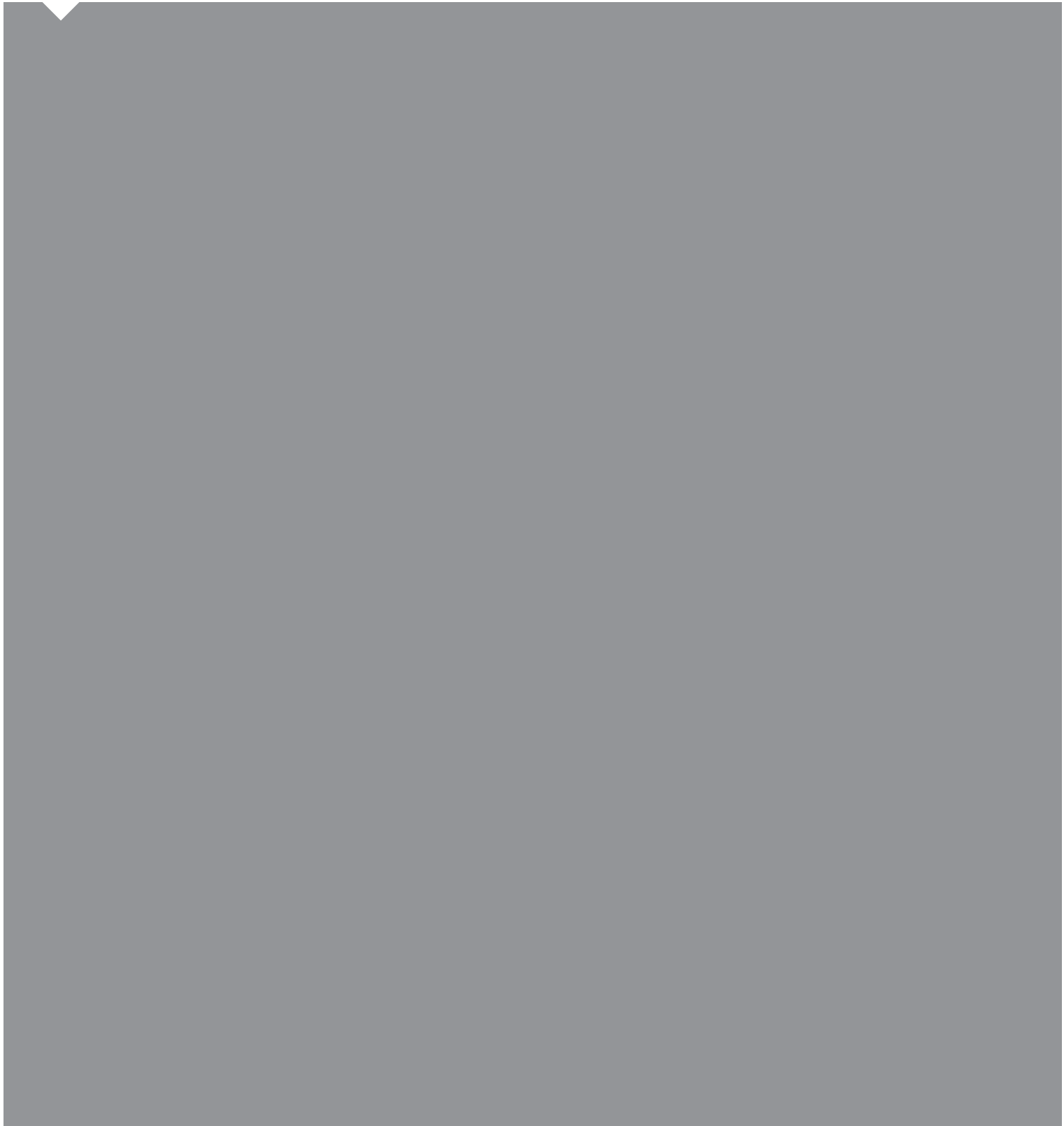


# 2008

HSBC Bank plc Annual Report and Accounts

HSBC   
The world's local bank



## Annual Report and Accounts 2008

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### Presentation of Information

This document comprises the *Annual Report and Accounts 2008* for HSBC Bank plc ('the bank') and its subsidiary undertakings (together 'the group'). It contains the Directors' Report and Accounts, together with the Auditor's report, as required by the UK Companies Act 1985. References to 'HSBC' or 'the Group' within this document mean HSBC Holdings plc together with its subsidiaries

### Cautionary Statement Regarding Forward-Looking Statements

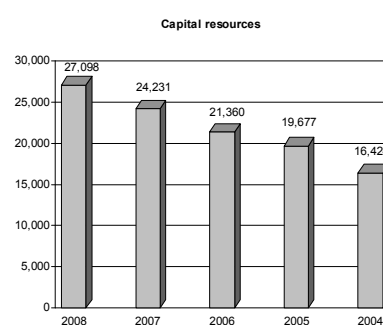
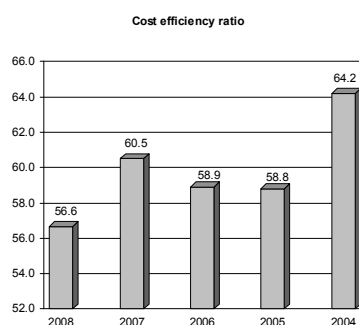
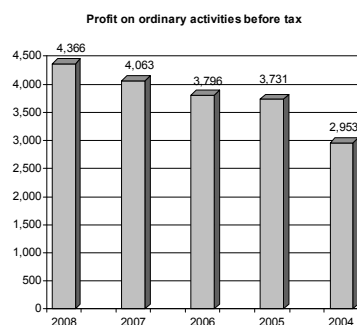
This *Annual Report* contains certain forward-looking statements with respect to the financial condition, results of operations and business of the bank.

Statements that are not historical facts, including statements about the bank'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, and it should not be assumed that they have been revised or updated in the light of new information or future events.

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

	2008	2007 (Restated)	2006	2005 <sup>2</sup>	2004
	£m	£m	£m	£m	£m
<b>For the year<sup>1</sup></b>					
Profit on ordinary activities before tax .....	4,366	4,063	3,796	3,731	2,953
Profit attributable to shareholders of the parent company .....	3,441	3,209	2,722	2,842	2,057
<b>At year-end</b>					
Shareholders' funds of the parent company .....	19,923	24,423	20,399	19,091	16,828
Capital resources <sup>2</sup> .....	27,098	24,231	21,360	19,677	16,424
Customer accounts and deposits by banks .....	431,311	317,055	265,863	239,673	193,664
Total assets .....	924,231	622,280	440,760	386,422	292,481
<b>Ratios (%)</b>					
Return on average shareholders' funds (equity) of the parent company .....	14.5	14.5	13.6	16.4	12.7
Capital ratios .....					
– total capital <sup>2</sup> .....	10.5	10.8	11.2	10.8	10.5
– tier 1 capital <sup>2</sup> .....	6.8	7.5	7.5	6.9	7.4
Cost efficiency ratio <sup>3</sup> .....	56.6	60.5	58.9	58.8	64.2



- The financial highlights are prepared in accordance with International Financial Reporting Standards ('IFRSs') as endorsed by the European Union ('EU'). 2004 financial highlights excludes IAS 32, IAS 39 and IFRS 4.
- 2007 capital balances and ratios are stated on a Basel I basis; pro-forma figures as at 31 December 2007 calculated under Basel II are: capital resources: £22,514; total capital ratio: 10.6%; Tier 1 capital ratio: 7.6%.
- 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 five years.

## Board Directors and Senior Management

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### Directors

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#### **S K Green**, Chairman

Age 60. Chairman since 2005 and a Director since 1995. Deputy Chairman from 2003 to December 2004. Group Chairman of HSBC Holdings plc. Joined HSBC in 1982.

#### **M F Geoghegan, CBE**, Deputy Chairman

Age 55. Deputy Chairman since 2006 and a Director since 2004. Chief Executive from 2004 to 2006. Group Chief Executive of HSBC Holdings plc. Joined HSBC in 1973.

#### **D D J John**, Deputy Chairman and Chief Executive

Age 58. Deputy Chairman since June 2008, Chief Executive since 2006 and a Director since 2003. A Group Managing Director since April 2008. Chairman of the European Management Committee. Joined HSBC in 1971.

#### **P A Thurston**, Managing Director, UK Banking

Age 55. Managing Director, UK Banking and a Director since June 2008. A Group Managing Director since April 2008. Chairman of the UK Banking Management Committee and a member of the European Management Committee. Joined HSBC in 1975.

#### **D C Budd \***

Age 55. Chairman of HFC Bank Limited since June 2008. A Director since 2005. A Group General Manager since 2005. Joined HSBC in 1972.

#### **J D Fishburn\*\***

Age 62. Formerly an independent non-executive Director of HSBC Finance Corporation and Chairman of HFC Bank Limited. A Director since 2003.

#### **S T Gulliver**

Age 49. A Director since 2006. A Director of HSBC Holdings plc. Chief Executive of Global Banking and Markets and HSBC Global Asset Management. Joined HSBC in 1980.

#### **Dame Mary Marsh\*\***

Age 62. Director of the Clore Social Leadership Programme and a member of the National Council of the Learning and Skills Council. A Trustee of Young Enterprise. A Director since 1 January 2009. Formerly Chief Executive of the National Society for the Prevention of Cruelty to Children (NSPCC).

#### **R E S Martin\*\***

Age 48. Member of the Legal Services Board. Formerly Chief Executive of Practical Law Company Limited. A Director since 2005.

#### **A R D Monro-Davies\*\***

Age 68. Formerly Chief Executive Officer, Fitch Ratings. A Director since 2004. Chairman of the Audit Committee.

#### **S P O'Sullivan**

Age 53. A Director and Chief Technology and Services Officer, UK Banking. A member of the UK Banking Management Committee. Joined HSBC in 1980.

#### **P M Shawyer\*\***

Age 58. Formerly a Managing Partner of Deloitte. A Director since 2004. A member of the Audit Committee.

#### **J F Trueman\*\***

Age 66. Formerly Deputy Chairman of S G Warburg & Co. A Director since 2004. A member of the Audit Committee.

\* *Non-Executive Director*

\*\* *Independent Non-Executive Director*

### Secretary

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#### **J H McKenzie**

Age 55. Joined HSBC in 1987.

*Registered Office:* 8 Canada Square, London E14 5HQ

## **European Regional Management**

### **P Y Antika**

Age 48. Chief Executive Officer, HSBC Bank A.S., Turkey. Joined HSBC in 1990. A Group General Manager since 2005.

### **J P Armstrong**

Age 49. Chief Technology and Services Officer, Europe. Joined HSBC in 1982.

### **P Boyles**

Age 53. Chief Executive Officer, HSBC France. Joined HSBC in 1975. A Group General Manager since 2006.

### **S E Anderson**

Age 51. Chief Risk Officer and Regional Head of Risk. Joined HSBC in 1981.

### **J M Flint**

Age 40. Head of Global Markets, Europe, Middle East and Africa. Joined HSBC in 1989.

### **S Jefford**

Age 46. Regional Head of Human Resources. Joined HSBC in 2000.

### **I S Jenkins**

Age 45. Chief Financial Officer and Regional Head of Finance. Joined HSBC in 2006.

### **A M Keir**

Age 50. Regional Head of Commercial Banking. Joined HSBC in 1981. A Group General Manager since 2006.

### **A M Mahoney**

Age 46. Head of International. Joined HSBC in 1983. A Group General Manager since 2006.

### **P M Nolan**

Age 43. Head of Coverage, Europe, Middle East and Africa, Global Banking. Joined HSBC in 1987.

### **A J J Schmitz**

Age 49. Chief Executive Officer, HSBC Trinkaus & Burkhardt AG, Germany. Joined HSBC in 1989.

### **D K Sheehan**

Age 47. Chief Executive Officer, HSBC Private Bank (UK) Limited. Joined HSBC in 2006.

## **UK Banking Management**

### **B A Fletcher**

Age 48. Chief Risk Officer, UK Banking. Joined HSBC in 2005.

### **J D Garner**

Age 39. Head of PFS, UK Banking. Joined HSBC in 2004. A Group General Manager since 2006.

### **J E Harding**

Age 56. Head of Human Resources, UK Banking. Joined HSBC in 1981.

### **J S Llewellyn-Jones**

Age 41. Chief Financial Officer, UK Banking. Joined HSBC in 2008.

### **N P Quinn**

Age 47. Head of Commercial Banking, UK Banking. Joined HSBC in 1987.

### **P K Seward**

Age 53. Head of Strategy Implementation. Joined HSBC in 1985.

### **A Watson**

Age 46. Head of Insurance, UK Banking. Joined HSBC in 2007.

## Report of the Directors

### Results for 2008

The consolidated profit for the year attributable to the shareholders of the bank was £3,441 million.

Interim dividends of £1,000 million (in lieu of a final dividend in respect of the previous financial year), £825 million and £1,037 million were paid on the ordinary share capital during the year.

Further information about the results is given in the consolidated income statement on page 26.

### Principal activities

The group provides a comprehensive range of banking and related financial services. The group divides its activities into geographical segments: UK, Continental Europe, and Rest of the World. The group also divides its activities into the following business segments: UK Personal Financial Services; UK Commercial Banking; UK Global Banking and Markets; International Banking; HSBC France; Private Banking; and HSBC Trinkaus & Burkhardt.

As at 31 December 2008, the bank had 1,430 branches in the United Kingdom, and 14 branches in the Isle of Man and the Channel Islands.

Outside the United Kingdom, the bank has branches in Belgium, the Czech Republic, France, Greece, the Hong Kong Special Administrative Region, Ireland, Israel, Italy, the Netherlands, Slovakia, and Spain; it has representative offices in Ukraine and Venezuela; and its subsidiaries have branches and offices in Armenia, the Channel Islands, the Czech Republic, France, Georgia, Germany, Greece, the Hong Kong Special Administrative Region, Hungary, Ireland, Kazakhstan, Luxembourg, Malta, Poland, Russia, South Africa, Slovakia, Switzerland and Turkey.

The Summary of Financial Performance is given on page 5.

### Significant events

On 30 June 2008, the group transferred the assets and liabilities relating to its point-of-sale card payment business into the newly-established entity, HSBC Merchant Services LLP. Simultaneously, the group sold a 51 per cent interest in this new entity to Global Payments Inc, forming a joint venture. The bank's card processing staff have become employees of the new entity. The group received an initial consideration of £225 million and the gain of £215 million is included in 'Other operating income' in the consolidated income statement.

On 2 July 2008, HSBC France completed the sale of seven French regional banking subsidiaries to Banque Fédérale des Banques Populaires (BFBP) for €2.1 billion (£1.7 billion). The group's profit on sale before tax was £644 million. At 30 June 2008 the aggregate total assets attributable to these French regional banking subsidiaries were £5.8 billion, and they generated net profits after tax of £48 million for the six months ended 30 June 2008. On 2 July 2008 the group signed an agreement with the seven banks and BFBP to provide them with transitional services.

On 4 December 2008, as a result of the significant market disruption that impacted the availability of term funding, syndication of the bridging loan provided to Metrovacesa S.A. to fund the sale of the group's head office, at 8 Canada Square, was not possible, and the bridging loan was not renewed. The parties agreed that the sale and leaseback agreement would be cancelled, the building handed back to HSBC, and the bridging loan extinguished. The agreement was effected through the acquisition of a subsidiary from Metrovacesa, whose main asset is 8 Canada Square. As a result of this transaction, a gain of £265 million was recognised in 'Other operating income' in 2008. Further details on this transaction are provided in Note 22 'Property, plant and equipment'.

## Summary of Financial Performance

	2008 £m	2007 £m (Restated)
Net interest income .....	5,697	3,854
Net fee income .....	3,957	4,184
Other income .....	4,686	4,762
Net operating income before loan impairment charges and credit risk provisions .....	14,340	12,800
Loan impairment charges and other credit risk provisions .....	(1,861)	(1,043)
<b>Net operating income</b> .....	<b>12,479</b>	<b>11,757</b>
Total operating expenses .....	(8,122)	(7,741)
<b>Operating profit</b> .....	<b>4,357</b>	<b>4,016</b>
Share of profit in associates and joint ventures .....	9	47
<b>Profit on ordinary activities before tax</b> .....	<b>4,366</b>	<b>4,063</b>
Tax on profit on ordinary activities .....	(843)	(767)
<b>Profit on ordinary activities after tax</b> .....	<b>3,523</b>	<b>3,296</b>
Attributable to shareholders of the parent company .....	3,441	3,209

‘Underlying basis’ refers to results after adjustment for the effects of acquisitions and disposals. The main disposals in the year were the sale of the seven regional banks completed in July 2008 and the card acquiring business in the UK to a joint venture with Global Payments Inc. The group’s acquisition of the remaining 50 per cent in HSBC Assurances in France was completed in March 2007.

The commentary that follows is on an underlying basis.

Net interest income increased by £1,935 million, or 53 per cent, primarily due to growth in Balance Sheet Management revenues and improved spreads in Global Banking in the UK, France, International and Germany.

Net fee income decreased by £87 million, or 2 per cent, with the majority of the decrease coming from UK Retail and Global Banking and Markets, primarily due to lower transactions and a decrease in new business volumes across lending, protection and investment products.

Other income decreased by £955 million or 20 per cent year-on-year. The main factors were write-downs on legacy positions in credit trading, leveraged and acquisition financing and monoline credit exposures. In addition, due to an alleged fraud in December at Madoff Investment Securities LLC, the group wrote off the value of units in related funds and took a charge of £585 million.

Loan impairment charges and other credit risk provisions increased by £831 million, or 81 per cent, primarily due to a deteriorating credit environment coupled with impairment charges on the group’s

available-for-sale portfolio. Furthermore, loan impairments increased in UK Commercial Banking due to a small number of larger customers impacted by the difficult trading conditions.

Operating expenses increased by £555 million, or 7 per cent. Expense growth was mainly due to the Financial Services Compensation Scheme (‘FSCS’) levy in the UK, expansion costs in Turkey and growth in the Private Banking business.

The bank’s share of profit in associates and joint ventures decreased by £31 million, largely from the absence of higher profits prior to the integration of HSBC Assurances in March 2007.

The effective tax rate was 19.3 per cent (2007: 18.9 per cent). This rate is lower than the UK blended tax rate of 28.5 per cent (2007: 30.0 per cent) reflecting the benefit of tax free gains in both years. In 2008 the most significant tax free gains related to the disposal of the seven regional banks in France and the card acquiring business in the UK.

## Report of the Directors (continued)

### Environment

#### Economy

In the **UK**, GDP growth decelerated markedly in 2008 to 0.7 per cent from 3.0 per cent in 2007, with a technical recession of two successive quarterly contractions in GDP being confirmed during the second half of the year. Weakness proved widespread across most areas of the economy, prompting a sharp deterioration in labour market conditions as the unemployment rate reached a nine year high of 6.1 per cent in November 2008. Consumer Price Index inflation reached a decade-long high of 5.2 per cent in September 2008 before falling back to 3.1 per cent by the year-end, still some way above the Bank of England's 2.0 per cent target. Nominal house prices registered a continued fall on most measures throughout the year and housing activity suffered an even more significant reduction. The Bank of England reduced interest rates by 350 basis points during 2008, to finish the year at 2.0 per cent, as policymakers sought to mitigate the worst effects of the economic slowdown.

The expansion of the **eurozone** economy slowed sharply in 2008, with GDP growth of 0.7 per cent following a 2.6 per cent expansion in 2007. As in the UK, conditions deteriorated markedly as the year progressed and three successive quarterly declines in GDP were recorded during 2008, confirming that the economy had entered a period of recession. Consumer spending growth proved subdued following the sharp rise in oil prices during the first half of 2008 and a progressive increase in the unemployment rate towards year-end. Inflation remained at elevated levels for much of 2008, hitting a peak of 4.0 per cent in July before falling rapidly to 1.6 per cent in December. The European Central Bank, having initially raised interest rates by 25 basis points in July, cut interest rates by 175 basis points within a short period to finish the year at 2.5 per cent.

In **Turkey**, economic growth moderated as the year progressed, with GDP rising by 3.0 per cent during the first three quarters of 2008 against the comparable period of 2007. Headline inflation pressures remained at an elevated level during much of the year, largely due to rising energy and food prices, while the unemployment rate averaged 10.2 per cent during the first ten months of 2008 versus 9.7 per cent during the comparable period of 2007. Sharply lower oil prices during the final months of 2008 contributed to a marked narrowing of the current account deficit, although concerns remain over substantial foreign currency exposures

within the private sector and negotiations over an IMF assistance programme are ongoing.

### Competition and Regulation

Consolidation in the financial services industry is increasingly concentrating activity in companies that are capable of offering a wide array of financial products at competitive prices, with globalisation exposing HSBC to competition in capital markets and financial services at global and local levels alike.

In addition, technological advances, the growth of e-commerce, regulatory developments and public sector participation or guarantees have made it possible for non-depository institutions to offer products and services that traditionally were the preserve of banks. The prominence in recent years of sovereign wealth funds, private equity and hedge funds as alternative sources of funding which has increased competition for traditional financial institutions, may ease as investors seek safer, more traditional alternatives.

Competition may further intensify or the competitive landscape may change as the consolidation of financial services companies continues and others are brought into part or full public ownership in response to the current market conditions. HSBC's ability to grow its businesses, and therefore its earnings, is affected by these competitive pressures and is dependent on HSBC's ability to attract and retain talented and dedicated employees.

#### UK

Changes in the market place are emerging following the part-nationalisation of certain financial institutions, and political interaction with the regulatory environment is becoming more frequent.

In the light of this current economic and more regulated climate, the Banking Act 2009 sets out detailed guidelines on the way the Tripartite Authorities of the Financial Services Authority ('FSA'), Bank of England and the Treasury will interact in future. It includes the steps that will be taken in the event of a bank getting into difficulties; a bank failure; a bank failing, or being likely to fail, to satisfy the threshold conditions that banks are required to meet; and the additional protection offered to depositors. This may result in systems changes for UK banks, subsidiaries and branches of overseas banks.

The court action between the Office of Fair Trading and a number of UK financial institutions, including HSBC, to determine the legal status and



enforceability of unarranged overdraft charges remains on-going. Pending the resolution of the court action, the FSA has granted the institutions a Waiver enabling them to place complaints about the overdraft charges on hold. The current Waiver runs until 26 July 2009.

## France

In order to limit the impact of the financial crisis, the French government has taken various measures which aim to stabilise the French economy.

An initiative called 'Plan de relance', of €26 billion, was launched to focus mainly on investments in the building sector and Small and Medium Enterprise ('SME') sectors. The main aim is to improve SME liquidity, where the government will guarantee commercial debts in the absence of insurers.

In addition, actions were taken to support the banking sector by injecting funds through Société de Prises de Participations de l'Etat by subscribing to subordinated debt, and the creation of a special vehicle, Société de Financement de l'Economie Française, 34 per cent owned by the state. In return, the banks have undertaken to increase their loan balances from 2009 by 3 or 4 per cent.

The Single European Payment Area ('SEPA') implementation commenced in January 2008 with SEPA Credit Transfer. SEPA Direct Debit remains under discussion between French Banks and European institutions.

In 2009, all French banks are able to offer Livret A, a regulatory savings account with tax exemptions, previously sold only by the Post Office bank and Caisses d'Epargne.

European legislation on consumer lending, including loan protection insurance, is in progress. This will allow the borrower of a real estate related loan to have a choice of loan insurer, without the obligation to buy insurance from the lending bank.

In the French retail banking sector, the merger of the two mutual groups, Banques Populaires and Caisses d'Epargne, is expected to take place during the second quarter of 2009. This merger will create one of the largest retail banks in France.

## Turkey

The Turkish banking industry is a highly competitive mix of large domestic, state-owned and global banks. State-owned banks have a 27 per cent share, while foreign-owned, including partial shareholdings, have 25 per cent. The remainder is controlled by privately-owned domestic banks. Five domestic banks dominate a market of 46 banks and comprise some 62 per cent of the industry's assets.

The global crisis has started to squeeze liquidity and availability of offshore funding is difficult for Turkish banks. Competition has intensified with irrational pricing, particularly in deposit markets. The failure of some global brands has harmed the reputation of, and consumer confidence in, foreign-owned banks, resulting in increased deposit flows to domestic or state-owned banks.

Network expansion of more than 1,000 branches for banks collectively has accelerated mass customer acquisition in all segments and the build up of deposit bases in 2008.

The regulated nature of the credit card market, through interest rate caps managed by the Central Bank, has continued to negatively impact the industry's profitability in 2008.

## Report of the Directors (continued)

### Strategy

HSBC's strategy reflects its position as 'The world's local bank' and is focused on delivering superior growth and earnings over time by building on the Group's heritage, skills and investment.

In particular, the group aims to leverage the HSBC brand and network to reach new customers and offer more services to existing customers, to maximise efficiency by taking advantage of local, regional and global economies of scale and to ensure staff are engaged by aligning objectives and incentives.

In alignment with the way the bank applies HSBC Group strategy are the development of the "Best Place to Bank" and the "Best Place to Work" strategies.

The "Best Place to Bank" builds upon the FSA's consumer outcomes and is translated into "Nine Little Words" – "Make Better Products"; "Sell Them Properly"; and "Keep Them Sold".

The "Best Place to Work" emphasises performance management, reward, personal development aligned to business strategy and operating plans, a performance-driven culture, and an engaged workforce.

The measures used to assess performance against the strategy are discussed in the Key Performance Indicators section below.

### Key Performance Indicators ('KPIs')

The Board of Directors monitors the group's progress against its strategic objectives on a regular basis. Performance is assessed against the strategy, operating plan targets and actual historical performance using financial and non-financial measures.

#### Financial KPIs

To support the Group strategy and ensure that group performance can be monitored, management use a number of financial KPIs.

The table below and related commentary presents, on an underlying basis, the measures for the period 2007-2008. At a business level, KPIs are complemented by various benchmarks, which are relevant to the planning process and to reviewing business performance.

	2008	2007
Revenue growth <sup>1</sup> (%) .....	7.2	7.0
Revenue mix <sup>2</sup> (%) .....		
Net interest income .....	41.9	29.3
Net fee income .....	29.7	32.5
Other income .....	28.4	38.1
Cost efficiency <sup>3</sup> (%) .....	60.6	60.5
Return on average shareholders funds <sup>4</sup> (%) .....	7.8	12.9

- The percentage increase in net operating income before loan impairment charges and other credit risk provisions compared with the previous reporting period.*
- As a percentage of net operating income before loan impairment charges and other credit risk provisions.*
- Total operating expenses divided by net operating income after insurance claims but before loan impairment charges and other credit risk provisions.*
- Profit attributable to ordinary shareholders divided by average invested capital.*

**Revenue growth** provides an important guide to the group's success in generating business. In 2008, revenue grew by 7.2 per cent. Growth in 2008 reflects continued improvements in brand recognition and refined segmentation to meet customer needs, which allowed balance sheet and transaction growth. Also contributing to revenue growth in 2008 were fair value gains, primarily on bank debt designated at fair value, which are expected to reverse over the life of the debt unless it is repaid before its contractual maturity.

**Revenue mix** represents the relative distribution of revenue streams between net interest income, net fee income and other income. It is used to understand how changing economic factors affect the group, to highlight dependence on balance sheet utilisation for income generation and to indicate success in cross-selling fee-based services to customers with loan facilities. This understanding assists management in making business investment decisions. The percentage of revenue attributable to net interest income increased from 29.3 per cent in 2007 to 41.9 per cent in 2008, primarily due to strong performance in Balance Sheet Management due to favourable positioning to take advantage of falling interest rates. Net fee income decreased from 32.5 per cent in 2007 to 29.7 per cent in 2008, partly due to lower fee income in Global Banking and Markets due to adverse market conditions. Other operating income was 28.4 per cent in 2008 compared to 38.1 per cent in 2007, partially due to the alleged fraud at Madoff Investment Securities LLC.

**Cost efficiency** is a relative measure that indicates the consumption of cost resources in generating revenue. Management uses this to assess the success of technology utilisation and, more generally, the

productivity of the group's distribution platforms and sales forces. Cost efficiency was 60.6 per cent, which is broadly in line with 2007. However, excluding charges for the FSCS levy, cost efficiency improved by 60 basis points.

**Return on average invested capital** measures the return on the capital investment made in the business, enabling management to benchmark HSBC against competitors. In 2008, the ratio of 7.8 per cent was lower than that reported in 2007, reflecting the challenging economic environment.

#### Non-financial KPIs

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

#### Employee engagement

Employee engagement is a measure of employees' emotional and rational attachment to HSBC that motivates them to remain with the Group and align themselves wholeheartedly with its success. In 2008, response rate across HSBC's retail businesses in Europe to its annual Global People Survey was 84 per cent, representing 59,000 respondents. Despite the challenging external environment, the results showed a year-on-year increase in employee engagement, with an overall score of 58 per cent. Through focused and targeted actions, leaders and employees throughout the region remain committed to driving engagement forward, with a view to realising "best in class" levels by 2012.

#### Brand perception

The score for brand health is set by data from surveys that are conducted by accredited, independent, third-party organisations. A weighted score card is used to produce an overall score on a 100 point scale which is then benchmarked against HSBC's main competitors.

#### *Results 2008 UK*

The benchmark brand scores set in 2007 for Personal Financial Services ('PFS') and Commercial Banking ('CMB') were ahead of the competitor average by five and seven points respectively. The 2008 results show good progress with PFS recording a score of +6 (target +8) and CMB +7 (target +7).

#### Customer satisfaction

HSBC has regularly conducted customer satisfaction surveys in its main markets over many years. HSBC now uses a consistent measure of customer

recommendation to gauge customer satisfaction with the services provided by the HSBC Group's PFS business and CMB businesses. This survey is also conducted by accredited, independent, third-party organisations and the resulting recommendation scores are benchmarked against competitors.

#### *Results for 2008 UK*

The benchmark recommendation scores set in 2007 for PFS and CMB were ahead of the competitor average by one point and three points respectively on a 100 point scale. The 2008 results show good performance with PFS recording a score of +1 (target +3) and CMB +5 (target +4).

#### *Targets 2009 UK*

To set targets for 2009, the bank has re-benchmarked the scores using customer samples that better reflect the target customers of the bank. Therefore the bank has a 2008 score of +2 ahead for PFS with a target for 2009 of +4 and CMB is ahead by +5 with a target of +5.

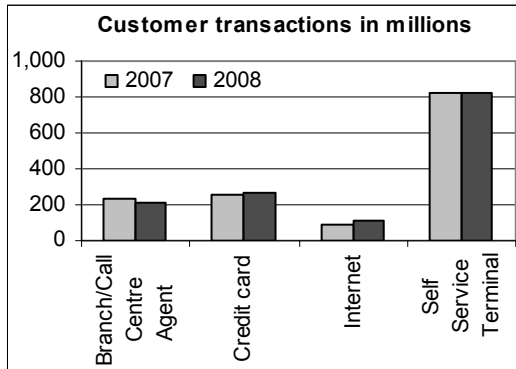
#### IT performance and systems reliability

HSBC tracks two key measures as indicators of IT performance; namely, the number of customer transactions processed and the reliability and resilience of the group's systems measured in terms of service availability targets.

#### Number of customer transactions processed

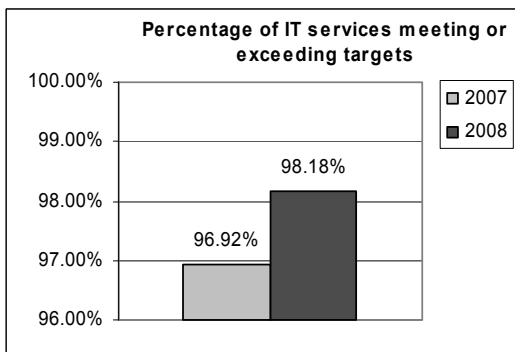
The overall number of customer transactions processed is a reflection of the usage of IT in the delivery channels used to service customers. Its aim is to manage the rate of increase in customer transactions cost effectively and enable growth in customer numbers. The transition of customer transactions from labour intensive (branch and call centre) to automated (credit card, internet and self service) channels is continuing. The following chart shows the 2007 and 2008 volumes per delivery channel, with a 9 per cent reduction in the total number of labour intensive branch and call centre transactions and a 17 per cent increase in automated internet transactions.

**Report of the Directors** (continued)



**Percentage of IT services meeting or exceeding targets**

HSBC’s IT function establishes with its end users agreed service levels for systems performance, such as systems running at 99.9 per cent of the time and processing credit card authorisations within two seconds. It monitors the achievement of each of these against agreed targets. The following chart reflects the percentage of IT services meeting and/or exceeding the agreed service targets. Performance in 2008 exceeded all previous years in all measures. At the same time, the number of services in production grew by more than 20 per cent, providing robust and high performing services to the group’s customers across Europe.



**Outlook**

Weak global economic conditions and contracting domestic demand are expected to further reduce inflationary pressures, encouraging a prolonged period of unusually low interest rates within both the eurozone and the UK.

Eurozone GDP is expected to contract by 2.0 per cent in 2009, following an expansion of 0.7 per cent in 2008. Such weakness is expected to be broadly-based across the region’s major economies, although the relatively high dependence of the German economy upon global trade represents a potential area of vulnerability. Consumption proved subdued in 2008 and is expected to remain weak given the deterioration in labour markets across the eurozone.

The bank expects UK GDP to fall by 2.5 per cent in 2009 following an expansion of 0.7 per cent in 2008. The earlier decline in commodity prices and weak domestic demand are expected to contribute to a steady fall in the headline rate of consumer price inflation throughout the course of 2009, and possibly into negative territory during the final months of the year. Declining consumer and investment expenditure are expected to be at the vanguard of the contraction of UK economic activity during 2009, and a further substantial increase in unemployment is expected.

## Performance and Business Review

### Profit on ordinary activities before tax

	2008 £m	2007 £m
UK Personal Financial Services .....	918	740
UK Commercial Banking .....	1,221	1,004
UK Global Banking and Markets .....	(188)	468
Other .....	227	137
International Banking .....	165	397
HSBC France .....	1,297	526
Private Banking .....	627	643
HSBC Trinkaus & Burkhardt .....	99	148
	<b>4,366</b>	<b>4,063</b>

#### UK Personal Financial Services ('PFS')

UK Personal Financial Services provides current accounts, savings, personal loans, mortgages, cards, financial planning, as well as and life and general insurance to UK personal customers through a variety of distribution channels under various HSBC brands. These include first direct, Marks & Spencer Money and partnership card™.

#### UK Commercial Banking ('CMB')

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.

#### UK Global Banking and Markets

Global Banking and Markets provides tailored financial solutions to major government, corporate and institutional clients worldwide. The business is managed as four principal business lines: Global Markets, Global Banking, Principal Investments and HSBC Global Asset Management. This structure allows HSBC 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.

#### Other

The main items reported under 'Other' include movements in the fair value of own debt and Guaranteed Capital Accounts, and the gain in respect of the repurchase of HSBC's London headquarters. In 2007, Other also included fees paid to Global Banking and Markets related to asset based finance rendered on behalf of the group, net under/over

recovery of IT services and exchange movement in US dollar preference shares.

#### International Banking

The International Banking business segment represents the bank's operations primarily in Europe excluding those of HSBC France, HSBC Trinkaus & Burkhardt and Private Banking. It provides a range of retail financial services to local and expatriate personal and commercial customers and Global Banking and Markets services to corporate and institutional clients.

#### HSBC France

HSBC France offers a wide range of retail, commercial, insurance, private banking, asset management, global markets and global banking products, to individuals, companies, corporates and institutional customers in France.

#### Private Banking

Private Banking reflects the operations of HSBC Private Banking Holdings (Suisse) SA and its subsidiaries. The Private Banking business in France, Germany and International Banking is discussed within respective commentaries for those business segments. Private Banking offers a range of client services to high net worth customers, including advisory portfolio management, discretionary asset management, tax, trust and estate planning, mutual funds and currency and securities transactions.

#### HSBC Trinkaus & Burkhardt

HSBC Trinkaus & Burkhardt, based in Düsseldorf, Germany, offers a comprehensive range of services to high net worth individuals, larger companies, institutional clients, public corporations and financial institutions.

## Report of the Directors (continued)

### Review of Business Performance

HSBC Bank plc reported a pre-tax profit of £4,366 million, compared with £4,063 million in 2007, an increase of 7 per cent.

These results include gains of £644 million on the disposal of seven regional banks in France in July 2008, and of £215 million on the sale of the card acquiring business in the UK to a joint venture with Global Payments Inc. in June 2008. They also reflect HSBC's acquisition of the remaining 50 per cent in HSBC Assurances in France not already owned, which was completed in March 2007.

Excluding the above acquisitions and disposals and substantial fair value gains on own debt, underlying pre-tax profits fell by 23 per cent. This primarily reflected a sharp decline in Global Banking and Markets' revenues in the UK and France which was mainly attributable to the deterioration in credit markets, the continuing illiquidity in asset-backed securities markets, which led to further write-downs, and a £585 million charge within the equities business following the alleged fraud at Madoff Securities. With the exception of Personal Financial Services in France, underlying revenue growth was delivered in the group's Private Banking, Commercial Banking and Personal Financial Services businesses across Europe.

The commentary that follows is on an underlying basis.

