	**(23)**	**–**	**–**
Impairment losses recognised	**(3)**	**–**	**–**	**–**	**(3)**
Exchange and other 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 2011, the bank had £4 million (2010: £2 million) of contractual commitments to acquire property, plant and equipment.*

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 2010	431	29	405	2,411	3,276
Additions at cost[1]	26	6	12	272	316
Reclassified from held for sale	–	–	–	2	2
Disposals	(8)	–	(11)	(37)	(56)
Exchange differences	(4)	(1)	(4)	1	(8)
At 31 December 2010	445	34	402	2,649	3,530
Accumulated depreciation and impairment					
At 1 January 2010	(74)	(11)	(197)	(1,714)	(1,996)
Depreciation charge for the year	(7)	(5)	(29)	(190)	(231)
Reclassified from held for sale	–	–	–	(2)	(2)
Disposals	2	–	10	32	44
Impairment losses recognised	(4)	–	–	–	(4)
Exchange differences	2	–	–	–	2
At 31 December 2010	(81)	(16)	(216)	(1,874)	(2,187)
Net carrying amount at 31 December 2010	364	18	186	775	1,343

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 2011	**140**
Additions at cost	**–**
Acquisition of subsidiaries	**151**
Fair value adjustments	**(15)**
Transfers	**(8)**
Exchange and other changes	**(9)**
At 31 December 2011	**259**
Fair value	
At 1 January 2010	86
Additions at cost	41
Fair value adjustments	4
Transfers	–
Exchange and other changes	9
At 31 December 2010	140

1 *Included in 'Property, plant and equipment' on page 166.*

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 (2010: £1 million) earned by the group on its investment properties. Direct operating expenses of £nil (2010: 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 (2010: nil). Net exchange differences on translation of investment properties were £1 million (2010: £1 million).

The bank

The bank had no investment properties at 31 December 2011 or 2010.

23 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 (C.I.) Limited	Guernsey	100.00	Ordinary US$1 Preference US$0.10
HSBC Private Bank (Suisse) S.A.	Switzerland	100.00	Ordinary CHF1,000
HSBC Private Bank (UK) Limited	England	100.00	Ordinary £10
HSBC Trinkaus & Burkhardt AG	Germany	80.44	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

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	2.5	Securities investment conduit
Bryant Park Funding LLC	1.8	Conduit
Malachite Funding Limited	2.3	Securities investment conduit
Mazarin Funding Limited	5.2	Securities investment conduit
Regency Assets Limited	4.8	Conduit
Solitaire Funding Limited	7.2	Securities investment conduit

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

In July 2011, the group acquired HSBC International Trustee Limited from HSBC Bank Bermuda Limited, a fellow subsidiary of HSBC Holdings Plc, for cash consideration of £139 million.

Disposals

In November 2010, HSBC agreed to sell Eversholt Rail Group ('Eversholt'), a subsidiary of HSBC Rail (UK) Limited to Eversholt Investment Group, a consortium consisting of investment funds managed by 3i Infrastructure plc, Morgan Stanley Infrastructure Partners and STAR Capital Partners. The sale was completed in December 2010 resulting in a gain on sale of £163 million.

In December 2009, HSBC entered into an agreement to sell part of its global insurance business, HSBC Insurance Brokers Limited and related entities, to Marsh & McLennan Companies for total consideration of £135 million, comprising cash and shares. The sale was completed in April 2010 resulting in a gain on sale of £83 million.

24 Other assets

	The group		The bank	
	2011	2010	**2011**	2010
	£m	£m	**£m**	£m
Bullion	**754**	979	**655**	880
Assets held for sale	**76**	56	**56**	38
Reinsurers' share of liabilities under insurance contracts	**470**	432	**–**	–
Endorsements and acceptances	**730**	494	**393**	231
Other accounts	**5,107**	4,157	**2,912**	2,205
	7,137	6,118	**4,016**	3,354

Assets held for sale

	The group		The bank	
	2011	2010	**2011**	2010
	£m	£m	**£m**	£m
Non-current assets held for sale:				
- property, plant and equipment	**74**	54	**56**	38
- other	**2**	2	**–**	–
Total assets classified as held for sale	**76**	56	**56**	38

On 21 December 2009, the group entered into a contract for the sale of 103 Champs-Elysées and 15 rue Vernet in Paris for a combined consideration of EUR 400 million. Under the terms of the arrangement, the group would lease the buildings back for a period of 9 years. The carrying amount included in assets held for sale at 31 December 2009 was EUR 257 million (£228 million). The transaction completed on 25 February 2010. Neither a gain nor a loss was recognised on reclassifying these assets as held for sale during 2009. A gain on disposal of EUR 141 million (£125 million) was recognised in the group's operating profit during 2010, within 'Other operating income'.

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.

25 Trading liabilities

	The group		The bank	
	2011	2010	**2011**	2010
	£m	£m	**£m**	£m
Deposits by banks	**30,143**	26,050	**37,046**	29,631
Customer accounts	**43,749**	36,915	**33,293**	30,559
Other debt securities in issue	**14,834**	17,454	**11,950**	13,978
Other liabilities – net short positions	**30,485**	51,941	**12,295**	24,244
	119,211	132,360	**94,584**	98,412

26 Financial liabilities designated at fair value

	The group		The bank	
	2011	2010	**2011**	2010
	£m	£m	**£m**	£m
Deposits by banks and customer accounts	**4,527**	4,040	**4,352**	3,859
Liabilities to customers under investment contracts	**4,527**	4,775	**–**	–
Debt securities in issue	**20,124**	15,460	**15,693**	10,813
Subordinated liabilities	**2,570**	3,381	**2,816**	3,662
Preference shares	**244**	279	**–**	–
	31,992	27,935	**22,861**	18,334

The group

The carrying amount at 31 December 2011 of financial liabilities designated at fair value was £684 million higher (2010: £95 million higher) than the contractual amount at maturity. At 31 December 2011, the accumulated amount of change in fair value attributable to changes in credit risk was a gain of £955 million (2010: £118 million gain).

The bank

The carrying amount at 31 December 2011 of financial liabilities designated at fair value was £488 million higher (2010: £144 million lower) than the contractual amount at maturity. At 31 December 2011, the accumulated amount of change in fair value attributable to changes in credit risk was a gain of £906 million (2010: £175 million gain).

27 Other liabilities

	The group		The bank	
	2011	2010	**2011**	2010
	£m	£m	**£m**	£m
Amounts due to investors in funds consolidated by the group	**317**	341	**–**	–
Obligations under finance leases	**169**	171	**–**	–
Endorsements and acceptances	**730**	494	**393**	231
Share-based payment liability to HSBC Holdings	**422**	344	**252**	197
Other liabilities	**2,932**	3,510	**1,735**	1,793
	4,570	4,860	**2,380**	2,221

Notes on the Financial Statements (continued)

28 Liabilities under insurance contracts

	At 31 December 2011		
	Gross	**Reinsurers' share**	**Net**
	£m	**£m**	**£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**

	At 31 December 2010		
	Gross	Reinsurers' share	Net
	£m	£m	£m
Non-life insurance liabilities			
Unearned premium provision	73	(4)	69
Notified claims	257	(94)	163
Claims incurred but not reported	215	(12)	203
Other	14	(2)	12
	559	(112)	447
Life insurance liabilities to policyholders			
Life (non-linked)	888	(292)	596
Investment contracts with discretionary participation features[1]	14,205	–	14,205
Life (linked)	1,464	(28)	1,436
	16,557	(320)	16,237
Total liabilities under insurance contracts	17,116	(432)	16,684

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

	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**

	2010		
	Gross £m	Reinsurers' share £m	Net £m
Unearned premium reserve ('UPR')			
At 1 January	168	(9)	159
Changes in UPR recognised as (income)/expense	(93)	5	(88)
– gross written premiums	113	(5)	108
– gross earned premiums	(206)	10	(196)
Exchange differences and other movements	(2)	–	(2)
At 31 December	73	(4)	69
Notified and incurred but not reported claims			
At 1 January	543	(101)	442
– notified claims	342	(89)	253
– claims incurred but not reported	201	(12)	189
Claims paid in current year	(229)	24	(205)
Claims incurred in respect of current year	76	(21)	55
Claims incurred in respect of prior years	61	7	68
Exchange differences and other movements	21	(15)	6
At 31 December	472	(106)	366
– notified claims	257	(94)	163
– claims incurred but not reported	215	(12)	203
Other	14	(2)	12
Total non-life insurance liabilities	559	(112)	447

Notes on the Financial Statements (continued)

Life insurance liabilities to policyholders

	2011		
	Gross	**Reinsurers' share**	**Net**
	£m	**£m**	**£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**

	2010		
	Gross	Reinsurers' share	Net
	£m	£m	£m
Life (non-linked)			
At 1 January	1,506	(278)	1,228
Benefits paid	(256)	78	(178)
Increase in liabilities to policyholders	236	(107)	129
Exchange differences and other movements	(598)	15	(583)
At 31 December	888	(292)	596
Investment contracts with discretionary participation features			
At 1 January	12,930	–	12,930
Benefits paid	(1,299)	–	(1,299)
Increase in liabilities to policyholders	2,395	–	2,395
Exchange differences and other movements[1]	179	–	179
At 31 December	14,205	–	14,205
Life (linked)			
At 1 January	1,310	(17)	1,293
Benefits paid	(133)	4	(129)
Increase in liabilities to policyholders	406	(16)	390
Exchange differences and other movements[2]	(119)	1	(118)
At 31 December	1,464	(28)	1,436
Total liabilities to policyholders	16,557	(320)	16,237

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)

The decrease in liabilities to policyholders represents the aggregate of all events giving rise to reduced liabilities to policyholders in the year. The key factors contributing to the movement in policyholder liabilities include death claims, surrenders, lapses, the setting up of policyholder liabilities at the initial inception of the policy, the declaration of bonuses and other amounts attributable to policyholders.

29 Provisions

	The group		The bank	
	2011	2010	**2011**	2010
	£m	£m	**£m**	£m
At 1 January	**425**	368	**229**	176
Additional provisions/increase in provisions[1]	**671**	237	**527**	102
Provisions utilised	**(242)**	(174)	**(202)**	(43)
Amounts reversed	**(41)**	(35)	**(5)**	(6)
Exchange differences and other movements	**7**	29	**16**	–
At 31 December	**820**	425	**565**	229

1 *Includes unwinding of discounts of £3 million (2010: £3 million) in relation to vacant space provisions.*

Provisions include £483 million (2010: £135 million) in respect of customer redress programmes. The most significant of these provisions are as follows and relate to both the group and bank.

(i) £262 million (2010: £16 million) for the group relates to the possible mis-selling of Payment Protection Insurance ('PPI') policies in previous years (the bank: 2011 £234 million; 2010 £16 million).

The key assumptions relevant to calculating the potential liability in respect of PPI sales are likely to evolve over time as root cause analysis is completed and more experience is available regarding actual complaint volumes received.

The main assumptions currently in use are around the level of customer complaints received and for how long a period; the level of non-complainant customers who will have to be contacted if systemic issues are identified following root cause analysis; the response rate from customers who are contacted pro-actively; and the expected uphold rate for complaints and the amount of redress payable in upheld cases.

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 is currently a high degree of uncertainty as to the eventual costs of redress for this matter.

(ii) A provision of £141 million (2010: £44 million) for the possible cost of redress relating to the sale of certain personal pension plans and advice. The provision is based on an actuarial calculation extrapolated from a sample of cases. The timing of the expenditure depends on settlement of individual claims.

(iii) Provisions of £51 million (2010: £62 million) for the estimated cost of redress in relation to 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 £29 million (2010: £15 million) for compensation payable in respect of customers who did not receive suitable advice from advisors in its NHFA subsidiary in relation to meeting the costs of long-term care, such as nursing home accommodation. The provision calculation is dependent on market returns which can vary over time.

Also included in the above table, for the bank and group, are provisions for onerous property contracts of £51 million (2010: £50 million) 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.

Notes on the Financial Statements (continued)

30 Subordinated liabilities

	The group		The bank	
	2011	2010	**2011**	2010
	£m	£m	**£m**	£m
Subordinated liabilities:				
– At amortised cost	**9,998**	7,407	**9,893**	7,562
Subordinated liabilities	**7,711**	5,070	**9,893**	7,562
Preference shares	**2,287**	2,337	**–**	–
– Designated at fair value	**2,814**	3,660	**2,816**	3,662
Subordinated liabilities	**2,570**	3,381	**2,816**	3,662
Preference shares	**244**	279	**–**	–
	12,812	11,067	**12,709**	11,224