*Net interest income* increased by 53 per cent. There was significant growth in Balance Sheet Management revenues, which reflected favourable interest rate risk positioning in expectation of interest rate cuts by central banks. Net interest income also benefited from selective incremental lending as credit availability generally contracted, and from improved spreads in Global Banking in the UK, France and Germany.

The group experienced a strong increase in customer numbers, with corresponding growth in liability balances across all businesses as the market turmoil intensified. The volume benefit was partially offset by narrowing deposit spreads as base rates were cut in the UK and increased funding costs, principally for trading activities in France. Higher net interest income from the expansion of credit card lending and commercial loan portfolio growth in the small and mid market customer segments in Turkey was partially offset by narrower spreads following credit card interest rate cap reductions by the central bank.

*Net fee income* fell by 2 per cent, with lower fees from mergers and acquisitions and equity capital markets due to origination and execution difficulties, coupled with a rise in brokerage expenses in line with increased trading activity in France. There were lower performance fees in the UK and France as the value of the funds under management reduced, reflecting the decline in global equity markets. Increased customer acquisition partly offset this with higher packaged account and transaction fees in France and credit card fees in Turkey.

*Trading income* was 15 per cent lower than in 2007, falling significantly in Global Banking and Markets in the UK and France. This arose from further write-downs on legacy exposures in credit, structured credit derivatives and leveraged and acquisition finance caused by the ongoing turmoil in the credit markets. In addition, a £585 million write-down was recorded by the equities business following the alleged fraud at Madoff Securities.

£6.0 billion and £1.6 billion of held-for-trading financial assets were reclassified under revised IFRS rules as loans and receivables and available-for-sale respectively, preventing any further mark-to-market trading losses on these assets. See note 14 for further detail on the impact of these reclassifications.

Excluding the write-downs on legacy exposures in the UK and France and the charge relating to Madoff Securities in Global Banking and Markets in UK, trading income rose by 20 per cent. This was driven by a significant increase in foreign exchange revenues against the backdrop of greater markets volatility, and robust revenues in the Rates business, as favourable positioning took advantage of falling interest rates. The widening of credit spreads, particularly in the second half of 2008, contributed to fair value gains on structured liabilities and on credit protection bought in the form of credit default swaps.

*Net income from financial instruments designated at fair value* decreased by £922 million, to a net expense of £797 million, primarily from a reduction in the value of instruments held to meet liabilities under unit-linked insurance business. This was partly offset by fair value gains from the effect of widening credit spreads on certain fixed-rate long-term debt. The reduction in fair value of assets held to meet liabilities under unit-linked insurance contracts was offset by a corresponding reduction in 'Net insurance claims and liabilities to policyholders'. The fair value gains on HSBC's own debt will fully reverse over the life of the debt.

*Gains less losses from financial investments* of £84 million, were £452 million lower than in 2007 as there were fewer disposal opportunities in 2008 and the significant private equity realisations in the UK and France in 2007 did not recur. Gains in 2008 largely reflected the sale of MasterCard shares and certain mutual funds in France.

Net unrealised losses on financial investments of £11.6 billion were recorded directly in equity. £10.9 billion of this amount related to debt securities, largely reflecting the fall in value of asset-backed securities during 2008. Such unrealised losses are expected to reverse over the life of the security where the investment is held to its maturity date. Net unrealised losses on debt securities are excluded from capital resources, under FSA rules.

*Net earned insurance premiums* increased by 31 per cent largely due to growth in the Guaranteed Income Bond launched in June 2007 and the introduction of enhanced death benefits to certain pension products in the UK. In France, HSBC Assurances performed well in a declining market, from the launch of a range of guaranteed rate products. However, net earned insurance premiums fell following a significant reinsurance transaction undertaken in the first half of 2008.

*Other operating income* increased by £383 million. This was primarily due to recognition of the gain in respect of the purchase of the subsidiary of Metrovacesa that owns the property and long leasehold land comprising 8 Canada Square, London. The growth in revenue also reflected the non-recurrence of a decrease in the value of PVIF business in 2007 following regulatory changes to the rules governing the calculation of insurance liabilities. In addition there was a favourable embedded value adjustment following HSBC's introduction of enhanced benefits to existing commercial pension products in the first half of 2008. These benefits were partially offset by costs associated with the support of money market funds in the global asset management business.

*Net insurance claims incurred and movement in liabilities to policyholders* increased by 5 per cent driven by an increase in liabilities following the rise in sales of the Guaranteed Income Bond. This was augmented by the implementation of FSA rule changes in 2007 which led to a lower reversing requirement. This was partially offset by a reduction in the movement of insurance liabilities due to the fall in the value of market-linked funds.

*Loan impairment charges and other credit risk provisions* rose by 81 per cent to £1,857 million, primarily in UK Global Banking and Markets and

International Banking. The deteriorating credit environment resulted in a rise in loan impairment charges. These largely reflected an exposure to a single European property company, and substantially higher credit risk provisions on debt securities held within the group's available-for-sale portfolio, mainly in Solitaire Funding Limited ('Solitaire'), a special purpose entity managed by HSBC.

Credit conditions worsened in Commercial Banking and specific loan impairment charges increased in the UK, International and France due to the deteriorating credit environment in the second half of 2008. In Turkey, credit card and personal loan delinquency rates were significantly higher resulting in the implementation of tighter underwriting criteria, reduced credit limits and revised account management policies throughout 2008.

*Operating costs* increased by 7 per cent to £8,072 million. Costs in the UK were broadly in line with 2007 which included ex-gratia payments expensed in respect of overdraft fees applied in previous years and a provision for reimbursement of certain charges on historic will trusts and other related services. Excluding these items, costs rose as a result of an increase in the FSCS levy, restructuring costs and increased rental charges following the sale and leaseback of branch properties. These were partially offset by lower performance related pay and a reduction in the defined benefit pension scheme costs due to a change in actuarial assumptions.

Operating costs in France were broadly in line with 2007 with lower incentive compensation and a reduction in pension and retirement healthcare costs following the transfer of certain obligations to a third-party offsetting the higher costs of a voluntary retirement programme.

There was investment in premises and new staff to support business expansion in Turkey, Russia and central and eastern Europe. In 2008, 112 new branches opened and staff numbers increased by 30 per cent in these markets.

*Share of profit in associates and joint ventures* declined to £9 million with 2007 benefiting from an adjustment to the embedded value of HSBC Assurances which is now a wholly-owned subsidiary. The absence of this gain was partially offset by increased joint venture profits following the sale of the card acquiring business in the UK.

## Report of the Directors (continued)

### Share capital

In May 2008, HSBC Holdings plc subscribed £1,000 million for one ordinary share of £1 credited as fully paid in the ordinary share capital of the bank. In October 2008, HSBC Holdings plc subscribed £750 million for a further ordinary share of £1 credited as fully paid in the ordinary share capital of the bank.

Save for this, there have been no other changes to the authorised or issued ordinary share capital of the bank in the year ended 31 December 2008.

Post the financial year end, on 30 January 2009, HSBC Holdings plc subscribed £527 million for an additional ordinary share of £1 credited as fully paid in the ordinary share capital of the bank.

### Capital management and allocation

#### Capital management

*(Audited)*

In June 2006, the Basel Committee on Banking Supervision published the final comprehensive version of 'International Convergence of Capital Measurement and Capital Standards', known as Basel II. Basel II is structured around three 'pillars': minimum capital requirements, supervisory review process and market discipline. The Capital Requirements Directive ('CRD') implements Basel II in the EU and the Financial Services Authority ('FSA') then gives effect to the CRD by including the requirements of the CRD in its own rulebooks. In 2008, the group operates under Basel II.

The FSA is the supervisor of the bank and the group and, in this capacity, receives information on their capital adequacy and sets minimum capital requirements. Individual banking subsidiaries are directly regulated by the appropriate local banking supervisors, which set and monitor their capital adequacy requirements.

The group's capital is divided into two tiers. Tier 1 capital comprises core equity tier 1 capital, non-innovative preference shares and innovative tier 1 securities. Core equity tier 1 capital comprises shareholders' funds, and minority interests in tier 1 capital, after adjusting for items reflected in shareholders' funds which are treated differently for the purposes of capital adequacy. The book values of goodwill and intangible assets are deducted in arriving at core equity tier 1 capital. Tier 2 capital comprises qualifying subordinated loan capital, allowable collective impairment allowances, minority and other interests in tier 2 capital 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.

Various limits are applied to elements of the capital base. The amount of innovative tier 1 securities cannot exceed 15 per cent of overall tier 1 capital, qualifying tier 2 capital cannot exceed tier 1 capital, and qualifying term subordinated loan capital may not exceed 50 per cent of tier 1 capital. There are also limitations on the amount of collective impairment allowances which may be included in tier 2 capital. For regulatory purposes, banking associates are proportionally consolidated, rather than the equity accounting method used for financial reporting.

The carrying amounts of investments in the capital of banks that exceed certain limits and the excess of expected losses over impairment allowances are deducted 50 per cent from each of tier 1 and tier 2 capital in the published disclosures. This also applies to deductions of investments in insurance subsidiaries and associates, but the FSA has granted a transitional provision, until 31 December 2012, under which those insurance investments that were acquired before 20 July 2006 may be deducted from the total of tier 1 and tier 2 capital instead. The group has elected to apply this transitional provision.

The basis of calculating capital changed with effect from 1 January 2008 and the effect on both tier 1 capital and total capital is shown in the table below, 'Composition of Capital'. The group's capital base is reduced compared with Basel I by the extent to which expected losses exceed the total of individual and collective impairment allowances on IRB portfolios. These collective impairment allowances are no longer eligible for inclusion in tier 2 capital.

For disclosure purposes, this excess of expected losses over total impairment allowances in IRB portfolios is deducted 50 per cent from core equity tier 1 and 50 per cent from tier 2 capital. In addition, a tax credit adjustment is made to tier 1 capital to reflect the tax consequences insofar as they affect the availability of tier 1 capital to cover risks or losses.

Expected losses derived under Basel II rules represent losses that would be expected in the scenario of a severe economic downturn over a 12-month period. This definition differs from loan impairment allowances, which only address losses incurred within lending portfolios at the balance sheet date and are not permitted to recognise the additional level of conservatism that the regulatory measure requires through reflecting a downturn



scenario. For rapidly revolving consumer credit portfolios such as credit cards, therefore, impairment allowances only capture some of the expected losses predicted over the next 12 months. These portfolios turn over three to four times per year, and therefore a large proportion of expected losses relate to credit advances not made at the measurement date.

The effect of deducting the difference between expected losses and total impairment allowances is to equate the total effect on capital with the regulatory definition of expected losses. Because expected losses are based on long-term estimates and incorporate through-the-cycle considerations, they are expected to be less volatile than actual loss experience. The impact of this deduction, however, may vary from time to time as the accounting measure of impairment moves closer to or further away from the regulatory measure of expected losses.

The FSA's rules permit the inclusion of profits in tier 1 capital to the extent that they have been verified in accordance with the FSA's General Prudential Sourcebook by the external auditor. Verification procedures covering profits for the year to 31 December 2008 were completed by the external auditor on 28 February 2009 and therefore these profits have been included in the group's tier 1 capital. Technically, from 1 January 2008, the FSA's regulatory reporting forms defer the recognition of these profits in tier 1 capital until the conclusion of the external auditor's procedures.

Basel II provides 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 groups other counterparties into broad categories and applies standardised risk weightings to these categories. The next level, the internal ratings-based ('IRB') foundation approach, allows banks to calculate their credit risk regulatory capital requirement on the basis of their internal assessment of the probability that a counterparty will default ('PD'), but with quantification of exposure at default ('EAD') and loss given default estimates ('LGD') being subject to standard supervisory parameters. Finally, the IRB advanced approach, allows banks to use their own internal assessment of not only PD, but also the quantification of EAD and LGD. Expected losses are calculated by multiplying EAD by PD and LGD. The capital requirement under the IRB approaches is intended to cover unexpected losses and is derived from a formula specified in the regulatory rules,

which incorporates these factors and other variables such as maturity and correlation.

For credit risk, with FSA approval, the group has adopted the IRB advanced approach to Basel II for the majority of its business with effect from 1 January 2008, with the remainder on either IRB foundation or standardised approaches. 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.

Market risk is derived from fluctuations on trading book assets arising from changes in values, income, interest and foreign exchange rates and is measured using VAR models with FSA permission or the standard rules prescribed by the FSA. Counterparty credit risk in the trading book and the non-trading book is the risk that the counterparty to a transaction may default before completing the satisfactory settlement of the transaction. Three counterparty credit risk calculation approaches are defined by Basel II to determine exposure values, being the standardised, mark to market and the internal model method. These exposure values are then used to determine risk weighted assets ('RWAs') using one of the credit risk approaches, standardised, IRB foundation and IRB advanced. The group uses both VAR and standard rules approaches for market risk and the mark to market and internal model method approaches for counterparty credit risk. It is the longer-term aim of the group to migrate more positions from standard rules to VAR for market risk and from mark to market to internal model for counterparty credit risk.

Basel II also introduces capital requirements for operational risk and, again, contains three levels of sophistication. The capital required under the basic indicator approach will be a simple percentage of gross revenues, whereas under the standardised approach it will be one of three different percentages of gross revenues allocated to each of eight defined business lines. 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.

The second pillar of Basel II (Supervisory Review and Evaluation Process) involves both firms and regulators taking a view on whether a firm should hold additional capital against risks not covered in pillar 1. Part of the pillar 2 process is the Internal Capital Adequacy Assessment Process (ICAAP) which is the firm's self assessment of risks not captured by pillar 1. The pillar 2 process culminates with the FSA providing firms with

## Report of the Directors (continued)

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Individual Capital Guidance ('ICG'). The ICG replaces the trigger ratio and is set as a capital resources requirement higher than that required under pillar 1, generally by a specified percentage.

Pillar 3 of Basel II is related to market discipline and aims to make firms more transparent by requiring them to publish more details of their risks, capital and risk management. The group expects to publish its first set of pillar 3 disclosures during the first half of 2009, on the investor relations section of its website.

During 2007, HSBC was supervised under Basel 1, under which banking operations are categorised as either trading book or banking book and risk-weighted assets are determined accordingly. Banking book risk-weighted assets are measured by means of a hierarchy of risk weightings classified according to the nature of each asset and counterparty, taking into account any eligible collateral or guarantees. Banking book off-balance sheet items giving rise to credit, foreign exchange or interest rate risk are assigned weights appropriate to the category of the counterparty, taking into account any eligible collateral or guarantees. Trading book risk-weighted assets are determined by taking into account market-related risks such as foreign exchange, interest rate and equity position risks, and counterparty risk.

## Capital structure at 31 December – Basel II

	<b>2008</b> <b>Basel II</b> <b>Actual</b> <b>£m</b> <i>(Audited)</i>	2007 Basel II Pro-forma <sup>1</sup> £m <i>(Unaudited)</i>	2007 Basel I Actual £m <i>(Audited)</i>
<b>Composition of regulatory capital</b>			
Tier 1 capital			
Shareholders funds.....	27,951	24,150	23,574
Minority interests and preference shares .....	–	–	1,007
Less:			
Goodwill capitalised and intangible assets.....	(11,239)	(9,458)	(9,458)
Material Holdings.....	(451)	(161)	–
Securitisation positions deducted from capital.....	(318)	(63)	–
Excess of expected losses over impairment allowances.....	(640)	(422)	–
<b>Core equity tier 1 capital</b> .....	<b>15,303</b>	<b>14,046</b>	<b>15,123</b>
Perpetual non-cumulative preference shares.....	431	431	–
Innovative tier 1 securities .....	1,789	1,636	1,636
<b>Other tier 1 capital</b> .....	<b>2,220</b>	<b>2,067</b>	<b>1,636</b>
<b>Total tier 1 capital</b> .....	<b>17,523</b>	<b>16,113</b>	<b>16,759</b>
Tier 2 capital			
Reserves arising from revaluation of property and unrealised gains on available-for-sale equities .....	342	402	402
Perpetual subordinated debt.....	3,451	1,843	1,843
Term subordinated debt.....	7,649	6,057	5,323
Collective impairment allowances.....	–	–	873
Minority and other interests in tier 2 capital.....	–	–	734
<b>Total qualifying tier 2 capital before deductions</b> .....	<b>11,442</b>	<b>8,302</b>	<b>9,175</b>
Deductions other than from Tier 1 Capital			
Material Holdings.....	(899)	(1,103)	–
Excess of expected losses over impairment allowances .....	(640)	(422)	–
Securitisation positions deducted from capital.....	(318)	(63)	–
Other deductions .....	(10)	(313)	(152)
Unconsolidated investments .....	–	–	(1,551)
<b>Total deductions other than from tier 1 capital</b> .....	<b>(1,867)</b>	<b>(1,901)</b>	<b>(1,703)</b>
<b>Total regulatory capital</b> .....	<b>27,098</b>	<b>22,514</b>	<b>24,231</b>
<b>Risk-weighted assets (Unaudited)</b>			
Credit risk .....	211,206	181,329	–
Market risk .....	25,311	12,531	–
Operational risk .....	21,366	18,521	–
Banking book .....	–	–	196,561
Trading book .....	–	–	27,310
<b>Total</b> .....	<b>257,883</b>	<b>212,381</b>	<b>223,871</b>
<b>Capital ratios (Unaudited)</b>			
	<b>%</b>	<b>%</b>	<b>%</b>
Core equity tier 1 ratio .....	5.9	6.6	n/a
Tier 1 ratio .....	6.8	7.6	7.5
Total capital ratio .....	10.5	10.6	10.8

1 The 2007 Basel II pro-forma has been restated to show separately the impact of securitisation positions and Perpetual non-cumulative preference shares as 'Other tier 1 capital'.

## Report of the Directors (continued)

### Board of Directors

The objectives of the management structures within the bank, headed by the Board of Directors and led by the Chairman, are to deliver sustainable value to shareholders. Implementation of the strategy set by the Board is delegated to the bank's European Management Committee, under the direction of the Deputy Chairman and Chief Executive, and the UK Banking Management Committee, under the direction of the Managing Director, UK Banking.

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 2.

Independent non-executive Directors are appointed for three-year terms, subject to their re-election by shareholders at the subsequent Annual General Meeting. Independent non-executive Directors have no service contracts.

C M S Jones and C-H Filippi retired as Directors on 29 April 2008 and 31 December 2008, respectively.

P A Thurston and Dame Mary Marsh were appointed as Directors on 1 June 2008 and 1 January 2009, respectively. Having been appointed since the Annual General Meeting in 2008, they will retire at the forthcoming Annual General Meeting and offer themselves for re-election.

J D Fishburn, M F Geoghegan and A R D Monro-Davies will retire by rotation at the forthcoming Annual General Meeting and, with the exception of J D Fishburn, who will retire as a Director, they will offer themselves for re-election.

None of the Directors had, during the year or at the end of the year, a material interest, directly or indirectly, in any contract of significance with the bank or any of its subsidiary undertakings.

### Board committees

The Board has appointed a number of committees consisting of certain Directors and senior executives.

In October 2008 the Board adopted a revised corporate governance structure creating a new European Regional Structure and realigning certain key roles within the UK. Under this revised structure the former Executive Committee was superseded by

a European Management Committee and a UK Banking Management Committee.

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, internal audit and compliance management and the external auditor to consider the bank's financial reporting, the nature and scope of audit reviews and the effectiveness of the systems of internal control and compliance.

The members of the Audit Committee are A R D Monro-Davies (Chairman), P M Shawyer and J F Trueman. All of the members of the Audit Committee who served during 2008 are independent non-executive Directors.

#### European Management Committee

The European Management Committee meets regularly and operates as a general management committee under the direct authority of the Board. The role of the European Management Committee is to direct the European business of the bank, under the direction of the Deputy Chairman and Chief Executive. The Committee brings together the Chief Executives of the bank's principal European Businesses – UK, France, Turkey and Germany; together with the Head of International; the Regional Heads of Commercial Banking, Personal Financial Services, Insurance, Global Banking and Markets; and the UK Private Banking Chief Executive.

The members of the European Management Committee are D D J John (Chairman), P A Thurston, both executive Directors, and P Y Antika, P W Boyles, A A Schmitz, D K Sheehan, A M Mahoney, A M Keir, P M Nolan, J M Flint, I S Jenkins, S E Anderson, J P Armstrong and S Jefford, all of whom are senior executives of the bank.

#### UK Banking Management Committee

The UK Banking Management Committee meets regularly and operates as a general management committee under the direct authority of the Board. The role of the UK Banking Management Committee is to direct the UK business of the bank, under the direction of the Managing Director, UK Banking.

The members of the UK Banking Management Committee are P A Thurston (Chairman), S P O'Sullivan, both executive Directors, and

N P Quinn, J D Garner, A Watson, P K Seward, J S Llewellyn-Jones, B A Fletcher and J E Harding, all of whom are senior executives of the bank.

### **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**

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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 of financial information used within the business or for publication. Such procedures are designed to manage rather than eliminate 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 2 March 2009, the date of approval of the *Annual Report and Accounts 2008*. In the case of companies acquired during the year, the internal controls in place are being reviewed against the group's benchmarks and they are being integrated into the group's systems.

The group's key internal control procedures include the following:

- Authority to operate the bank is delegated to the Chief Executive who has responsibility for overseeing the establishment and maintenance of appropriate systems and controls, and has authority to delegate such duties and responsibilities as he deems fit among the Directors and senior management. The appointment of executives to the most senior positions within the group requires the approval of the Board of Directors.
- Functional, operating, financial reporting and certain management reporting standards are established by HSBC Holdings' management for application across the whole HSBC Group. These are supplemented by operating standards set by the bank's management, as required.
- Systems and procedures are in place in the group to identify, control and report on the major risks including credit, changes in the market prices of financial instruments, liquidity, operational error, breaches of law or regulations, unauthorised activities and fraud. Exposure to these risks is monitored by the bank's or major subsidiaries' executive committees, risk management committees and the asset and liability management committees.
- Processes are in place to identify new risks from changes in market practices or customer behaviours which could expose the group to heightened risk of loss or reputational damage.
- Comprehensive annual financial plans setting out the key business initiatives and the likely financial effects of those initiatives are prepared, reviewed and approved by the Board of Directors. Results are monitored regularly and reports on progress as compared with the related plan are prepared monthly.
- Governance and oversight arrangements are in place to ensure that risk analytical models are fit for purpose, used accordingly and complemented by a variety of 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 computer system developments and operations. Common systems are employed where possible for similar business processes. Credit and market risks are measured and reported on in the bank and major subsidiaries, and aggregated for review of risk concentrations on an HSBC Group-wide basis.
- Responsibilities for financial performance against plans and for capital expenditure, credit exposures and market risk exposures are delegated with limits to line management. In addition, functional management in HSBC Holdings is responsible for setting policies, procedures and standards in the following areas of risk: credit risk; market risk; liquidity risk; operational risk; IT risk; insurance risk; accounting risk; tax risk; legal and regulatory

## Report of the Directors (continued)

compliance risk; human resources risk; reputational risk and purchasing risk; and for certain global product lines.

- Policies and procedures have been established to guide the bank, subsidiary companies and management at all levels in the conduct of business to avoid reputational risk which can arise from social, ethical or environmental issues, or as a consequence of operational risk events. 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.
- 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 compliance with policies and standards and the effectiveness of internal control structures across the group. The work of the internal audit function is focused on areas of greatest risk to the group as determined by a risk management approach.
- 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. Management must also confirm annually to internal audit that offices 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 reports from the heads of key risk functions; the production and regular updating of summaries of key controls measured against group benchmarks which cover all internal controls, both financial and non-financial; 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 Audit Committee has reviewed a 'Risk Map' of the status of key areas which impact the group and has considered the mitigating actions put in place. In addition, where unexpected losses have arisen or where incidents have occurred which indicate gaps

in the control framework or in adherence to Group policies, the Audit Committee has reviewed 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 Audit Committee has received confirmation that management has taken or is taking the necessary action to remedy any failings or weaknesses identified through the operation of the group's framework of controls.

### **Risk management**

The group regularly updates its policies and procedures for safeguarding against reputational, strategic and operational risks. This is an evolutionary process.

The safeguarding of the group's reputation is of paramount importance to its continued prosperity and is the responsibility of every member of staff. The group has always aspired to the highest standards of conduct and, as a matter of routine, takes account of reputational risks to its business.

Reputational risks are considered and assessed by the Board, its committees and senior management in adherence with HSBC Holdings plc standards. Policies on all major aspects of business are set for the group and for individual subsidiary companies, businesses and functions. These policies, which form an integral part of the internal control systems, are communicated through manuals and statements of policy and are promulgated through internal communications. The policies cover social, ethical and environmental issues and set out operational procedures in all areas of reputational risk, including money laundering deterrence, environmental impact, anti-corruption measures and employee relations. The policy manuals address risk issues in detail, and co-operation between head office departments and businesses is required to ensure a strong adherence to the group's risk management system and its corporate social responsibility practices.

Internal controls are an integral part of how the group conducts its business. HSBC Holdings plc's manuals and statements of policy are the foundation of these internal controls. There is a strong process in place to ensure controls operate effectively. Any significant failings are reported through the control mechanisms, internal audit and compliance functions

to the Audit Committee, which keeps under review the effectiveness of the system of internal controls and reports regularly to the Board.

The financial risk management objectives and policies of the bank and its subsidiaries, including those in respect of financial instruments, together with an analysis of the exposure to such risks, as required under the Companies Act and International Financial Reporting Standards are set out in Note 38 'Risk management' of the Notes on the Financial statements.

## **Health and safety**

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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.

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 Coordinators based in each country in which the Group operates.

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.

## **Directors' emoluments**

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Details on the emoluments of the Directors of the bank for 2008, disclosed in accordance with the Companies Act, are shown in Note 7 'Employee compensation and benefits' in the Notes on the Financial statements.

## **Employee involvement**

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The bank has a well established framework for employees to provide feedback, engage and action

plan at local and national level to improve the working experience

The bank participates in the HSBC Group annual employee engagement survey. The Group wide survey, launched in July and August, attracted a response rate of 85 per cent.

There was a significant improvement in overall engagement. Our strongest improvement areas included leadership, Corporate sustainability and Strategy and Vision.

The bank has recorded good improvements year on year on its engagement results and this reflects the commitment of all levels of Leadership within the bank to deliver local action plans.

Areas for improvement included performance management and effective communication and understanding of our reward strategy. to our employees. Both these areas will be a priority in 2009.

In the UK, the bank has continued to evolve its 'Best Place to Work' initiative and involve its employees through a number of complimentary programmes – 'Best Place to Discuss'; 'Best Place to Suggest'; 'Best Place to Workout'; 'Best Place to Blog'; 'Best Place to Meet'; and 'Best Place to Bank for Employees'. These programmes have been delivered through the intranet, 'meet the top leadership team' sessions, intranet delivered TV debates and feedback.

## **Diversity policy: employees with disabilities**

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The group continues to be committed to providing equal opportunities to employees and to proactively encourage an inclusive workplace in line with our brand promise

In the UK, the bank was recognised as one of the Top 50 Employers for Women to Work For in 2008 by The Times newspaper index.

We continue to recruit, train and develop disabled employees and make reasonable adjustments where employees become disabled during their employment. The bank received an award for our commitment to interview disabled candidates who meet the minimum job criteria as part of the two tick symbol employability campaign

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.

## Report of the Directors (continued)

### Community involvement and donations

HSBC has a long record of support for the communities in which it operates. These are the communities from which we draw our employees and our customers, and we believe we can and should play a role in supporting them.

During 2008, the bank gave £5 million in charitable donations to support community activities in the UK. The donations were used to fund a wide variety of initiatives, as described below, with the main focus on education, particularly for under-privileged primary and secondary school students, and the environment. The bank also continued its focus on employee-led charitable initiatives.

#### Education

In 2007 HSBC launched a £3.4m partnership with the financial education charity *pfeg* (Personal Finance Education Group). Called *What Money Means*, this partnership aims to increase the quality and quantity of financial capability education in UK primary schools. *What Money Means* will bring *pfeg*, local authorities and educationalists together to develop resources and approaches that will help primary school teachers feel more confident in teaching money skills to younger children. In addition to HSBC's financial commitment, it is planned that thousands of HSBC employees will, where appropriate, work alongside teachers in the classroom. During 2008 hundreds of HSBC employees became engaged with *What Money Means*.

#### Environment

The group's employees are involved in a variety of projects related to environmental sustainability and climate change.

In 2007 the HSBC Group launched a new global programme aimed at tackling some of the issues generated by climate change. Called the *HSBC Climate Partnership*, this is a US\$100 million contribution to the work of four of the world's leading environmental organisations: The Climate Group; The Earthwatch Institute; WWF; and the Smithsonian Tropical Research Institute. Working with these partners, the *HSBC Climate Partnership* aims to create cleaner, greener cities across the world; create individual HSBC climate champions worldwide; help protect some of the world's major rivers; and conduct the world's largest ever field experiment on the long-term effects of climate change on the world's forests. During 2008, over 1,000 HSBC employees took part in projects across

the UK designed to increase their personal awareness and understanding of climate change. 120 employees took part in a two week long residential learning experience at a bespoke field centre near Oxford and became HSBC Climate Champions. As such, their roles are to inspire their colleagues and local communities to take action to combat climate change.

#### Community

While some of our community activities are managed centrally, as the world's local bank we want to stay close to the communities in which we operate. In 2008 we continued our policy of allowing our employees to propose local projects for HSBC support.

Over 400 employee-led projects were initiated as a result of this policy with financial support exceeding £1.1 million and actively involving over 6,000 HSBC employees. In addition, over £2.1 million was donated to charities to match funds raised, or time given, by employees through our staff charity scheme.

Across various activities, HSBC employees volunteered over 135,000 hours in working time to their local communities.

We continued our innovative service to allow customers to donate money to charity through our ATMs. HSBC customers can donate to several well-known charities directly from their account at any HSBC ATM.

More details of HSBC's community activities can be found at:-

[www.hsbc.com/1/2/sustainability/community](http://www.hsbc.com/1/2/sustainability/community)

No political donations were made during the year.

### Valuation of freehold and leasehold land and buildings

The group's freehold and long leasehold properties were valued in 2008. The value of these properties was £937 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**

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The Company does not currently subscribe to any code or standard on payment practice. It is the Company's policy, however, to settle the terms of payment with those suppliers when agreeing the terms of each transaction, to ensure that those suppliers are made aware of the terms of payment, and to abide by the terms of payment.

The amount due to the bank's trade creditors at 31 December 2008 represented 22 days' average daily purchases of goods and services received from those creditors, calculated in accordance with the Companies Act 1985, as amended by Statutory Instrument 1997/571.

## **Auditor**

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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.

## **Disclosure of information to the Auditor**

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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*

2 March 2009

## Statement of Directors' Responsibilities in Respect of the *Annual Report and Accounts 2008* and the Financial Statements

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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.

The group and bank financial statements are required by law and IFRSs as adopted by the EU to present fairly the financial position of the group and the bank and the performance for that period; the Companies Act 1985 provides in relation to such financial statements that references in the relevant part of that Act to financial statements giving a true and fair view are references to their achieving a fair presentation.

In preparing each of the group and bank financial statements, the Directors are required to:

- select suitable accounting policies and then apply them consistently;
- make judgements 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 1985.

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.

On behalf of the Board  
J H McKenzie, *Secretary*

2 March 2009

## Independent Auditor's Report to the Member of HSBC Bank plc

We have audited the consolidated financial statements of HSBC Bank plc and its subsidiaries ('the group') and parent company financial statements of HSBC Bank plc ('the bank') for the year ended 31 December 2008 which comprise the group Income Statement, the group and bank Balance Sheets, the group and bank Cash Flow Statements, the group and bank Statement of Recognised Income and Expense and the related notes. These financial statements have been prepared under the accounting policies set out therein.

This report is made solely to the bank's member, as a body, in accordance with section 235 of the Companies Act 1985. 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 auditor's 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

The directors' responsibilities for preparing the Directors' Report and the financial statements in accordance with applicable law and International Financial Reporting Standards ('IFRSs') as adopted by the European Union ('EU') are set out in the Statement of Directors' Responsibilities on page 24.

Our responsibility is to audit the financial statements in accordance with relevant legal and regulatory requirements and International Standards on Auditing (UK and Ireland).

We report to you our opinion as to whether the financial statements give a true and fair view and whether the financial statements have been properly prepared in accordance with the Companies Act 1985 and, as regards the group financial statements, Article 4 of the IAS Regulation. We also report to you whether in our opinion the information given in the Directors' Report is consistent with the financial statements.

In addition we report to you if, in our opinion, the company has not kept proper accounting records, if we have not received all the information and explanations we require for our audit, or if information specified by law regarding directors' remuneration and other transactions is not disclosed.

We read the other information contained in the Directors' Report and consider whether it is consistent with the audited financial statements. We consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies with the financial statements. Our responsibilities do not extend to any other information.

### Basis of audit opinion

We conducted our audit in accordance with International Standards on Auditing (UK and Ireland) issued by the Auditing Practices Board. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the financial statements. It also includes an assessment of the significant estimates and judgements made by the Directors in the preparation of the financial statements, and of whether the accounting policies are appropriate to the group's and bank's circumstances, consistently applied and adequately disclosed.

We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or other irregularity or error. In forming our opinion we also evaluated the overall adequacy of the presentation of information in the financial statements.

### Opinion

In our opinion:

- the group's financial statements give a true and fair view, in accordance with IFRSs as adopted by the EU, of the state of the group's affairs as at 31 December 2008 and of its profit for the year then ended;
- the bank's financial statements give a true and fair view, in accordance with IFRSs as adopted by the EU as applied in accordance with the provisions of the Companies Act 1985, of the state of the bank's affairs as at 31 December 2008;
- the financial statements have been properly prepared in accordance with the Companies Act 1985 and, as regards the group financial statements, Article 4 of the IAS Regulation; and
- the information given in the Directors' Report is consistent with the financial statements.

**KPMG Audit Plc**  
Chartered Accountants  
Registered Auditor  
London

2 March 2009

## Financial Statements

### Consolidated income statement for the year ended 31 December 2008

	Notes	2008 £m	2007 £m (restated) <sup>1</sup>
Interest income .....		18,998	16,439
Interest expense .....		(13,301)	(12,585)
Net interest income .....		5,697	3,854
Fee income .....		5,453	5,442
Fee expense .....		(1,496)	(1,258)
Net fee income .....		3,957	4,184
Trading income excluding net interest income .....		1,165	1,698
Net interest income on trading activities .....		1,802	1,789
Net trading income .....		2,967	3,487
Net (expense)/income from financial instruments designated at fair value .....		(1,097)	126
Gains less losses from financial investments .....		82	552
Dividend income .....		85	43
Net earned insurance premiums .....	4	2,891	1,921
Other operating income .....		1,593	307
<b>Total operating income</b> .....		<b>16,175</b>	<b>14,474</b>
Net insurance claims incurred and movement in liabilities to policyholders .....	5	(1,835)	(1,674)
<b>Net operating income before loan impairment charges and other credit risk provisions</b> .....		<b>14,340</b>	<b>12,800</b>
Loan impairment charges and other credit risk provisions .....		(1,861)	(1,043)
<b>Net operating income</b> .....	6	<b>12,479</b>	<b>11,757</b>
Employee compensation and benefits <sup>1</sup> .....	7	(4,498)	(4,305)
General and administrative expenses .....	8	(3,049)	(2,872)
Depreciation and impairment of property, plant and equipment .....	22	(466)	(422)
Amortisation and impairment of intangible assets .....	21	(109)	(142)
<b>Total operating expenses</b> .....		<b>(8,122)</b>	<b>(7,741)</b>
<b>Operating profit</b> .....		<b>4,357</b>	<b>4,016</b>
Share of profit in associates and joint ventures .....		9	47
<b>Profit before tax</b> .....		<b>4,366</b>	<b>4,063</b>
Tax expense .....	10	(843)	(767)
<b>Profit for the year</b> .....		<b>3,523</b>	<b>3,296</b>
Profit attributable to shareholders of the parent company .....		3,441	3,209
Profit attributable to minority interests .....		82	87

<sup>1</sup> On 1 January 2008, the group adopted IFRIC 11. Comparative information has been restated accordingly. See note 1(a).