Subordinated borrowings of the group

		Carrying amount	
		2011	2010
		£m	£m
£350m	Callable Subordinated Variable Coupon Notes 2017[1]	**355**	362
€1,000m	Floating Rate Subordinated Loan 2017	**835**	862
£500m	4.75% Callable Subordinated Notes 2020[2]	**490**	499
€500m	Callable Subordinated Floating Rate Notes 2020	**355**	381
US$1,000m	Floating Rate Subordinated Loan 2020	**646**	644
US$1,450m	Floating Rate Subordinated Loan 2021	**937**	–
US$450m	Subordinated Floating Rate Notes 2021	**291**	–
€250m	Floating Rate Subordinated Loan 2021	**209**	215
US$275m	Floating Rate Subordinated Loan 2021	**178**	–
£350m	5% Callable Subordinated Notes 2023[3]	**344**	353
£300m	6.5% Subordinated Notes 2023	**299**	297
US$300m	7.65% Subordinated Notes 2025	**242**	220
£350m	5.375% Callable Subordinated Step-up Notes 2030[4]	**318**	329
£500m	5.375% Subordinated Notes 2033	**438**	469
£390m	6.9% Subordinated Loan 2033	**390**	390
US$977m	Floating Rate Subordinated Loan 2040	**631**	629
€900m	7.75% Non-cumulative Subordinated Notes 2040	**752**	775
£225m	6.25% Subordinated Notes 2041	**224**	224
£600m	4.75% Subordinated Notes 2046	**592**	592
£700m	5.844% Non-cumulative Step-up Perpetual Preferred Securities[5]	**700**	700
£300m	5.862% Non-cumulative Step-up Perpetual Preferred Securities[6]	**244**	279
US$750m	Undated Floating Rate Primary Capital Notes	**484**	483
US$500m	Undated Floating Rate Primary Capital Notes	**323**	322
US$300m	Undated Floating Rate Primary Capital Notes (Series 3)	**194**	193
US$2,862m	Perpetual Subordinated Debt[7]	**1,849**	–
US$300m	6.95% Subordinated Notes 2011	**–**	200
€600m	4.25% Callable Subordinated Notes 2016[8]	**–**	530
€800m	Callable Subordinated Floating Rate Notes 2016[9]	**–**	689
	Other subordinated liabilities less than £100m	**492**	430
		12,812	11,067

1 *The interest rate is fixed at 5.75% until June 2012. Thereafter, the rate per annum is the sum of the gross redemption yield of the then prevailing five year UK gilt plus 1.70%.*
2 *In September 2015 the interest rate changes to three month sterling LIBOR plus 0.82%.*
3 *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%.*
4 *In November 2025 the interest rate changes to three month sterling LIBOR plus 1.50%.*
5 *In November 2013 the distribution rate changes to six month sterling LIBOR plus 1.76%.*
6 *In April 2020 the distribution rate changes to six month sterling LIBOR plus 1.85%.*
7 *In March 2011, the bank repaid to HSBC Holdings plc £1,750 million of perpetual subordinated debt classified as equity. At the same time, the bank issued US dollar denominated perpetual subordinated debt of $2,862 million to HSBC Holdings plc.*
8 *On 18 March 2011, the bank called and redeemed the 4.25% Callable Subordinated Notes 2016 at par.*
9 *On 29 March 2011, the bank called and redeemed the Callable Subordinated Floating Rate Notes 2016 at par.*
Footnotes 1 to 6 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 non-objection of the Financial Services Authority.

Notes on the Financial Statements (continued)

31 Fair value of financial instruments

The classification of financial instruments is determined in accordance with the accounting policies set out in Note 2(i) 'Financial instruments designated at fair value'. 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. The following table sets out the financial instruments carried at fair value.

The group

	Of which are classified in the following valuation hierarchy			
	Level 1 quoted market price	**Level 2 using observable inputs**	**Level 3 with significant un-observable inputs**	**Total**
	£m	**£m**	**£m**	**£m**
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**
At 31 December 2010				
Assets				
Trading assets	110,369	47,635	1,548	159,552
Financial assets designated at fair value	9,674	5,793	–	15,467
Derivatives	783	127,115	1,260	129,158
Financial investments: available-for-sale	61,199	34,796	1,810	97,805
Liabilities				
Trading liabilities	71,744	57,440	3,176	132,360
Financial liabilities at fair value	3,932	24,003	–	27,935
Derivatives	601	126,543	2,060	129,204

The bank

	Of which are classified in the following valuation hierarchy			
	Level 1 quoted market price	**Level 2 using observable inputs**	**Level 3 with significant un-observable inputs**	**Total**
	£m	**£m**	**£m**	**£m**
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**
At 31 December 2010				
Assets				
Trading assets	76,983	47,983	1,527	126,493
Financial assets designated at fair value	608	3,897	–	4,505
Derivatives	605	106,919	1,381	108,905
Financial investments: available-for-sale	34,135	3,411	3,792	41,338
Liabilities				
Trading liabilities	40,205	54,776	3,431	98,412
Financial liabilities at fair value	40	18,294	–	18,334
Derivatives	537	105,940	2,309	108,786

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, independent development or validation 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. The group has, for collateralised counterparties and in significant major currencies, adopted a discounting curve that reflects the overnight interest rate ('OIS discounting'). Prior to 2010, in line with market practice, discount curves did not reflect this overnight interest rate but were based on term LIBOR rates. During the period, the group applied an OIS discounting curve to an expanded range of significant currencies in line with evolving market practice. The financial effect of this change was not significant at the time of adoption.

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 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 carrying

amount and/or 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 there is no market data available at all upon which to base a determination of fair value (consensus pricing data may, for example, be used).

In certain circumstances, primarily where debt is hedged with interest rate derivatives, 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 is calculated for each legal entity of the group, and within each entity for each counterparty to which the entity has exposure. The calculation of the monoline credit valuation adjustment and sensitivity to different assumptions is described below. The credit valuation adjustment is calculated by applying the probability of default of the counterparty to the expected positive exposure to the counterparty, and multiplying the result by the loss expected in the event of default. The calculation is performed over the life of the potential exposure.

The probability of default is based on the group's internal credit rating for the counterparty, taking into account how credit ratings may deteriorate over the duration of the exposure through the use of historic rating transition matrices. For most products, to calculate the expected positive exposure to a counterparty, a simulation methodology is used 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. In respect of own credit risk, the group considers that zero spread is appropriate and consequently does not adjust derivative liabilities for the group's own credit risk; such an adjustment is often referred to as a 'debit valuation adjustment'.

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.

All third party counterparties are included in the credit valuation adjustment calculation and credit valuation adjustments are not netted across group entities.

During 2011, no material changes were made to the methodologies used to calculate the credit valuation adjustment.

Consideration of other methodologies for calculation of credit valuation adjustments

The group's credit valuation adjustment methodology, in the opinion of management, appropriately quantifies the group's exposure to counterparty risk on the OTC derivative portfolio and appropriately reflects the risk management strategy of the business.

It is recognised that a variety of credit valuation adjustment methodologies are adopted within the banking industry.

Some of the key attributes that may differ between these methodologies are:

- the PD may be calculated from historical market data, or implied from current market levels for certain transaction types such as CDSs, either with or without an adjusting factor;
- some entities derive their own PD from a non-zero spread, which has the effect of reducing the overall adjustment;
- differing loss assumptions in setting the level of LGD, which may utilise levels set by regulators for capital calculation purposes; and
- counterparty exclusions, whereby certain counterparty types (for example collateralised counterparties) are excluded from the calculation.

The group's monoline credit valuation adjustment calculation utilises a range of approaches dependent upon the credit quality of the monoline.

The group has estimated the impact of adopting two alternative methodologies on the level of its credit and debit valuation adjustments (excluding the monocline credit valuation adjustment) as follows:

- adapting the existing methodology to utilise probabilities of default implied from credit default swaps, with no adjustment factor applied, and also including an adjustment to take into account the group's own probability of default implied from credit default swaps, results in an overall adverse adjustment of £0.6 billion (2010: £0.1 billion).
- adapting the existing debit valuation adjustment methodology to include the group's own probability of default on a basis symmetric with the current calculation of credit valuation adjustment would result in a favourable reduction of the credit risk charge of £57 million (2010: £53 million).

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 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**
At 31 December 2010							
Private equity investments	492	51	–	–	–	–	–
Asset-backed securities	1,228	58	–	–	–	–	–
Leverage finance	–	–	–	–	–	–	7
Structured notes	–	–	–	–	3,147	–	–
Derivatives with monolines	–	–	–	144	–	–	–
Other derivatives	–	–	–	1,116	–	–	2,048
Other portfolios	90	1,439	–	–	29	–	5
	1,810	1,548	–	1,260	3,176	–	2,060

Notes on the Financial Statements (continued)

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 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**
At 31 December 2010							
Private equity investments	354	51	–	–	–	–	–
Asset-backed securities	3,348	47	–	–	–	–	–
Leverage finance	–	–	–	–	–	–	7
Structured notes	–	–	–	–	3,147	–	–
Derivatives with monolines	–	–	–	144	–	–	–
Other derivatives	–	–	–	1,237	284	–	2,297
Other portfolios	90	1,429	–	–	–	–	5
	3,792	1,527	–	1,381	3,431	–	2,309

- *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.

- *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.

Notes on the Financial Statements (continued)

- *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. The valuation of derivatives with monolines is discussed on pages 178 to 179.

  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 tranched CDS transactions.

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 2011	**1,810**	**1,548**	**–**	**1,260**	**3,176**	**–**	**2,060**
Total gains or losses recognised in profit or loss	**71**	**(62)**	**–**	**321**	**107**	**–**	**168**
Total gains or losses recognised in other comprehensive income	**(97)**	**–**	**–**	**–**	**–**	**–**	**(1)**
Purchases	**80**	**260**	**–**	**–**	**(1,176)**	**–**	**–**
Issues	**–**	**–**	**–**	**–**	**934**	**–**	**–**
Sales	**(31)**	**(1,371)**	**–**	**–**	**10**	**–**	**–**
Settlements	**(307)**	**(73)**	**–**	**(18)**	**(791)**	**–**	**(455)**
Transfer out	**(535)**	**(162)**	**–**	**(195)**	**(571)**	**–**	**(377)**
Transfer in	**1,325**	**636**	**–**	**202**	**16**	**–**	**310**
Exchange differences	**33**	**2**	**–**	**(15)**	**(1)**	**–**	**(2)**
At 31 December 2011	**2,349**	**778**	**–**	**1,555**	**1,704**	**–**	**1,703**
Total gains or losses recognised in profit or loss relating to those assets and liabilities held at the end of the reporting period	**44**	**(77)**	**–**	**529**	**124**	**–**	**518**

Notes on the Financial Statements (continued)

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 2011	**3,792**	**1,527**	**–**	**1,381**	**3,431**	**–**	**2,309**
Total gains or losses recognised in profit or loss	**41**	**(58)**	**–**	**366**	**89**	**–**	**(35)**
Total gains or losses recognised in other comprehensive income	**(575)**	**–**	**–**	**–**	**–**	**–**	**(1)**
Purchases	**19**	**260**	**–**	**–**	**(1,447)**	**–**	**–**
Issues	**–**	**–**	**–**	**–**	**934**	**–**	**–**
Sales	**(26)**	**(1,371)**	**–**	**–**	**10**	**–**	**–**
Settlements	**(154)**	**(73)**	**–**	**(86)**	**(791)**	**–**	**(382)**
Transfer out	**(124)**	**(162)**	**–**	**(216)**	**(571)**	**–**	**(372)**
Transfer in	**154**	**636**	**–**	**238**	**–**	**–**	**310**
Exchange differences	**(4)**	**2**	**–**	**(16)**	**(4)**	**–**	**2**
At 31 December 2011	**3,123**	**761**	**–**	**1,667**	**1,651**	**–**	**1,831**
Total gains or losses recognised in profit or loss relating to those assets and liabilities held at the end of the reporting period	**25**	**(78)**	**–**	**580**	**103**	**–**	**457**

Available-for-sale securities: reduced pricing certainty of valuation in the ABS market has resulted in the transfer of assets into Level 3 during 2011.

Trading assets: disposals of convertible debenture positions during the year drove the decrease in Level 3 trading assets during 2011.

Trading liabilities: the reduction in the Level 3 balance in the year was driven by the purchase of a convertible debenture to close a trading liability exposure.

During 2011, there were no material transfers between Level 1 and 2.

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 fair values to reasonably possible alternative assumptions:

The group

	Reflected in profit or loss		Reflected in other comprehensive income	
	Favourable changes £m	Unfavourable changes £m	Favourable changes £m	Unfavourable changes £m
At 31 December 2011				
Derivatives/trading assets/trading liabilities[1]	**200**	**(169)**	**–**	**–**
Financial investments: available-for-sale	**–**	**–**	**189**	**(183)**
At 31 December 2010				
Derivatives/trading assets/trading liabilities[1]	232	(217)	–	–
Financial investments: available-for-sale	–	–	180	(166)

Notes on the Financial Statements (continued)

The bank

	Reflected in profit or loss		Reflected in other comprehensive income	
	Favourable changes £m	Unfavourable changes £m	Favourable changes £m	Unfavourable changes £m
At 31 December 2011				
Derivatives/trading assets/trading liabilities[1]	**203**	**(171)**	**–**	**–**
Financial investments: available-for-sale	**–**	**–**	**191**	**(162)**
At 31 December 2010				
Derivatives/trading assets/trading liabilities[1]	242	(231)	–	–
Financial investments: available-for-sale	–	–	159	(145)

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 fair values to reasonably possible alternative assumptions by Level 3 instrument type

	Reflected in profit or loss		Reflected in other comprehensive income	
	Favourable changes £m	Unfavourable changes £m	Favourable changes £m	Unfavourable changes £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)**

	Reflected in profit or loss		Reflected in other comprehensive income	
	Favourable changes £m	Unfavourable changes £m	Favourable changes £m	Unfavourable changes £m
At 31 December 2010				
Private equity investments	52	(25)	37	(36)
Asset-backed securities	5	(5)	114	(116)
Leverage finance	11	(10)	–	–
Derivatives with monolines	35	(32)	–	–
Other derivatives	111	(116)	–	–
Other portfolios	18	(29)	29	(14)

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.
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.

Notes on the Financial Statements (continued)

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.

32 Fair values of financial instruments not carried at fair value

The classification of financial instruments is determined in accordance with the accounting policies set out in Note 2. The following financial instruments are not carried at fair value on the balance sheet. Their fair values are, however, provided for information and are calculated as described below.