## Consolidated balance sheet at 31 December 2008

	Notes	2008 £m	2007 £m
<b>ASSETS</b>			
Cash and balances at central banks .....		9,470	7,146
Items in the course of collection from other banks .....		1,917	2,434
Trading assets .....	15	172,026	153,206
Financial assets designated at fair value .....	16	13,895	14,969
Derivatives .....	17	243,084	60,470
Loans and advances to banks .....	31	50,719	60,764
Loans and advances to customers .....	31	298,304	227,687
Financial investments .....	18	103,511	69,528
Interests in associates and joint ventures .....	20	73	118
Goodwill and intangible assets .....	21	11,780	9,877
Property, plant and equipment .....	22	4,697	4,119
Other assets .....	24	8,802	5,869
Current tax assets .....		215	67
Deferred tax assets .....	10	113	50
Prepayments and accrued income .....		5,625	5,976
<b>Total assets .....</b>		<b>924,231</b>	<b>622,280</b>
<b>LIABILITIES AND EQUITY</b>			
<b>Liabilities</b>			
Deposits by banks .....	31	61,431	48,786
Customer accounts .....	31	369,880	268,269
Items in the course of transmission to other banks .....		1,802	1,975
Trading liabilities .....	25	124,450	117,454
Financial liabilities designated at fair value .....	26	15,184	15,659
Derivatives .....	17	241,031	61,539
Debt securities in issue .....	31	52,308	50,921
Retirement benefit liabilities .....	7	664	674
Other liabilities <sup>1</sup> .....	27	6,897	6,843
Current tax liability .....		197	467
Liabilities under insurance contracts issued .....	28	16,132	12,251
Accruals and deferred income .....		5,464	6,509
Provisions .....	29	428	427
Deferred tax liability .....	10	443	302
Subordinated liabilities .....	30	7,259	5,205
<b>Total liabilities .....</b>		<b>903,570</b>	<b>597,281</b>
<b>Equity</b>			
Called up share capital .....	35	797	797
Share premium account .....	36	17,249	15,499
Other equity instruments .....	36	1,750	1,000
Other reserves .....	36	(7,842)	(460)
Retained earnings .....	36	7,969	7,587
<b>Total equity attributable to shareholders of the parent company .....</b>		<b>19,923</b>	<b>24,423</b>
Minority interests .....	36	738	576
<b>Total equity .....</b>		<b>20,661</b>	<b>24,999</b>
<b>Total equity and liabilities .....</b>		<b>924,231</b>	<b>622,280</b>

S K Green, *Chairman*

2 March 2009

**Financial Statements** (continued)**Consolidated statement of recognised income and expense for the year ended 31 December 2008**

	<b>2008</b>	2007
	<b>£m</b>	£m
		(restated) <sup>1</sup>
Available-for-sale investments:		
– fair value losses taken to equity .....	<b>(11,551)</b>	(964)
– fair value gains transferred to income statement on disposal .....	<b>(330)</b>	(517)
– amount transferred to the income statement in respect of impairment .....	<b>429</b>	16
Cash flow hedges:		
– fair value gains/(losses) taken to equity .....	<b>545</b>	(71)
– fair value (gains)/losses transferred to income statement .....	<b>(8)</b>	33
Foreign exchange reserve:		
– amounts transferred to income statement on disposal .....	<b>(136)</b>	–
– exchange differences taken to equity .....	<b>3,357</b>	1,109
Share of changes in equity of associates and joint ventures .....	–	101
Actuarial (losses)/gains on defined benefit plans .....	<b>(129)</b>	1,267
	<b>(7,823)</b>	974
Tax on items taken directly to equity .....	<b>438</b>	(311)
Total income and expense taken to equity during the year .....	<b>(7,385)</b>	663
Profit for the year .....	<b>3,523</b>	3,296
Total recognised income and expense for the year .....	<b>(3,862)</b>	3,959
Total recognised income and expense for the year attributable to:		
– shareholders of the parent company .....	<b>(4,062)</b>	3,857
– minority interests .....	<b>200</b>	102

<sup>1</sup> On 1 January 2008, the group adopted IFRIC 11. Comparative information has been restated accordingly. See note 1(a).

## Consolidated cash flow statement for the year ended 31 December 2008

	Notes	2008 £m	2007 £m (restated) <sup>1</sup>
<b>Cash flows from operating activities</b>			
Profit before tax .....		4,366	4,063
Adjustments for:			
– non-cash items included in profit before tax .....	37	2,733	2,205
– change in operating assets .....	37	(72,242)	(56,617)
– change in operating liabilities .....	37	118,194	83,387
– elimination of exchange differences <sup>2</sup> .....		(24,765)	(332)
– net gain from investing activities .....		(1,284)	(552)
– share of profits in associates and joint ventures .....		(9)	(47)
– distributions from associates .....		2	7
– contributions paid for defined benefit plans .....		(273)	(548)
– tax paid .....		(795)	(872)
Net cash generated from operating activities .....		<u>25,927</u>	<u>30,694</u>
<b>Cash flows from investing activities</b>			
Purchase of financial investments .....		(102,333)	(71,980)
Proceeds from the sale of financial investments .....		71,626	43,217
Purchase of property, plant and equipment .....		(782)	(578)
Proceeds from the sale of property, plant and equipment .....		281	67
Purchase of goodwill and intangible assets .....		(182)	(123)
Proceeds from the sale of goodwill and intangible assets .....		18	-
Net cash (outflow)/inflow from acquisition of and increase in stake of subsidiaries .....		(28)	9
Net cash outflow from acquisition of and increase in stake of associates .....		(1)	(118)
Proceeds from disposal of subsidiaries .....		1,554	-
Proceeds from disposal of associates .....		62	982
Purchases of HSBC Holdings plc shares to satisfy share based payment transactions .....		(197)	(182)
Net cash used in investing activities .....		<u>(29,982)</u>	<u>(28,706)</u>
<b>Cash flows from financing activities</b>			
Issue of share capital .....		1,750	510
Issue of capital securities .....		750	1,000
Subordinated loan capital issued .....		1,014	59
Subordinated loan capital repaid .....		(51)	10
Dividends paid to shareholders .....		(2,974)	(1,706)
Dividends paid to minority interests .....		(25)	(7)
Net cash generated from/(used in) financing activities .....		<u>464</u>	<u>(134)</u>
<b>Net (decrease)/increase in cash and cash equivalents .....</b>		<b>(3,591)</b>	<b>1,854</b>
Cash and cash equivalents at 1 January .....		51,235	46,721
Effect of exchange rate changes on cash and cash equivalents .....		13,211	2,660
Cash and cash equivalents at 31 December .....	37	<u>60,855</u>	<u>51,235</u>

1 On 1 January 2008, the group adopted IFRIC 11. Comparative information has been restated accordingly. See note 1(a).

2 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.

## Financial Statements (continued)

### HSBC Bank plc balance sheet at 31 December 2008

	<i>Notes</i>	<b>2008</b> <b>£m</b>	2007 <b>£m</b>
<b>ASSETS</b>			
Cash and balances at central banks .....		6,779	3,677
Items in the course of collection from other banks .....		692	1,377
Trading assets .....	15	130,205	149,102
Financial assets designated at fair value .....	16	4,592	3,439
Derivatives .....	17	197,128	46,325
Loans and advances to banks .....	31	18,295	32,028
Loans and advances to customers .....	31	217,309	150,649
Financial investments .....	18	46,608	13,821
Interests in associates and joint ventures .....	20	53	46
Investments in subsidiary undertakings .....	23	15,236	15,754
Goodwill and intangible assets .....	21	598	540
Property, plant and equipment .....	22	1,515	1,078
Other assets .....	24	3,637	2,076
Current tax assets .....		291	1
Deferred tax assets .....	10	138	515
Prepayments and accrued income .....		2,705	3,601
Total assets .....		<b>645,781</b>	<b>424,029</b>
<b>LIABILITIES AND EQUITY</b>			
<b>Liabilities</b>			
Deposits by banks .....	31	54,986	41,061
Customer accounts .....	31	240,397	184,899
Items in the course of transmission to other banks .....		772	1,056
Trading liabilities .....	25	98,389	99,755
Financial liabilities designated at fair value .....	26	9,429	8,082
Derivatives .....	17	197,247	47,536
Debt securities in issue .....	31	8,670	8,117
Retirement benefit liabilities .....	7	414	551
Other liabilities <sup>1</sup> .....	27	3,163	2,874
Current taxation .....		4	198
Accruals and deferred income .....		2,585	4,214
Provisions .....	29	158	163
Deferred tax liability .....	10	2	2
Subordinated liabilities .....	30	7,310	4,744
Total liabilities .....		<b>623,526</b>	<b>403,252</b>
<b>Equity</b>			
Called up share capital .....	35	797	797
Share premium account .....	36	17,249	15,499
Other equity instruments .....	36	1,750	1,000
Other reserves .....	36	(622)	180
Retained earnings .....	36	3,081	3,301
Total equity .....		<b>22,255</b>	<b>20,777</b>
Total equity and liabilities .....		<b>645,781</b>	<b>424,029</b>

S K Green, *Chairman*

2 March 2009



## HSBC Bank plc statement of recognised income and expense for the year ended 31 December 2008

	2008 £m	2007 £m (restated) <sup>1</sup>
Available-for-sale investments:		
– fair value (losses)/gains taken to equity .....	(1,533)	238
– fair value gains transferred to income statement on disposal .....	(164)	(167)
– amounts transferred to the income statement in respect of impairment .....	103	–
Cash flow hedges:		
– fair value gains taken to equity .....	563	10
– fair value (gains)/losses transferred to income statement .....	(16)	19
Exchange differences .....	(34)	(10)
Actuarial gains on defined benefit plans .....	33	1,231
	<b>(1,048)</b>	1,321
Tax on items taken directly to equity .....	<b>281</b>	(364)
Total income and expense taken to equity during the year .....	<b>(767)</b>	957
Profit for the year .....	<b>2,681</b>	2,336
Total recognised income and expense for the year .....	<b>1,914</b>	3,293

<sup>1</sup> On 1 January 2008, the group adopted IFRIC 11. Comparative information has been restated accordingly. See note 1(a).

## Financial Statements (continued)

### HSBC Bank plc cash flow statement for the year ended 31 December 2008

	Notes	2008 £m	2007 £m (restated) <sup>1</sup>
<b>Cash flows from operating activities</b>			
Profit before tax .....		3,235	2,844
Adjustments for:			
– non-cash items included in net profit .....	37	1,448	1,719
– change in operating assets .....	37	(39,012)	(44,754)
– change in operating liabilities .....	37	70,364	39,266
– elimination of exchange differences <sup>2</sup> .....		(7,301)	(924)
– net gain from investing activities .....		(733)	(167)
– contribution paid for defined pension schemes .....		(252)	(535)
– tax paid .....		(365)	(428)
Net cash generated from/(used in) operating activities .....		<u>27,384</u>	<u>(2,979)</u>
<b>Cash flows from investing activities</b>			
Purchase of financial investments .....		(77,011)	(20,361)
Proceeds from the sale of financial investments .....		48,606	19,027
Purchase of property, plant and equipment .....		(393)	(307)
Proceeds from the sale of property, plant and equipment .....		67	59
Purchase of goodwill and intangible assets .....		(132)	(97)
Proceeds from the sale of goodwill and intangible assets .....		16	–
Net cash outflow from acquisition of and increase in stake of subsidiaries .....		(28)	–
Net cash outflow from acquisition of and increase in stake of associates .....		(7)	(61)
Net cash inflow due to repayment of capital in subsidiary .....		1,116	–
Proceeds from disposal of subsidiaries .....		224	–
Proceeds from disposal of associates .....		–	298
Purchases of HSBC Holdings plc shares to satisfy share based payment transactions .....		(99)	(26)
Net cash used in investing activities .....		<u>(27,641)</u>	<u>(1,468)</u>
<b>Cash flows from in financing activities</b>			
Issue of ordinary share capital .....		1,750	510
Issue of capital securities .....		750	1,000
Subordinated loan capital issued .....		1,612	–
Subordinated loan capital repaid .....		–	22
Dividends paid .....		(2,974)	(1,706)
Net cash generated from/(used in) financing activities .....		<u>1,138</u>	<u>(174)</u>
<b>Net increase/(decrease) in cash and cash equivalents</b> .....		<b>881</b>	<b>(4,621)</b>
Cash and cash equivalents at 1 January .....		22,592	26,485
Effect of exchange rate changes on cash and cash equivalents .....		4,318	728
Cash and cash equivalents at 31 December .....	37	<u>27,791</u>	<u>22,592</u>

1 On 1 January 2008, the bank adopted IFRIC 11. Comparative information has been restated accordingly. See note 1(a).

2 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.

## 1 Basis of preparation

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### (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 2008, there were no unendorsed standards effective for the year ended 31 December 2008 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 2008 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 International Financial Reporting Interpretations Committee ('IFRIC') and its predecessor body.

During 2008, the group adopted the following amendments to standards and interpretations:

- IFRIC 14 'IAS 19 – The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction' had no significant effect on the consolidated financial statements of the group or the separate financial statements of HSBC Bank plc;
- An amendment to IAS 39 'Financial Instruments: Recognition and Measurement' ('IAS 39') and to IFRS 7 'Financial Instruments: Disclosures' ('IFRS 7') – 'Reclassification of Financial Assets' ('Reclassification Amendment'). See note 14 – Reclassification of financial assets.
- IFRIC 11 'Group and Treasury Share Transactions' ('IFRIC 11'). Application of this interpretation has resulted in the group treating all share based payment transactions as equity settled.

This change in accounting policy was made in accordance with the transitional provisions of IFRIC 11, which require that the interpretation be applied retrospectively in accordance with IAS 8 'Accounting Policies, changes in Accounting Estimates and Errors', subject to the transitional provisions of IFRS 2 'Share-based Payments'. The effect of the adoption of IFRIC 11 was to increase the group's 'employee compensation and benefits' in 2007 by £18 million. (bank £15 million)

### (b) Presentation of information

In publishing the parent company financial statements together with the group financial statements, the group is taking advantage of the exemption in s230 of the Companies Act 1985 not to present its individual income statement and related notes that form part of these approved financial statements.

The group has taken advantage of the exemption under Regulation 7 of the Partnerships and Unlimited Companies (Accounts) Regulations 1993 from certain partnerships that are consolidated by the group presenting their own individual financial statements under IFRSs.

Capital disclosures under IAS 1 'Presentation of Financial Statements' have been included in the audited sections of the Report of the Directors on pages 14 to 17.

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 purchase method of accounting is used to account for the acquisition of subsidiaries by the group. The cost of an acquisition is measured at the fair value of the consideration given at the date of exchange, together with costs directly attributable to that acquisition. The acquired identifiable assets, liabilities and contingent liabilities are measured at their fair values at the date of acquisition. Any excess of the cost of acquisition over the fair value of the group's share of the identifiable assets, liabilities and contingent liabilities acquired is recorded as goodwill. If the cost of acquisition is less than the fair value of the group's share of the identifiable assets, liabilities and contingent liabilities of the business acquired, the difference is recognised immediately in the

## Notes on the Financial Statements (continued)

income statement.

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 incident 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

#### **Standards and Interpretations issued by the IASB and endorsed by the EU**

IFRS 8 'Operating Segments' ('IFRS 8'), which replaces IAS 14 'Segment Reporting' ('IAS 14'), was issued on 30 November 2006 and is effective for annual periods beginning on or after 1 January 2009. This standard specifies how an entity should disclose information about its segments which enables users to evaluate the nature and financial effects of its business activities and the economic environments in which it operates. The group will adopt IFRS 8 with effect from 1 January 2009, and will accordingly present financial information for segments whose operating activities are regularly reviewed by the chief operating decision maker in order to make decisions about allocating resources and assessing performance. The group currently presents two sets of segment data in accordance with IAS 14, one geographical and one based on customer groups.

A revised IAS 1, which is applicable for annual periods beginning on or after 1 January 2009, was issued on 6 September 2007. The revised standard aims to improve users' ability to analyse and compare information given in financial statements. The adoption of the revised standard will have no effect on the results reported in the group's consolidated financial statements or the separate financial statements of the bank. It will, however, result in certain presentational changes in the primary financial statements of the group.

The IASB issued an amendment to IFRS 2 'Share-based Payment' – 'Vesting Conditions and Cancellations' – on 17 January 2008. The amendment, which is applicable for annual periods beginning on or after 1 January 2009, clarifies that vesting conditions comprise only service conditions and performance conditions. It also specifies the accounting treatment for a failure to meet a non-vesting condition. The group does not expect adoption of the amendment to have a significant effect on the group's consolidated financial statements or the separate financial statements of the bank.

The IASB issued a revised IAS 23 'Borrowing Costs' on 29 March 2007, which is applicable for annual periods beginning on or after 1 January 2009. The revised standard eliminates the option of recognising borrowing costs immediately as an expense, to the extent that they are directly attributable to the acquisition, construction or production of a qualifying asset. The group does not expect adoption of the revised standard to have a significant effect on the consolidated financial statements or the separate financial statements of the bank.

IFRIC 13 'Customer Loyalty Programmes' ('IFRIC 13') was issued on 28 June 2007 and is effective for annual periods beginning on or after 1 July 2008. IFRIC 13 addresses how companies that grant their customers loyalty award credits (often called 'points') when buying goods or services should account for their obligation to

provide free or discounted goods and services, if and when the customers redeem the points. IFRIC 13 requires companies to allocate some of the proceeds of the initial sale to the award credits and recognise these proceeds as revenue only when they have fulfilled their obligations to provide goods or services. The group does not expect the adoption of this interpretation to have a significant effect on the consolidated financial statements or the separate financial statements of the bank.

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

At 31 December 2008, the following amendments to standards and interpretations, effective for these consolidated financial statements, were issued by the IASB but not endorsed by the EU:

- An amendment to IAS 39 and to IFRS 7 – ‘Reclassification of Financial Assets – Effective Date and Transition’ was issued on 27 November 2008. The amendment, which clarifies the effective date of the Reclassification Amendment, will have no effect on the consolidated financial statements of the group or the separate financial statements of the bank.
- IFRIC 12 ‘Service Concession Arrangements’ was issued on 30 November 2006 and is effective for annual periods beginning on or after 1 January 2008. The adoption of this interpretation is not expected to have a significant effect on the consolidated financial statements of the group or the separate financial statements of the bank.

A revised IFRS 3 ‘Business Combinations’ and an amended IAS 27 ‘Consolidated and Separate Financial Statements’ were issued on 10 January 2008. The revisions to the standards apply prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual financial reporting period beginning on or after 1 July 2009. The main changes under the standards are that:

- acquisition-related costs are recognised as expenses in the income statement in the period they are incurred;
- equity interests held prior to control being obtained are remeasured to fair value at the time control is obtained, and any gain or loss is recognised in the income statement;
- changes in a parent’s ownership interest in a subsidiary that do not result in a change of control are treated as transactions between equity holders and reported in equity; and
- an option is available, on a transaction-by-transaction basis, to measure any non-controlling (previously referred to as minority) interests in the entity acquired either at fair value, or at the non-controlling interests’ proportionate share of the net identifiable assets of the entity acquired.

The effect that the changes will have on the consolidated financial statements of the group and the separate financial statements of the bank will depend on the incidence and timing of business combinations occurring on or after 1 January 2010.

The IASB issued amendments to IAS 32 ‘Financial Instruments: Presentation’ and IAS 1 – ‘Puttable Financial Instruments and Obligations Arising on Liquidation’ – on 14 February 2008. The amendments are applicable for annual periods beginning on or after 1 January 2009. The group does not expect the adoption of this amendment to have a significant effect on the consolidated financial statements or the separate financial statements of the bank.

The IASB issued ‘Improvements to IFRSs’ on 22 May 2008, which comprises a collection of necessary, but not urgent, amendments to IFRSs. The amendments are primarily effective for annual periods beginning on or after 1 January 2009, with earlier application permitted. The group does not expect adoption of the amendments to have a significant effect on the consolidated financial statements or the separate financial statements of the bank.

The IASB issued amendments to IFRS 1 ‘First-time Adoption of International Financial Reporting Standards’ and IAS 27 – ‘Determining the cost of an Investment in the Separate Financial Statements’ – on 22 May 2008. The amendment is effective for annual periods beginning on or after 1 January 2009. These amendments are not expected to have a significant effect on the separate financial statements of the bank and will have no effect on the consolidated financial statements.

The IASB issued an amendment to IAS 39 – ‘Eligible Hedged Items’ on 31 July 2008, which is applicable for annual periods beginning on or after 1 July 2009. The amendment clarifies how the existing principles underlying hedge accounting should be applied. This amendment will have no effect on the consolidated financial statements or the separate financial statements of the bank..

## Notes on the Financial Statements (continued)

IFRIC 15 'Agreements for the Construction of Real Estate' ('IFRIC 15') was issued on 3 July 2008 and is effective for annual periods beginning on or after 1 January 2009. IFRIC 15 provides guidance on the recognition of revenue among real estate developers for sales of units. The group does not expect adoption of IFRIC 15 to have a significant effect on the group's consolidated financial statements. This interpretation will have no effect on the separate financial statements of the bank.

IFRIC 16 'Hedges of a Net Investment in a Foreign Operation' ('IFRIC 16') was issued on 3 July 2008 and is effective for annual periods beginning on or after 1 October 2008. IFRIC 16 provides guidance on accounting for the hedge of a net investment in a foreign operation in an entity's consolidated financial statements. The main change introduced by IFRIC 16 is to eliminate the possibility of an entity applying hedge accounting for a hedge of foreign exchange differences between the functional currency of a foreign operation and the presentation currency of the parent's consolidated financial statements. The adoption of IFRIC 16 will have no effect on the group's consolidated financial statements.

IFRIC 17 'Distributions of Non-cash Assets to Owners' ('IFRIC 17') was issued on 27 November 2008 and is effective for annual periods beginning on or after 1 July 2009. IFRIC 17 provides guidance on how distributions of assets other than cash as dividends to its shareholders should be accounted for. The group does not expect adoption of IFRIC 17 to have a significant effect on the group's consolidated financial statements or the separate financial statements of the bank.

IFRIC 18 'Transfers of Assets from Customers' ('IFRIC 18') was issued on 29 January 2009 and is required to be applied prospectively to transfers of assets from customers received on or after 1 July 2009. IFRIC 18 clarifies the requirements of IFRSs for agreements in which an entity receives from a customer an item of property, plant, and equipment that the entity must then use either to connect the customer to a network or to provide the customer with ongoing access to a supply of goods or services (such as a supply of electricity, gas or water). The group does not expect adoption of IFRIC 18 to have an effect on the group's consolidated financial statements or the separate financial statements of the bank.

## 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 calculated by applying the original effective interest rate (or, when appropriate, the effective interest rate calculated upon reclassification) of the financial asset to the carrying amount as reduced by any allowance for impairment.

### (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 expense/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 debt securities issued, and derivatives managed in conjunction with debt securities issued, which is recognised in ‘Interest expense’.

**Dividend income** is recognised when the right to receive payment is established. For equity securities this is the ex-dividend date.

#### (c) Segment reporting

The group is organised into three geographical regions – the United Kingdom, Continental Europe and Rest of the World – and manages its business through seven business segments: UK Personal Financial Services; UK Commercial Banking; UK Global Banking and Markets; International Banking; France; Private Banking; and HSBC Trinkaus & Burkhardt. The ‘Other’ segment comprises activities, operations and sources of income and expense which are not allocated to any of the other business segments. This includes movements in fair value on debt securities issued by the group designated at fair value and exchange movements on foreign-currency denominated equity instruments issued by the group. Segment income and expenses include transfers between geographical regions and transfers between business segments. These transfers are conducted on arm’s length terms and conditions.

#### (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 initial 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. 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 that are quoted in active markets are based on bid prices for assets held and offer prices for liabilities issued. When independent prices are not available, fair values are determined by using valuation techniques which refer to observable market data. These include comparison with similar instruments where market observable prices exist, discounted cash flow analysis, option pricing models and other valuation techniques commonly used by market participants. Fair values of financial instruments may be determined in whole or in part using valuation techniques based on assumptions that are not supported by prices from current market transactions or observable market data, where current prices or observable market data are not available.

Factors such as bid-offer spread, credit profile and model uncertainty are taken into account, as appropriate, when fair values are calculated using valuation techniques. Valuation techniques incorporate assumptions that other market participants would use in their valuations, including assumptions about interest rate yield curves, exchange rates, volatilities, and prepayment and default rates. Where a portfolio of financial instruments has quoted prices in an active market, the fair value of the instruments are calculated as the product of the number of units and quoted price and no block discounts are applied.

If the fair value of a financial asset measured at fair value becomes negative, it is recorded as a financial liability until its fair value becomes positive, at which time it is recorded as a financial asset.

## Notes on the Financial Statements (continued)

The fair values of financial liabilities are measured using quoted market prices where available, or using valuation techniques. These fair values include market participants' assessments of the appropriate credit spread to apply to the group's liabilities. The amount of change during the period, and cumulatively, in the fair value of designated financial liabilities and loans and advances that is attributable to changes in their credit spread is determined as the amount of change in the fair value that is not attributable to changes in market conditions that give rise to market risk.

### (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 particular 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.
- Financial assets (except financial assets that would have met the definition of loans and receivables) 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 borrowers repay 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 loans and advances 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.

For certain leveraged finance and syndicated lending activities, 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 of 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 rate 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 expected from future events are not recognised.

#### **Individually assessed loans and advances**

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. For those loans where objective evidence of impairment exists, impairment losses are determined by 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.

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.

#### **Collectively assessed loans and advances**

Impairment is assessed on a collective basis in two circumstances:

- to cover losses which have been incurred but have not yet been identified on loans subject to individual assessment; and
- for homogeneous groups of loans that are not considered individually significant.

#### *Incurred but not yet identified impairment*

Individually assessed loans for which no evidence of loss has been specifically identified on an individual basis are grouped together according to their credit risk characteristics for the purpose of calculating an estimated collective loss. This reflects impairment losses that the group has incurred as a result of events occurring before the balance sheet date, which the group is not able to identify on an individual loan basis, and that can be reliably estimated. These losses will only be individually identified in the future. As soon as information becomes available which identifies losses on individual loans within the group, those loans are removed from the group and assessed on an individual basis for impairment.

The collective impairment allowance is determined after taking into account:

- historical loss experience in portfolios of similar credit risk characteristics (for example, by industry sector, loan grade or product);
- the estimated period between impairment occurring and the loss being identified and evidenced by the establishment of an appropriate allowance against the individual loan; and

## Notes on the Financial Statements (continued)

- management's experienced judgement as to whether current economic and credit conditions are such that the actual level of inherent losses at the balance sheet date is likely to be greater or less than that suggested by historical experience.

The period between a loss occurring and its identification is estimated by local management for each identified portfolio.

### *Homogeneous groups of loans and advances*

Statistical methods are used to determine impairment losses on a collective basis for homogeneous groups of loans that are not considered individually significant, because individual loan assessment is impracticable. Losses in these groups of loans are recorded on an individual basis when individual loans are written off, at which point they are removed from the group. Two alternative methods are used to calculate allowances on a collective basis:

- When appropriate empirical information is available, the group uses roll-rate methodology. This methodology employs statistical analyses of historical data and experience of delinquency and default to estimate the amount of loans that will eventually be written off as a result of the events occurring before the balance sheet date which the group is not able to identify on an individual loan basis, and that can be reliably estimated. Under this methodology, loans are grouped into ranges according to the number of days past due, and statistical analysis is used to estimate the likelihood that loans in each range will progress through the various stages of delinquency and ultimately prove irrecoverable. 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. Current economic conditions are also evaluated when calculating the appropriate level of allowance required to cover inherent loss. 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.
- In other cases, 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 formulaic approach which allocates progressively higher percentage loss rates the longer a customer's loan is overdue. Loss rates are 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. 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.

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**

A loan (and the related impairment allowance account) is normally written off, either partially or in full, when there is no realistic prospect of recovery of the principal amount and, for a collateralised loan, when the proceeds from realising the security have been received.

### **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'. 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 new loans for measurement purposes once the minimum numbers of payments required under the new arrangements have been received. 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.

## **(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 all gains and losses from changes therein are recognised in the income statement in 'Net trading income' as they arise.

## **(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

## Notes on the Financial Statements (continued)

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 equity. These financial instruments are managed on a fair value basis and management information is also prepared on this 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 '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 or classified as loans and receivables, 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 equity in the 'Available-for-sale fair value reserve' 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 equity 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 rate 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 or group of financial assets. 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 equity and recognised in the income statement.

Impairment losses for available-for-sale debt securities are recognised within 'Loan impairment charges and other credit risk provisions' in the income statement and impairment losses for available-for-sale equity securities are recognised within 'Gains less losses from financial investments' in the income statement.

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 directly in equity. 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 cumulative 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 equity. Impairment losses recognised on the equity security are not reversed through the income statement. Subsequent decreases in the fair value of the available-for-sale equity security are recognised in the income statement, to the extent that further cumulative impairment losses have been incurred in relation to the acquisition cost of the equity security.
- (ii) Held-to-maturity investments are non-derivative financial assets with fixed or determinable payments and fixed maturities that the group positively intends, and is able, to hold until maturity. Held-to-maturity investments are initially recorded at fair value plus any directly attributable transaction costs, and are subsequently measured at amortised cost using the effective interest rate 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 tradings 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.

## Notes on the Financial Statements (continued)

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'); or (iii) a hedge of net investments in a foreign operation ('net investment 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 equity 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.

Amounts accumulated in equity are recycled 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 deferred in equity are transferred 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 equity at that time remains 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 equity is immediately transferred 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 hedge instrument is recognised in equity; a gain or loss on the ineffective portion is recognised immediately in the income statement. Gains and losses accumulated in equity are included in 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 expense/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 expense/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 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.

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.

The bank's investments in subsidiaries, associates and joint ventures are stated at cost less any impairment losses. Reversals of impairment losses are recognised in the income statement if there has been a change in the estimates used to determine the recoverable amount of the investment.

## Notes on the Financial Statements (continued)

### (p) Goodwill and intangible assets

- (i) Goodwill arises on business combinations, including the acquisition of subsidiaries, and on the acquisition of interests in joint ventures and associates, when the cost of acquisition exceeds the fair value of the group's share of the identifiable assets, liabilities and contingent liabilities acquired. If the group's interest in the fair value of the identifiable assets, liabilities and contingent liabilities of an acquired business is greater than the cost of acquisition, the excess is recognised immediately in the income statement.

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'.

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.

- (ii) Intangible assets include the present value of in-force long-term insurance business, computer software, trade names, mortgage servicing 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.
- 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.
  - 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 servicing 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 two per cent per annum on a straight-line basis or over their remaining useful lives; and



- leasehold buildings are depreciated over the 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 directly in equity, in which case it is recognised in equity.

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.

## Notes on the Financial Statements (continued)

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 equity. Deferred tax relating to fair value remeasurement of available-for-sale investments and cash flow hedging instruments which are charged or credited directly to equity, is also credited or charged directly to equity 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 health care.

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 'Equity' and presented in the Statement of recognised income and expense 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) Equity compensation plans

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. 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. 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 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 is 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 the extra equity instruments is recognised in addition to the expense of the original grant, measured at the date of modification, over the remaining vesting period.

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.

#### (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 equity if the gain or loss on the non-monetary item is recognised directly in equity. Any exchange component of a gain or loss on a non-monetary item is recognised directly 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 equity in the 'Foreign exchange reserve'. 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 the 'Foreign exchange reserve' in shareholders' equity. On disposal of a foreign operation, exchange differences relating thereto and previously recognised in reserves 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

## Notes on the Financial Statements (continued)

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.

HSBC Bank plc has issued financial guarantees 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.

### (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.

Although investment contracts with discretionary participation features are financial instruments, they are 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 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.

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 against the carrying value of the liability. Where 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 and are in force at the balance sheet date is recognised as an asset.

The present value of in-force ('PVIF') long-term insurance business is determined by discounting future cash flows 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 long-term insurance business. Movements in the PVIF long-term insurance business are included in 'Other operating income' on a gross of tax basis.

#### **Future profit participation**

Where contracts provide discretionary profit participation benefits to policyholders, insurance liabilities include the net unrealised gains recognised in connection with the assets backing the contracts to the extent that policyholders will benefit from such gains. The benefit may arise from the contractual terms, regulation or past distribution policy. The corresponding movement in the liability is recognised in equity or in the income statement in the same proportion to the net unrealised gains on the assets. In the case of net unrealised losses, a deferred participating asset is recognised only to the extent that its recoverability is highly probable.

#### **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 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.

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 consideration 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 net of directly attributable transaction costs and the redemption amount over the expected life of the debt.

#### **(aa) Share capital and other equity instruments**

Shares and other financial instruments 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.

#### **(ab) 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.

## Notes on the Financial Statements (continued)

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 Use of assumptions, estimates and judgement

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(f). Further information can be found in Note 38 'Risk Management'. 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 group uses two alternative methods to calculate collective impairment allowances on homogeneous groups of loans that are not considered individually significant:

- When appropriate empirical information is available, the group uses roll-rate methodology. This methodology employs statistical analysis of historical data and experience of delinquency and default to estimate the likelihood that loans will progress through the various stages of delinquency and ultimately prove irrecoverable. 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 other cases, 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 formulaic approach which allocates progressively higher percentage loss rates the longer a customer's loan is overdue. Loss rates are based on historical experience.

Both methodologies 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.

In addition, 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.

This key area of judgement is subject to uncertainty and is highly sensitive to factors such as 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 assumptions underlying this judgement are highly subjective. 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.

The total amount of the group's impairment allowances on homogeneous groups of loans is inherently uncertain because it is highly sensitive to changes in economic and credit conditions across a large number of geographical areas. Economic and credit conditions within geographical areas are influenced by many factors with a high degree of interdependency so that there is no one single factor to which the group's loan impairment allowances as a whole are particularly sensitive. It is possible that the outcomes within the next financial year could be different from the assumptions built in to 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 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 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 in future years; however, the cash flow forecasts 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 the CGU's 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 to reflect the inherent risk of the business being evaluated. These variables are established on the basis of significant management judgement and are subject to uncertainty.

When this exercise demonstrates that the expected cash flows of a CGU have declined and/or that its cost of capital has increased, the effect is to reduce the CGU's estimated recoverable amount. If this results in an estimated recoverable amount that is lower than the carrying value of the CGU, a charge for impairment of goodwill will be recognised in the group's income statement for the year.

The accuracy of forecast cash flows is subject to a high degree of uncertainty in volatile market conditions. In such market conditions, management retests goodwill for impairment more frequently than annually to ensure that the assumptions on which the cash flow forecasts are based continue to reflect current market conditions and management's best estimate of future business prospects.

Management concluded that the recoverable amount of the goodwill included within each of the CGUs to which goodwill has been allocated exceeded its carrying value. However, in the event of further significant deterioration in the economic and credit conditions beyond the levels already reflected by management in the cash flow forecasts for the CGUs, a material adjustment to a CGU's recoverable amount may occur which may result in the recognition of an impairment charge in the income statement.

Note 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). 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 include comparisons with similar financial instruments for which market observable prices exist, discounted cash flow analysis, option pricing models and other valuation techniques commonly used by market participants. Valuation techniques incorporate assumptions that other market participants

## Notes on the Financial Statements (continued)

would use in their valuations, including assumptions about interest rate yield curves, exchange rates, volatilities, and prepayment and default rates. When valuing instruments by reference to comparable instruments, management takes into account the maturity, structure and rating of the instrument with which the position held is being compared.

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 judgement 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
- judgement 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.

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'.

The objective evidence required to determine whether an available-for-sale debt security is impaired comprises evidence of the occurrence of a loss event, and evidence that the loss event results in a decrease in estimated future cash flows. Where cash flows are readily determinable, a low level of judgement may be involved. Where determination of estimated future cash flows requires consideration of a number of variables, some of which may be unobservable in current market conditions, more significant judgement is required.

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.

### Pensions

The assumptions used are disclosed in Note 7 'Employee compensation and benefits'.

### Share-based payments

The assumptions used are disclosed in Note 9 'Share-based payments'.

### Consolidation

The circumstances under which the group consolidates special purpose entities are outlined in Note 1(c) and disclosed in Note 38 'Risk Management'.