The group

	At 31 December 2011		At 31 December 2010	
	Carrying amount £m	**Fair value £m**	Carrying amount £m	Fair value £m
Assets				
Loans and advances to banks	**44,603**	**44,588**	57,027	57,019
Loans and advances to customers	**288,014**	**282,813**	285,218	281,853
Financial investments: Debt securities	**4,151**	**4,204**	4,281	4,548
Liabilities				
Deposits by banks[1]	**41,032**	**41,032**	48,287	48,287
Customer accounts	**346,129**	**346,184**	344,123	344,176
Debt securities in issue	**42,688**	**42,661**	48,119	47,991
Subordinated liabilities	**9,998**	**9,266**	7,407	6,948

The bank

	At 31 December 2011		At 31 December 2010	
	Carrying amount £m	**Fair value £m**	Carrying amount £m	Fair value £m
Assets				
Loans and advances to banks	**22,203**	**22,189**	27,860	27,860
Loans and advances to customers	**210,561**	**205,587**	208,548	205,163
Liabilities				
Deposits by banks[1]	**32,324**	**32,324**	38,873	38,873
Customer accounts	**237,654**	**237,654**	230,795	230,795
Debt securities in issue	**25,705**	**25,705**	29,417	29,414
Subordinated liabilities	**9,893**	**9,125**	7,562	7,075

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.*

(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.

Performing loans are grouped, as far as possible, into homogeneous pools segregated by maturity and coupon rates. In general, contractual 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 and estimates of market participants' expectations of credit losses over the life of the loans. For impaired loans, fair value is estimated by discounting the future cash flows over the time period in which they are expected to be recovered.

(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.

33 Maturity analysis of assets and liabilities

The balance in the table below will not agree directly with those in our 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 our 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. We classify 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. We therefore manage our 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)

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 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**
At 31 December 2010						
Deposits by banks	13,018	39,150	4,759	3,204	658	60,789
Customer accounts	234,438	86,053	31,709	4,564	641	357,405
Trading liabilities	132,360	–	–	–	–	132,360
Financial liabilities designated at fair value	4,762	857	1,855	11,153	14,810	33,437
Derivatives	129,204	200	649	814	202	131,069
Debt securities in issue	652	22,033	15,301	10,776	411	49,173
Subordinated liabilities	22	737	68	724	7,850	9,401
Other financial liabilities	1,795	4,628	1,874	553	411	9,261
	516,251	153,658	56,215	31,788	24,983	782,895
Loan commitments	112,718	717	386	204	19	114,044
Financial guarantee contracts	571	4,092	5,263	3,146	1,559	14,631
	629,540	158,467	61,864	35,138	26,561	911,570

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 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**
At 31 December 2010						
Deposits by banks	11,619	24,858	2,311	2,067	135	40,990
Customer accounts	186,133	18,386	23,088	3,252	187	231,046
Trading liabilities	98,412	–	–	–	–	98,412
Financial liabilities designated at fair value	4	857	1,730	7,398	12,432	22,421
Derivatives	108,786	199	627	461	196	110,269
Debt securities in issue	652	7,285	13,918	7,962	63	29,880
Subordinated liabilities	–	735	25	1,353	6,458	8,571
Other financial liabilities	186	2,380	739	166	156	3,627
	405,792	54,700	42,438	22,659	19,627	545,216
Loan commitments	82,267	282	225	124	18	82,916
Financial guarantee contracts	–	3,729	3,816	2,031	812	10,388
	488,059	58,711	46,479	24,814	20,457	638,520

The group

	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)

	At 31 December 2010		
	Due within one year £m	Due after more than one year £m	Total £m
Assets			
Financial assets designated at fair value	556	14,911	15,467
Loans and advances to banks	54,356	2,671	57,027
Loans and advances to customers	140,227	144,991	285,218
Financial investments	27,312	74,774	102,086
Other financial assets	5,070	1,360	6,430
	227,521	238,707	466,228
Liabilities			
Deposits by banks	48,686	(399)	48,287
Customer accounts	338,438	5,685	344,123
Financial liabilities designated at fair value	2,860	25,075	27,935
Debt securities in issue	37,332	10,787	48,119
Other financial liabilities	4,627	1,159	5,786
Subordinated liabilities	22	7,385	7,407
	431,965	49,692	481,657

The bank

	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**

	At 31 December 2010		
	Due within one year £m	Due after more than one year £m	Total £m
Assets			
Financial assets designated at fair value	84	4,421	4,505
Loans and advances to banks	26,760	1,100	27,860
Loans and advances to customers	99,035	109,513	208,548
Financial investments	8,995	32,343	41,338
Other financial assets	2,561	1,076	3,637
	137,435	148,453	285,888
Liabilities			
Deposits by banks	38,514	359	38,873
Customer accounts	224,655	6,140	230,795
Financial liabilities designated at fair value	2,493	15,841	18,334
Debt securities in issue	21,334	8,083	29,417
Other financial liabilities	2,334	583	2,917
Subordinated liabilities	–	7,562	7,562
	289,330	38,568	327,898

Notes on the Financial Statements (continued)

Further discussion of the group's liquidity and funding management can be found in the Risk section of the Report of the Directors.

34 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 currency exposures
Currency of structural exposure

	2011 £m	2010 £m
Euro	**11,927**	12,313
US dollars	**3,331**	2,558
Swiss francs	**1,553**	2,162
Turkish lira	**1,011**	1,194
Russian rouble	**166**	166
Others, each less than £100 million	**191**	221
Total	**18,179**	18,614

35 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	
	2011 **£m**	2010 £m	**2011** **£m**	2010 £m
Treasury bills and other eligible securities	**440**	532	**–**	29
Loans and advances to banks	**11,422**	6,467	**7,856**	6,432
Loans and advances to customers	**39,736**	23,077	**23,407**	12,439
Debt securities	**102,416**	110,978	**60,580**	61,721
Equity shares	**3,993**	4,231	**3,971**	4,173
Other	**54**	84	**–**	–
	158,061	145,369	**95,814**	84,794

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 £144,699 million (2010: £157,462 million) (the bank: 2011 £85,654 million; 2010 £83,643 million). The fair value of any such collateral that has been sold or repledged is £84,228 million (2010: £93,643 million) (the bank: 2011 £33,581 million; 2010 £29,208 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.

36 Called up share capital and other equity instruments

Issued capital

HSBC Bank plc ordinary shares

	Number	£m
At 1 January 2011	**796,969,107**	**797**
Shares issued	**–**	**–**
At 31 December 2011	**796,969,107**	**797**
At 1 January 2010	796,969,107	797
Shares issued	–	–
At 31 December 2010	796,969,107	797

HSBC Bank plc preferred ordinary shares

	Number	£'000
At 1 January and 31 December 2011	**1**	**–**
At 1 January and 31 December 2010	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 non-cumulative third dollar preference shares

	Number	£'000
At 1 January and 31 December 2011	**35,000,000**	**172**
At 1 January and 31 December 2010	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, with prior notification to the FSA. 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 FSA 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 2011	**1,750**
Debt repaid[1]	**(1750)**
At 31 December 2011	**–**
At 1 January and 31 December 2010	1,750

1 *In March 2011, the bank repaid to HSBC Holdings plc £1,750 million of perpetual subordinated debt. At the same time, the bank issued US dollar denominated perpetual subordinated debt of US$2,862 million to HSBC Holdings plc, which is included in 'Subordinated liabilities'.*

Interest on HSBC Bank plc perpetual subordinated debt was paid quarterly at the sole and absolute discretion of the Board of Directors. The perpetual subordinated debt could only be redeemed at the option of the bank and carried no rights to conversion into ordinary shares of the bank.

Notes on the Financial Statements (continued)

37 Notes on the cash flow statement

Non-cash items included in profit before tax

	The group		The bank	
	2011	2010	**2011**	2010
	£m	£m	**£m**	£m
Depreciation, amortisation and impairment	**549**	622	**359**	343
Share-based payment expense	**328**	246	**213**	166
Credit-related impairment losses	**1,623**	1,952	**1,109**	1,614
Provisions raised	**630**	202	**522**	95
Impairment of investments	**18**	8	**7**	156
Credit charge for defined benefit plans	**(219)**	(432)	**(255)**	208
Accretion of discounts and amortisation of premiums	**161**	239	**1**	(367)
	3,090	2,837	**1,956**	2,215

Change in operating assets

	The group		The bank	
	2011	2010	**2011**	2010
	£m	£m	**£m**	£m
Change in prepayments and accrued income	**631**	(214)	**308**	(294)
Change in net trading securities and net derivatives	**17,430**	22,388	**18,628**	(1,260)
Change in loans and advances to banks	**6,365**	1,229	**6,787**	(5,783)
Change in loans and advances to customers	**(2,601)**	(10,482)	**(2,392)**	(1,205)
Change in financial assets designated at fair value	**122**	951	**(90)**	2,087
Change in other assets	**(1,015)**	3,353	**(250)**	932
	20,932	17,225	**22,991**	(5,523)

Change in operating liabilities

	The group		The bank	
	2011	2010	**2011**	2010
	£m	£m	**£m**	£m
Change in accruals and deferred income	**(440)**	214	**(186)**	103
Change in deposits by banks	**(7,255)**	(9,443)	**(6,549)**	(473)
Change in customer accounts	**2,006**	11,232	**7,053**	7,152
Change in debt securities in issue	**(5,418)**	8,974	**(3,712)**	14,781
Change in financial liabilities designated at fair value	**4,057**	9,770	**4,527**	7,659
Change in other liabilities	**(1,298)**	121	**(100)**	(488)
	(8,348)	20,868	**1,033**	28,734

Cash and cash equivalents

	The group		The bank	
	2011	2010	**2011**	2010
	£m	£m	**£m**	£m
Cash and balances at central banks	**56,460**	24,495	**44,967**	22,357
Items in the course of collection from other banks	**1,663**	1,932	**908**	1,030
Loans and advances to banks of one month or less	**47,497**	53,557	**27,109**	26,086
Treasury bills, other bills and certificates of deposit less than three months	**3,974**	7,432	**2,818**	2,463
Less: items in the course of transmission to other banks	**(1,154)**	(1,411)	**(446)**	(577)
Total cash and cash equivalents[1]	**108,440**	86,005	**75,356**	51,359

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 (2010: nil); and £1,335 million subject to other restrictions (2010: £1,459 million).*

Total interest paid by the group during the year was £5,044 million (2010: £4,062 million). Total interest received by the group during the year was £13,200 million (2010: £12,401 million). Total dividends received by the group during the year were £234 million (2010: £259 million).

Notes on the Financial Statements (continued)

38 Contingent liabilities, contractual commitments and guarantees

	The group		The bank	
	2011	2010	**2011**	2010
	£m	£m	**£m**	£m
Guarantees and other contingent liabilities				
Guarantees	**17,510**	17,324	**10,883**	11,293
Other contingent liabilities	**88**	32	**60**	–
	17,598	17,356	**10,943**	11,293
Commitments[1]				
Documentary credits and short-term trade-related transactions	**2,436**	1,809	**1,160**	725
Forward asset purchases and forward deposits placed	**21**	19	**–**	–
Undrawn formal standby facilities, credit lines and other commitments to lend[2]	**118,424**	112,215	**80,641**	82,191
	120,881	114,043	**81,801**	82,916

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 40.

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. The bank could be liable to pay a proportion of the outstanding borrowings that the FSCS has borrowed from HM Treasury which at 31 December 2011 stood at approximately £18.5 billion. Currently, the Management Expenses Levy paid by the bank represents its share of the interest on these borrowings.

The interest rate to be applied on HM Treasury loans for the period from 1 April 2012, on which the Management Expenses Levy for Scheme Year 2012/2013 will be based, has yet to be formally agreed by FSCS and HM Treasury. The bank's accrual for the Scheme Year 2012/2013 levy is based on an estimated funding rate which considers rates levied in prior years as well as previous public announcements.

The accrual at 31 December 2011 reflects an estimate of £56 million in respect of expected Management Expenses Levy due in Scheme Year 2012/2013. However until negotiations are complete and the funding rate is finalised there exists the possibility that the levy for Scheme Year 2012/2013 will be based on a higher rate and that the bank's liability will be consequently higher. In addition, an agreement by the FSCS not to charge Compensation Cost Levy for three years is also at an end and there exists the possibility that compensation for losses suffered could be levied in Scheme Year commencing 1 April 2012.

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.

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

	At 31 December 2011		At 31 December 2010	
	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
Guarantee type				
Financial guarantees[1]	**9,060**	**1,458**	12,184	1,024
Credit-related substitutes[2]	**1,825**	**67**	1,317	264
Other guarantees	**5,156**	**32**	2,523	44
Total	**16,041**	**1,557**	16,024	1,332

The bank

	At 31 December 2011		At 31 December 2010	
	Guarantees in favour of third parties	**Guarantees by the bank in favour of other Group entities**	Guarantees in favour of third parties	Guarantees by the bank in favour of other Group entities
	£m	**£m**	£m	£m
Guarantee type				
Financial guarantee contracts[1]	**5,451**	**2,320**	7,391	2,240
Credit-related substitutes[2]	**444**	**316**	937	66
Other guarantees	**2,336**	**76**	184	475
Total	**8,231**	**2,712**	8,512	2,781

1 *Financial guarantees 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 2011 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 £5 million (2010: £4 million).

The group had no contingent liabilities or commitments in relation to joint ventures or associates, incurred jointly or otherwise.

39 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.