## 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
<b>2008</b>					
Gross written premiums .....	418	1,252	238	1,500	3,408
Movement in unearned premiums .....	42	(84)	–	–	(42)
Gross earned premiums .....	460	1,168	238	1,500	3,366
Gross written premiums ceded to reinsurers .....	(63)	(423)	(3)	–	(489)
Reinsurers' share of movement in unearned premiums .....	(2)	16	–	–	14
Reinsurers' share of gross earned premiums .....	(65)	(407)	(3)	–	(475)
Net earned insurance premiums .....	<b>395</b>	<b>761</b>	<b>235</b>	<b>1,500</b>	<b>2,891</b>
<b>2007</b>					
Gross written premiums .....	372	723	129	933	2,157
Movement in unearned premiums .....	6	2	–	–	8
Gross earned premiums .....	378	725	129	933	2,165
Gross written premiums ceded to reinsurers .....	(73)	(154)	(9)	–	(236)
Reinsurers' share of movement in unearned premiums .....	(8)	–	–	–	(8)
Reinsurers' share of gross earned premiums .....	(81)	(154)	(9)	–	(244)
Net earned insurance premiums .....	<b>297</b>	<b>571</b>	<b>120</b>	<b>933</b>	<b>1,921</b>

## 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
<b>2008</b>					
Claims, benefits and surrenders paid .....	318	374	135	1,047	1,874
Movement in liabilities .....	(8)	682	(189)	(138)	347
Gross claims incurred and movement in liabilities .....	310	1,056	(54)	909	2,221
Reinsurers' share of claims, benefits and surrenders paid .....	(46)	(83)	(7)	–	(136)
Reinsurers' share of movement in liabilities .....	42	(313)	21	–	(250)
Reinsurers' share of claims incurred and movement in liabilities .....	(4)	(396)	14	–	(386)
Net insurance claims incurred and movement in liabilities to policyholders	<b>306</b>	<b>660</b>	<b>(40)</b>	<b>909</b>	<b>1,835</b>
<b>2007</b>					
Claims, benefits and surrenders paid .....	250	132	139	537	1,058
Movement in liabilities .....	36	(123)	19	536	468
Gross claims incurred and movement in liabilities .....	286	9	158	1,073	1,526
Reinsurers' share of claims, benefits and surrenders paid .....	(65)	(73)	(8)	–	(146)
Reinsurers' share of movement in liabilities .....	29	263	2	–	294
Reinsurers' share of claims incurred and movement in liabilities .....	(36)	190	(6)	–	148
Net insurance claims incurred and movement in liabilities to policyholders	<b>250</b>	<b>199</b>	<b>152</b>	<b>1,073</b>	<b>1,674</b>

## 6 Net operating income

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

	2008 £m	2007 £m
<b>Income</b>		
Interest recognised on impaired financial assets .....	21	28
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 .....	2,997	2,966
Fees earned relating to trust and other fiduciary activities where the group holds or invests assets on behalf of its customers .....	751	767
<b>Expense</b>		
Interest on financial instruments, excluding interest on financial liabilities held for trading or designated at fair value .....	12,968	12,310
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 .....	606	571
Fees payable on trust and other fiduciary activities where the group holds or invests assets on behalf of its customers .....	21	18
<b>Gains/(losses)</b>		
Gain on disposal of assets held for sale .....	53	111
Impairment of available-for-sale equity shares .....	(282)	(20)
Gain/(loss) on loans and receivables .....	–	–
Gain/(loss) on financial liabilities measured at amortised cost .....	15	–
Gains on disposal of property, plant and equipment, intangible assets and non-financial investments:		
– Gain on disposal of French regional banks (see note 23) .....	644	–
– Gain on disposal of HSBC Merchant Services LLP .....	215	–
– Other .....	60	–
Gain on financing 8 Canada Square (see note 22) .....	265	–
<b>Loan impairment charge and other credit risk provisions</b>		
Net impairment charge on loans and advances .....	(1,716)	(1,043)
Impairment of available for sale debt securities .....	(147)	(3)
Net reversal in respect of other credit risk provisions .....	2	3
	<b>(1,861)</b>	<b>(1,043)</b>

## 7 Employee compensation and benefits

Total employee compensation

	The group		The bank	
	2008 £m	2007 (restated) £m	2008 £m	2007 (restated) £m
Wages and salaries .....	3,758	3,483	1,985	1,950
Social security costs .....	495	478	197	195
Post-employment benefits .....	245	344	178	287
	<b>4,498</b>	<b>4,305</b>	<b>2,360</b>	<b>2,432</b>

The average number of persons employed by the group during the year was as follows:

	2008	2007
UK PFS, UK Commercial Banking, UK Global Banking and Markets and UK Other .....	51,788	51,050
International Banking .....	15,395	12,671
HSBC France .....	13,215	14,905
Private Banking .....	4,842	4,486
HSBC Trinkaus & Burkhardt .....	2,252	1,817
Total .....	<b>87,492</b>	<b>84,929</b>

## Notes on the Financial Statements (continued)

### Post-employment benefit plans

#### Income statement charge

	The group		The bank	
	2008 £m	2007 £m	2008 £m	2007 £m
Defined benefit pension plans				
– HSBC Bank (UK) Pension Scheme .....	140	245	140	245
– Other plans .....	3	(5)	–	1
Defined contribution plans .....	110	95	30	33
Defined benefit healthcare plans .....	(8)	9	8	8
	<b>245</b>	<b>344</b>	<b>178</b>	<b>287</b>

#### Defined benefit post-retirement benefit plans

*Net liabilities recognised on balance sheet in respect of defined benefit plans*

	The group		The bank	
	2008 £m	2007 £m	2008 £m	2007 £m
Defined benefit pension plans				
– HSBC Bank (UK) Pension Scheme .....	269	403	269	403
– Other plans .....	265	107	15	12
Defined benefit healthcare plans .....	130	164	130	136
	<b>664</b>	<b>674</b>	<b>414</b>	<b>551</b>

#### *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 cost vary according to the economic conditions of the countries in which they are situated.

Defined benefit pension arrangements for bank employees are provided 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 benefits plans*

The group provides post-employment healthcare benefits which are unfunded under plans in the United Kingdom and France. Post-employment healthcare benefits plans are accounted for in the same manner as defined benefit 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 a credit of £8 million (2007: cost of £9 million).

*Post-employment defined benefit plans' principal actuarial assumptions*

The principal actuarial financial assumptions used to calculate the group's obligations under its defined benefit pension and post-employment healthcare plans at 31 December 2008 were as follows. These assumptions will also form the basis for measuring periodic costs under the plans in 2009:

	Discount rate %	Inflation rate %	Rate of increase for pensions in payment – pensioners %	Rate of increase for pensions in payment – active members and deferred pensioners	Deferred revaluation	Rate of pay increase %	Healthcare cost trend rates %
UK .....	6.50	2.90	3.00	2.80	2.90	3.40	6.90
France .....	5.75	2.00	2.00	2.00	2.00	3.00	6.00
Switzerland .....	2.60	1.50	n/a	n/a	n/a	2.50	n/a
Germany .....	5.75	2.00	2.00	2.00	2.00	3.00	n/a

The principal actuarial financial assumptions used to calculate the group's obligations under its defined benefit pension and post-employment healthcare plans at 31 December 2007, were as follows. These assumptions also formed the basis for measuring periodic costs under the plans in 2008:

	Discount rate %	Inflation rate %	Rate of increase for pensions in payment – pensioners %	Rate of increase for pensions in payment – active members and deferred pensioners	Deferred revaluation	Rate of pay increase %	Healthcare cost trend rates %
UK .....	5.80	3.30	3.30	3.30	3.30	4.30	7.30
France .....	4.50	2.00	2.00	2.00	2.00	3.00	6.00
Switzerland .....	2.25	1.50	n/a	n/a	n/a	2.25	n/a
Germany .....	4.50	2.00	2.00	2.00	2.00	3.00	n/a

The group determines the discount rates to be applied to its obligations in consultation with the plans' local actuaries, on the basis of current average yield of high quality (AA rated or equivalent) debt instruments, with maturities consistent with those of the defined benefit obligations. The expected rate of return on plan assets represents the best estimate of long-term future assets returns, which takes into account historical market returns plus additional factors such as the current rate of inflation and interest rates.

The mortality tables and average life expectancy at 65 used at 31 December 2008 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
UK .....	PA92 <sup>1</sup>	20.80	22.80	24.10	26.20
France .....	TG 05	23.10	25.90	26.60	29.40
Switzerland .....	BVG 2005 (3% load)	17.90	17.90	20.98	20.98
Germany .....	Heubeck 2005 G	18.00	20.70	22.10	24.70

<sup>1</sup> PA92 with standard improvements to 2005 and medium cohort improvements underpinned by a minimum 1 per cent annual improvement, thereafter.

## Notes on the Financial Statements (continued)

The mortality tables and average life expectancy at 65 used at 31 December 2007 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
		UK .....	PA92 <sup>1</sup>	20.40	21.70
France .....	TG 05	22.93	25.73	26.41	29.29
Switzerland .....	BVG 2005 (3% load)	17.90	17.90	20.98	20.98
Germany .....	Heubeck 2005 G	18.06	20.84	22.20	24.85

1 PA92 with standard improvements to 2005 and medium cohort improvements thereafter.

### 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:

	HSBC Bank (UK) Pension Scheme	
	2008 £m	2007 £m
<b>Discount rate</b>		
Change in pension obligation at year end from a 25bps increase .....	(383)	(493)
Change in pension obligation at year end from a 25bps decrease .....	408	530
Change in following year pension cost from a 25bps increase .....	(6)	(10)
Change in following year pension cost from a 25bps decrease .....	7	10
<b>Rate of inflation</b>		
Change in pension obligation at year end from a 25bps increase .....	360	530
Change in pension obligation at year end from a 25bps decrease .....	(338)	(493)
Change in following year pension cost from a 25bps increase .....	31	40
Change in following year pension cost from a 25bps decrease .....	(28)	(37)
<b>Rate of increase for pensions in payment and deferred revaluation</b>		
Change in pension obligation at year end from a 25bps increase .....	239	410
Change in pension obligation at year end from a 25bps decrease .....	(225)	(378)
Change in following year pension cost from a 25bps increase .....	20	30
Change in following year pension cost from a 25bps decrease .....	(16)	(28)
<b>Rate of pay increase</b>		
Change in pension obligation at year end from a 25bps increase .....	118	120
Change in pension obligation at year end from a 25bps decrease .....	(115)	(115)
Change in following year pension cost from a 25bps increase .....	11	11
Change in following year pension cost from a 25bps decrease .....	(10)	(10)
<b>Investment return</b>		
Change in following year pension cost from a 25bps increase .....	25	28
Change in following year pension cost from a 25bps decrease .....	(25)	(28)
<b>Mortality</b>		
Change in pension obligation from each additional year of longevity assumed .....	250	340

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

	Other plans	
	2008 £m	2007 £m
Increase in pension obligation from each additional year of longevity assumed .....	13	9

## Defined benefit pension plans

Value recognised on the balance sheet

HSBC Bank (UK) Pension Scheme				
2008			2007	
	Expected rates of return %	Value £m	Expected rates of return %	Value £m
Fair value of plan assets .....		<b>10,191</b>		11,316
Equities .....	<b>8.1</b>	<b>1,536</b>	8.3	2,283
Bonds .....	<b>5.7</b>	<b>7,541</b>	6.1	7,646
Property .....	<b>6.9</b>	<b>812</b>	7.3	936
Other .....	<b>4.2</b>	<b>302</b>	5.1	451
Defined benefit obligation .....		<b>(10,460)</b>		(11,719)
Present value of funded obligations .....		<b>(10,460)</b>		(11,719)
Present value of unfunded obligations .....		–		–
Adjustment for minimum funding requirements .....		–		–
Net liability <sup>1</sup> .....		<b>(269)</b>		<b>(403)</b>

Other plans				
2008			2007	
	Expected rates of return <sup>2</sup> %	Value £m	Expected rates of return <sup>2</sup> %	Value £m
Fair value of plan assets .....		<b>617</b>		557
Equities .....	<b>7.4</b>	<b>128</b>	7.2	196
Bonds .....	<b>4.2</b>	<b>368</b>	3.6	260
Property .....	<b>5.3</b>	<b>13</b>	5.2	11
Other .....	<b>5.0</b>	<b>108</b>	4.9	90
Defined benefit obligation .....		<b>(889)</b>		(643)
Present value of funded obligations .....		<b>(750)</b>		(610)
Present value of unfunded obligations .....		<b>(139)</b>		(33)
Effect of limit on plan surpluses .....		–		(21)
Unrecognised past service cost .....		7		–
Adjustment for minimum funding requirements .....		–		–
Net liability <sup>1</sup> .....		<b>(265)</b>		<b>(107)</b>

1 £284 million of the net liability for defined benefit pension plans relates to the bank (2007: £415 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 (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 information on these swaps is detailed in Note 42 ‘Related party transactions’.

## Notes on the Financial Statements (continued)

*Changes in the present value of defined benefit obligations*

	2008		2007	
	HSBC Bank (UK) Pension Scheme £m	Other plans £m	HSBC Bank (UK) Pension Scheme £m	Other plans £m
At 1 January .....	11,719	643	12,392	627
Current service cost .....	211	23	227	23
Interest cost .....	670	27	623	23
Contributions by employees .....	–	20	–	16
Actuarial (gains)/losses .....	(1,664)	53	(1,208)	(49)
Benefits paid .....	(476)	(43)	(315)	(37)
Past service cost				
– vested immediately .....	–	5	–	3
– unvested benefits .....	–	6	–	–
Acquisitions .....	–	2	–	–
Reduction in liabilities resulting from curtailments .....	–	–	–	(29)
Liabilities extinguished on settlements .....	–	(40)	–	–
Exchange differences .....	–	193	–	66
At 31 December .....	<b>10,460</b>	<b>889</b>	<b>11,719</b>	<b>643</b>

*Changes in the fair value of plan assets*

	2008		2007	
	HSBC Bank (UK) Pension Scheme £m	Other plans £m	HSBC Bank (UK) Pension Scheme £m	Other plans £m
At 1 January .....	11,316	557	10,485	460
Expected return on plan assets .....	741	31	605	25
Contributions by the group				
– normal .....	252	21	235	13
– special .....	–	–	300	–
Contributions by employees .....	–	20	–	16
Experience gains/(losses) .....	(1,643)	(130)	6	3
Benefits paid .....	(475)	(33)	(315)	(24)
Assets distributed on curtailments .....	–	–	–	–
Assets distributed on settlements .....	–	(19)	–	(3)
Exchange differences .....	–	170	–	67
At 31 December .....	<b>10,191</b>	<b>617</b>	<b>11,316</b>	<b>557</b>

The actual return on plan assets for the year ended 31 December 2008 was a negative return £1,001 million (2007: positive return of £639 million). The group expects to make £274 million of contributions to defined benefit pension plans during 2009.

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

	2008		2007	
	HSBC Bank (UK) Pension Scheme £m	Other plans £m	HSBC Bank (UK) Pension Scheme £m	Other plans £m
Current service cost .....	211	23	227	23
Interest cost .....	670	27	623	23
Expected return on plan assets .....	(741)	(31)	(605)	(25)
Past service cost .....	–	5	–	3
Gains on curtailments .....	–	–	–	(29)
Gains on settlements .....	–	(21)	–	–
Total expense .....	<b>140</b>	<b>3</b>	<b>245</b>	<b>(5)</b>



Total net actuarial gains/(losses)

	2008		2007	
	HSBC Bank (UK) Pension Scheme £m	Other plans £m	HSBC Bank (UK) Pension Scheme £m	Other plans £m
Experience losses on plan liabilities .....	(7)	(6)	(30)	(4)
Experience gains/(losses) on plan assets .....	(1,643)	(130)	6	3
Gains/(losses) from changes in actuarial assumptions .....	1,671	(47)	1,238	53
Total net actuarial gains/(losses) .....	<b>21</b>	<b>(183)</b>	1,214	52

Total net actuarial gains recognised in equity since transition to IFRSs are £573 million. The total effect of the limit on plan surpluses recognised within actuarial losses in equity during 2008 was a gain of £25 million (2007: £17 million loss).

The most recently completed triennial actuarial valuation of the principal plan performed by the Scheme Actuary on behalf of the Trustee was carried out as at 31 December 2005. The valuation identified a deficit of £1,200 million. The method adopted for this valuation was the projected unit method. The expected cash flows from the plan were projected by reference to the Retail Price Index ('RPI') swap break-even curve at 31 December 2005. Salary increases were assumed to be 1 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, were assumed to be in line with RPI. The projected cash flows were discounted at the LIBOR swap curve at 31 December 2005 plus a margin for the expected return on the investment strategy of 110 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 with allowances for medium cohort future improvements on the PA92 series of tables from the valuation date.

As part of the 31 December 2005 valuation, calculations were also carried out as to the amount of assets that might be needed to meet the liabilities if the Scheme was discontinued and the members' benefits bought out with an insurance company (although in practice this may not be possible for a plan of this size) or the Trustee continued to run the plan without the support of the bank. The amount required under this approach is estimated to be £15,500 million as at 31 December 2005. 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.

In anticipation of the results of the 2005 valuation, on 22 December 2005 HSBC Bank plc made an additional contribution of £1 billion in order to reduce the deficit of the plan. Following receipt of the valuation results, the bank agreed with the Trustee to reduce the deficit of the plan by meeting a schedule of additional future funding payments, as set out below:

	£m
2012 .....	465
2013 .....	465
2014 .....	465

The bank also decided to make ongoing contributions to the Scheme in respect of the accrual of benefits of defined benefit section members at the rate of 36 per cent of pensionable salaries from 1 January 2007 until the completion of the next actuarial valuation, to be calculated as at 31 December 2008. During 2006 the bank paid contributions at the rate of 20 per cent of pensionable salaries. A further 2 per cent of pensionable salaries is being paid over the period 1 January 2007 to 31 December 2014 to make good the difference in contributions during 2006.

The Trustee and the bank will monitor progress towards closing the deficit in the light of the next triennial valuation that is currently being performed as at 31 December 2008. This valuation process is currently underway and is due to be completed later in 2009. Future funding commitments will be determined on conclusion of the actuarial valuation.

## Notes on the Financial Statements (continued)

## Summary

	HSBC Bank (UK) Pension Scheme				
	2008 £m	2007 £m	2006 £m	2005 £m	2004 £m
Defined benefit obligation .....	(10,460)	(11,719)	(12,392)	(11,961)	(10,335)
Fair value of plan assets .....	10,191	11,316	10,485	10,107	7,810
Effect of limit on plan surpluses .....	–	–	–	–	–
Net deficit .....	<b>(269)</b>	<b>(403)</b>	<b>(1,907)</b>	<b>(1,854)</b>	<b>(2,525)</b>
Experience gains on plan liabilities .....	(7)	(30)	300	40	219
Experience gains/(losses) on plan assets .....	(1,643)	6	–	905	276
Gains/(losses) from changes in actuarial assumptions .....	1,671	1,238	(298)	(1,166)	(741)
Total net actuarial gains/(losses) .....	<b>21</b>	<b>1,214</b>	<b>2</b>	<b>(221)</b>	<b>(246)</b>
	Other Plans				
	2008 £m	2007 £m	2006 £m	2005 £m	2004 £m
Defined benefit obligation .....	(889)	(643)	(627)	(601)	(505)
Fair value of plan assets .....	617	557	460	404	240
Effect of limit on plan surpluses .....	–	(21)	2	–	–
Net deficit .....	<b>(272)</b>	<b>(107)</b>	<b>(165)</b>	<b>(197)</b>	<b>(265)</b>
Experience gains on plan liabilities .....	(6)	(4)	1	3	–
Experience gains/(losses) on plan assets .....	(130)	3	7	9	(20)
Gains/(losses) from changes in actuarial assumptions .....	(47)	53	14	(71)	(9)
Total net actuarial gains/(losses) .....	<b>(183)</b>	<b>52</b>	<b>22</b>	<b>(59)</b>	<b>(29)</b>

## Defined benefit healthcare plans

## Liability recognised on the balance sheet

	2008 £m	2007 £m
Present value of unfunded obligations .....	130	164
Unrecognised past service cost .....	–	–
Net liability <sup>1</sup> .....	<b>130</b>	<b>164</b>

1 £130 million of the net liability for defined benefit healthcare plans relates to the bank (2007: £136 million).

## Changes in the present value of defined benefit obligations

	2008 £m	2007 £m
At 1 January .....	164	180
Current service cost .....	–	1
Interest cost .....	9	8
Actuarial gains .....	(8)	(22)
Benefits paid .....	(21)	(6)
Reduction in liabilities resulting from curtailments .....	–	–
Liabilities extinguished on settlements .....	(17)	–
Exchange differences .....	3	3
At 31 December .....	<b>130</b>	<b>164</b>

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

	<b>2008</b>	2007
	<b>£m</b>	£m
Current service cost .....	–	1
Interest cost .....	<b>(8)</b>	8
Past service cost .....	–	–
<b>Total expense .....</b>	<b>(8)</b>	<b>9</b>

*Total net actuarial gains/(losses)*

	Year ended 31 December	
	<b>2008</b>	2007
	<b>£m</b>	£m
Experience (losses)/gains on plan liabilities .....	<b>(5)</b>	8
Gains from changes in actuarial assumptions .....	<b>13</b>	14
<b>Total net actuarial gains .....</b>	<b>8</b>	<b>22</b>

The actuarial assumptions of the healthcare cost trend rates have a significant effect on the amounts recognised. A one percentage point change in assumed healthcare cost trend rates would have the following effects on amounts recognised in 2008:

	<b>1% increase</b>	<b>1% decrease</b>
	<b>£m</b>	<b>£m</b>
Increase/(decrease) of the aggregate of the current service cost and interest cost .....	<b>1</b>	<b>1</b>
Increase/(decrease) of defined benefit obligation .....	<b>16</b>	<b>16</b>

**Post-employment benefit plans (the bank)**

Employees of the bank who are members of defined benefit pension plans are principally members of the HSBC Bank (UK) Pension Scheme, as disclosed above.

## Notes on the Financial Statements (continued)

### Directors' emoluments

The aggregate emoluments of the Directors of the bank, computed in accordance with Part I of Schedule 6 of the Companies Act were:

	2008 £000	2007 £000
Fees .....	452	466
Salaries and other emoluments .....	2,706	2,026
Bonuses <sup>1</sup> .....	3,430	8,448
	<b>6,588</b>	<b>10,940</b>
Gain on the exercise of share options .....	13	37
Vesting of Restricted Share Plan awards .....	1,621	4,243

<sup>1</sup> 2008 includes the sum of £2,357,019 (2007: £4,274,098) deferred into shares which are not subject to performance conditions, but are subject to a restricted period.

No awards were made to Directors under long-term incentive plans in respect of qualifying services rendered in 2008 (2007: one Director, £157,576).

Retirement benefits accrue to one Director under a defined benefit scheme and to one Director under a money purchase scheme. A further Director is entitled to benefits under an employer funded retirement benefit scheme. The unfunded liability under this scheme as at 31 December 2008 was £259,000. Aggregate contributions during the year to money purchase arrangements in respect of Directors services were £65,000 (2007: £395,023).

In addition, there were payments under retirement benefit agreements with former Directors of £742,874 (2007: £700,887), including payments in respect of unfunded pension obligations to former Directors of £410,251 (2007: £386,873). The provision as at 31 December 2008 in respect of unfunded pension obligations to former Directors amounted to £4,238,032 (2007: £4,653,000). During the year, aggregate contributions to pension schemes in respect of Directors were £65,000 (2007: £395,023).

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 the conditional awards under the HSBC Holdings Restricted Share Plan 2000 and The HSBC Share Plan are recognised through an annual charge based on the fair value of the awards and the likely level of vesting of shares, apportioned over the period of service to which the award relates.

Of these aggregate figures, the following amounts are attributable to the highest paid Director:

	2008 £000	2007 £000
Fees .....	–	–
Salaries and other emoluments .....	608	208
Bonuses <sup>1</sup> .....	1,493	3,064

<sup>1</sup> 2008 includes the sum of £1.1 million (2007: £1.2 million) deferred into shares which are not subject to performance conditions, but are subject to a restricted period.

The highest paid Director received 28,537 shares as the result of awards under long-term incentive plans that vested during the year. The highest paid Director exercised share options over 567 HSBC Holdings plc ordinary shares during the year.

No pension contributions were made by the bank in respect of services by the highest paid Director during the year.

The Remuneration Committee of the bank's parent company, HSBC Holdings plc, has decided that the highest paid Director will not receive a conditional award of HSBC Holdings plc ordinary shares under The HSBC Share Plan in respect of services rendered as a Director during the year. Details of The HSBC Share Plan and performance conditions are contained within the Directors' Remuneration Report of HSBC Holdings plc.

## 8 General and administrative expenses

### Auditors' remuneration

Auditors' remuneration in relation to the statutory audit amounted to £9.8 million (2007: £9.0 million).

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

	2008 £m	2007 £m
Audit fees for HSBC Bank plc statutory audit:		
– fees relating to current year .....	2.3	2.2
– fees relating to prior year .....	0.2	0.1
	<u>2.5</u>	<u>2.3</u>
Fees payable to KPMG for other services provided to the group		
Audit-related services:		
– audit of the group's subsidiaries, pursuant to legislation .....	7.1	6.1
– other services pursuant to legislation .....	5.7	2.2
Tax services .....	0.4	0.2
Other services:		
– services relating to information technology .....	0.2	0.2
– services relating to corporate finance transactions .....	0.2	–
– all other services .....	1.4	2.0
	<u>15.0</u>	<u>10.7</u>
Total fees payable .....	<u>17.5</u>	<u>13.0</u>

'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

During 2008, £225 million was charged to the income statement in respect of equity-settled share-based payment transactions (2007: £182 million, as restated for the impact of IFRIC 11 (see note 1a)). This expense, which was computed from the fair values of the share-based payment transactions when contracted, arose under employee share awards made in accordance with the HSBC Group's reward structures.

### Calculation of fair values

Fair values of share options/awards, measured at the date of grant of the option/award are calculated using a binomial lattice model methodology that is based on the underlying assumptions of the Black-Scholes model. When modelling options/share awards with vesting dependent on HSBC's Total Shareholder Return ('TSR') over a period, the TSR performance targets are incorporated into the model using Monte-Carlo simulation. The expected life of options depends on the behaviour of option holders, which is incorporated into the option model on the basis of historic observable data. The fair values calculated are inherently subjective and uncertain due to the assumptions made and the limitations of the model used.

## Notes on the Financial Statements (continued)

The significant weighted average assumptions used to estimate the fair value of the options granted were as follows:

	1-year Savings- Related Share Option Plans	3-year Savings- Related Share Option Plans	5-year Savings- Related Share Option Plans
<b>2008</b>			
Risk-free interest rate <sup>1</sup> (%) .....	4.5	4.5	4.5
Expected life <sup>2</sup> (years) .....	1	3	5
Expected volatility <sup>3</sup> (%) .....	25	25	25
Share price at grant date (£) .....	8.80	8.80	8.80
<b>2007</b>			
Risk-free interest rate <sup>1</sup> (%) .....	5.6	5.5	5.4
Expected life <sup>2</sup> (years) .....	1	3	5
Expected volatility <sup>3</sup> (%) .....	17	17	17
Share price at grant date (£) .....	9.24	9.24	9.24

1 The risk-free rate was determined from the UK gilts yield curve for the UK Savings-Related Share Option Plans. A similar yield curve was used for the Overseas Savings-Related Share Option Schemes.

2 Expected life 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.

Expected dividends are incorporated into the valuation model for share options/awards, where applicable. The expected US dollar denominated dividend growth was determined to be 7 per cent for the first year (2007: 10 per cent for first 3 years) and 8 per cent thereafter (2007: 8 per cent), in line with consensus analyst forecasts.

### The HSBC Share Plan

The HSBC Share Plan was adopted by the Group in 2005. Under this plan, performance share awards, restricted share awards and share option awards may be made. The aim of the HSBC Share Plan is to align the interests of executives with the creation of shareholder value and recognise individual performance and potential. Awards are also made under this plan for recruitment and retention purposes.

#### Performance share awards

Performance share awards are awarded to executive Directors and other senior executives after taking into account individual performance in the previous year. Each award is divided into two equal parts for testing attainment against pre-determined benchmarks. One half of the reward is subject to a TSR measure, based on HSBC's ranking against a comparator group of 28 major banks; the other half of the award is subject to an earnings per share target. For each element of the award, shares are released to the employee on a sliding scale from 30 to 100 per cent of the award, depending on the scale of achievement against the benchmarks, providing that the minimum criteria for each performance measure have been met. These shares vest after three years to the extent that the vesting conditions are satisfied.

	2008 Number (000's)	2007 Number (000's)
Outstanding at 1 January .....	2,184	1,966
Additions during the year .....	167	421
Released in the year .....	(809)	(203)
Forfeited in the year .....	(314)	—
Outstanding at 31 December <sup>1</sup> .....	<b>1,228</b>	<b>2,184</b>

1 The above table includes the bank employee awards of 809,522 (2007: 1,735,782).

The weighted average fair value of shares awarded by the group for Performance Share Awards in 2008 was £8.56 (2007: £8.96).

#### Restricted share awards

Restricted shares are awarded to other employees on the basis of their performance, potential and retention requirements, to aid recruitment or as a part-deferral of annual bonuses. Shares are awarded without corporate

performance conditions and generally vest between one and three years from the date of award, providing the employees have remained continuously employed by the group for this period.

	<b>2008</b> <b>Number</b> <b>(000's)</b>	2007 Number (000's)
Outstanding at 1 January .....	<b>29,590</b>	13,333
Additions during the year .....	<b>25,202</b>	21,035
Released during the year .....	<b>(9,328)</b>	(2,454)
Forfeited in the year .....	<b>(2,583)</b>	(2,324)
Outstanding at 31 December .....	<b>42,881</b>	29,590

The weighted average fair value of shares awarded by the group for Restricted Share Awards in 2008 was £8.56 (2007: £8.96).

#### Share options

Share options were granted in 2005 under The HSBC Share Plan to employees in France on the basis of their performance in the previous year. The share options are subject to the corporate Performance Conditions, which consists of an absolute Earnings Per Share measure and a TSR measure based on the Group's ranking against a comparator group of 28 major banks. The options may vest after three years. Options granted in June 2005 are exercisable up to the fourth anniversary of the date of grant, after which they will lapse. Options granted in September 2005 are exercisable up to the tenth anniversary of the grant, after which they will lapse.

	<b>2008</b>		2007	
	<b>Number</b> <b>(000's)</b>	<b>Weighted</b> <b>average</b> <b>exercise</b> <b>price</b> <b>£</b>	Number (000's)	Weighted average exercise price £
Outstanding at 1 January .....	<b>525</b>	<b>8.85</b>	628	8.84
Forfeited in the year .....	<b>(225)</b>	<b>8.79</b>	(103)	8.79
Outstanding at 31 December .....	<b>300</b>	<b>8.89</b>	525	8.85

No options were granted in 2008 (2007: nil). The weighted average remaining contractual life of options outstanding at the balance sheet date was 2.1 years. (2007: 2.4 years). The exercise price range of options outstanding at the balance sheet date was £8.79-£9.17. None of these options was exercisable at the balance sheet date.

#### Savings-related share option plans

Savings-related share option plans invite eligible employees to enter into savings contracts to save up to £250 per month, with the option to use the savings to acquire shares. The aim of the plans is to align the interests of all employees with the creation of shareholder value. 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 the fifth anniversary of the commencement of three-year or five-year contracts, respectively. The exercise price is set at 20 per cent (2007: 20 per cent) discount to the market value immediately preceding the date of invitation.

	<b>2008</b>		2007	
	<b>Number</b> <b>(000's)</b>	<b>Weighted</b> <b>average</b> <b>exercise</b> <b>price</b> <b>£</b>	Number (000's)	Weighted average exercise price £
Outstanding at 1 January .....	<b>41,029</b>	<b>6.59</b>	37,053	6.46
Granted in the year .....	<b>13,718</b>	<b>6.82</b>	10,845	7.08
Exercised in the year .....	<b>(13,273)</b>	<b>5.73</b>	(3,623)	6.45
Transferred in the year .....	<b>(1,404)</b>	<b>7.20</b>	(1,242)	6.89
Expired in the year .....	<b>(2,955)</b>	<b>7.02</b>	(2,004)	6.76
Outstanding at 31 December <sup>1,2</sup> .....	<b>37,115</b>	<b>6.94</b>	41,029	6.59

1 The above table includes the bank employee options of 34,569,476 outstanding at 1 January 2008 (2007: 33,571,481) 12,085,353 options granted in the year (2007: 8,269,034) and 33,404,227 options outstanding at 31 December 2008 (2007: 34,569,476).

## Notes on the Financial Statements (continued)

2 The weighted average exercise price for bank employees at 1 January 2008 was £6.57 (2007: £6.44) and at 31 December 2008 was £6.94 (2007: £6.57).

The weighted average fair value of options granted during the year was £2.17 (2007: £2.12). The weighted average share price at the dates the share options were exercised was £8.56 (2007: £8.96). The number of options, weighted average exercise price, and the weighted average remaining contractual life for options outstanding at the balance sheet date, analysed by exercise price range, were as follows:

### The group

	2008	2007
Exercise price range (£).....	<b>£5.35-£8.02</b>	£5.35-£8.02
Weighted average remaining contractual life (years) .....	<b>2.19</b>	1.77
Of which exercisable:		
– number (000's) .....	<b>605</b>	154
– weighted average exercise price (£) .....	<b>5.91</b>	6.49

### The bank

	2008	2007
Exercise price range (£).....	<b>£5.35-£8.02</b>	£5.35-£8.02
Weighted average remaining contractual life (years) .....	<b>2.26</b>	1.76
Of which exercisable:		
– number (000's) .....	<b>485</b>	85
– weighted average exercise price (£) .....	<b>5.83</b>	6.49

## HSBC Holdings Restricted Share Plan 2000

### Performance share awards made under the HSBC Holdings Restricted Share Plan 2000 (the 'Restricted Share Plan')

Performance share awards under the Restricted Share Plan were granted to senior executives from 1996 to 2004. The aim of the plan was to align the interests of executives with the creation of shareholder value. This was achieved by setting certain TSR targets against a peer group of major banks which would normally have to be attained in order for the awards to vest. In addition to these performance conditions, none of the outstanding awards will vest unless the Group's Remuneration Committee is satisfied that, during the performance period, HSBC has achieved sustained growth. Following adoption of The HSBC Share Plan in 2005, no further awards will be made under this Plan other than from reinvested scrip dividends.

	2008 Number (000's)	2007 Number (000's)
Outstanding at 1 January .....	<b>1,052</b>	1,977
Additions during the year <sup>1</sup> .....	<b>23</b>	849
Released in the year .....	<b>(985)</b>	(1,750)
Transferred in the year .....	<b>(90)</b>	(24)
Outstanding at 31 December .....	<b>–</b>	1,052

1 Additions during the year comprised reinvested scrip dividends.

The weighted average remaining vesting period as at 31 December 2007 was 10 months.

### Restricted share awards made under the HSBC Holdings Restricted Share Plan 2000

Restricted share awards under the Restricted Share Plan were granted to eligible employees from 2000 to 2005, after taking into account the employees' performance in the previous year, their potential and retention requirements. Restricted shares were also awarded as part-deferral of annual bonuses or for recruitment purposes. Shares are awarded without corporate performance conditions and generally vest between one and three years from the date of award, providing the employees have remained continuously employed by the group for the period.



	<b>2008</b>	2007
	<b>Number</b>	Number
	<b>(000's)</b>	(000's)
Outstanding at 1 January .....	<b>6,111</b>	12,867
Additions during the year <sup>1</sup> .....	<b>223</b>	452
Released in the year .....	<b>(5,896)</b>	(7,299)
Forfeited in the year .....	<b>(304)</b>	(792)
Transferred in the year .....	<b>19</b>	883
Outstanding at 31 December <sup>2</sup> .....	<b>153</b>	6,111

1 Additions during the year comprised reinvested scrip dividends.

2 The above table includes bank employee shares of 3,569,950 outstanding at 1 January 2008 (2007: 7,525,817), nil shares granted in the year (2007: nil) and 85,051 outstanding at 31 December 2008 (2007: 3,569,950).

No shares were awarded by the group for the HSBC Holdings Restricted Share Plan 2000 in 2008 or 2007.

The weighted average remaining vesting period as at 31 December 2008 was 5 months (2007: 2 months).

### The HSBC Holdings Group Share Option Plan

The HSBC Holdings Group Share Option Plan was a long-term incentive plan under which certain group employees between 2000 and 2005 were awarded share options. The aim of the plan was to align the interests of those higher-performing employees with the creation of shareholder value. This was achieved by setting certain TSR targets which would normally have to be attained in order for the awards to vest. Options were granted at market value and are normally exercisable between the third and tenth anniversaries of the date of grant, subject to vesting conditions. Options granted after May 2005 are made under The HSBC Share Plan.

	<b>2008</b>		2007	
	Number (000's)	Weighted average exercise price £	Number (000's)	Weighted average exercise price £
Outstanding at 1 January .....	42,222	7.86	45,352	7.82
Exercised in the year .....	(1,596)	7.16	(2,098)	6.96
Transferred in the year .....	2,059	7.78	1,141	7.72
Forfeited in the year .....	(108)	8.15	–	–
Expired in the year .....	(2,354)	8.09	(2,173)	7.97
Outstanding at 31 December .....	<b>40,223</b>	<b>7.87</b>	42,222	7.86

The weighted average share price at the date the share options were exercised was £7.87 (2007: £7.86). No share options were awarded by the group for the Group Share Option Plan in 2008 (2007: nil). The number of options, weighted average exercise price, and the weighted average remaining contractual life for options outstanding at the balance sheet date, analysed by exercise price range, were as follows:

#### *The group*

	<b>2008</b>		2007	
	£6.00-£8.00	£8.01-£10.00	£6.00-£8.00	£8.01-£10.00
Exercise price range (£) .....				
Number (000's) .....	12,611	27,612	13,573	28,649
Weighted average exercise price (£) .....	6.91	8.30	6.91	8.30
Weighted average remaining contractual life (years) .....	–	–	–	0.06
Of which exercisable:				
– number (000's) .....	12,611	27,612	13,573	23,383
– weighted average exercise price (£) .....	6.91	8.30	6.91	7.78

## Notes on the Financial Statements (continued)

### The bank

	2008		2007	
	£6.00-£8.00	£8.01-£10.00	£6.00-£8.00	£8.01-£10.00
Exercise price range (£) .....				
Number (000's) .....	6,169	13,165	7,029	14,241
Weighted average exercise price (£) .....	6.91	8.29	6.91	8.29
Weighted average remaining contractual life (years) .....	-	-	-	0.002
Of which exercisable:				
- number (000's) .....	6,169	13,165	7,029	14,143
- weighted average exercise price (£) .....	6.91	8.29	6.91	8.28

### HSBC France and subsidiary company plans

Before its acquisition by the group in 2000, HSBC France and certain of its subsidiaries operated employee share plans under which share options were granted over their respective shares.

Options over HSBC France shares granted between 1994 and 1999 vested upon announcement of the group's agreement to acquire HSBC France and were therefore included in the valuation of HSBC France.

HSBC France granted 909,000 options in 2000 after the public announcement of the acquisition and these options did not vest as a result of the change in control. The options were subject to continued employment and vested on 1 January 2002. The HSBC France shares obtained on exercise of the options are exchangeable for HSBC's ordinary shares of US\$0.50 each in the same ratio as the Exchange Offer for HSBC France shares (13 ordinary shares of US\$0.50 for each HSBC France share). Options are granted at market value and are exercisable within 10 years of the date of grant.

	2008		2007	
	Number (000's)	Exercise price €	Number (000's)	Exercise price €
Outstanding at 1 January .....	604	142.50	646	142.50
Exercised in the year .....	-	142.50	(42)	142.50
Outstanding and exercisable at 31 December .....	604	142.50	604	142.50

The weighted average remaining contractual life for options outstanding at 31 December 2008 was 1.3 years (2007: 2.3 years).

In 2007, the weighted average share price at the date the share options were exercised was £9.03.

At the date of its acquisition in 2000, certain of HSBC France's subsidiary companies also operated employee share option plans under which options could be granted over their respective shares. On exercise of certain of these options, the subsidiary shares are exchanged for HSBC ordinary shares. The total number of HSBC Holdings ordinary shares exchanged under such arrangements in 2008 was 12,810 (2007: 113,240).

### 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

	2008		2007	
	Number (000's)	Weighted average exercise price £	Number (000's)	Weighted average exercise price £
Outstanding at 1 January .....	34,411	8.20	35,798	8.17
Exercised in the year .....	(2,281)	6.92	(3,695)	7.87
Transferred in the year .....	368	8.51	2,552	8.22
Expired in the year .....	(1,556)	8.20	(244)	7.81
Outstanding at 31 December <sup>1,2</sup> .....	30,942	8.30	34,411	8.20

1 The above includes the bank employee awards of 20,236,879 options outstanding at 1 January 2008 (2007: 21,402,021), and 17,857,524 options outstanding at 31 December 2008 (2007: 20,236,879).

2 The weighted average exercise price for bank employees was £8.02 at 1 January 2008 (2007: £7.97) and £8.17 at 31 December 2008 (2007: £8.02).

The number of options, weighted average exercise price, and the weighted average remaining contractual life for options outstanding at the balance sheet date, analysed by exercise price range, were as follows:

*The group*

	2008		2007	
	£6.38-£7.46	£7.47-£9.54	£6.38-£7.46	£7.47-£9.54
Exercise price range (£) .....				
Number (000's) .....	4,801	26,142	7,121	27,290
Weighted average exercise price (£) .....	6.92	8.56	6.85	8.56
Weighted average remaining contractual life (years) .....	-	-	-	-
Of which exercisable:				
- number (000's) .....	4,801	26,142	7,121	27,290
- weighted average exercise price (£) .....	6.92	8.56	6.85	8.56

*The bank*

	2008		2007	
	£6.38-£7.46	£7.47-£9.54	£6.38-£7.46	£7.47-£9.54
Exercise price range (£) .....				
Number (000's) .....	4,240	13,618	6,281	13,956
Weighted average exercise price (£) .....	6.92	8.56	6.82	8.56
Weighted average remaining contractual life (years) .....	-	-	-	-
Of which exercisable:				
- number (000's) .....	4,240	13,618	6,281	13,956
- weighted average exercise price (£) .....	6.92	8.56	6.82	8.56

**Savings-Related Share Option Plan**

	2008		2007	
	Number (000's)	Weighted average exercise price £	Number (000's)	Weighted average exercise price £
Outstanding at 1 January .....	103	6.32	3,650	6.33
Exercised in the year .....	(85)	6.32	(3,465)	6.33
Transferred in the year .....	2	6.59	(24)	6.29
Expired in the year .....	(20)	6.32	(58)	6.46
Outstanding at 31 December <sup>1,2</sup> .....	-	-	103	6.32

1 The above table includes the bank employee options of 98,706 outstanding at 1 January 2008 (2007:3,500,932) and nil options outstanding at 31 December 2008 (2007:98,706).

2 The weighted average exercise price for bank employees was £6.32 at 1 January 2008 (2007: £6.33) and nil at 31 December 2008 (2007: £6.32).

The number of options, weighted average exercise price, and the weighted average remaining contractual life for options outstanding at the balance sheet date, analysed by exercise price range, were as follows:

*The group*

	2008	2007
Exercise price range (£).....	-	£6.04-£6.75
Number (000's) .....	-	103
Weighted average exercise price (£) .....	-	6.32
Weighted average remaining contractual life (years) .....	-	-
Of which exercisable:		
- number (000's) .....	-	103
- weighted average exercise price (£) .....	-	6.32

## Notes on the Financial Statements (continued)

*The bank*

	2008	2007
Exercise price range (£)	–	£6.04-£6.75
Number (000's) .....	–	99
Weighted average exercise price (£) .....	–	6.32
Weighted average remaining contractual life (years) .....	–	–
Of which exercisable:		
– number (000's) .....	–	99
– weighted average exercise price (£) .....	–	6.32

**10 Tax expense**

	2008	2007
	£m	£m
<b>Current taxation</b>		
UK corporation tax charge – on current year profit .....	592	661
UK corporation tax charge – adjustments in respect of prior years .....	(22)	7
Overseas tax – on current year profit .....	298	331
Overseas tax – adjustment in respect of prior years .....	1	26
	<u>869</u>	<u>1,025</u>
<b>Deferred taxation</b>		
Origination and reversal of temporary differences .....	(16)	(220)
Effect of changes in the tax rates .....	–	(20)
Adjustment in respect of prior years .....	(10)	(18)
	<u>(26)</u>	<u>(258)</u>
Tax expense .....	<u>843</u>	<u>767</u>

The UK corporation tax rate applying to HSBC Bank plc and its subsidiaries changed from 30 per cent to 28 per cent with effect from 1 April 2008 (2007: 30 per cent). Other overseas subsidiaries and overseas branches provided for taxation at the appropriate rates in the countries in which they operate. The 2007 Finance Act reduction in the UK corporation tax rate from 30 per cent to 28 per cent, and the reduction of the German Federal tax rate, both enacted in 2007 but commencing in 2008, resulted in a one off re-measurement of deferred tax assets and liabilities. It gave rise to a credit to the group's tax charge of £20 million for 2007.

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

	2008		2007	
	£m	Percentage of overall tax charge %	£m	Percentage of overall tax charge %
<b>Analysis of overall tax charge</b>				
Taxation at UK corporate tax rate of 28.5% (2007: 30%) <sup>1</sup> .....	1,244	28.5	1,219	30.0
Effect of taxing overseas profit in principal locations at different rates .....	(51)	(1.2)	(61)	(1.5)
Tax-free gains .....	(333)	(7.6)	(253)	(6.2)
Effect of profits in associates and joint ventures .....	(2)	0.0	(12)	(0.3)
Effect of previously unrecognised temporary differences .....	(27)	(0.6)	(53)	(1.3)
Release of deferred tax consequent on restructuring of group interest .....	–	–	(180)	(4.4)
Adjustments in respect of prior period liabilities .....	(31)	(0.7)	15	0.4
Other items .....	43	0.9	92	2.2
Overall tax expense .....	<u>843</u>	<u>19.3</u>	<u>767</u>	<u>18.9</u>

<sup>1</sup> The change in the UK corporation tax rate from 30 per cent to 28 per cent with effect from 1 April 2008 gave rise to a blended tax rate for 2008 of 28.5 per cent.

In addition to the amount charged to the income statement, the aggregate amount of current and deferred taxation relating to items that are taken directly to equity was a £438 million increase in equity (2007: £311 million reduction in equity).

#### Movement in deferred taxation during the year

	The group		The bank	
	2008 £m	2007 £m	2008 £m	2007 £m
At 1 January .....	(252)	(113)	513	840
Income statement credit/(charge) .....	26	258	(223)	52
Equity:				
– available-for-sale investments .....	121	49	2	3
– cash flow hedges .....	(151)	10	(153)	(8)
– share-based payments .....	5	(19)	5	(18)
– actuarial gains and losses .....	26	(364)	(9)	(357)
Disposal of subsidiary .....	(44)	–	–	–
Loss of future deduction on restructuring of a partnership interest .....	(52)	–	–	–
Foreign exchange and other adjustments .....	(9)	(73)	1	1
At 31 December .....	<b>(330)</b>	<b>(252)</b>	<b>136</b>	<b>513</b>

The amount of deferred taxation accounted for in the balance sheet, before netting off balances within countries, comprised the following deferred tax assets and liabilities:

	The group		The bank	
	2008 £m	2007 £m	2008 £m	2007 £m
Deferred tax assets				
Retirement benefits .....	21	35	135	262
Loan impairment allowances .....	3	8	56	63
Unused tax losses .....	–	1	–	43
Accelerated capital allowances .....	–	–	(37)	(50)
Available-for-sale investments .....	85	(22)	(2)	(31)
Cash flow hedges .....	1	37	(160)	(7)
Share-based payments .....	–	8	24	43
Other temporary differences .....	3	(17)	122	192
	<b>113</b>	<b>50</b>	<b>138</b>	<b>515</b>
Deferred tax liabilities				
Assets leased to customers .....	(499)	(577)	–	–
Revaluation of property .....	(71)	(36)	–	–
Accelerated capital allowances .....	(35)	(49)	–	–
Other temporary differences .....	246	397	(2)	(2)
Provision for tax on profit remitted from overseas .....	–	–	–	–
Available-for-sale investments .....	15	(35)	–	–
Cash flow hedges .....	(99)	(2)	–	–
	<b>(443)</b>	<b>(302)</b>	<b>(2)</b>	<b>(2)</b>
Net deferred tax asset/(liability) .....	<b>(330)</b>	<b>(252)</b>	<b>136</b>	<b>513</b>

For the group, the amount of temporary differences for which no deferred tax asset is recognised in the balance sheet is £61 million (2007: £53 million). This amount is in respect of unrealised capital losses where the recoverability of potential benefits is not considered likely.

For the bank, the amount of temporary differences for which no deferred tax asset is recognised in the balance sheet is £55 million (2007: £46 million). This amount is in respect of unrealised capital losses where the recoverability of potential benefits is not considered likely.

## 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	
	2008 £m	2007 £m	2008 £m	2007 £m
Deferred tax assets .....	113	50	138	515
Deferred tax liabilities .....	(443)	(302)	(2)	(2)
	<b>(330)</b>	<b>(252)</b>	<b>136</b>	<b>513</b>

Deferred tax is not recognised in respect of the group's investments in subsidiaries, branches, associates and interests in joint ventures where remittance is not contemplated or where no additional tax is expected to arise. The aggregate amount of temporary differences associated with such investments is £7,477 million (2007: £3,486 million).

### 11 Dividends

Dividends to the shareholders of the parent company were as follows:

	2008		2007	
	£ per share	Total £m	£ per share	Total £m
<b>Dividends declared on ordinary shares</b>				
Second interim dividend in respect of previous year .....	1.25	1,000	1.05	840
First interim dividend in respect of current year .....	1.04	825	1.03	825
Second interim dividend in respect of current year .....	1.30	1,037	–	–
	<b>3.59</b>	<b>2,862</b>	<b>2.08</b>	<b>1,665</b>
	2008		2007	
	£ per share	Total £m	£ per share	Total £m
<b>Dividends on preference shares classified as equity</b>				
Dividend on HSBC Bank plc non-cumulative third dollar preference shares .....	1.17	41	0.91	32
	<b>1.17</b>	<b>41</b>	<b>0.91</b>	<b>32</b>
	2008		2007	
	£m	£m	£m	£m
<b>Interest on capital securities classified as equity</b>				
Interest in respect of the first quarter of the year .....	18	-	18	-
Interest in respect of the second quarter of the year .....	18	-	17	-
Interest in respect of the third quarter of the year .....	17	-	18	9
Interest in respect of the fourth quarter of the year .....	18	9	71	9
			<b>71</b>	<b>9</b>

## 12 Segment analysis

The primary segment reporting format is determined to be by geographical regions.

### By geographical region

Geographical information has been classified by the location of the principal operations of the subsidiary undertaking or, in the case of the bank, by the location of the branch responsible for reporting the results or for advancing the funds.

2008	United Kingdom £m	Continental Europe £m	Rest of the world £m	Intra-group £m	Total £m
Net interest income .....	3,725	1,482	190	300	5,697
Net fee income .....	2,499	1,365	93	–	3,957
Net trading income .....	1,877	1,274	105	(289)	2,967
Net income from financial instruments designated at fair value .....	(238)	(848)	–	(11)	(1,097)
Gains less losses from financial investments .....	85	(3)	–	–	82
Dividend income .....	61	24	–	–	85
Net earned insurance premiums .....	1,223	1,668	–	–	2,891
Other operating income .....	1,026	573	2	(8)	1,593
Total operating income .....	10,258	5,535	390	(8)	16,175
Share of profits/losses in associates and joint ventures .....	9	–	–	–	9
Profit before tax .....	2,552	1,631	183	–	4,366
Profit attributable to shareholders .....	1,899	1,386	156	–	3,441
Depreciation and impairment of property, plant and equipment .....	(351)	(113)	(2)	–	(466)
Amortisation and impairment of intangible assets and impairment of goodwill .....	(87)	(22)	–	–	(109)
Loan impairment charges and other credit risk provisions .....	(1,542)	(310)	(9)	–	(1,861)
Cost to acquire property, plant and equipment .....	(584)	(195)	(3)	–	(782)
Cost to acquire intangible assets .....	(137)	(39)	–	–	(176)
Total assets .....	613,600	348,150	24,255	(61,774)	924,231
Total liabilities .....	608,273	333,205	23,866	(61,774)	903,570

## Notes on the Financial Statements (continued)

	United Kingdom £m	Continental Europe £m	Rest of the world £m	Intra-group £m	Total £m
2007					
Net interest income .....	2,275	1,188	88	303	3,854
Net fee income .....	2,723	1,355	106	–	4,184
Net trading income .....	2,525	1,080	185	(303)	3,487
Net income from financial instruments					
designated at fair value .....	93	33	–	–	126
Gains less losses from financial investments .....	364	188	–	–	552
Dividend income .....	19	23	1	–	43
Net earned insurance premiums .....	693	1,228	–	–	1,921
Other operating income .....	191	106	15	(5)	307
Total operating income .....	8,883	5,201	395	(5)	14,474
Share of profits/losses in associates and joint ventures .....	(1)	49	(1)	–	47
Profit before tax .....	2,513	1,313	237	–	4,063
Profit attributable to shareholders .....	2,054	963	192	–	3,209
Depreciation and impairment of property, plant and equipment .....	(338)	(84)	–	–	(422)
Amortisation and impairment of intangible assets and impairment of goodwill .....	(122)	(19)	(1)	–	(142)
Loan impairment charges .....	(953)	(91)	1	–	(1,043)
Cost to acquire property, plant and equipment .....	(371)	(203)	(4)	–	(578)
Cost to acquire intangible assets .....	(97)	(25)	–	–	(122)
Total assets .....	440,411	218,927	14,333	(51,391)	622,280
Total liabilities .....	430,604	203,830	14,238	(51,391)	597,281

## By class of business

The group's operations include a number of support services and head office functions. The costs of these functions are allocated to business lines, where it is appropriate, on a systematic and consistent basis.

	2008 £m	2007 £m
<b>Net operating income before loan impairment charges</b>		
UK Personal Financial Services .....	3,859	3,745
UK Commercial Banking .....	2,581	2,207
UK Global Banking and Markets .....	1,561	2,065
UK Other .....	196	106
International Banking .....	1,424	1,104
France .....	2,847	1,910
Private Banking .....	1,448	1,299
HSBC Trinkaus & Burkhardt .....	424	364
	<b>14,340</b>	<b>12,800</b>



	2008	2007 (restated)
	£m	£m
<b>Profit/(loss) on ordinary activities before tax</b>		
UK Personal Financial Services .....	918	740
UK Commercial Banking .....	1,221	1,004
UK Global Banking and Markets .....	(188)	468
UK Other .....	227	137
International Banking .....	165	397
France .....	1,297	526
Private Banking .....	627	643
HSBC Trinkaus & Burkhardt .....	99	148
	<b>4,366</b>	<b>4,063</b>
<b>Total assets</b>		
UK Personal Financial Services .....	77,940	69,837
UK Commercial Banking .....	48,152	44,905
UK Global Banking and Markets .....	422,278	273,791
UK Other .....	–	–
International Banking .....	32,948	22,190
France .....	271,464	156,533
Private Banking .....	53,905	40,900
HSBC Trinkaus & Burkhardt .....	17,544	14,124
	<b>924,231</b>	<b>622,280</b>
<b>Cost to acquire property, plant and equipment</b>		
UK Personal Financial Services .....	205	165
UK Commercial Banking .....	95	77
UK Global Banking and Markets .....	284	130
UK Other .....	–	–
International Banking .....	98	62
France .....	72	42
Private Banking .....	19	13
HSBC Trinkaus & Burkhardt .....	9	89
	<b>782</b>	<b>578</b>
<b>Cost to acquire intangible assets</b>		
UK Personal Financial Services .....	84	51
UK Commercial Banking .....	34	26
UK Global Banking and Markets .....	31	25
UK Other .....	–	–
International Banking .....	4	4
France .....	14	12
Private Banking .....	–	–
HSBC Trinkaus & Burkhardt .....	9	4
	<b>176</b>	<b>122</b>

### 13 Analysis of financial assets and liabilities by measurement basis

The following table analyses the carrying amount of financial assets and liabilities by category as defined in IAS 39 and by balance sheet heading:

## Notes on the Financial Statements (continued)

## The group

		At 31 December 2008									
		£m	£m	£m	£m	£m	£m	£m	£m	£m	£m
Held for trading	Designated at fair value	Held-to-maturity securities	Loans and receivables	Available-for-sale securities	Financial assets and liabilities at amortised cost	Derivatives designated as fair value hedging instruments	Derivatives designated as cash flow hedging instruments	Total			
£m	£m	£m	£m	£m	£m	£m	£m	£m			
<b>Financial assets</b>											
Cash and balances at central banks	-	-	-	-	9,470	-	-	9,470	-	-	9,470
Items in the course of collection from other banks	-	-	-	-	1,917	-	-	1,917	-	-	1,917
Trading assets	172,026	-	-	-	-	-	-	-	-	-	172,026
Financial assets designated at fair value	-	13,895	-	-	-	-	-	-	-	-	13,895
Derivatives	241,132	-	-	-	-	87	1,865	243,084	-	-	243,084
Loans and advances to banks	-	-	50,719	-	-	-	-	50,719	-	-	50,719
Loans and advances to customers	-	-	298,304	-	-	-	-	298,304	-	-	298,304
Financial investments	-	25	-	103,486	-	-	-	103,511	-	-	103,511
Other assets	-	-	7	-	7,328	-	-	7,335	-	-	7,335
Accrued income	-	-	-	-	5,279	-	-	5,279	-	-	5,279
Total financial assets	413,158	13,895	25	349,030	23,994	87	1,865	905,540	-	-	905,540
Total non-financial assets	-	-	-	103,486	-	-	-	18,691	-	-	18,691
Total assets	-	-	-	-	-	-	-	924,231	-	-	924,231
<b>Financial liabilities</b>											
Deposits by banks	-	-	-	-	61,431	-	-	61,431	-	-	61,431
Customer accounts	-	-	-	-	369,880	-	-	369,880	-	-	369,880
Items in the course of transmission to other banks	-	-	-	-	1,802	-	-	1,802	-	-	1,802
Trading liabilities	124,450	-	-	-	-	-	-	124,450	-	-	124,450
Financial liabilities designated at fair value	-	15,184	-	-	-	-	-	15,184	-	-	15,184
Derivatives	239,394	-	-	-	-	432	1,205	241,031	-	-	241,031
Debt securities in issue	-	-	-	-	52,308	-	-	52,308	-	-	52,308
Other liabilities	-	-	-	-	6,565	-	-	6,565	-	-	6,565
Accruals	-	-	-	-	4,930	-	-	4,930	-	-	4,930
Subordinated liabilities	-	-	-	-	7,259	-	-	7,259	-	-	7,259
Total financial liabilities	363,844	15,184	-	-	504,175	432	1,205	884,840	-	-	884,840
Total non-financial liabilities	-	-	-	-	-	-	-	18,730	-	-	18,730
Total liabilities	-	-	-	-	-	-	-	903,570	-	-	903,570

## The group

At 31 December 2007

	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
<b>Financial assets</b>									
Cash and balances at central banks	-	-	-	-	-	7,146	-	-	7,146
Items in the course of collection from other banks	-	-	-	-	-	2,434	-	-	2,434
Trading assets	153,206	-	-	-	-	-	-	-	153,206
Financial assets designated at fair value	-	14,969	-	-	-	-	-	-	14,969
Derivatives	60,103	-	-	-	-	-	367	-	60,470
Loans and advances to banks	-	-	-	60,764	-	-	-	-	60,764
Loans and advances to customers	-	-	-	227,687	-	-	-	-	227,687
Financial investments	-	-	38	-	69,490	-	-	-	69,528
Other assets	-	-	-	-	-	4,385	-	-	4,385
Accrued income	-	-	-	-	-	5,647	-	-	5,647
<b>Total financial assets</b>	<b>213,309</b>	<b>14,969</b>	<b>38</b>	<b>288,451</b>	<b>69,490</b>	<b>19,612</b>	<b>-</b>	<b>367</b>	<b>606,236</b>
<b>Total non-financial assets</b>									<b>16,044</b>
<b>Total assets</b>									<b>622,280</b>
<b>Financial liabilities</b>									
Deposits by banks	-	-	-	-	-	48,786	-	-	48,786
Customer accounts	-	-	-	-	-	268,269	-	-	268,269
Items in the course of transmission to other banks	-	-	-	-	-	1,975	-	-	1,975
Trading liabilities	117,454	-	-	-	-	-	-	-	117,454
Financial liabilities designated at fair value	-	15,659	-	-	-	-	-	-	15,659
Derivatives	60,908	-	-	-	-	-	138	493	61,539
Debt securities in issue	-	-	-	-	-	50,921	-	-	50,921
Other liabilities	-	-	-	-	-	6,332	-	-	6,332
Accruals	-	-	-	-	-	5,726	-	-	5,726
Subordinated liabilities	-	-	-	-	-	5,205	-	-	5,205
<b>Total financial liabilities</b>	<b>178,362</b>	<b>15,659</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>387,214</b>	<b>138</b>	<b>493</b>	<b>581,866</b>
<b>Total non-financial liabilities</b>									<b>15,415</b>
<b>Total liabilities</b>									<b>597,281</b>

## Notes on the Financial Statements (continued)

## The bank

		At 31 December 2008									
		Held for trading	Designated at fair value	Held-to-maturity securities	Loans and receivables	Available-for-sale securities	Financial assets and liabilities at amortised cost	Derivatives designated as fair value hedging instruments	Derivatives designated as cash flow hedging instruments	Total	
		£m	£m	£m	£m	£m	£m	£m	£m	£m	£m
<b>Financial assets</b>											
	Cash and balances at central banks	-	-	-	-	-	6,779	-	-	-	6,779
	Items in the course of collection from other banks	-	-	-	-	-	692	-	-	-	692
	Trading assets	130,205	-	-	-	-	-	-	-	-	130,205
	Financial assets designated at fair value	-	4,592	-	-	-	-	-	-	-	4,592
	Derivatives	195,758	-	-	-	-	-	-	1,370	-	197,128
	Loans and advances to banks	-	-	-	18,295	-	-	-	-	-	18,295
	Loans and advances to customers	-	-	-	217,309	-	-	-	-	-	217,309
	Financial investments	-	-	-	-	46,608	-	-	-	-	46,608
	Accrued income	-	-	-	-	-	3,159	-	-	-	3,159
	Other assets	-	-	-	-	-	2,541	-	-	-	2,541
	Total financial assets	325,963	4,592	-	235,604	46,608	13,171	-	1,370	-	627,308
	Total non-financial assets	-	-	-	-	-	-	-	-	-	18,473
	Total assets	-	-	-	-	-	-	-	-	-	645,781
<b>Financial liabilities</b>											
	Deposits by banks	-	-	-	-	-	54,986	-	-	-	54,986
	Customer accounts	-	-	-	-	-	240,397	-	-	-	240,397
	Items in the course of transmission to other banks	-	-	-	-	-	772	-	-	-	772
	Trading liabilities	98,389	-	-	-	-	-	-	-	-	98,389
	Financial liabilities designated at fair value	-	9,429	-	-	-	-	-	-	-	9,429
	Derivatives	196,549	-	-	-	-	-	93	605	-	197,247
	Debt securities in issue	-	-	-	-	-	8,670	-	-	-	8,670
	Other liabilities	-	-	-	-	-	3,163	-	-	-	3,163
	Accruals	-	-	-	-	-	2,434	-	-	-	2,434
	Subordinated liabilities	-	-	-	-	-	7,310	-	-	-	7,310
	Total financial liabilities	294,938	9,429	-	-	-	317,732	93	605	-	622,797
	Total non-financial liabilities	-	-	-	-	-	-	-	-	-	729
	Total liabilities	-	-	-	-	-	-	-	-	-	623,526

## The bank

At 31 December 2007

	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
<b>Financial assets</b>									
Cash and balances at central banks	-	-	-	-	-	3,677	-	-	3,677
Items in the course of collection from other banks	-	-	-	-	-	1,377	-	-	1,377
Trading assets	149,102	-	-	-	-	-	-	-	149,102
Financial assets designated at fair value	-	3,439	-	-	-	-	-	-	3,439
Derivatives	46,093	-	-	-	-	-	232	-	46,325
Loans and advances to banks	-	-	-	32,028	-	-	-	-	32,028
Loans and advances to customers	-	-	-	150,649	-	-	-	-	150,649
Financial investments	-	-	-	-	13,821	-	-	-	13,821
Other assets	-	-	-	-	-	3,477	-	-	3,477
Accrued income	-	-	-	-	-	1,372	-	-	1,372
<b>Total financial assets</b>	<b>195,195</b>	<b>3,439</b>	<b>-</b>	<b>182,677</b>	<b>13,821</b>	<b>9,903</b>	<b>-</b>	<b>232</b>	<b>405,267</b>
<b>Total non-financial assets</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>18,762</b>
<b>Total assets</b>	<b>195,195</b>	<b>3,439</b>	<b>-</b>	<b>182,677</b>	<b>13,821</b>	<b>9,903</b>	<b>-</b>	<b>232</b>	<b>424,029</b>
<b>Financial liabilities</b>									
Deposits by banks	-	-	-	-	-	41,061	-	-	41,061
Customer accounts	-	-	-	-	-	184,899	-	-	184,899
Items in the course of transmission to other banks	-	-	-	-	-	1,056	-	-	1,056
Trading liabilities	99,755	-	-	-	-	-	-	-	99,755
Financial liabilities designated at fair value	-	8,082	-	-	-	-	-	-	8,082
Derivatives	47,339	-	-	-	-	-	197	-	47,536
Debt securities in issue	-	-	-	-	-	8,117	-	-	8,117
Other liabilities	-	-	-	-	-	2,767	-	-	2,767
Accruals	-	-	-	-	-	3,745	-	-	3,745
Subordinated liabilities	-	-	-	-	-	4,744	-	-	4,744
<b>Total financial liabilities</b>	<b>147,094</b>	<b>8,082</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>246,389</b>	<b>-</b>	<b>197</b>	<b>401,762</b>
<b>Total non-financial liabilities</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>1,490</b>
<b>Total liabilities</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>403,252</b>

## Notes on the Financial Statements (continued)

### 14 Reclassification of financial assets

In October 2008, the IASB issued amendments to IAS 39 'Financial Instruments: Recognition and Measurement' and IFRS 7 'Financial Instruments: Disclosures' which permits an entity to reclassify non-derivative financial assets out of the held-for-trading category, as described in Note 2(e) on the financial statements.

During the second half of 2008, the group and the bank reclassified the following financial assets from the held-for-trading category:

	On reclassification			At 31 December 2008	
	Amount reclassified <sup>1</sup> £m	Estimate of future cash flows <sup>2</sup> £m	Effective interest rate %	Carrying amount £m	Fair value £m
<b>Reclassification to loans and receivables</b>					
Asset-backed securities .....	3,521	6,121	8	4,292	3,207
Trading loans – commercial mortgage loans .....	344	508	5	403	383
Leveraged finance loans .....	2,086	3,685	7	2,432	1,877
	<b>5,951</b>	<b>10,314</b>		<b>7,127</b>	<b>5,467</b>
<b>Reclassification to available-for-sale</b>					
Corporate debt and other securities .....	1,596	2,394	6	1,592	1,592
	<b>7,547</b>	<b>12,708</b>		<b>8,719</b>	<b>7,059</b>

1 Amounts reclassified have been translated using the rate of exchange at the date of the reclassification; all other amounts denominated in foreign currencies have been translated into the functional currency at the rate of exchange ruling at the balance sheet date.

2 The estimate of future cash flows represents the cash flows expected to be recovered at the date of reclassification.

The amount reclassified is based on the fair value of the financial assets at the date of reclassification. 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.

The reclassifications were made as a result of significant reductions 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 amendments 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 pre-tax profit would have reduced by £1,793 million from £4,366 million to £2,573 million. The reduction in group profit would have been entirely in the UK Global Banking & Markets segment.

The following table shows the fair value gains and losses, income and expense recognised in the income statement both before and after the date of reclassification.

	Impact on income statement			
	Prior to reclassification		After reclassification	Assuming no reclassification
	2008	2007	2008	2008
	£m	£m	£m	£m
<b>Reclassification to loans and receivables</b>				
Asset-backed securities .....	(451)	(134)	167	(918)
Trading loans – commercial mortgage loans .....	(8)	-	11	(9)
Leveraged finance .....	(106)	(52)	77	(478)
	<b>(565)</b>	<b>(186)</b>	<b>255</b>	<b>(1,405)</b>
<b>Reclassification to available-for-sale</b>				
Corporate debt and other securities .....	(53)	(1)	13	(120)
	<b>(618)</b>	<b>(187)</b>	<b>268</b>	<b>(1,525)</b>

1 Income and expense recorded in the income statement after reclassification represents the accrual of the effective interest rate and also includes £18 million in respect of impairment of leveraged finance loans. The group recorded no impairment charges on other financial assets reclassified during the second half of 2008.

## 15 Trading assets

	The group		The bank	
	2008	2007	2008	2007
	£m	£m	£m	£m
Trading assets:				
– which may be repledged or resold by counterparties	50,364	57,912	16,903	37,040
– not subject to repledge or resale by counterparties ...	121,662	95,294	113,302	112,062
	<b>172,026</b>	<b>153,206</b>	<b>130,205</b>	<b>149,102</b>
Treasury and other eligible bills .....	21	445	7	437
Debt securities .....	77,241	58,741	32,132	37,902
Equity securities .....	13,126	22,419	11,050	13,095
Loans and advances to banks .....	37,898	37,020	45,299	59,451
Loans and advances to customers .....	43,740	34,581	41,717	38,217
	<b>172,026</b>	<b>153,206</b>	<b>130,205</b>	<b>149,102</b>

Included within the above figures for the group are debt securities issued by banks and other financial institutions of £24,371 million (2007: £27,947 million), of which £831 million (2007: £399 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 £14,140 million (2007: £22,535 million), of which £37 million (2007: £nil) are guaranteed by various governments.

## Notes on the Financial Statements (continued)

### 16 Financial assets designated at fair value through profit or loss

	The group		The bank	
	2008 £m	2007 £m	2008 £m	2007 £m
Financial assets designated at fair value:				
– not subject to repledge or resale by counterparties ...	<b>13,895</b>	14,969	<b>4,592</b>	3,439
Treasury and other eligible bills .....	43	25	–	–
Debt securities .....	7,380	7,822	4,514	3,439
Equity securities .....	5,822	7,033	–	–
Loans and advances to banks .....	153	89	78	–
Loans and advances to customers .....	497	–	–	–
	<b>13,895</b>	14,969	<b>4,592</b>	3,439

### 17 Derivatives

#### Fair values of derivatives by product contract type held

##### The group

	At 31 December 2008					
	Assets			Liabilities		
	Trading £m	Hedging £m	Total £m	Trading £m	Hedging £m	Total £m
Foreign exchange.....	59,121	11	59,132	(59,891)	(10)	(59,901)
Interest rate .....	140,158	1,941	142,099	(138,094)	(1,627)	(139,721)
Equities .....	11,260	–	11,260	(12,383)	–	(12,383)
Credit derivatives .....	29,972	–	29,972	(28,331)	–	(28,331)
Commodity and other .....	621	–	621	(695)	–	(695)
Total fair values .....	<b>241,132</b>	<b>1,952</b>	<b>243,084</b>	<b>(239,394)</b>	<b>(1,637)</b>	<b>(241,031)</b>

	At 31 December 2007					
	Assets			Liabilities		
	Trading £m	Hedging £m	Total £m	Trading £m	Hedging £m	Total £m
Foreign exchange.....	17,279	–	17,279	(17,757)	(30)	(17,787)
Interest rate .....	31,397	367	31,764	(31,393)	(601)	(31,994)
Equities .....	7,014	–	7,014	(6,719)	–	(6,719)
Credit derivatives .....	3,629	–	3,629	(4,294)	–	(4,294)
Commodity and other .....	784	–	784	(745)	–	(745)
Total fair values .....	<b>60,103</b>	<b>367</b>	<b>60,470</b>	<b>(60,908)</b>	<b>(631)</b>	<b>(61,539)</b>

##### The bank

	At 31 December 2008					
	Assets			Liabilities		
	Trading £m	Hedging £m	Total £m	Trading £m	Hedging £m	Total £m
Foreign exchange.....	58,265	–	58,265	(59,163)	–	(59,163)
Interest rate .....	105,828	1,370	107,198	(104,887)	(698)	(105,585)
Equities .....	1,134	–	1,134	(3,575)	–	(3,575)
Credit derivatives .....	29,667	–	29,667	(27,988)	–	(27,988)
Commodity and other .....	864	–	864	(936)	–	(936)
Total fair values .....	<b>195,758</b>	<b>1,370</b>	<b>197,128</b>	<b>(196,549)</b>	<b>(698)</b>	<b>(197,247)</b>



	At 31 December 2007					
	Assets			Liabilities		
	Trading £m	Hedging £m	Total £m	Trading £m	Hedging £m	Total £m
Foreign exchange.....	17,428	–	17,428	(17,493)	–	(17,493)
Interest rate .....	22,240	232	22,472	(23,005)	(197)	(23,202)
Equities .....	2,036	–	2,036	(1,825)	–	(1,825)
Credit derivatives .....	3,607	–	3,607	(4,276)	–	(4,276)
Commodity and other .....	782	–	782	(740)	–	(740)
Total fair values .....	<b>46,093</b>	<b>232</b>	<b>46,325</b>	<b>(47,339)</b>	<b>(197)</b>	<b>(47,536)</b>

## Use of derivatives

The group transacts derivatives for three primary purposes: to create risk management solutions for clients, for proprietary trading purposes, 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.

### *Notional contract amounts of derivatives held for trading purposes by product type*

	At 31 December			
	The group		The bank	
	2008 £m	2007 £m	2008 £m	2007 £m
Foreign exchange.....	<b>1,490,980</b>	1,027,254	<b>1,366,091</b>	996,917
Interest rate .....	<b>6,971,748</b>	4,089,512	<b>4,860,786</b>	2,815,793
Equity .....	<b>133,737</b>	119,493	<b>23,059</b>	31,186
Credit .....	<b>655,423</b>	485,976	<b>659,262</b>	482,397
Commodity .....	<b>28,937</b>	13,837	<b>28,550</b>	15,283
Total derivatives .....	<b>9,280,825</b>	<b>5,736,072</b>	<b>6,937,748</b>	<b>4,341,576</b>

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	
	2008 £m	2007 £m	2008 £m	2007 £m
Unamortised balance at 1 January .....	90	84	59	66
Deferral on new transactions .....	123	102	37	46
Recognised in the income statement during the period:				
– amortisation .....	(46)	(26)	(16)	(9)
– subsequent to unobservable inputs becoming observable .....	(47)	(33)	(7)	(26)
– maturity or termination, or offsetting derivative .....	(32)	(37)	(19)	(18)
Exchange differences .....	11	–	1	–
Risk hedged .....	(1)	–	(1)	–
Unamortised balance at 31 December <sup>1</sup> .....	<b>98</b>	<b>90</b>	<b>54</b>	<b>59</b>

<sup>1</sup> 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.

### Notional contract amounts of derivatives held for hedging purposes by product type

	The group			
	At 31 December 2008		At 31 December 2007	
	Cash flow hedge £m	Fair value hedge £m	Cash flow hedge £m	Fair value hedge £m
	Exchange rate contracts .....	197	585	93
Interest rate contracts .....	92,661	6,478	69,323	9,065
Equity contracts .....	–	–	–	12

	The bank			
	At 31 December 2008		At 31 December 2007	
	Cash flow hedge £m	Fair value hedge £m	Cash flow hedge £m	Fair value hedge £m
	Interest rate contracts .....	43,810	943	21,001

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.

### 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.

#### The group

	At 31 December 2008		At 31 December 2007	
	Assets £m	Liabilities £m	Assets £m	Liabilities £m
Foreign exchange .....	–	(9)	–	–
Interest rate .....	87	(423)	–	(138)
	<b>87</b>	<b>(432)</b>	<b>–</b>	<b>(138)</b>

*The bank*

	At 31 December 2008		At 31 December 2007	
	Assets £m	Liabilities £m	Assets £m	Liabilities £m
Foreign exchange.....	-	-	-	-
Interest rate .....	-	(93)	-	-
	<u>-</u>	<u>(93)</u>	<u>-</u>	<u>-</u>

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

	The group		The bank	
	2008 £m	2007 £m	2008 £m	2007 £m
(Losses)/ gains:				
- on hedging instruments .....	(189)	(58)	(49)	-
- on hedged items attributable to the hedged risk ..	196	62	50	-

The gains and losses on ineffective portions of fair value hedges are recognised immediately in 'Net trading income'. The amount reported in the income statement in respect of the ineffectiveness of fair value hedges was insignificant in the year ended 31 December 2008.