	2011 Total future minimum payments	**2011** Interest charges	**2011** Present value	2010 Total future minimum payments	2010 Interest charges	2010 Present value
	£m	**£m**	**£m**	£m	£m	£m
No later than one year	**8**	**(8)**	**–**	12	(11)	1
Later than one year and no later than five years	**56**	**(54)**	**2**	53	(51)	2
Later than five years	**227**	**(60)**	**167**	242	(74)	168
	291	**(122)**	**169**	307	(136)	171

At 31 December 2011 future minimum sublease payments of £267 million (2010: £281 million) were expected to be received under non-cancellable subleases at the balance sheet date.

Operating lease commitments

At 31 December 2011, 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 2011	Land and buildings 2010
	£m	£m
Future minimum lease payments under non-cancellable operating leases expiring		
No later than one year	**193**	189
Later than one year and no later than five years	**685**	680
Later than five years	**1,143**	1,213
	2,021	2,082

In 2011, £164 million (2010: £162 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.

	2011 Total future minimum payments	**2011** Interest charges	**2011** Present value	2010 Total future minimum payments	2010 Interest charges	2010 Present value
	£m	**£m**	**£m**	£m	£m	£m
Lease receivables						
No later than one year	**1,165**	**(132)**	**1,033**	1,049	(138)	911
Later than one year and no later than five years	**3,193**	**(495)**	**2,698**	2,938	(438)	2,500
Later than five years	**2,486**	**(637)**	**1,849**	2,766	(762)	2,004
	6,844	**(1,264)**	**5,580**	6,753	(1,338)	5,415

At 31 December 2011, unguaranteed residual values of £117 million (2010: £114 million) had been accrued, and the accumulated allowance for uncollectible minimum lease payments receivable amounted to £12 million (2010: £2 million).

In 2011, £35 million (2010: £42 million) was received as contingent rents and recognised in the income statement.

Notes on the Financial Statements (continued)

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 2011	2010
	£m	£m
Future minimum lease payments under non-cancellable operating leases expiring		
No later than one year	**11**	10
Later than one year and no later than five years	**25**	14
Later than five years	**–**	1
	36	25

In 2011, nil (2010: nil) was received as contingent rents and recognised in 'Other operating income'.

40 Legal proceedings and regulatory matters

The bank 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 bank considers that none of these matters is material, either individually or in the aggregate. The bank 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 as at 31 December 2011.

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$8.4bn, 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$4bn.

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 July 2010, the US District Court Judge overseeing a putative class action in the Southern District of Florida dismissed all claims against the HSBC defendants for lack of personal jurisdiction and on forum non-conveniens grounds. In August 2011, the US Court of Appeals for the Eleventh Circuit affirmed the dismissal.

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 has 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.

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$9bn 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 District Court issued an order that allowed the trustee to immediately appeal that ruling and the trustee has filed a notice of appeal.

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 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. In September 2011, certain non-HSBC defendants moved again to withdraw the case from the Bankruptcy Court. Those withdrawal motions are currently pending before the District Court.

The trustee's English action seeks recovery of unspecified transfers of money from Madoff Securities to or through HSBC, on the ground that the HSBC defendants actually or constructively knew of Madoff's fraud. HSBC has not been served.

Between October 2009 and July 2011, Fairfield Sentry Limited and Fairfield Sigma 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 while plaintiffs pursue an appeal of a decision that reversed the Bankruptcy Court's denial of defendants' motions to remand or abstain and 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.

Investigations into the setting of London interbank offered rates and European interbank offered rates

Various regulators and competition and enforcement authorities around the world including in the UK, the US and the EU, are conducting investigations related to certain past submissions made by panel banks in connection with the setting of London interbank offered rates ('LIBOR') and European interbank offered 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 their investigations. In addition, HSBC and other panel banks have been named in putative class action lawsuits filed by private parties in the US with respect to the setting of US dollar LIBOR. Based on the facts currently known, it is not practicable at this time for HSBC to predict the resolution of these regulatory investigations or putative class action lawsuits, including the timing and potential impact, if any, on HSBC.

US Regulatory Investigations

Various HSBC Group companies are co-operating in ongoing investigations by the US Department of Justice and the US Internal Revenue Service regarding whether certain Group companies acted appropriately in relation to certain customers who had US tax reporting requirements. HSBC continues to cooperate in ongoing investigations by the US Securities and Exchange Commission in relation to compliance with securities laws.

HSBC continues to cooperate with an investigation by the US Senate Permanent Subcommittee on Investigations relating to compliance with US tax and securities laws.

HSBC is co-operating in ongoing investigations by the US Department of Justice, the New York County District Attorney's Office, the Office of Foreign Asset Control ('OFAC'), the Federal Reserve and the Office of the Comptroller of the Currency regarding historical transactions involving Iranian parties and other parties subject to OFAC economic sanctions.

Based on the facts currently known, it is not practicable at this time for HSBC to determine the terms on which the ongoing investigations will be resolved, or the timing of such resolution, or for HSBC to estimate reliably the amounts or range of possible amounts of any fines and/or penalties which could be significant.

41 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 by Key Management Personnel or their close family members.

(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.

	2011	2010[1]
	£000	£000
Short-term employee benefits	**3,090**	2,173
Post-employment benefits	**203**	–
Other long-term benefits	**947**	122
Termination benefits	–	–
Share-based payments	**4,222**	2,724
	8,462	5,019

1 *2010 figures have been restated to reflect services rendered during the year in respect of deferred awards made under HSBC's remuneration policy.*

Shareholdings and options of Directors and other Key Management Personnel

	Balance at 31 December 2011	Balance at 31 December 2010
Number of options over HSBC Holdings plc ordinary shares held by Directors and other key management personnel under employee share plans	**630,044**	688,652
Number of HSBC Holdings plc shares held by Directors and other key management personnel beneficially	**16,227,279**	14,552,607

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.

	2011		2010	
	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 Personnel[2]				
Loans	**181,846**	**158,196**	1,217,401	700,616
Credit cards	**881**	**298**	8,798	319
Guarantees	**43,920**	**31,036**	19,904	17,512

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.

The group

	Balance at 31 December 2011	Balance at 31 December 2010
	£000	£000
Directors		
Loans	**8,582**	10,271
Credit cards	**91**	65

No guarantees were issued in favour of Directors during 2011 (2010: £nil).

Notes on the Financial Statements (continued)

(b) Transactions with other related parties

Associates and joint ventures

The group

	2011		2010	
	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	**208**	**204**	208	208
Amounts due from associates – unsubordinated	**25**	**25**	45	25
Amounts due to joint ventures	**2**	**2**	8	2
Amounts due to associates	**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

	2011		2010	
	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	**208**	**204**	208	208
Amounts due from associates – unsubordinated	**25**	**25**	45	25
Amounts due to joint ventures	**–**	**–**	–	–
Amounts due to associates	**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.