*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.

*Fair value of derivatives designated as cash flow hedges*

*The group*

	At 31 December 2008		At 31 December 2007	
	Assets £m	Liabilities £m	Assets £m	Liabilities £m
Foreign exchange .....	11	(1)	-	(30)
Interest rate .....	1,854	(1,204)	367	(463)
	<u>1,865</u>	<u>(1,205)</u>	<u>367</u>	<u>(493)</u>

*The bank*

	At 31 December 2008		At 31 December 2007	
	Assets £m	Liabilities £m	Assets £m	Liabilities £m
Interest rate .....	<u>1,370</u>	<u>(605)</u>	<u>232</u>	<u>(197)</u>

The schedule of forecast principal balances on which the expected interest cash flows arise as at 31 December 2008 is as follows. This table reflects the interest rate repricing profile of the underlying hedged items.

## Notes on the Financial Statements (continued)

*The group*

	At 31 December 2008			
	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 .....	41,517	32,994	29,743	42
Liabilities .....	(20,624)	(20,985)	(18,170)	(1,836)
Net cash inflow/(outflow) exposure .....	<u>20,893</u>	<u>12,009</u>	<u>11,573</u>	<u>(1,794)</u>

	At 31 December 2007			
	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 .....	22,133	24,583	16,648	13
Liabilities .....	(11,007)	(10,736)	(11,582)	(571)
Net cash inflow/(outflow) exposure .....	<u>11,126</u>	<u>13,847</u>	<u>5,066</u>	<u>(558)</u>

*The bank*

	At 31 December 2008			
	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 .....	28,892	26,477	22,777	41
Liabilities .....	(12,825)	(12,707)	(11,350)	(190)
Net cash inflow/(outflow) exposure .....	<u>16,067</u>	<u>13,770</u>	<u>11,427</u>	<u>(149)</u>

	At 31 December 2007			
	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 .....	12,703	12,305	10,435	13
Liabilities .....	(7,516)	(7,516)	(8,955)	(181)
Net cash inflow/(outflow) exposure .....	<u>5,187</u>	<u>4,789</u>	<u>1,480</u>	<u>(168)</u>

The gains and losses on ineffective portions of such derivatives are recognised immediately in 'Net trading income'. During the year to 31 December 2008, a loss of £3 million (2007: loss of £1 million) was recognised due to hedge ineffectiveness.

**18 Financial investments**

	The group		The bank	
	2008 £m	2007 £m	2008 £m	2007 £m
Financial investments:				
– which may be pledged or resold by counterparties .....	6,558	3,710	5,843	3,047
– not subject to repledge or resale by counterparties .....	96,953	65,818	40,765	10,774
	<u>103,511</u>	<u>69,528</u>	<u>46,608</u>	<u>13,821</u>

	The group		The bank	
	2008 £m	2007 £m	2008 £m	2007 £m
Treasury and other eligible bills .....	10,562	1,882	9,818	1,397
– available-for-sale .....	10,562	1,882	9,818	1,397
– held-to-maturity .....	-	-	-	-
Debt securities .....	90,281	64,594	35,701	11,497
– available-for-sale .....	90,256	64,556	35,701	11,497
– held-to-maturity .....	25	38	-	-
Equity securities .....	2,668	3,052	1,089	927
– available-for-sale .....	2,668	3,052	1,089	927
Total financial investments .....	103,511	69,528	46,608	13,821

For the group, £12,364 million (2007: £30 million), and for the bank, £10,607 million (2007: £22 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 table analyses the carrying amount of financial assets as at 31 December that did not qualify for derecognition during the year and their associated financial liabilities:

#### The group

Nature of transaction	2008		2007	
	Carrying amount of assets £m	Carrying amount of associated liabilities £m	Carrying amount of assets £m	Carrying amount of associated liabilities £m
Repurchase agreements .....	53,965	52,531	50,868	51,338
Securities lending agreements .....	2,989	2,977	10,818	10,813
Total .....	56,954	55,508	61,686	62,151

#### The bank

Nature of transaction	2008		2007	
	Carrying amount of assets £m	Carrying amount of associated liabilities £m	Carrying amount of assets £m	Carrying amount of associated liabilities £m
Repurchase agreements .....	19,993	18,655	29,376	29,942
Securities lending agreements .....	2,753	2,753	10,713	10,713
Total .....	22,746	21,408	40,089	40,655

## Notes on the Financial Statements (continued)

### 20 Interests in associates and joint ventures

#### Principal associates of the group

	At 31 December 2008		
	Country of incorporation	The group's interest in equity capital	Issued equity capital
VocaLink Holdings Ltd	England	13.95%	100,000

#### Summarised aggregate financial information on associates

##### HSBC's share of:

	2008 £m	2007 £m
Assets .....	44	46
Liabilities .....	36	41
Net income .....	(2)	56

#### Interests in significant joint ventures

	At 31 December 2008		
	Principal activity	The group's interest in equity capital	Issued equity capital
HSBC Merchant Services LLP .....	Merchant acquiring facility	49%	–
Vaultex UK Limited .....	Cash management	50%	£10m
Holmwoods Termtree Credit Limited .....	Investment Holdings and management	50%	£1

On 1 July 2008, the bank and Global Payments Inc commenced a card processing joint venture in the UK. The bank has a 49% stake in the new company, HSBC Merchant Services LLP, which is treated as a Joint Venture as all the strategic financial and operating decisions relating to the activities require the unanimous consent of the parties sharing control.

#### Summarised aggregate financial information on joint ventures

##### HSBC's share of:

	2008 £m	2007 £m
Assets .....	176	268
Liabilities .....	159	207
Net income .....	15	4

### 21 Goodwill and intangible assets

	The group		The bank	
	2008 £m	2007 £m	2008 £m	2007 £m
Goodwill .....	10,649	8,974	296	291
Present value of in-force long-term assurance business ('PVIIF') .....	579	444	–	–
Other intangible assets .....	552	459	302	249
	<b>11,780</b>	<b>9,877</b>	<b>598</b>	<b>540</b>

## Goodwill

### The group

	2008 £m	2007 £m
<b>Cost</b>		
At 1 January .....	8,974	8,395
Additions .....	6	1
Disposals <sup>1</sup> .....	(747)	–
Amounts written off <sup>2</sup> .....	–	(33)
Exchange differences .....	2,419	585
Other changes .....	(3)	26
<b>At 31 December</b> .....	<b>10,649</b>	<b>8,974</b>
<b>Accumulated impairment losses</b>		
At 1 January .....	–	–
Impairment loss recognised <sup>2</sup> .....	–	(33)
Amounts written off <sup>2</sup> .....	–	33
<b>At 31 December</b> .....	<b>–</b>	<b>–</b>
<b>Net book value at 31 December</b> .....	<b>10,649</b>	<b>8,974</b>

1 2008 disposals are related to the sale of the French regional banks.

2 The impairment charge for 2007 of £33 million is recognised in the income statement under 'Amortisation and impairment of intangible assets and arose on reclassification of certain HFC card portfolios to assets held for sale during the year. These portfolios were also sold during 2007, resulting in the goodwill and related impairment allowance of £33 million being written off.

### The bank

	2008 £m	2007 £m
<b>Cost</b>		
At 1 January .....	291	331
Impairment loss reversed <sup>1</sup> .....	–	(33)
Exchange differences .....	–	1
Other changes .....	5	(8)
<b>At 31 December</b> .....	<b>296</b>	<b>291</b>
<b>Accumulated impairment losses</b>		
At 1 January .....	–	–
Impairment loss recognised <sup>1</sup> .....	–	(33)
Impairment loss reversed <sup>1</sup> .....	–	33
<b>At 31 December</b> .....	<b>–</b>	<b>–</b>
<b>Net book value at 31 December</b> .....	<b>296</b>	<b>291</b>

1 The impairment charge for 2007 of £33 million is recognised in the income statement under 'Amortisation and impairment of intangible assets and impairment of goodwill' and arose on reclassification of certain HFC card portfolios to assets held for sale during the year. These portfolios were also sold during 2007, resulting in the goodwill and related impairment allowance of £33 million written off.

During 2008, no goodwill impairment was recognised (2007: £33million). Impairment testing in respect of goodwill is performed annually by comparing the recoverable amount of cash-generating units ('CGUs') determined at 1 July 2008 based on a value-in-use calculation. That 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

## Notes on the Financial Statements (continued)

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.

Cash generating unit ("CGU")	Goodwill at 1 July 2008 £m	Discount rate %	Nominal growth rate beyond initial cash flow projections %
Private Banking .....	2,552	9.0	3.6
France .....	<u>6,303</u>	<u>9.0</u>	<u>4.0</u>
Total goodwill in the CGUs listed above .....	<u>8,855</u>		

The recoverable amount of goodwill assigned to the France CGU exceeds its carrying amount by £323 million. However, a reasonably possible change in the long-term growth rate could cause its carrying amount to exceed its recoverable amount, resulting in the goodwill being impaired. Assuming no effects on other variables, the long-term growth rate would need to decrease by 15 basis points in order for the CGU's recoverable amount to be equal to its carrying amount.

As at 1 July 2008, aggregate goodwill of £694 million (2007: £694 million) had been allocated to CGUs that were not considered individually significant. These CGUs do not carry on their balance sheets any intangible assets with indefinite useful lives other than goodwill.

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

#### Movement on the PVIF

##### The group

	2008 £m	2007 £m
At 1 January .....	444	407
Addition from current year new business .....	105	67
Movement from in-force business (including investment return variances and changes in investment assumptions).....	(94)	(50)
Exchange differences and other movements .....	<u>124</u>	<u>20</u>
At 31 December .....	<u>579</u>	<u>444</u>

#### PVIF-specific assumptions

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

	2008 UK Life	2007 UK Life
Risk free rate .....	4.30%	4.30%
Risk discount rate .....	8.00%	8.00%
Expenses inflation .....	3.50%	3.40%

The PVIF represents the value of the shareholder's interest in the in-force business of the life insurance operations. 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. Some of the group's insurance operations incorporate risk margins separately into the projection assumptions for each product, while others



incorporate risk margins into the overall discount rate. This is reflected in the wide range of risk discount rates applied.

## Other intangible assets

The analysis of the movement of intangible assets, excluding the PVIF, was follows:

### *The group*

	Trade names £m	Internally generated software £m	Purchased software £m	Customer/ merchant relationships £m	Other £m	Total <sup>2</sup> £m
<b>Cost</b>						
At 1 January 2008 .....	15	788	78	204	12	1,097
Additions <sup>1</sup> .....	–	148	20	2	6	176
Acquisition of subsidiaries .....	–	–	33	–	–	33
Disposals .....	–	(20)	(3)	(1)	(3)	(27)
Exchange differences .....	1	33	35	4	1	74
Other changes .....	–	–	(3)	–	(4)	(7)
<b>At 31 December 2008 .....</b>	<b>16</b>	<b>949</b>	<b>160</b>	<b>209</b>	<b>12</b>	<b>1,346</b>
<b>Accumulated amortisation and impairment</b>						
At 1 January 2008 .....	(7)	(526)	(51)	(52)	(2)	(638)
Amortisation charge for the year .....	(1)	(75)	(15)	(18)	–	(109)
Disposals .....	–	7	3	–	1	11
Exchange differences .....	–	(33)	(20)	(1)	–	(54)
Other changes .....	–	3	(7)	–	–	(4)
<b>At 31 December 2008 .....</b>	<b>(8)</b>	<b>(624)</b>	<b>(90)</b>	<b>(71)</b>	<b>(1)</b>	<b>(794)</b>
<b>Net book value at 31 December 2008 .....</b>	<b>8</b>	<b>325</b>	<b>70</b>	<b>138</b>	<b>11</b>	<b>552</b>
<b>Cost</b>						
At 1 January 2007 .....	13	675	58	244	17	1,007
Additions <sup>1</sup> .....	–	103	15	–	4	122
Disposals .....	–	–	(2)	–	–	(2)
Exchange differences .....	2	9	7	–	1	19
Other changes .....	–	1	–	(40)	(10)	(49)
<b>At 31 December 2007 .....</b>	<b>15</b>	<b>788</b>	<b>78</b>	<b>204</b>	<b>12</b>	<b>1,097</b>
<b>Accumulated amortisation and impairment</b>						
At 1 January 2007 .....	(5)	(441)	(38)	(73)	(1)	(558)
Amortisation charge for the year .....	(1)	(75)	(12)	(19)	(1)	(108)
Impairment charge for the year .....	–	(1)	–	–	–	(1)
Disposals .....	–	–	3	–	–	3
Exchange differences .....	(1)	(9)	(4)	–	–	(14)
Other changes .....	–	–	–	40	–	40
<b>At 31 December 2007 .....</b>	<b>(7)</b>	<b>(526)</b>	<b>(51)</b>	<b>(52)</b>	<b>(2)</b>	<b>(638)</b>
<b>Net book value at 31 December 2007 .....</b>	<b>8</b>	<b>262</b>	<b>27</b>	<b>152</b>	<b>10</b>	<b>459</b>

1 At 31 December 2008, the group had nil (2007: £2 million) of contractual commitments to acquire intangible assets.

2 Included in the above are intangible assets relating to Marks and Spencer Retail Financial Services Holdings Limited with a net book value of £124 million (2007: £141 million), on which the amortisation charge for the year to 31 December 2008 was £16 million (2007: £17 million). The remaining amortisation period is 6 years.

**Notes on the Financial Statements** (continued)*The bank*

	Internally generated software £m	Customer/ merchant relationships £m	Other £m	Total £m
<b>Cost</b>				
At 1 January 2008 .....	668	–	3	671
Additions .....	132	–	–	132
Disposals .....	(20)	–	(3)	(23)
<b>At 31 December 2008 .....</b>	<b>780</b>	<b>–</b>	<b>–</b>	<b>780</b>
<b>Accumulated amortisation and impairment</b>				
At 1 January 2008 .....	(420)	–	(2)	(422)
Amortisation charge for the year .....	(68)	–	–	(68)
Disposals .....	7	–	2	9
Other changes .....	3	–	–	3
<b>At 31 December 2008 .....</b>	<b>(478)</b>	<b>–</b>	<b>–</b>	<b>(478)</b>
<b>Net book value at 31 December 2008 .....</b>	<b>302</b>	<b>–</b>	<b>–</b>	<b>302</b>
<b>Cost</b>				
At 1 January 2007 .....	572	41	3	616
Additions .....	96	–	–	96
Other changes .....	–	(41)	–	(41)
<b>At 31 December 2007 .....</b>	<b>668</b>	<b>–</b>	<b>3</b>	<b>671</b>
<b>Accumulated amortisation and impairment</b>				
At 1 January 2007 .....	(348)	(41)	(1)	(390)
Amortisation charge for the year .....	(72)	–	(1)	(73)
Impairment charge for the year .....	(1)	–	–	(1)
Other changes .....	1	41	–	42
<b>At 31 December 2007 .....</b>	<b>(420)</b>	<b>–</b>	<b>(2)</b>	<b>(422)</b>
<b>Net book value at 31 December 2007 .....</b>	<b>248</b>	<b>–</b>	<b>1</b>	<b>249</b>

## 22 Property, plant and equipment

### The group

	Freehold land and buildings <sup>4</sup> £m	Long leasehold land and buildings £m	Short leasehold land and buildings £m	Equipment, fixtures and fittings <sup>1</sup> £m	Equipment on operating leases £m	Total <sup>2</sup> £m
<b>Cost or fair value</b>						
At 1 January 2008 .....	924	45	357	2,903	3,005	7,234
Additions at cost.....	87	2	79	421	193	782
Reclassified from held for sale ...	31	300	–	63	–	394
Acquisition of subsidiaries.....	–	–	–	1	–	1
Fair value adjustments .....	(5)	–	–	–	–	(5)
Disposals .....	(102)	(3)	(8)	(220)	(81)	(414)
Transfers .....	22	(22)	–	–	–	–
Exchange differences .....	87	1	25	155	–	268
At 31 December 2008 .....	<u>1,044</u>	<u>323</u>	<u>453</u>	<u>3,323</u>	<u>3,117</u>	<u>8,260</u>
<b>Accumulated depreciation and impairment</b>						
At 1 January 2008 .....	(75)	(15)	(169)	(1,888)	(968)	(3,115)
Depreciation charge for the year	(19)	(13)	(29)	(297)	(101)	(459)
Reclassified from held for sale ...	(13)	(12)	–	(20)	–	(45)
Disposals .....	6	–	4	130	19	159
Transfers .....	(7)	7	–	–	–	–
Impairment losses recognised.....	(7)	–	–	–	–	(7)
Exchange differences .....	(4)	–	(10)	(82)	–	(96)
At 31 December 2008 .....	<u>(119)</u>	<u>(33)</u>	<u>(204)</u>	<u>(2,157)</u>	<u>(1,050)</u>	<u>(3,563)</u>
<b>Net carrying amount at 31 December 2008 .....</b>						
	<u>925</u>	<u>290</u>	<u>249</u>	<u>1,166</u>	<u>2,067</u>	<u>4,697</u>

1 Including assets held on finance leases with a carrying amount of £139 million (2007: £171 million).

2 Including assets with a carrying amount of £143 million (2007: £173 million) pledged as security for liabilities.

3 At 31 December 2008, the group had £367 million (2007: £281 million) of contractual commitments to acquire property, plant and equipment.

4 Including the investment properties on page 99.

## Notes on the Financial Statements (continued)

	Freehold land and buildings <sup>1</sup> £m	Long leasehold land and buildings £m	Short leasehold land and buildings £m	Equipment, fixtures and fittings £m	Equipment on operating leases £m	Total £m
<b>Cost or fair value</b>						
At 1 January 2007 .....	966	362	275	2,657	3,004	7,264
Additions at cost .....	104	3	84	321	66	578
Acquisition of subsidiaries .....	49	–	–	1	–	50
Fair value adjustments .....	13	–	–	–	–	13
Disposals .....	(257)	(320)	(12)	(135)	(65)	(789)
Transfers .....	–	–	4	(1)	–	3
Exchange differences .....	55	–	4	69	–	128
Other changes .....	(6)	–	2	(9)	–	(13)
At 31 December 2007 .....	<u>924</u>	<u>45</u>	<u>357</u>	<u>2,903</u>	<u>3,005</u>	<u>7,234</u>
<b>Accumulated depreciation and impairment</b>						
At 1 January 2007 .....	(97)	(27)	(150)	(1,656)	(926)	(2,856)
Depreciation charge for the year .....	(22)	(3)	(22)	(281)	(100)	(428)
Disposals .....	48	15	8	76	58	205
Transfers .....	–	–	(2)	–	–	(2)
Impairment losses recognised .....	–	–	–	–	–	–
Impairment losses reversed .....	6	–	–	–	–	6
Exchange differences .....	(4)	–	(2)	(39)	–	(45)
Other changes .....	(6)	–	(1)	12	–	5
At 31 December 2007 .....	<u>(75)</u>	<u>(15)</u>	<u>(169)</u>	<u>(1,888)</u>	<u>(968)</u>	<u>(3,115)</u>
Net carrying amount at 31 December 2007 .....	<u>849</u>	<u>30</u>	<u>188</u>	<u>1,015</u>	<u>2,037</u>	<u>4,119</u>

<sup>1</sup> Including the investment properties on page 99.

## 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
<b>Cost or fair value</b>					
At 1 January 2008 .....	221	50	311	2,206	2,788
Additions at cost <sup>1</sup> .....	60	–	65	268	393
Reclassified from held for sale .....	31	300	–	63	394
Disposals .....	(13)	–	(6)	(137)	(156)
Transfers .....	22	(22)	–	–	–
Exchange differences .....	1	–	3	8	12
At 31 December 2008 .....	<u>322</u>	<u>328</u>	<u>373</u>	<u>2,408</u>	<u>3,431</u>
<b>Accumulated depreciation and impairment</b>					
At 1 January 2008 .....	(35)	(15)	(147)	(1,513)	(1,710)
Depreciation charge for the year .....	(10)	(13)	(24)	(197)	(244)
Disposals .....	2	–	4	84	90
Reclassified as held for sale .....	(13)	(12)	–	(20)	(45)
Transfers .....	(7)	7	–	–	–
Exchange differences .....	–	–	(2)	(5)	(7)
At 31 December 2008 .....	<u>(63)</u>	<u>(33)</u>	<u>(169)</u>	<u>(1,651)</u>	<u>(1,916)</u>
Net carrying amount at 31 December 2008 .....	<u>259</u>	<u>295</u>	<u>204</u>	<u>757</u>	<u>1,515</u>

	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 2007	397	368	240	2,105	3,110
Additions at cost <sup>1</sup>	18	2	78	209	307
Disposals	(191)	(320)	(9)	(109)	(629)
Transfers	–	–	–	(1)	(1)
Exchange differences	–	–	1	2	3
Other changes	(3)	–	1	–	(2)
At 31 December 2007	221	50	311	2,206	2,788
Accumulated depreciation and impairment					
At 1 January 2007	(59)	(27)	(136)	(1,367)	(1,589)
Depreciation charge for the year	(11)	(3)	(18)	(201)	(233)
Disposals	35	15	7	56	113
Transfers	–	–	–	–	–
Exchange differences	–	–	–	(1)	(1)
At 31 December 2007	(35)	(15)	(147)	(1,513)	(1,710)
Net carrying amount at 31 December 2007	186	35	164	693	1,078

1 At 31 December 2008, the bank had £84 million (2007: £103 million) of contractual commitments to acquire property, plant and equipment.

On 31 May 2007, the group entered into a contract for the sale and leaseback of the property and long leasehold land comprising 8 Canada Square, London to Metrovacesa, S.A. ('Metrovacesa') for £1,090 million. The group retained a significant interest by virtue of a bridging loan of £810 million provided to Metrovacesa preventing immediate recognition of the sale. As a result at 31 December 2007 this property was reclassified as 'Assets held for sale' and the net proceeds received were recognised as deferred income on the balance sheet. On 4 December 2008 the bank purchased Project Maple II, B.V., the subsidiary of Metrovacesa which legally owned 8 Canada Square, for £838 million. The deferred income recognised by the group was released to the income statement and the property and long leasehold land have been reclassified to 'Property plant and equipment' respectively 'Prepayments and accrued income'. The impact on the group's operating profit for the year ended 31 December 2008 is a net gain of £244 million, comprising a gain of £265 million included within 'Other operating income' and a charge of £21 million included within 'Depreciation and impairment of property, plant and equipment'.

### Investment properties

The composition of the investment properties at fair value in the year was as follows:

#### The group

	Freehold land and buildings <sup>1</sup> £m
<b>Fair value</b>	
At 1 January 2008	152
Additions at cost	21
Fair value adjustments	(5)
Exchange and other changes	(63)
At 31 December 2008	105
<b>Fair value</b>	
At 1 January 2007	31
Additions at cost	82
Acquisitions of subsidiaries	49
Fair value adjustments	13
Reclassified as held for sale	(30)
Exchange and other changes	7
At 31 December 2007	152

1 Included in 'Property, plant and equipment' on page 97.

## Notes on the Financial Statements (continued)

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 £2 million (2007: £2 million) earned by the group on its investment properties. Direct operating expenses of £ nil million (2007: nil) incurred in respect of the investment properties during the year were recognised in 'General and administrative expenses'. No such costs (2007: none) were included in investment property. Direct operating expenses arising in respect of investment properties that did not generate rental income during the year amounted to £ nil million (2007: nil). Net exchange differences on translation of investment properties were £67 million (2007: £19 million).

### *The bank*

The bank had no investment properties at 31 December 2008 or 2007.

### Group properties leased to customers

The group properties leased to customers included £4 million at 31 December 2008 (2007: £4 million) let under operating leases, net of accumulated depreciation of £6 million (2007: £5 million). None was held by the bank.

## 23 Investments

### Principal subsidiary undertakings of HSBC Bank plc

	Country of incorporation or registration	HSBC Bank plc's interest in equity capital %
HSBC France .....	France	99.99
HSBC Asset Finance (UK) Limited .....	England	100.00
HSBC Bank A.S. ....	Turkey	100.00
HSBC Bank International Limited .....	Jersey	99.84
HSBC Bank Malta p.l.c. ....	Malta	68.25
HSBC Guyerzeller Bank AG .....	Switzerland	99.84
HSBC Invoice Finance (UK) Limited .....	England	100.00
HSBC Life (UK) Limited .....	England	100.00
HSBC Rail (UK) Limited .....	England	100.00
HSBC Private Bank (C.I.) Limited .....	Guernsey	99.84
HSBC Private Bank (Suisse) S.A. ....	Switzerland	94.41
HSBC Private Bank (UK) Limited .....	England	99.84
HSBC Trinkaus & Burkhardt AG .....	Germany	78.60
HSBC Trust Company (UK) Limited .....	England	100.00
Marks and Spencer Retail Financial Services Holdings Limited .....	England	100.00

Special purpose entities ('SPEs') consolidated where HSBC Bank plc owns less than 50 per cent of the voting rights:

	Carrying value of total consolidated assets £bn	Nature of SPE
Barion Funding Limited .....	3.1	Securities investment conduit
Bryant Park Funding LLC .....	3.7	Conduit
Malachite Funding Limited .....	2.9	Securities investment conduit
Mazarin Funding Limited .....	7.9	Securities investment conduit
Metrix Funding plc .....	2.5	Securitisation vehicle
Regency Assets Limited .....	5.6	Conduit
Solitaire Funding Limited .....	8.3	Securities investment conduit
Turquoise Receivable Trust Limited .....	1.5	Securitisation vehicle

All the above make their financial statements up to 31 December.

### Acquisitions

HSBC Bank plc made acquisitions of subsidiary undertakings, and increased its investment in existing subsidiary undertakings, during 2008. These transactions were accounted for by applying the purchase method and goodwill of £6 million arose.

## Disposals

On 2 July 2008, the group completed the sale of seven French regional banks to Banque Fédérale des Banques Populaires for €2.1 billion (£1.7 billion). On 2 July 2008, the aggregate total assets attributable to these French regional banking subsidiaries were £5.8 billion, and they generated net profits after tax of £48 million for the period to 2 July 2008. The group's pre-tax profit on sale was £644 million.

## 24 Other assets

	The group		The bank	
	2008 £m	2007 £m	2008 £m	2007 £m
Bullion .....	570	147	423	70
Assets held for sale .....	70	626	56	555
Assets of disposal groups held for sale <sup>1</sup> .....	–	78	–	78
Reinsurers' share of liabilities under insurance contracts .....	618	528	–	–
Endorsements and acceptances .....	370	375	224	251
Other accounts .....	7,174	4,115	2,934	1,122
	<b>8,802</b>	<b>5,869</b>	<b>3,637</b>	<b>2,076</b>

<sup>1</sup> At 31 December 2007, assets of HFC card portfolios with a carrying amount of £78 million were classified as disposal groups held for sale.

## Assets held for sale

	The group		The bank	
	2008 £m	2007 £m	2008 £m	2007 £m
<b>Non-current assets held for sale</b>				
Property, plant and equipment .....	62	586	56	555
Investment properties .....	–	31	–	–
Financial assets .....	7	7	–	–
Other .....	1	2	–	–
Total assets classified as held for sale .....	<b>70</b>	<b>626</b>	<b>56</b>	<b>555</b>

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.

8 Canada Square has been reclassified from 'Assets held for sale', as described in Note 22.

## 25 Trading liabilities

	The group		The bank	
	2008 £m	2007 £m	2008 £m	2007 £m
Deposits by banks .....	43,882	39,382	46,928	48,390
Customer accounts .....	29,347	21,999	25,039	17,636
Other debt securities in issue .....	15,677	14,353	12,152	10,597
Other liabilities – net short positions .....	35,544	41,720	14,270	23,132
	<b>124,450</b>	<b>117,454</b>	<b>98,389</b>	<b>99,755</b>

## Notes on the Financial Statements (continued)

### 26 Financial liabilities designated at fair value

	The group		The bank	
	2008	2007	2008	2007
	£m	£m	£m	£m
Deposits by banks .....	4,357	3,635	4,162	3,513
Liabilities to customers under investment contracts .....	3,641	5,842	–	–
Debt securities in issue .....	3,584	2,820	1,658	1,204
Subordinated liabilities .....	3,374	3,084	3,609	3,365
Preference shares .....	228	278	–	–
	<b>15,184</b>	<b>15,659</b>	<b>9,429</b>	<b>8,082</b>

The carrying amount at 31 December 2008 of financial liabilities designated at fair value was £491 million higher for the group (2007: £37 million lower) (the bank: 2008: £439 million higher; 2007: £19 million lower) than the contractual amount at maturity. At 31 December 2008, the accumulated amount of change in fair value attributable to changes in credit risk was a gain of £672 million for the group (2007: £165 million gain) (the bank: 2008: £623 million gain; 2007: £163 million gain).

### 27 Other liabilities

	The group		The bank	
	2008	2007 (restated)	2008	2007 (restated)
	£m	£m	£m	£m
Amounts due to investors in funds consolidated by the group .....	782	1,225	–	–
Obligations under finance leases .....	332	327	–	–
Endorsements and acceptances .....	367	375	224	251
Other liabilities .....	5,416	4,916	2,939	2,623
	<b>6,897</b>	<b>6,843</b>	<b>3,163</b>	<b>2,874</b>



## 28 Liabilities under insurance contracts issued

	At 31 December 2008		
	Gross £m	Reinsurers' share £m	Net £m
<b>Non-life insurance liabilities</b>			
Unearned premium provision .....	445	(71)	374
Notified claims .....	345	(109)	236
Claims incurred but not reported .....	77	(19)	58
Other .....	16	(1)	15
	<b>883</b>	<b>(200)</b>	<b>683</b>
<b>Life insurance liabilities to policyholders</b>			
Life (non-linked) .....	2,031	(411)	1,620
Investment contracts with discretionary participation features <sup>1</sup> .....	12,157	–	12,157
Life (linked) .....	1,061	(7)	1,054
	<b>15,249</b>	<b>(418)</b>	<b>14,831</b>
Total liabilities under insurance contracts .....	<b>16,132</b>	<b>(618)</b>	<b>15,514</b>
	At 31 December 2007		
	Gross £m	Reinsurers' share £m	Net £m
<b>Non-life insurance liabilities</b>			
Unearned premium provision .....	387	(48)	339
Notified claims .....	301	(129)	172
Claims incurred but not reported .....	112	(15)	97
Other .....	18	(18)	–
	<b>818</b>	<b>(210)</b>	<b>608</b>
<b>Life insurance liabilities to policyholders</b>			
Life (non-linked) .....	1,128	(290)	838
Investment contracts with discretionary participation features <sup>1</sup> .....	9,447	–	9,447
Life (linked) .....	858	(28)	830
	<b>11,433</b>	<b>(318)</b>	<b>11,115</b>
Total liabilities under insurance contracts .....	<b>12,251</b>	<b>(528)</b>	<b>11,723</b>

<sup>1</sup> 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)

The movement of liabilities under insurance contracts during the year was as follows:

## Non-life insurance liabilities

	2008		
	Gross £m	Reinsurers' share £m	Net £m
<b>Unearned premium reserve ('UPR')</b>			
At 1 January .....	387	(48)	339
Changes in UPR recognised as (income)/expense .....	(42)	2	(40)
– Gross written premiums .....	418	(63)	355
– Gross earned premiums .....	(460)	65	(395)
Exchange differences and other movements .....	100	(25)	75
At 31 December .....	445	(71)	374
<b>Notified and incurred but not reported claims</b>			
At 1 January .....	413	(144)	269
– Notified claims .....	301	(129)	172
– Claims incurred but not reported .....	112	(15)	97
Claims paid in current year .....	(318)	46	(272)
Claims incurred in respect of current year .....	152	(43)	109
Claims incurred in respect of prior years .....	66	(1)	65
Exchange differences and other movements .....	109	14	123
At 31 December .....	422	(128)	294
– Notified claims .....	345	(109)	236
– Claims incurred but not reported .....	77	(19)	58
Other .....	16	(1)	15
Total non-life insurance liabilities .....	883	(200)	683
	2007		
	Gross £m	Reinsurers' share £m	Net £m
<b>Unearned premium reserve ('UPR')</b>			
At 1 January .....	286	(27)	259
Changes in UPR recognised as (income)/ expense .....	(6)	8	2
– Gross written premiums .....	372	(73)	299
– Gross earned premiums .....	(378)	81	(297)
Exchange differences and other movements .....	107	(29)	78
At 31 December .....	387	(48)	339
<b>Notified and incurred but not reported claims</b>			
At 1 January .....	116	(52)	64
– Notified claims .....	75	(32)	43
– Claims incurred but not reported .....	41	(20)	21
Claims paid in current year .....	(250)	65	(185)
Claims incurred in respect of current year .....	244	36	280
Claims incurred in respect of prior years .....	58	(7)	51
Exchange differences and other movements .....	245	(186)	59
At 31 December .....	413	(144)	269
– Notified claims .....	301	(129)	172
– Claims incurred but not reported .....	112	(15)	97
Other .....	18	(18)	–
Total non-life insurance liabilities .....	818	(210)	608

## Life insurance liabilities to policyholders

	2008		
	Gross £m	Reinsurers' share £m	Net £m
<b>Life (non-linked)</b>			
At 1 January .....	1,128	(290)	838
Benefits paid .....	(374)	83	(291)
Increase in liabilities to policyholders .....	1,056	(396)	660
Exchange differences and other movements .....	221	192	413
At 31 December .....	<u>2,031</u>	<u>(411)</u>	<u>1,620</u>
<b>Investment contracts with discretionary participation features</b>			
At 1 January .....	9,447	–	9,447
Benefits paid .....	(1,047)	–	(1,047)
Increase in liabilities to policyholders .....	909	–	909
Exchange differences and other movements .....	2,848	–	2,848
At 31 December .....	<u>12,157</u>	<u>–</u>	<u>12,157</u>
<b>Life (linked)</b>			
At 1 January .....	858	(28)	830
Benefits paid .....	(135)	7	(128)
Increase in liabilities to policyholders .....	(54)	14	(40)
Exchange differences and other movements <sup>1</sup> .....	392	–	392
At 31 December .....	<u>1,061</u>	<u>(7)</u>	<u>1,054</u>
Total liabilities to policyholders .....	<u>15,249</u>	<u>(418)</u>	<u>14,831</u>
	2007		
	Gross £m	Reinsurers' share £m	Net £m
<b>Life (non-linked)</b>			
At 1 January .....	837	(525)	312
Benefits paid .....	(132)	73	(59)
Increase in liabilities to policyholders .....	9	190	199
Exchange differences and other movements .....	414	(28)	386
At 31 December .....	<u>1,128</u>	<u>(290)</u>	<u>838</u>
<b>Investment contracts with discretionary participation features</b>			
At 1 January .....	–	–	–
Benefits paid .....	(537)	–	(537)
Increase in liabilities to policyholders .....	1,073	–	1,073
Exchange differences and other movements <sup>2</sup> .....	8,911	–	8,911
At 31 December .....	<u>9,447</u>	<u>–</u>	<u>9,447</u>
<b>Life (linked)</b>			
At 1 January .....	647	(29)	618
Benefits paid .....	(139)	8	(131)
Increase in liabilities to policyholders .....	158	(6)	152
Exchange differences and other movements <sup>1</sup> .....	192	(1)	191
At 31 December .....	<u>858</u>	<u>(28)</u>	<u>830</u>
Total liabilities to policyholders .....	<u>11,433</u>	<u>(318)</u>	<u>11,115</u>

<sup>1</sup> Includes amounts arising under reinsurance agreements.

<sup>2</sup> As a result of obtaining control of HSBC Assurances VIE (France) and HSBC Assurances IARD (France) during 2007, £8,929 million of liabilities under insurance contracts issued were recognised by the group.

The increase in liabilities to policyholders represents the aggregate of all events giving rise to additional liabilities to policyholders in the year. These include death claims, surrenders, lapses, the setting up of liability to policyholders at the initial inception of the policy, the declaration of bonuses and other amounts attributable to policyholders.

## Notes on the Financial Statements (continued)

### 29 Provisions

#### *The group*

	<b>Provisions</b>	
	<b>2008</b>	2007
	<b>£m</b>	£m
At 1 January .....	427	402
Additional provisions/increase in provisions <sup>1</sup> .....	140	406
Acquisition of subsidiaries .....	4	-
Provisions utilised .....	(143)	(317)
Amounts reversed .....	(39)	(86)
Exchange differences and other movements .....	39	22
At 31 December .....	<b>428</b>	<b>427</b>

<sup>1</sup> Includes unwinding of discounts of £1 million (2007: £1 million) in relation to vacant space provisions.

Included above are:

- (i) A provision of £35 million (2007: £60million) for the possible cost of redress relating to the sale of certain personal pension plans and mortgage endowment policies and a provision for indemnity clawbacks. 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.
- (ii) Provisions of £84 million (2007: £85million) 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.

#### *The bank*

	<b>Provisions</b>	
	<b>2008</b>	2007
	<b>£m</b>	£m
At 1 January .....	163	105
Additional provisions/increase in provisions <sup>1</sup> .....	30	251
Provisions utilised .....	(22)	(172)
Amounts reversed .....	(14)	(29)
Exchange differences and other movements .....	1	8
At 31 December .....	<b>158</b>	<b>163</b>

<sup>1</sup> Includes unwinding of discounts of £1 million (2007: £1 million) in relation to vacant space provisions.

Included in the above are provisions for onerous property contracts of £27 million (2007: £28 million), of which £5 million (2007: £7 million) relates to discounted future costs associated with leasehold properties that became vacant as a consequence of the bank's move to Canary Wharf in 2002. 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.

### 30 Subordinated liabilities

	The group		The bank	
	2008	2007	2008	2007
	£m	£m	£m	£m
Subordinated liabilities:				
– At amortised cost .....	7,259	5,205	7,310	4,744
Subordinated liabilities .....	4,741	3,111	7,310	4,744
Preference shares .....	2,518	2,094	–	–
– Designated at fair value .....	3,602	3,362	3,609	3,365
Subordinated liabilities .....	3,374	3,084	3,609	3,365
Preference shares .....	228	278	–	–
	<b>10,861</b>	<b>8,567</b>	<b>10,919</b>	<b>8,109</b>

#### Subordinated borrowings of the group

		Carrying amount	
		2008	2007
		£m	£m
US\$300m	6.95% Subordinated Notes 2011 .....	222	162
€250m	Floating Rate Subordinated Loan 2015 .....	239	183
€600m	4.25% Callable Subordinated Notes 2016 <sup>1</sup> .....	570	439
€800m	Callable Subordinated Floating Rate Notes 2016 .....	765	586
£350m	Callable Subordinated Variable Coupon Notes 2017 <sup>2</sup> .....	355	355
€1,000m	Floating Rate Subordinated Loan 2017 .....	957	734
£500m	4.75% Callable Subordinated Notes 2020 <sup>3</sup> .....	463	464
€500m	Callable Subordinated Floating Rate Notes 2020 .....	389	337
£350m	5% Callable Subordinated Notes 2023 <sup>4</sup> .....	330	335
£300m	6.5% Subordinated Notes 2023 .....	299	298
US\$300m	7.65% Subordinated Notes 2025 .....	263	179
£350m	5.375% Callable Subordinated Step-up Notes 2030 <sup>5</sup> .....	316	325
£500m	5.375% Subordinated Notes 2033 .....	452	474
£390m	6.9% Subordinated Loan 2033 .....	390	–
€900m	7.75% Non-cumulative Subordinated Notes 2040 .....	861	660
£225m	6.25% Subordinated Notes 2041 .....	223	223
£600m	4.75% Subordinated Notes 2046 .....	592	591
£700m	5.844% Non-cumulative Step-up Perpetual Preferred Securities <sup>6</sup> .....	700	700
£300m	5.862% Non-cumulative Step-up Perpetual Preferred Securities <sup>7</sup> .....	228	278
US\$750m	Undated Floating Rate Primary Capital Notes .....	514	374
US\$500m	Undated Floating Rate Primary Capital Notes .....	343	249
US\$300m	Undated Floating Rate Primary Capital Notes (Series 3) .....	206	150
£350m	7.9% Perpetual Subordinated Debt .....	350	–
£250m	7.991% Perpetual Subordinated Debt .....	250	–
	Other subordinated liabilities less than £200m .....	584	471
		<b>10,861</b>	<b>8,567</b>

1 The interest rate on the 4.25% Callable Subordinated Notes 2016 changes in March 2011 to three month EURIBOR plus 1.05%.

2 The interest rate on the Callable Subordinated Variable Coupon Notes 2017 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%.

3 The interest rate on the 4.75% Callable Subordinated Notes 2020 changes in September 2015 to three month sterling LIBOR plus 0.82%.

4 The interest rate on the 5% Callable Subordinated Notes 2023 changes in March 2018 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%.

5 The interest rate on the 5.375% Callable Subordinated Step-up Notes 2030 changes in November 2025 to three month sterling LIBOR plus 1.50%.

6 The distribution rate on the 5.844% Non-cumulative Step-up Perpetual Preferred Securities changes in November 2031 to six month sterling LIBOR plus 1.76%.

7 The distribution rate on the 5.862% Non-cumulative Step-up Perpetual Preferred Securities changes in April 2020 to six month sterling LIBOR plus 1.85%.

Footnotes 1 to 7 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

#### 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. To this end, ultimate responsibility for the determination of fair values lies with Finance, which reports functionally through the group's Chief Financial Officer to the HSBC Group Finance Director. Finance establishes the accounting policies and procedures governing valuation, and is responsible for ensuring that these comply with all relevant accounting standards.

For fair values determined by reference to external quotation or evidenced pricing parameters, independent price determination or validation is used. In less liquid 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. Greater weight will be 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 tradeable 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.

The results of the independent price validation process are reported to senior management, and adjustments to fair values resulting from considerations of the above information are recorded where appropriate.

For fair values determined using a valuation model, the model being a logical framework for the capture and processing of necessary valuation inputs, the control framework may include, as applicable, independent development or validation of the logic within valuation models, the inputs to those models, any adjustments required outside the valuation models, and, where possible, model outputs.

The results of the independent validation process are reported to, and considered by, Valuation Committees. Valuation Committees are composed of individuals from several independent support functions (Product Control, Market Risk Management, Derivative Model Review Group and Finance) in addition to senior trading management. Any adjustments made to the assessed fair values as a result of the validation process are reported to senior management.

#### Determination of fair value

Fair values are determined according to the following hierarchy:

- (a) *Quoted market price*: financial instruments with quoted prices for identical instruments in active markets.
- (b) *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) *Valuation technique with significant non-observable inputs*: financial instruments valued using models where one or more significant inputs are not observable.

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 not observable. For these instruments, the fair value derived is more judgemental. 'Not observable' in this context means that there is little or no current market data available from which to determine the level at which an arm's length transaction would be likely to occur, but 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). Furthermore, the majority of the fair value derived from a valuation technique with significant non-observable inputs may in some cases still be attributable to the observable inputs. Consequently, the impact of uncertainty in the determination of the unobservable inputs will generally only give rise to a degree of uncertainty about the overall fair value of the

financial instrument being measured. To assist in understanding the extent and the range of this uncertainty, additional information is provided in respect of instruments valued using non-observable inputs in the section headed 'Effect of changes in significant unobservable assumption to reasonably possible alternatives' below.

In certain circumstances, primarily where debt is hedged with interest rate derivatives or structured notes issued, the group uses fair value to measure the carrying value of its own debt in issue. Where available, fair value is based upon quoted prices in an active market for the specific instrument concerned. Where unavailable, these instruments are valued using valuation techniques, the inputs of which are based either upon quoted prices in an inactive market for the specific instrument concerned, or estimated by comparison with quoted prices in an active market for similar instruments. The fair value of these instruments therefore includes the effect of applying the credit spread which is appropriate to the group's liabilities. For all issued debt securities, discounted cash flow modelling is utilised to isolate that element of the change in fair value that may be attributed to the group's credit spread movements rather than movements in other market factors such as benchmark interest rates or foreign exchange rates.

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. These market spreads are significantly smaller than credit spreads observed for plain vanilla debt or in the credit default swap markets.

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 early. All net positions in non-derivative financial instruments, and all derivative portfolios, are valued at bid or offer prices as appropriate. Long positions are marked at bid prices; short positions are marked at offer prices.

The fair values of large holdings of non-derivative financial instruments are based on a multiple of the value of a single instrument, and do not include block adjustments for the size of the holding.

Transaction costs are not included in the fair value calculation. Trade origination costs such as brokerage fees and post-trade costs are included in operating expenses. The future costs of administering the over the counter ('OTC') derivative portfolio are also not included in fair value, but are expensed as incurred.

- *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. The exercise of judgment is required because of uncertainties inherent in estimating fair value for private equity investments.

- *Debt securities, treasury and other eligible bills, and equities*

The fair value of these instruments is based on quoted market prices from an exchange, dealer, broker, industry group or pricing service, when available. When unavailable, the fair value is determined by reference to quoted market prices for similar instruments.

Illiquidity and a lack of transparency in the market for debt securities backed by mortgages has resulted in less observable data being available. 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.

In the absence of quoted market prices, fair value is determined using valuation techniques. The inputs to these valuation techniques are derived from observable market data and, where relevant, assumptions in respect of unobservable inputs. In respect of asset-backed securities ('ABSs') and mortgages, the assumptions may include prepayment speeds, default rates and loss severity based on collateral type, and performance as appropriate.

- *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

## Notes on the Financial Statements (continued)

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. Finally, some inputs are not observable, but can generally be estimated from historical data or other sources. Examples of inputs that are generally observable include foreign exchange spot and forward rates, benchmark interest rate curves and volatility surfaces for commonly traded option products. 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.

- *Loans including leveraged loans 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 including 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*

For structured notes whose fair value is derived from a valuation technique, the fair value will be derived from the fair value of the underlying debt security as described above, and the fair value of the embedded derivative determined as described in the section above on derivatives.

### Bases of valuing financial assets and liabilities measured at fair value

#### *The group*

	Quoted market price £m	Valuation techniques:		Total £m
		using observable inputs £m	with significant non-observable inputs £m	
<b>At 31 December 2008</b>				
<b>Assets</b>				
Trading assets .....	100,829	69,001	2,196	172,026
Financial assets designated at fair value .....	7,530	6,365	–	13,895
Derivatives .....	4,866	236,090	2,128	243,084
Financial investments: available-for-sale .....	38,201	60,942	4,368	103,511
<b>Liabilities</b>				
Trading liabilities .....	58,226	63,815	2,409	124,450
Financial liabilities at fair value .....	4,174	11,010	–	15,184
Derivatives .....	6,093	233,961	977	241,031
<b>At 31 December 2007</b>				
<b>Assets</b>				
Trading assets .....	83,008	66,595	3,603	153,206
Financial assets designated at fair value .....	10,630	4,339	–	14,969
Derivatives .....	2,890	56,758	822	60,470
Financial investments: available-for-sale .....	17,816	48,360	3,352	69,528
<b>Liabilities</b>				
Trading liabilities .....	61,386	53,702	2,366	117,454
Financial liabilities at fair value .....	9,481	6,178	–	15,659
Derivatives .....	2,892	57,787	860	61,539

#### *The bank*

	Quoted market price £m	Valuation techniques:		Total £m
		using observable inputs £m	with significant non-observable inputs £m	
<b>At 31 December 2008</b>				
<b>Assets</b>				
Trading assets .....	50,175	77,834	2,196	130,205
Financial assets designated at fair value .....	424	4,168	–	4,592
Derivatives .....	270	194,901	1,957	197,128
Financial investments: available-for-sale .....	21,416	23,040	2,152	46,608



<b>Liabilities</b>				
Trading liabilities .....	<b>38,274</b>	<b>57,706</b>	<b>2,409</b>	<b>98,389</b>
Financial liabilities at fair value .....	<b>1,658</b>	<b>7,771</b>	<b>–</b>	<b>9,429</b>
Derivatives .....	<b>564</b>	<b>195,836</b>	<b>847</b>	<b>197,247</b>
At 31 December 2007				
Assets				
Trading assets .....	50,643	94,856	3,603	149,102
Financial assets designated at fair value .....	–	3,439	–	3,439
Derivatives .....	33	45,966	326	46,325
Financial investments: available-for-sale .....	6,749	6,046	1,026	13,821
Liabilities				
Trading liabilities .....	39,140	58,296	2,319	99,755
Financial liabilities at fair value .....	4,278	3,804	–	8,082
Derivatives .....	176	47,030	330	47,536

### Effects of changes in significant unobservable assumption 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 cannot be based on observable market data. The following table shows the sensitivity of fair values to reasonably possible alternative assumptions:

#### *The group*

	Reflected in profit/(loss)		Reflected in equity	
	Favourable changes £m	Unfavourable changes £m	Favourable changes £m	Unfavourable changes £m
<b>At 31 December 2008</b>				
Derivatives/trading assets/trading liabilities <sup>1</sup> .....	<b>182</b>	<b>(250)</b>	<b>–</b>	<b>–</b>
Financial investments: available-for-sale .....	<b>–</b>	<b>–</b>	<b>519</b>	<b>(519)</b>
At 31 December 2007				
Derivatives/trading assets/trading liabilities <sup>1</sup> .....	150	(93)	–	–
Financial investments: available-for-sale .....	–	–	171	(202)

#### *The bank*

	Reflected in profit/(loss)		Reflected in equity	
	Favourable changes £m	Unfavourable changes £m	Favourable changes £m	Unfavourable changes £m
<b>At 31 December 2008</b>				
Derivatives/trading assets/trading liabilities <sup>1</sup> .....	<b>155</b>	<b>(239)</b>	<b>–</b>	<b>–</b>
Financial investments: available-for-sale .....	<b>–</b>	<b>–</b>	<b>344</b>	<b>(344)</b>
At 31 December 2007				
Derivatives/trading assets/trading liabilities <sup>1</sup> .....	135	(107)	–	–
Financial investments: available-for-sale .....	–	–	87	(87)

<sup>1</sup> Derivatives, trading assets and trading liabilities are presented as one category to reflect the manner in which these financial instruments are risk-managed.

The increase in the effect of changes in significant unobservable inputs in relation to derivatives, trading assets and trading liabilities in the period primarily reflects increased uncertainty in determining the fair value of credit derivative transactions executed against certain monoline insurers. In addition, there has been a general increase in structured derivative business exposures and the valuation measurement uncertainty of certain ABSs.

## Notes on the Financial Statements (continued)

### Changes in fair value recorded in the income statement

The following table quantifies the changes in fair values recognised in profit or loss during the period in respect of exposures where the fair value of these exposures is estimated using valuation techniques that incorporate significant 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 table details the total change in fair value of these instruments; it does not isolate the component of the change that is attributable to the unobservable component;
- instruments valued with significant unobservable inputs are frequently dynamically managed with instruments valued using observable inputs; the table does not include any changes in fair value of these latter instruments; and
- for assets and liabilities valued using significant unobservable inputs at 31 December 2008 where these inputs were observable at 31 December 2007, the table reflects the full change in fair value of those instruments during the period.

	<b>The group</b>		<b>The bank</b>	
	<b>Year ended 31 December</b>		<b>Year ended 31 December</b>	
	<b>2008</b>	2007	<b>2008</b>	2007
	<b>£m</b>	£m	<b>£m</b>	£m
<b>Recorded profit/(loss) on:</b>				
Derivatives/trading assets/trading liabilities.....	<b>(164)</b>	92	<b>(214)</b>	(27)

### Fair values of financial instruments not carried at fair value

Fair values at the balance sheets date of the assets and liabilities set out below are estimated for the purpose of disclosure at follows:

#### (i) *Loans and advances to banks and customers*

The fair value of loans and advances is based on observable market transactions (broker quotes and/or market data consensus), 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.

For all classes of financial instruments, fair value represents the product of the value of a single instrument, multiplied by the number of instruments held. No block discount or premium adjustments are made.

The fair values of intangible assets related to the businesses which originate and hold the financial instruments subject to fair value measurement, such as values placed on portfolios of core deposits, credit card and customer relationships, are not included above because they are not classified as financial instruments. Accordingly, an aggregation of fair value measurements does not approximate the value of the organisation as a whole as a going concern.

The following table lists financial instruments whose carrying amount is a reasonable approximation of fair value because, for example, they are short-term in nature or reprice to current market rates frequently:

<b>Assets</b>	<b>Liabilities</b>
Cash and balances at central banks	Items in the course of transmission to other banks
Items in the course of collection from other banks	Endorsements and acceptances within 'Other liabilities'
Endorsements and acceptances within 'Other assets'	Short-term payables within 'Other liabilities'
Short-term receivables within 'Other assets'	Accruals within 'Accruals and deferred income'
Accrued income within 'Prepayments and accrued income'	

*Fair values of financial instruments which are not carried at fair value on the balance sheet*

*The group*

	At 31 December 2008		At 31 December 2007	
	Carrying amount £m	Fair value £m	Carrying amount £m	Fair value £m
<b>Assets</b>				
Loans and advances to banks .....	50,719	50,703	60,764	60,764
Loans and advances to customers .....	298,304	292,059	227,687	226,572
Financial investments: debt securities .....	25	25	254	254
<b>Liabilities</b>				
Deposits by banks .....	61,431	61,454	48,786	48,783
Customer accounts .....	369,880	369,857	268,269	268,059
Debt securities in issue .....	52,308	51,461	50,921	50,620
Subordinated liabilities .....	7,259	6,589	5,205	4,921

*The bank*

	At 31 December 2008		At 31 December 2007	
	Carrying amount £m	Fair value £m	Carrying amount £m	Fair Value £m
<b>Assets</b>				
Loans and advances to banks .....	18,295	18,297	32,028	32,028
Loans and advances to customers .....	217,309	211,958	150,649	149,876
<b>Liabilities</b>				
Deposits by banks .....	54,986	54,981	41,061	41,061
Customer accounts .....	240,397	240,393	184,899	184,899
Debt securities in issue .....	8,670	8,624	8,117	8,194
Subordinated liabilities .....	7,310	6,623	4,744	4,469

### 32 Maturity analysis of assets and liabilities

The following is an analysis, by remaining contractual maturities at the balance sheet date, of undiscounted cash flows payable under financial liabilities.

## Notes on the Financial Statements (continued)

*The group*

	On demand	Due within 3 months	Due between 3 and 12 months	Due between 1 and 5 years	Due after 5 years	Total
	£m	£m	£m	£m	£m	£m
<b>At 31 December 2008</b>						
Deposits by banks .....	14,375	49,561	3,521	2,510	3,129	73,096
Customer accounts .....	231,596	129,687	17,117	1,934	1,393	381,727
Trading liabilities .....	124,450	–	–	–	–	124,450
Financial liabilities designated at fair value .....	3,627	59	208	4,904	9,478	18,276
Derivatives .....	239,394	130	1,098	1,661	243	242,526
Debt securities in issue .....	235	25,880	18,371	9,217	2,858	56,561
Subordinated liabilities .....	63	69	182	1,229	9,162	10,705
Other financial liabilities .....	1,957	6,205	1,124	646	511	10,443
	<b>615,697</b>	<b>211,591</b>	<b>41,621</b>	<b>22,101</b>	<b>26,774</b>	<b>917,784</b>
Loan commitments .....	37,897	41,746	10,249	22,231	10,901	123,024
	<b>653,594</b>	<b>253,337</b>	<b>51,870</b>	<b>44,332</b>	<b>37,675</b>	<b>1,040,808</b>
<b>At 31 December 2007</b>						
Deposits by banks .....	11,564	34,031	4,375	1,561	3,043	54,574
Customer accounts .....	173,902	90,818	7,720	2,232	1,255	275,927
Trading liabilities .....	117,454	–	–	–	–	117,454
Financial liabilities designated at fair value .....	5,828	408	1,345	2,716	8,134	18,431
Derivatives .....	60,908	4	246	483	104	61,745
Debt securities in issue .....	316	32,903	8,741	11,527	2,962	56,449
Subordinated liabilities .....	–	36	190	782	7,121	8,129
Other financial liabilities .....	2,567	6,152	861	253	585	10,418
	372,539	164,352	23,478	19,554	23,204	603,127
Loan commitments .....	36,914	58,332	8,610	23,791	11,497	139,144
	<b>409,453</b>	<b>222,684</b>	<b>32,088</b>	<b>43,345</b>	<b>34,701</b>	<b>742,271</b>

*The bank*

<b>At 31 December 2008</b>						
Deposits by banks .....	12,589	40,673	1,555	152	152	55,121
Customer accounts .....	192,570	35,643	8,218	625	786	237,842
Trading liabilities .....	98,389	–	–	–	–	98,389
Financial liabilities designated at fair value .....	–	44	187	2,469	8,824	11,524
Derivatives .....	196,549	55	275	339	105	197,323
Debt securities in issue .....	47	6,264	2,243	394	–	8,948
Subordinated liabilities .....	–	60	71	2,688	6,245	9,064
Other financial liabilities .....	28	4,608	20	15	1	4,672
	<b>500,172</b>	<b>87,347</b>	<b>12,569</b>	<b>6,682</b>	<b>16,113</b>	<b>622,883</b>
Loan commitments .....	13,521	38,250	2,186	11,623	8,471	74,051
	<b>513,693</b>	<b>125,597</b>	<b>14,755</b>	<b>18,305</b>	<b>24,584</b>	<b>696,934</b>
<b>At 31 December 2007</b>						
Deposits by banks .....	9,626	29,888	1,496	137	112	41,259
Customer accounts .....	141,788	35,584	2,648	5,094	1,334	186,448
Trading liabilities .....	99,755	–	–	–	–	99,755
Financial liabilities designated at fair value .....	–	54	161	2,401	7,769	10,385
Derivatives .....	47,339	(41)	66	229	5	47,598
Debt securities in issue .....	3	5,408	2,029	506	1,121	9,067
Subordinated liabilities .....	–	34	102	1,894	4,542	6,572
Other financial liabilities .....	–	4,639	64	15	1	4,719
	298,511	75,566	6,566	10,276	14,884	405,803
Loan commitments .....	16,538	55,765	1,787	14,418	8,340	96,848
	<b>315,049</b>	<b>131,331</b>	<b>8,353</b>	<b>24,694</b>	<b>23,224</b>	<b>502,651</b>

Trading liabilities and trading derivatives have been included in the 'On demand' time bucket, and not by contractual maturity, because trading liabilities are typically held for short periods of time. The undiscounted cash flows on

hedging derivative liabilities are classified according to their contractual maturity.

The following is an analysis by remaining contractual maturity at the balance sheet date, of assets and liability line items that combine amounts expected to be recovered or settled within one year and after more than one year.

Trading assets and liabilities are excluded because they are not held for collection or settlement over the period of contractual maturity.

*The group*

	At 31 December 2008		
	Due within one year £m	Due after more than one year £m	Total £m
<b>Assets</b>			
Financial assets designated at fair value .....	1,634	12,261	13,895
Loans and advances to banks .....	48,242	2,477	50,719
Loans and advances to customers .....	160,300	138,004	298,304
Financial investments .....	37,199	66,312	103,511
Other financial assets .....	7,954	1,757	9,711
	<b>255,329</b>	<b>220,811</b>	<b>476,140</b>
<b>Liabilities</b>			
Deposits by banks .....	59,517	1,914	61,431
Customer accounts .....	366,547	3,333	369,880
Financial liabilities designated at fair value .....	376	14,808	15,184
Debt securities in issue .....	41,115	11,193	52,308
Other financial liabilities .....	6,705	1,545	8,250
Subordinated liabilities .....	71	7,188	7,259
	<b>474,331</b>	<b>39,981</b>	<b>514,312</b>
	At 31 December 2007		
	Due within one year £m	Due after more than one year £m	Total £m
<b>Assets</b>			
Financial assets designated at fair value .....	2,267	12,702	14,969
Loans and advances to banks .....	55,163	5,601	60,764
Loans and advances to customers .....	119,052	108,635	227,687
Financial investments .....	16,467	53,061	69,528
Other financial assets .....	4,330	413	4,743
	<b>197,279</b>	<b>180,412</b>	<b>377,691</b>
<b>Liabilities</b>			
Deposits by banks .....	44,422	4,364	48,786
Customer accounts .....	264,976	3,293	268,269
Financial liabilities designated at fair value .....	4,750	10,909	15,659
Debt securities in issue .....	39,675	11,246	50,921
Other financial liabilities .....	6,332	358	6,690
Subordinated liabilities .....	–	5,205	5,205
	<b>360,155</b>	<b>35,375</b>	<b>395,530</b>

## Notes on the Financial Statements (continued)

*The bank*

	At 31 December 2008		
	Due within one year £m	Due after more than one year £m	Total £m
<b>Assets</b>			
Financial assets designated at fair value .....	78	4,514	4,592
Loans and advances to banks .....	15,810	2,485	18,295
Loans and advances to customers .....	111,970	105,339	217,309
Financial investments .....	27,894	18,714	46,608
Other financial assets .....	3,254	1,531	4,785
	<b>159,006</b>	<b>132,583</b>	<b>291,589</b>
<b>Liabilities</b>			
Deposits by banks .....	54,215	771	54,986
Customer accounts .....	234,572	5,825	240,397
Financial liabilities designated at fair value .....	241	9,188	9,429
Debt securities in issue .....	8,345	325	8,670
Other financial liabilities .....	3,292	524	3,816
Subordinated liabilities .....	–	7,310	7,310
	<b>300,665</b>	<b>23,943</b>	<b>324,608</b>
<b>At 31 December 2007</b>			
	Due within one year £m	Due after more than one year £m	Total £m
<b>Assets</b>			
Financial assets designated at fair value .....	–	3,439	3,439
Loans and advances to banks .....	28,479	3,549	32,028
Loans and advances to customers .....	71,543	79,106	150,649
Financial investments .....	8,467	5,354	13,821
Other financial assets .....	1,485	154	1,639
	<b>109,974</b>	<b>91,602</b>	<b>201,576</b>
<b>Liabilities</b>			
Deposits by banks .....	38,854	2,207	41,061
Customer accounts .....	181,340	3,559	184,899
Financial liabilities designated at fair value .....	3,366	4,716	8,082
Debt securities in issue .....	7,282	835	8,117
Other financial liabilities .....	2,793	–	2,793
Subordinated liabilities .....	–	4,744	4,744
	<b>233,635</b>	<b>16,061</b>	<b>249,696</b>

Further discussion of the group's liquidity and funding management can be found in Note 38 'Risk management'.

### 33 Foreign exchange exposures

#### Structural 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 Note 38.

#### Net structural currency exposures

<i>Currency of structural exposure</i>	<b>2008</b>	2007
	<b>£m</b>	£m
Euro .....	<b>11,040</b>	10,584
US dollars .....	<b>(1,384)</b>	558
Swiss francs .....	<b>1,499</b>	1,324
Turkish lira .....	<b>1,032</b>	895
Russian rouble .....	<b>184</b>	–
Others, each less than £100 million .....	<b>154</b>	189
Total .....	<b>12,525</b>	13,550

### 34 Assets charged as security for liabilities and collateral accepted as security for assets

Financial assets pledged to secure liabilities are as follows:

	<u>Group assets pledged at 31 December</u>		<u>Bank assets pledged at 31 December</u>	
	<b>2008</b>	2007	<b>2008</b>	2007
	<b>£m</b>	£m	<b>£m</b>	£m
Treasury bills and other eligible securities.....	–	1,410	–	1,404
Loans and advances to banks .....	<b>2,521</b>	5,402	<b>2,359</b>	1,113
Loans and advances to customers .....	<b>18,623</b>	24,664	<b>5,826</b>	3,408
Debt securities .....	<b>106,633</b>	100,750	<b>51,003</b>	38,696
Equity shares.....	<b>2,801</b>	9,366	<b>2,747</b>	9,300
	<b>130,578</b>	141,592	<b>61,935</b>	53,921

These transactions are conducted under terms that are usual and customary to 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 £95,191 million (2007: £104,506 million). The fair value of financial assets accepted as collateral that have been sold or repledged is £72,569 million (2007: £59,668 million). The group is obliged to return these assets.

These transactions are conducted under terms that are usual and customary to standard stock borrowing and lending activities.

### 35 Called up share capital

#### Authorised

At 31 December 2008 the authorised ordinary share capital of HSBC Bank plc was £1,000 million (2007: £1,000 million) divided into 999,999,999 (2007: 999,999,999) ordinary shares of £1 each and 1 (2007: 1) preferred ordinary share of £1.

At 31 December 2008, the authorised preference share capital of HSBC Bank plc was £150 million (2007: £150 million) and US\$ 2.44 million (2007: US\$ 2.44 million), divided into 150,000,000 (2007: 150,000,000) sterling preference shares of £1 each, 40,000 (2007: 40,000) non-cumulative US dollar preference shares of US\$0.01 each, 2,000,000 (2007: 2,000,000) non-cumulative second US dollar preference shares of US\$0.01 each and 400,000 (2007: 400,000) non-cumulative third US dollar preference shares of US\$0.01 each.

## Notes on the Financial Statements (continued)

### Issued

#### HSBC Bank plc Ordinary shares

	Number	£m
At 1 January 2008 .....	796,969,102	797
Shares issued .....	2	–
<b>At 31 December 2008 .....</b>	<b>796,969,104</b>	<b>797</b>
At 1 January 2007 .....	796,969,101	797
Shares issued .....	1	–
At 31 December 2007 .....	796,969,102	797

#### HSBC Bank plc Non-cumulative third dollar preference shares

	Number	£'000
<b>At 1 January and 31 December 2008 .....</b>	<b>35,000,000</b>	<b>172</b>
At 1 January 2007 .....	–	–
Recognised during the year .....	35,000,000	172
At 31 December 2007 .....	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 the prior non-objection of the FSA. Dividends on the preference shares 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 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 are not sufficient to enable the bank to pay in full both dividends on the preference shares 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 carry no rights to conversion into ordinary shares of the bank. Holders of the preference shares 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 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 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.

#### HSBC Bank plc Perpetual subordinated debt

At 1 January 2008 .....	1,000
Issued during the year .....	750
<b>At 31 December 2008 .....</b>	<b>1,750</b>
At 1 January 2007 .....	–
Issued during the year .....	1,000
<b>At 31 December 2007 .....</b>	<b>1,000</b>

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



## 36 Equity

### The group

	2008										
	Called up share capital £m	Share premium account £m	Other equity instruments £m	Retained earnings £m	Other reserves				Total share- holders' equity £m	Minority interests £m	Total equity £m
					Available- for-sale fair value reserve £m	Cash flow hedging reserve £m	Foreign exchange reserve £m	Associates and joint ventures £m			
At 1 January as reported.....	797	15,499	1,000	7,587	(757)	(60)	357	–	24,423	576	24,999
Share capital issued, net of costs <sup>1</sup> .....	–	1,750	–	–	–	–	–	–	1,750	–	1,750
Capital securities issued in the year .....	–	–	750	–	–	–	–	–	750	–	750
Profit for the year attributable to											
shareholders .....	–	–	–	3,441	–	–	–	–	3,441	–	3,441
Dividends to shareholders of the parent company .....	–	–	–	(2,974)	–	–	–	–	(2,974)	–	(2,974)
Actuarial gains on defined benefit plans .....	–	–	–	(126)	–	–	–	–	(126)	(3)	(129)
Fair value gains/(losses) taken to equity .....	–	–	–	–	(11,551)	545	–	–	(11,006)	–	(11,006)
Amounts transferred to the income statement .....	–	–	–	–	99	(8)	(136)	–	(45)	(1)	(46)
Net impact of equity-settled											
share-based payments.....	–	–	–	49	–	–	–	–	49	–	49
Tax on items taken directly to or											
transferred from equity .....	–	–	–	31	558	(151)	–	–	438	–	438
Transfer to minority interest.....	–	–	–	–	27	1	–	–	28	(28)	–
Profit attributable to minority interests .....	–	–	–	–	–	–	–	–	–	82	82
Dividends to minority interests .....	–	–	–	(25)	–	–	–	–	(25)	(38)	(63)
Transfers from associates .....	–	–	–	–	(3)	–	–	–	(3)	–	(3)
Exchange differences .....	–	–	–	(2)	–	–	3,237	–	3,235	122	3,357
Other .....	–	–	–	(12)	–	–	–	–	(12)	28	16
<b>At 31 December .....</b>	<b>797</b>	<b>17,249</b>	<b>1,750</b>	<b>7,969</b>	<b>(11,627)</b>	<b>327</b>	<b>3,458</b>	<b>–</b>	<b>19,923</b>	<b>738</b>	<b>20,661</b>

<sup>1</sup> All shares issued in the year were issued to HSBC Holdings plc. Further information is provided in Note 35.

	2007 (restated)										
	Called up share capital £m	Share premium account £m	Other equity instruments £m	Retained Earnings £m	Other reserves				Total share- holders' equity £m	Minority interests £m	Total equity £m
					Available- for-sale fair value reserve £m	Cash flow hedging reserve £m	Foreign exchange reserve £m	Associates and joint ventures £m			
At 1 January .....	797	14,558	–	5,165	523	(32)	(737)	125	20,399	539	20,938
Share capital issued, net of costs .....	–	510	–	–	–	–	–	–	510	2	512
Capital securities issued in the year .....	–	–	1,000	–	–	–	–	–	1,000	–	1,000
Preference shares recognised in the year <sup>1</sup> .....	–	431	–	–	–	–	–	–	431	–	431
Profit for the year attributable to shareholders (restated) .....	–	–	–	3,209	–	–	–	–	3,209	–	3,209
Dividends to shareholders of the parent company .....	–	–	–	(1,706)	–	–	–	–	(1,706)	–	(1,706)
Actuarial gains on defined benefit plans .....	–	–	–	1,267	–	–	–	–	1,267	3	1,270
Fair value gains/(losses) taken to equity .....	–	–	–	–	(964)	(71)	–	101	(934)	–	(934)
Amounts transferred to the income statement .....	–	–	–	–	(501)	33	–	(122)	(590)	–	(590)
Net impact of equity-settled share-based payments .....	–	–	–	58	–	–	–	–	58	–	58
Tax on items taken directly to or transferred from equity .....	–	–	–	(382)	61	10	–	–	(311)	–	(311)
Transfer to minority interest .....	–	–	–	–	3	–	–	–	3	(3)	–
Profit attributable to minority interests .....	–	–	–	–	–	–	–	–	–	87	87
Dividends to minority interests .....	–	–	–	(7)	–	–	–	–	(7)	(67)	(74)
Transfers from associates .....	–	–	–	(16)	120	–	–	(104)	–	–	–
Exchange differences .....	–	–	–	–	–	–	1,094	–	1,094	15	1,109
Other .....	–	–	–	(1)	1	–	–	–	–	–	–
At 31 December .....	797	15,499	1,000	7,587	(757)	(60)	357	–	24,423	576	24,999

1 Share premium arising on the bank's Non-cumulative third dollar preference shares recognised as equity instruments during the year. Further information is provided in Note 35.

The bank

2008

	Called up share capital £m	Share premium account £m	Other equity instruments £m	Retained earnings £m	Other reserves					Total equity £m
					Available-for-sale fair value reserve £m	Cash flow hedging reserve £m	Foreign exchange reserve £m	Associates and joint ventures £m		
At 1 January as reported	797	15,499	1,000	3,301	179	13	(12)	-	-	20,777
Share capital issued, net of costs	-	1,750	-	-	-	-	-	-	-	1,750
Capital securities issued in the year	-	-	750	-	-	-	-	-	-	750
Profit for the year attributable to shareholders	-	-	-	2,681	-	-	-	-	-	2,681
Dividends to shareholders of the parent company	-	-	-	(2,974)	-	-	-	-	-	(2,974)
Actuarial gain on defined benefit plans	-	-	-	33	-	-	-	-	-	33
Fair value gains/(losses) taken to equity	-	-	-	-	(1,533)	563	-	-	-	(970)
Amounts transferred to the income statement	-	-	-	-	(61)	(16)	(6)	-	-	(83)
Net impact of equity-settled share-based payments	-	-	-	28	-	-	-	-	-	28
Tax on items taken directly to or transferred from equity	-	-	-	(4)	438	(153)	-	-	-	281
Exchange differences	-	-	-	-	-	-	(34)	-	-	(34)
Other	-	-	-	16	-	-	-	-	-	16
<b>At 31 December</b>	<b>797</b>	<b>17,249</b>	<b>1,750</b>	<b>3,081</b>	<b>(977)</b>	<b>407</b>	<b>(52)</b>	<b>-</b>	<b>-</b>	<b>22,255</b>

1 All shares issued in the year were issued to HSBC Holdings plc. Further information is provided in Note 35.

## Notes on the Financial Statements (continued)

	2007 (restated)									
	Called up share capital	Share premium account	Other equity instruments	Retained earnings	Available-for-sale fair value reserve	Cash flow hedging reserve	Foreign exchange reserve	Associates and joint ventures	Total equity	
	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m
At 1 January	797	14,558	-	1,771	91	(8)	(2)	-	17,207	
Share capital issued, net of costs	-	510	-	-	-	-	-	-	510	
Capital securities issued in the year	-	-	1,000	-	-	-	-	-	1,000	
Preference shares recognised in the year <sup>1</sup>	-	431	-	-	-	-	-	-	431	
Profit for the year attributable to shareholders (restated)	-	-	-	2,336	-	-	-	-	2,336	
Dividends to shareholders of the parent company	-	-	-	(1,706)	-	-	-	-	(1,706)	
Actuarial gains on defined benefit plans	-	-	-	1,231	-	-	-	-	1,231	
Fair value gains/(losses) taken to equity	-	-	-	-	238	10	-	-	248	
Amounts transferred to the income statement	-	-	-	-	(167)	19	-	-	(148)	
Net impact of equity-settled share-based payments	-	-	-	41	-	-	-	-	41	
Tax on items taken directly to or transferred from equity	-	-	-	(372)	16	(8)	-	-	(364)	
Exchange differences	-	-	-	-	-	-	(10)	-	(10)	
Other	-	-	-	-	1	-	-	-	1	
At 31 December	797	15,499	1,000	3,301	179	13	(12)	-	20,777	

<sup>1</sup> Share premium arising on the bank's Non-cumulative third dollar preference shares recognised as equity instruments during the year. Further information is provided in Note 35.