	2011		2010	
	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	**36**	**9**	567	36
Financial assets designated at fair value	**27**	**25**	26	26
Loans and advances to customers	**465**	**270**	228	–
Financial investments	**75**	**28**	78	74
Liabilities				
Trading liabilities	**16**	**16**	17	16
Deposits by banks	**236**	**–**	35	–
Customer accounts	**7,318**	**6,857**	8,693	7,318
Subordinated amounts due	**4,452**	**4,452**	–	–
Guarantees	**–**	**–**	–	–

Notes on the Financial Statements (continued)

	For the year ended 31 December 2011	For the year ended 31 December 2010
	£m	£m
Income Statement		
Interest income	**2**	1
Interest expense	**148**	81
Fee income	**1**	1
Dividend income	**2**	5
Trading income	**9**	9
Other operating income	**12**	(39)
General and administrative expenses	**81**	111

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 March 2011, the bank repaid to HSBC Holdings plc £1,750 million of perpetual subordinated debt. At the same time, the bank issued US dollar denominated perpetual subordinated debt of US$2,862 million to HSBC Holdings plc. Interest on this debt is payable quarterly at prevailing market rates.

Transactions detailed below include amounts due to/from fellow subsidiaries of HSBC Holdings plc

	2011		2010	
	Highest balance during the year[1]	**Balance at the year end[1]**	Highest balance during the year[1]	Balance at the year end[1]
	£m	**£m**	£m	£m
Assets				
Trading assets	**11,736**	**5,887**	9,653	5,384
Derivatives	**40,658**	**21,059**	360,117	14,424
Financial assets designated at fair value	**14**	**10**	12	11
Loans and advances to banks	**8,757**	**8,757**	6,832	6,150
Loans and advances to customers	**3,348**	**2,398**	2,758	961
Financial investments	**7,445**	**7,229**	6,120	5,295
Liabilities				
Trading liabilities	**20,055**	**11,853**	17,299	12,362
Financial liabilities designated at fair value	**34**	**32**	35	34
Deposits by banks	**6,384**	**5,445**	6,061	5,599
Customer accounts	**2,855**	**1,038**	2,576	1,365
Derivatives	**39,578**	**20,521**	330,808	14,784
Guarantees	**1,171**	**1,131**	1,171	1,171

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.*

	For the year ended 31 December 2011	For the year ended 31 December 2010
	£m	£m
Income Statement		
Interest income	**134**	141
Interest expense	**111**	99
Fee income	**122**	93
Fee expense	**231**	210
Trading income	**60**	48
Other operating income	**84**	4
General and administrative expenses	**355**	201

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.

	2011		2010	
	Highest balance during the year[1]	**Balance at the year end[1]**	Highest balance during the year[1]	Balance at the year end[1]
	£m	**£m**	£m	£m
Assets				
Trading assets	**26,035**	**18,291**	23,756	16,245
Derivatives	**20,486**	**20,486**	25,580	14,897
Financial assets designated at fair value	**77**	**–**	87	77
Loans and advances to banks	**8,287**	**5,903**	10,157	8,287
Loans and advances to customers	**21,031**	**17,764**	21,307	20,425
Financial investments	**3,309**	**2,522**	3,309	3,309
Liabilities				
Trading liabilities	**16,305**	**14,092**	21,946	9,244
Deposits by banks	**12,454**	**11,326**	12,918	10,906
Customer accounts	**8,909**	**6,887**	11,243	7,085
Derivatives	**15,877**	**15,877**	22,495	11,597
Subordinated amounts due	**–**	**–**	–	–
Guarantees	**1,284**	**1,271**	1,896	1,273

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 November 2011, the bank acquired £2.5 billion of French and £0.6 billion of Belgian sovereign debt from HSBC France. These debt securities were acquired, together with related hedging arrangements, at an arm's length fair value and are reported as available-for-sale by the bank. The securities continue to be reported as 'trading assets' within the group's statement of financial position and the transfer had no impact on the group's financial performance for the year.

Transactions detailed below include amounts due to/from HSBC Bank plc and HSBC Holdings plc.

	2011		2010	
	Highest balance during the year[1]	**Balance at the year end[1]**	Highest balance during the year[1]	Balance at the year end[1]
	£m	**£m**	£m	£m
Assets				
Trading assets	**36**	**9**	567	36
Loans and advances to customers	**464**	**269**	228	–
Liabilities				
Trading liabilities	**16**	**16**	17	16
Deposits by banks	**–**	**–**	35	–
Customer accounts	**7,541**	**6,292**	8,378	7,541
Subordinated amounts due	**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 renewed an existing contract and 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 losses on 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.

Notes on the Financial Statements (continued)

The bank pays no fee to its parent company for the provision of these guarantees.

Transactions detailed below include amounts due to/from HSBC Bank plc and fellow subsidiaries of HSBC

	2011		2010	
	Highest balance during the year[1]	**Balance at the year end[1]**	Highest balance during the year[1]	Balance at the year end[1]
	£m	**£m**	£m	£m
Assets				
Trading assets	**11,291**	**5,869**	9,081	5,138
Derivatives	**20,854**	**18,779**	17,496	14,030
Loans and advances to banks	**5,065**	**5,026**	5,408	4,096
Loans and advances to customers	**3,202**	**2,211**	2,052	864
Liabilities				
Trading liabilities	**19,598**	**11,575**	16,813	11,949
Deposits by banks	**5,274**	**4,135**	4,798	4,351
Customer accounts	**2,513**	**868**	2,198	557
Derivatives	**20,241**	**18,819**	17,327	14,577
Guarantees	**988**	**988**	969	969

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 2011, fees of £8 million (2010: £6 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 £761 million (2010: £1,163 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 2011, the gross notional value of the swaps was £16,056 million (2010: £14,686 million), the swaps had a negative fair value of £3,591 million to the bank (2010: negative fair value of £1,400 million) and the bank had delivered collateral of £4,451 million (2010: £2,136 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.

In June 2010, the Scheme used a special contribution by the bank of £1,760 million, which was made to accelerate the reduction of the deficit of the Scheme, to acquire debt securities from the bank in a transaction at an arm's length value determined by the Scheme's independent third party advisors.

In December 2011, the bank 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.

Purchase of HSBC International Trustee Limited

In July 2011, the group purchased HSBC International Trustee Limited from HSBC Bank Bermuda Limited, for a cash consideration of £139m.

Purchase of non-controlling interests

In November 2011, the group purchased the non-controlling interest in HSBC Investment Holdings (Guernsey) Limited which was owned by HSBC International Finance Corporation (Delaware), an indirect subsidiary of HSBC Bank USA, National Association, for a cash consideration of £45m.

In June 2010, the group purchased the non-controlling interest in HSBC Europe B.V. which was owned by HSBC Holdings (Luxembourg) S.A., a direct subsidiary of HSBC Overseas Holdings (UK) Limited, for a cash consideration of £176m.

42 Events after the balance sheet date

A second interim dividend for 2011 of £200 million to shareholders of the parent company was declared by the Directors after 31 December 2011.

HSBC Bank plc
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