### 37 Notes on the cash flow statement

#### Non-cash items included in profit before tax

	The group		The bank	
	2008	2007 (restated)	2008	2007 (restated)
	£m	£m	£m	£m
Depreciation, amortisation and impairment .....	575	564	312	340
Share-based payment expense .....	225	182	129	112
Profit on repayment of capital in subsidiary .....	–	–	(280)	–
Gain on financing 8 Canada Square .....	(244)	–	(244)	–
Loan impairment losses gross of recoveries .....	1,861	1,043	1,328	825
Provisions raised .....	103	342	16	230
Impairment of financial investments .....	282	–	50	–
Charge for defined benefit plans .....	135	240	148	245
Accretion of discounts and amortisation of premiums .....	(204)	(166)	(11)	(33)
	<b>2,733</b>	<b>2,205</b>	<b>1,448</b>	<b>1,719</b>

#### Change in operating assets

	The group		The bank	
	2008	2007	2008	2007
	£m	£m	£m	£m
Change in prepayments and accrued income .....	455	(2,129)	896	(1,454)
Change in net trading securities and net derivatives .....	(15,976)	(6,299)	15,375	(25,811)
Change in loans and advances to banks .....	9,704	(10,421)	8,510	(7,371)
Change in loans and advances to customers .....	(64,643)	(27,302)	(60,016)	(6,616)
Change in financial assets designated at fair value .....	1,575	(8,984)	(2,004)	(3,439)
Change in other assets .....	(3,357)	(1,482)	(1,773)	(63)
	<b>(72,242)</b>	<b>(56,617)</b>	<b>(39,012)</b>	<b>(44,754)</b>

#### Change in operating liabilities

	The group		The bank	
	2008	2007	2008	2007
	£m	£m	£m	£m
Change in accruals and deferred income .....	(771)	2,313	(1,354)	1,642
Change in deposits by banks .....	12,645	10,273	13,925	11,879
Change in customer accounts .....	101,611	40,919	55,498	20,845
Change in debt securities in issue .....	1,695	12,831	553	2,709
Change in financial liabilities designated at fair value .....	(474)	6,199	1,347	3,346
Change in other liabilities .....	3,488	10,852	395	(1,155)
	<b>118,194</b>	<b>83,387</b>	<b>70,364</b>	<b>39,266</b>

## Notes on the Financial Statements (continued)

### Cash and cash equivalents

	The group		The bank	
	2008 £m	2007 £m	2008 £m	2007 £m
Cash and balances at central banks .....	9,470	7,146	6,779	3,677
Items in the course of collection from other banks .....	1,917	2,434	692	1,377
Loans and advances to banks of one month or less .....	37,448	37,751	8,021	13,205
Treasury bills, other bills and certificates of deposit less than three months .....	13,822	5,879	13,071	5,389
Less: items in the course of transmission to other banks .....	(1,802)	(1,975)	(772)	(1,056)
<b>Total cash and cash equivalents<sup>1</sup> .....</b>	<b>60,855</b>	<b>51,235</b>	<b>27,791</b>	<b>22,592</b>

<sup>1</sup> 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 (2007: £18 million); and £2,175 million subject to other restrictions (2007: £3,098 million).

Total interest paid by the group during the year was £17,126 million (2007: £13,318 million). Total interest received by the group during the year was £17,815 million (2007: £14,632 million). Total dividends received by the group during the year was £837 million (2007: £715 million).

## 38 Risk management

All the group's activities involve the measurement, evaluation, acceptance and management of some degree of risk, or combination of risks.

The most important risk categories that the group is exposed to are credit risk (including cross-border country risk), insurance risk, liquidity risk, market risk (including foreign exchange, interest rate, equity price and credit spread risks). In addition, risk also arises from transactions with special purpose entities, both consolidated and unconsolidated, and other types of off-balance sheet arrangement, including financial guarantees, letters of credit and commitments to lend. Along with insurance risk, the insurance business manages its own credit, liquidity and market risk separately from the rest of the group due to the different nature of its activities.

The management of all risks that are significant to the group are discussed below.

### Credit risk

Credit risk is the risk of financial loss if a customer or counterparty fails to meet an obligation under a contract. It arises principally from direct lending, trade finance and leasing business, but also from guarantees and derivatives, and from the group's holdings of assets in the form of debt securities. The group has standards, policies and procedures dedicated to monitoring and managing risk from such activities.

### Credit risk management

HSBC Holdings plc is responsible for the formulation of high-level credit risk policies and provides high-level centralised oversight and management of credit risk for HSBC worldwide. In addition its responsibilities include:

- Controlling exposures to sovereign entities, banks and other financial institutions. HSBC's credit and settlement risk limits to counterparties in these sectors are approved and managed by Group Credit Risk, to optimise the use of credit availability and avoid excessive risk concentration.
- Monitor intra-Group exposures to ensure they are maintained within regulatory limits. Plans are in place to adopt the FSA's new 'Integrated Groups' regime in accordance with the agreed transition timetable.
- Controlling cross-border exposures, through the imposition of country limits with sub-limits by maturity and type of business. Country limits are determined by taking into account economic and political factors, and applying local business knowledge. Transactions with countries deemed to be higher risk are considered case by case.

Within the group, 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 HSBC Group Chief Risk Officer. Its responsibilities include:

- Formulating and recording in instruction manuals detailed credit policies and procedures, consistent with HSBC policy.
- Issuing policy guidelines to subsidiaries and offices on appetite for credit risk exposure to specified market sectors, activities and banking products.
- Undertaking independent review and objective assessment of risk. Credit Risk approves all commercial non-bank credit facilities and exposures – including those embedded in derivatives – that are originated or renewed by subsidiaries and offices over designated limits.
- Monitoring the performance and management of retail portfolios.
- Maintaining 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 governance and operation of HSBC’s risk rating framework and systems, to classify exposures.
- Assisting the Risk Strategy unit in the development of stress testing scenarios, economic capital measurement and the refinement of key risk indicators and their reporting.
- Reporting to senior executives on aspects of the group’s credit risk portfolio. These executives, as well as the European Risk Management Committee, Audit Committee and the Board of Directors of the bank receive a variety of regular and ad hoc reports covering:
  - risk concentrations;
  - retail portfolio performance;
  - specific higher-risk portfolio segments, for example, real estate, banks, and automotive sector;
  - individual large impaired accounts, and impairment allowances/charges for all customer segments;
  - country limits, cross-border exposures and related impairment allowances;
  - portfolio and analytical model performance data, employing Basel 2 metrics, and
  - stress testing results and recommendations.
- Where appropriate, establishing specialist units to provide intensive management and control to maximise recoveries of doubtful debts.
- Managing and directing credit risk management systems initiatives.
- Providing advice and guidance to offices and subsidiaries, to promote best practice on credit-related matters such as:
  - regulatory developments;
  - risk modelling;
  - collective impairment allowances; and
  - new products and credit risk reporting.
- Acting on behalf of the group as the primary interface, for credit-related issues, with external parties including the Bank of England, the FSA, rating agencies, corporate analysts, trade associations and counterparts.

### Credit quality

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. For individually significant accounts, risk ratings are reviewed regularly and amendments, where necessary, are implemented promptly. Within the group’s retail portfolios, risk is assessed and managed using a wide range of risk and pricing models.

## Notes on the Financial Statements (continued)

Previously, the group has deployed a seven-grade rating system based on a 'composite' assessment of the likelihood and extent of delinquency and risk mitigation. This legacy risk rating scale has been superseded by a more granular methodology, based on probability of default and loss estimates, compliant with an internal ratings-based ('IRB') approach required to support the Basel II framework for calculating the group's minimum capital requirement. The integration of this framework into the group's reporting structure will enable reporting on the new basis to internal management in accordance with the group's IRB obligations. The new framework is used by the group's principal operating entities.

### Impairment assessment

When impairment losses occur, the group reduces the carrying amount of loans and advances and held-to-maturity financial investments through the use of an allowance account. When impairment of available-for-sale financial assets occurs, the carrying amount of the asset is reduced directly. Two types of impairment allowance are in place: individually assessed and collectively assessed. 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. It is the group's policy that each operating company creates allowances for impaired loans promptly and on a consistent basis.

Management regularly evaluates the adequacy of the established allowances for impaired loans by conducting a detailed review of the loan portfolio, comparing performance and delinquency statistics with historical trends and assessing the impact of current economic conditions.

### Maximum exposure to credit risk

The following table presents the maximum exposure to credit risk in respect of financial instruments, before taking account of any collateral held or other credit enhancements unless such credit enhancements meet offsetting requirements as set out in Note 2(n) on the Financial Statements. For financial assets recognised on the balance sheet, the exposure to credit risk equals their carrying amount. For financial guarantees granted, the maximum exposure to credit risk 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, the maximum exposure to credit risk is the full amount of the committed facilities.

In respect of certain financial assets, the group typically has legally enforceable rights to offset certain credit exposures against amounts owing to the same counterparty. In normal circumstances there would be no intention of settling net, or of realising the financial assets and settling the financial liabilities simultaneously. Consequently, for reporting purposes the financial assets are not offset against the respective financial liabilities. However, the exposure to credit risk relating to the respective financial assets is reduced as tabulated below.



The group

	Maximum exposure at 31 December 2008 £m	Offset £m	Net Exposure to Credit Risk £m
Items in the course of collection from other banks .....	1,917	–	1,917
Trading assets .....	<b>158,900</b>	<b>(6,945)</b>	<b>151,955</b>
– treasury and other eligible bills .....	21	–	21
– debt securities .....	77,241	–	77,241
– loans and advances to banks .....	37,898	–	37,898
– loans and advances to customers .....	43,740	(6,945)	36,795
Financial assets designated at fair value .....	<b>8,073</b>	–	<b>8,073</b>
– treasury and other eligible bills .....	43	–	43
– debt securities .....	7,380	–	7,380
– loans and advances to banks .....	153	–	153
– loans and advances to customers .....	497	–	497
Derivatives .....	243,084	(173,522)	69,562
Loans and advances held at amortised cost .....	<b>349,023</b>	<b>(54,890)</b>	<b>294,133</b>
– loans and advances to banks .....	50,719	(82)	50,637
– loans and advances to customers .....	298,304	(54,808)	243,496
Financial investments .....	<b>100,843</b>	–	<b>100,843</b>
– treasury and other similar bills .....	10,562	–	10,562
– debt securities .....	90,281	–	90,281
Other assets .....	7,759	–	7,759
– endorsements and acceptances .....	370	–	370
– other .....	7,389	–	7,389
Financial guarantees .....	20,293	–	20,293
Loan commitments and other credit-related commitments .....	<b>154,391</b>	–	<b>154,391</b>
	<b>1,044,283</b>	<b>(235,357)</b>	<b>808,926</b>
	Maximum exposure at 31 December 2007 £m	Offset £m	Net Exposure to Credit Risk £m
Items in the course of collection from other banks .....	2,434	–	2,434
Trading assets .....	130,787	(3,307)	127,480
– treasury and other eligible bills .....	445	–	445
– debt securities .....	58,741	–	58,741
– loans and advances to banks .....	37,020	–	37,020
– loans and advances to customers .....	34,581	(3,307)	31,274
Financial assets designated at fair value .....	7,936	–	7,936
– treasury and other eligible bills .....	25	–	25
– debt securities .....	7,822	–	7,822
– loans and advances to banks .....	89	–	89
– loans and advances to customers .....	–	–	–
Derivatives .....	60,470	(30,452)	30,018
Loans and advances held at amortised cost .....	288,451	(31,951)	256,500
– loans and advances to banks .....	60,764	(135)	60,629
– loans and advances to customers .....	227,687	(31,816)	195,871
Financial investments .....	66,476	–	66,476
– treasury and other similar bills .....	1,882	–	1,882
– debt securities .....	64,594	–	64,594
Other assets .....	3,668	(111)	3,557
– endorsements and acceptances .....	375	(111)	264
– other .....	3,293	–	3,293
Financial guarantees .....	17,603	–	17,603
Loan commitments and other credit-related commitments .....	<b>146,019</b>	–	<b>146,019</b>
	<b>723,844</b>	<b>(65,821)</b>	<b>658,023</b>

## Notes on the Financial Statements (continued)

## The bank

	Maximum exposure at 31 December 2008 £m	Offset £m	Net Exposure to Credit Risk £m
Items in the course of collection from other banks .....	692	–	692
Trading assets .....	119,155	(6,945)	112,210
– treasury and other eligible bills .....	7	–	7
– debt securities .....	32,132	–	32,132
– loans and advances to banks .....	45,299	–	45,299
– loans and advances to customers .....	41,717	(6,945)	34,772
Financial assets designated at fair value .....	4,592	–	4,592
– treasury and other eligible bills .....	–	–	–
– debt securities .....	4,514	–	4,514
– loans and advances to banks .....	–	–	–
– loans and advances to customers .....	78	–	78
Derivatives .....	197,128	(120,488)	76,640
Loans and advances held at amortised cost .....	235,604	(47,501)	188,103
– loans and advances to banks .....	18,295	–	18,295
– loans and advances to customers .....	217,309	(47,501)	169,808
Financial investments .....	45,519	–	45,519
– treasury and other similar bills .....	9,818	–	9,818
– debt securities .....	35,701	–	35,701
Other assets .....	2,928	–	2,928
– endorsements and acceptances .....	224	–	224
– other .....	2,704	–	2,704
Financial guarantees .....	11,032	–	11,032
Loan commitments and other credit-related commitments .....	103,487	–	103,487
	<b>720,137</b>	<b>(174,934)</b>	<b>545,203</b>
	Maximum exposure at 31 December 2007 £m	Offset £m	Net Exposure to Credit Risk £m
Items in the course of collection from other banks .....	1,377	–	1,377
Trading assets .....	136,007	(3,307)	132,700
– treasury and other eligible bills .....	437	–	437
– debt securities .....	37,902	–	37,902
– loans and advances to banks .....	59,451	–	59,451
– loans and advances to customers .....	38,217	(3,307)	34,910
Financial assets designated at fair value .....	3,439	–	3,439
– treasury and other eligible bills .....	–	–	–
– debt securities .....	3,439	–	3,439
– loans and advances to banks .....	–	–	–
– loans and advances to customers .....	–	–	–
Derivatives .....	46,325	(17,813)	28,512
Loans and advances held at amortised cost .....	182,677	(29,974)	152,703
– loans and advances to banks .....	32,028	–	32,028
– loans and advances to customers .....	150,649	(29,974)	120,675
Financial investments .....	12,894	–	12,894
– treasury and other similar bills .....	1,397	–	1,397
– debt securities .....	11,497	–	11,497
Other assets .....	1,337	–	1,337
– endorsements and acceptances .....	251	–	251
– other .....	1,086	–	1,086
Financial guarantees .....	9,706	–	9,706
Loan commitments and other credit-related commitments .....	102,326	–	102,326
	<b>496,088</b>	<b>(51,094)</b>	<b>444,994</b>

## **Collateral and other credit enhancements**

Collateral held against financial instruments presented above in the maximum exposure to credit risk tables is described in more detail below.

### **Items in the course of collection from other banks**

Settlement risk arises in any situation where a payment in cash, securities or equities is made in the expectation of a corresponding receipt in cash, securities or equities. Daily settlement limits are established for each counterparty to cover the aggregate of all settlement risk arising from the group's transactions with them, on any single day. Settlement risk on many transactions, particularly those involving securities and equities, is substantially mitigated through being effected via assured payment systems, or on a delivery-versus-payment basis.

### **Treasury, other eligible bills and debt securities**

Collateral held as security for financial assets other than loans and advances is determined by the nature of the instrument. Debt securities, treasury and other eligible bills are generally unsecured, with the exception of asset-backed securities and similar instruments, which are secured by pools of financial assets.

### **Derivatives**

The 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.

### **Loans and advances**

It is the group's policy, when lending, to do so within the customer's capacity to repay, rather than rely excessively on security. Depending on the customer's standing and the type of product, facilities may be unsecured. Nevertheless, collateral can be an important mitigant of credit risk.

Operating companies are required to implement appropriate guidelines on the acceptability of specific classes of collateral or credit risk mitigation, and determine suitable valuation parameters. Such parameters, structures and legal covenants are supported by empirical evidence and continue to fulfil their intended purpose. The principal collateral types are as follows:

- in the personal sector, mortgages over residential properties;
- in the commercial and industrial sector, charges over business assets such as premises, stock and debtors;
- in the commercial real estate sector, charges over the properties being financed; and
- in the financial sector, charges over financial instruments such as debt securities and equities in support of trading facilities.

In addition, credit derivatives, including credit default swaps and structured credit notes, as well as securitisation structures, are used to manage credit risk in the group's loan portfolio.

The group does not disclose the fair value of collateral held as security or other credit enhancements on loans and advances past due but not impaired, or on individually assessed impaired loans and advances, as it is not practicable to do so.

## Notes on the Financial Statements (continued)

### Concentrations of credit risk exposure

Concentrations of credit risk exist when a number of counterparties are engaged in similar activities, or operate in the same geographical areas or industry sectors and have comparable economic characteristics, so that their ability to meet contractual obligations is uniformly affected by changes in economic, political or other conditions.

#### *The group*

	2008 %	2007 %
United Kingdom .....	42	42
France .....	16	18
Germany .....	6	5
Rest of Continental Europe .....	<u>20</u>	<u>20</u>
Continental Europe .....	42	43
United States .....	8	6
Rest of the world .....	<u>8</u>	<u>9</u>
	<b><u>100</u></b>	<b><u>100</u></b>

#### *The bank*

	2008 %	2007 %
United Kingdom .....	58	56
France .....	3	5
Germany .....	2	3
Rest of Continental Europe .....	<u>20</u>	<u>21</u>
Continental Europe .....	25	29
United States .....	7	5
Rest of the world .....	<u>10</u>	<u>10</u>
	<b><u>100</u></b>	<b><u>100</u></b>

The group provides a diverse range of financial services both in the United Kingdom and internationally. As a result, its portfolio of financial instruments with credit risk is diversified with no exposures to individual industries or economic groupings totalling more than 10 per cent of consolidated total assets, except as follows:

- the bank's position as one of the principal UK clearing banks means that the majority of the group's exposure to credit risk is concentrated in the United Kingdom. Within the United Kingdom, the group's credit risk is diversified over a wide range of industrial and economic groupings; and
- the group's position as part of a major international banking group means, that it has a significant concentration of exposure to banking counterparties. The majority of credit risk to the banking industry at 31 December 2008 and 31 December 2007 was concentrated in Europe (including the United Kingdom).

## Loans and advances to customers by industry sector

### The group

	At 31 December 2008		At 31 December 2007	
	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 %
<b>Personal</b>				
Residential mortgages .....	60,240	20.03%	47,997	20.92%
Other personal .....	38,412	12.77%	36,496	15.90%
	<b>98,652</b>	<b>32.80%</b>	<b>84,493</b>	<b>36.82%</b>
<b>Corporate and commercial</b>				
Commercial, industrial and international trade .....	83,163	27.65%	60,036	26.16%
Commercial real estate .....	22,563	7.50%	18,372	8.01%
Other property-related .....	5,301	1.76%	5,656	2.46%
Government .....	1,275	0.41%	1,137	0.50%
Other commercial .....	38,915	12.94%	27,310	11.90%
	<b>151,217</b>	<b>50.26%</b>	<b>112,511</b>	<b>49.03%</b>
<b>Financial</b>				
Non-bank financial institutions .....	45,891	15.26%	31,663	13.80%
Settlement accounts .....	754	0.25%	813	0.35%
	<b>46,645</b>	<b>15.51%</b>	<b>32,476</b>	<b>14.15%</b>
Asset-backed securities reclassified .....	4,292	1.43%	–	–
Total gross loans and advances to customers .....	<b>300,806</b>	<b>100.00%</b>	<b>229,480</b>	<b>100.00%</b>

### The bank

	At 31 December 2008		At 31 December 2007	
	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 %
<b>Personal</b>				
Residential mortgages .....	52,230	23.88%	40,939	27.03%
Other personal .....	12,396	5.67%	13,594	8.97%
	<b>64,626</b>	<b>29.55%</b>	<b>54,533</b>	<b>36.00%</b>
<b>Corporate and commercial</b>				
Commercial, industrial and international trade .....	60,957	27.87%	41,290	27.27%
Commercial real estate .....	13,660	6.25%	10,580	6.98%
Other property-related .....	4,057	1.86%	4,612	3.04%
Government .....	757	0.35%	777	0.51%
Other commercial .....	28,428	13.00%	18,706	12.35%
	<b>107,859</b>	<b>49.33%</b>	<b>75,965</b>	<b>50.15%</b>
<b>Financial</b>				
Non-bank financial institutions .....	41,489	18.97%	20,715	13.67%
Settlement accounts .....	411	0.19%	270	0.18%
	<b>41,900</b>	<b>19.16%</b>	<b>20,985</b>	<b>13.85%</b>
Asset-backed securities reclassified .....	4,292	1.96%	–	–
Total gross loans and advances to customers .....	<b>218,677</b>	<b>100.00%</b>	<b>151,483</b>	<b>100.00%</b>

## Notes on the Financial Statements (continued)

There are no special collateral requirements relating to industrial concentrations, with the exception of exposures to the property sector. The majority of exposures to the property and construction industry and the residential mortgage market are secured on the underlying property.

### Credit quality of financial instruments

The four classifications below describe the credit quality of the group's lending, debt securities portfolios and derivatives. These categories each encompass a range of more granular, internal credit rating grades assigned to wholesale and retail lending business, as well as the external ratings attributed by external agencies to debt securities. There is no direct correlation between the internal and external ratings at granular level, except insofar as both fall within one of the four classifications.

#### Quality Classification

	Wholesale lending and Derivatives	Retail lending	Debt securities / other
<b>Strong</b>	CRR 1 to CRR 2	EL 1 to EL 2	A- and above
<b>Medium</b>	CRR 3 to CRR 5	EL 3 to EL 5	B+ to BBB+, and unrated
<b>Sub-Standard</b>	CRR 6 to CRR 8	EL 6 to EL 8	B and below
<b>Impaired</b>	CRR 9 to CRR 10	EL 9 to EL 10	Impaired

#### Quality classification definitions

'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 applicable product parameters and only exceptionally show any period of delinquency.

'Medium': Exposures require closer monitoring, with low to moderate default risk. Retail accounts typically show only short periods of delinquency, with losses expected to be minimal 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. The group observes the disclosure convention, reflected in the quality classification definitions above, that all retail accounts delinquent by 90 days or more are considered impaired. Such accounts may occur in any EL grade, whereby in the higher quality grades the grading assignment will reflect the offsetting of the impact of delinquency status by credit risk mitigation in one form or another.

#### Granular risk rating scales

The CRR (Customer Risk Rating) 10-grade scale maps to a more granular underlying 22-grade scale of obligor probability of default. The scales are used group-wide for all distinct customers, depending on the Basel 2 approach adopted for the exposure in question. The EL (Expected Loss) 10-grade scale for retail business summarises a more granular, group-wide 29-grade scale combining obligor and facility/product risk factors in a composite measure. For consistency of disclosure and based on market practice for transactions in debt securities and certain other financial instruments, external ratings have been aligned as above, and in the table of 'Distribution of financial instruments by credit quality' below, to the four quality classifications defined for internally-rated exposures, although it should be noted that there is no fixed correlation between internal and external ratings. The ratings of Standard and Poor's are cited, with those of other agencies being treated equivalently. Debt securities with short-term ratings are reported below against the long-term rating of the issuer of the short-term debt securities. If major rating agencies have different ratings for the same debt securities, the securities are reported against the lower rating.

The basis of reporting has been changed from previous years, replacing the former uniform seven-grade portfolio quality scale, in order both to extend the range of financial instruments covered in the presentation of portfolio quality and to reflect the more risk-sensitive rating systems introduced under the group's Basel II programme.

Impairment is not measured for assets held in trading portfolios or 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 profit and loss statement. Consequently, all such balances are reported under 'neither past due nor impaired'.

For details of impairment incurred on available-for-sale debt and equity securities, see 'Accounting policies' in Note 2(j).

## Distribution of financial instruments by credit quality

The group

	31 December 2008						
	Neither past due nor impaired			Past due not impaired	Impaired	Impairment allowances	Total
	Strong £m	Medium £m	Sub- standard £m	£m	£m	£m	£m
Items in the course of collection from other banks ..	1,917	–	–	–	–	–	1,917
Trading assets .....	117,335	40,822	743	–	–	–	158,900
– treasury and other eligible bills .....	–	21	–	–	–	–	21
– debt securities .....	66,272	10,969	–	–	–	–	77,241
– loans and advances to banks .....	32,006	5,892	–	–	–	–	37,898
– loans and advances to customers .....	19,057	23,940	743	–	–	–	43,740
Financial assets designated at fair value .....	1,649	6,424	–	–	–	–	8,073
– treasury and other eligible bills .....	22	21	–	–	–	–	43
– debt securities .....	977	6,403	–	–	–	–	7,380
– loans and advances to banks .....	153	–	–	–	–	–	153
– loans and advances to customers .....	497	–	–	–	–	–	497
Derivatives .....	201,340	41,336	408	–	–	–	243,084
Loans and advances held at amortised cost .....	195,187	138,836	11,462	2,339	3,744	(2,545)	349,023
– loans and advances to banks .....	41,824	8,656	240	–	42	(43)	50,719
– loans and advances to customers .....	153,363	130,180	11,222	2,339	3,702	(2,502)	298,304
Financial investments .....	94,540	5,518	521	–	264	–	100,843
– treasury and other similar bills .....	10,551	–	11	–	–	–	10,562
– debt securities .....	83,989	5,518	510	–	264	–	90,281
Other assets .....	4,229	3,290	239	–	1	–	7,759
– endorsements and acceptances .....	165	191	13	–	1	–	370
– other .....	4,064	3,099	226	–	–	–	7,389

## Notes on the Financial Statements (continued)

## The group

	31 December 2007						
	Neither past due nor impaired			Past due not impaired £m	Impaired £m	Impairment allowances £m	Total £m
	Strong £m	Medium £m	Sub- standard £m				
Items in the course of collection from other banks ..	2,434	–	–	–	–	–	2,434
Trading assets .....	93,681	36,932	174	–	–	–	130,787
– treasury and other eligible bills .....	444	–	1	–	–	–	445
– debt securities .....	50,890	7,851	–	–	–	–	58,741
– loans and advances to banks .....	29,836	7,184	–	–	–	–	37,020
– loans and advances to customers .....	12,511	21,897	173	–	–	–	34,581
Financial assets designated at fair value .....	1,401	6,535	–	–	–	–	7,936
– treasury and other eligible bills .....	25	–	–	–	–	–	25
– debt securities .....	1,287	6,535	–	–	–	–	7,822
– loans and advances to banks .....	89	–	–	–	–	–	89
– loans and advances to customers .....	–	–	–	–	–	–	–
Derivatives .....	48,308	11,858	304	–	–	–	60,470
Loans and advances held at amortised cost .....	161,574	118,670	5,669	1,375	2,959	(1,796)	288,451
– loans and advances to banks .....	47,089	13,237	435	–	6	(3)	60,764
– loans and advances to customers .....	114,485	105,433	5,234	1,375	2,953	(1,793)	227,687
Financial investments .....	63,859	2,541	76	–	–	–	66,476
– treasury and other similar bills .....	1,842	26	14	–	–	–	1,882
– debt securities .....	62,017	2,515	62	–	–	–	64,594
Other assets .....	2,341	1,278	49	–	–	–	3,668
– endorsements and acceptances .....	286	89	–	–	–	–	375
– other .....	2,055	1,189	49	–	–	–	3,293



The bank

31 December 2008

	Neither past due nor impaired			Past due not impaired £m	Impaired £m	Impairment allowances £m	Total £m
	Strong £m	Medium £m	Sub- standard £m				
Items in the course of collection from other banks ..	692	–	–	–	–	–	692
Trading assets .....	86,776	31,636	743	–	–	–	119,155
– treasury and other eligible bills .....	7	–	–	–	–	–	7
– debt securities .....	26,552	5,580	–	–	–	–	32,132
– loans and advances to banks .....	40,333	4,966	–	–	–	–	45,299
– loans and advances to customers .....	19,884	21,090	743	–	–	–	41,717
Financial assets designated at fair value .....	502	4,090	–	–	–	–	4,592
– treasury and other eligible bills .....	–	–	–	–	–	–	–
– debt securities .....	424	4,090	–	–	–	–	4,514
– loans and advances to banks .....	–	–	–	–	–	–	–
– loans and advances to customers .....	78	–	–	–	–	–	78
Derivatives .....	173,828	22,897	394	–	9	–	197,128
Loans and advances held at amortised cost .....	141,771	83,480	7,758	1,220	2,786	(1,411)	235,604
– loans and advances to banks .....	16,125	2,023	149	–	41	(43)	18,295
– loans and advances to customers .....	125,646	81,457	7,609	1,220	2,745	(1,368)	217,309
Financial investments .....	43,851	1,615	–	–	53	–	45,519
– treasury and other similar bills .....	9,818	–	–	–	–	–	9,818
– debt securities .....	34,033	1,615	–	–	53	–	35,701
Other assets .....	2,725	190	12	–	1	–	2,928
– endorsements and acceptances .....	34	178	11	–	1	–	224
– other .....	2,691	12	1	–	–	–	2,704

## Notes on the Financial Statements (continued)

## The bank

	31 December 2007						
	Neither past due nor impaired			Past due not impaired	Impaired	Impairment allowances	Total
	Strong £m	Medium £m	Sub- standard £m	£m	£m	£m	£m
Items in the course of collection from other banks ..	1,377	–	–	–	–	–	1,377
Trading assets .....	99,368	30,934	5,705	–	–	–	136,007
– treasury and other eligible bills .....	–	437	–	–	–	–	437
– debt securities .....	27,896	4,474	5,532	–	–	–	37,902
– loans and advances to banks .....	53,978	5,473	–	–	–	–	59,451
– loans and advances to customers .....	17,494	20,550	173	–	–	–	38,217
Financial assets designated at fair value .....	–	3,439	–	–	–	–	3,439
– treasury and other eligible bills .....	–	–	–	–	–	–	–
– debt securities .....	–	3,439	–	–	–	–	3,439
– loans and advances to banks .....	–	–	–	–	–	–	–
– loans and advances to customers .....	–	–	–	–	–	–	–
Derivatives .....	44,190	2,061	74	–	–	–	46,325
Loans and advances held at amortised cost .....	113,514	63,718	3,631	1,149	1,502	(837)	182,677
– loans and advances to banks .....	27,056	4,670	299	–	6	(3)	32,028
– loans and advances to customers .....	86,458	59,048	3,332	1,149	1,496	(834)	150,649
Financial investments .....	12,602	292	–	–	–	–	12,894
– treasury and other similar bills .....	1,397	–	–	–	–	–	1,397
– debt securities .....	11,205	292	–	–	–	–	11,497
Other assets .....	1,274	62	–	1	–	–	1,337
– endorsements and acceptances .....	188	62	–	1	–	–	251
– other .....	1,086	–	–	–	–	–	1,086

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

The following table provides an analysis of gross loans and advances to customers held at amortised cost which are past due but not considered impaired. There are no other significant balance sheet items where past due balances are not considered impaired.

## The group

	Up to 29 days £m	30-59 days £m	60-89 days £m	90-180 days £m	Over 180 days £m	Total £m
At 31 December 2008 .....	1,220	437	257	198	227	2,339
At 31 December 2007 .....	756	308	210	96	5	1,375

## The bank

	Up to 29 days £m	30-59 days £m	60-89 days £m	90-180 days £m	Over 180 days £m	Total £m
At 31 December 2008 .....	555	266	191	191	17	1,220
At 31 December 2007 .....	594	274	188	93	1	1,150

## Renegotiated loans

Restructuring activity is designed to manage customer relationships, maximise collection opportunities and, if possible, avoid foreclosure or repossession. Such activities include extended payment arrangements, approved external debt management plans, deferring foreclosure, modification, loan rewrites and/or deferral of payments pending a change in circumstances. Following restructuring, an overdue consumer account is normally reset from delinquent to current status. Restructuring policies and practices are based on indicators or criteria which, in the judgement of local management, indicate that repayment will probably continue. These policies are required to be kept under continual review and their application varies according to the nature of the market, the product, and the availability of empirically based data. Criteria vary between products, but typically include: receipt of one or more qualifying payments within a certain period, a minimum lapse of time from origination before restructuring may occur, and restrictions on the number and/or frequency of successive restructurings. When empirical evidence indicates an increased propensity to default on restructured accounts, the use of roll rate methodology ensures this factor is taken into account when calculating impairment allowances.

### Renegotiated loans that would otherwise be past due or impaired

#### *The group*

	At 31 December	
	2008	2007
	£m	£m
Loans and advances to customers .....	<b>1,298</b>	<b>813</b>

#### *The bank*

	At 31 December	
	2008	2007
	£m	£m
Loans and advances to customers .....	<b>1,181</b>	<b>642</b>

## Collateral and other credit enhancements obtained

The group obtained assets by taking possession of collateral held as security, or calling upon other credit enhancements, as follows:

	The group		The bank	
	2008	2007	2008	2007
	£m	£m	£m	£m
<b>Nature of assets</b>				
Residential property .....	<b>67</b>	<b>67</b>	<b>67</b>	<b>65</b>

Reposessed properties are made available for sale in orderly fashion, with the proceeds used to reduce or repay the outstanding indebtedness. Where excess funds are available either for other secured lenders with lower priority or are returned to the customer. The group does not generally occupy the reposessed properties for its business use.

## Impairment allowances as a percentage of gross loans and advances to banks and customers<sup>1</sup>

#### *The group*

	At 31 December	
	2008	2007
	%	%
<i>Banks</i>		
Individually assessed impairment allowances .....	<b>0.17</b>	0.01
<i>Customers</i>		
Individually assessed impairment allowances .....	<b>0.50</b>	0.43
Collectively assessed impairment allowances .....	<b>0.41</b>	0.41
	<b>1.08</b>	<b>0.85</b>

<sup>1</sup> Net of reverse repo transactions, settlement accounts and stock borrowings.

## Notes on the Financial Statements (continued)

*The bank*

	At 31 December	
	2008 %	2007 %
<i>Banks</i>		
Individually assessed impairment allowances .....	0.33	0.01
<i>Customers</i>		
Individually assessed impairment allowances .....	0.31	0.24
Collectively assessed impairment allowances .....	0.27	0.32
	<b>0.91</b>	<b>0.57</b>

**Movement in impairment allowances***The group*

	Banks		Customers		Total £m
	Individually assessed £m	Individually assessed £m	Collectively assessed £m	Total £m	
At 1 January 2008 .....	3	920	873	1,796	
Amounts written off .....	–	(222)	(928)	(1,150)	
Recoveries of loans and advances written off in previous years .....	–	(180)	(106)	(286)	
Charge to income statement .....	35	858	1,266	2,159	
Foreign exchange and other movements .....	5	4	17	26	
<b>At 31 December 2008 .....</b>	<b>43</b>	<b>1,380</b>	<b>1,122</b>	<b>2,545</b>	
At 1 January 2007 .....	3	879	884	1,766	
Amounts written off .....	–	(185)	(1,112)	(1,297)	
Recoveries of loans and advances written off in previous years .....	–	(194)	(113)	(307)	
Charge to income statement .....	–	390	1,228	1,618	
Foreign exchange and other movements .....	–	30	(14)	16	
At 31 December 2007 .....	3	920	873	1,796	

*The bank*

	Banks		Customers		Total £m
	Individually assessed £m	Individually assessed £m	Collectively assessed £m	Total £m	
At 1 January 2008 .....	3	356	478	837	
Amounts written off .....	–	(160)	(825)	(985)	
Recoveries of loans and advances written off in previous years .....	–	(59)	(31)	(90)	
Charge to income statement .....	35	621	938	1,594	
Foreign exchange and other movements .....	5	50	–	55	
<b>At 31 December 2008 .....</b>	<b>43</b>	<b>808</b>	<b>560</b>	<b>1,411</b>	
At 1 January 2007 .....	3	331	572	906	
Amounts written off .....	–	(96)	(1,018)	(1,114)	
Recoveries of loans and advances written off in previous years .....	–	(78)	(46)	(124)	
Charge to income statement .....	–	211	1,004	1,215	
Foreign exchange and other movements .....	–	(12)	(34)	(46)	
At 31 December 2007 .....	3	356	478	837	

## Liquidity and funding management

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 to do so 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 necessary liquidity 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 is to ensure that all foreseeable funding commitments, including deposit withdrawals, can be met when due, and that access to the wholesale markets is co-ordinated and cost-effective. To that end, the group maintains a diversified and stable 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 obligations can be met when due.

The group adapts its liquidity and funding risk 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 has continuously monitored the impact of recent market events on the group's liquidity positions and introduced more conservative assumptions where justified. The liquidity and funding risk framework will continue to evolve as the group assimilates knowledge from the recent dislocations in the market.

### *Policies and procedures*

The management of liquidity and funding is primarily undertaken locally in the group's operating entities in compliance with practices and limits set by the group's Risk Management Meeting ('RMM'). These limits vary according to the depth and liquidity of the market in which the entities operate. It is HSBC's general policy that each banking entity should be self-sufficient when funding its own operations. Exceptions are permitted for certain short-term treasury requirements and start-up operations or branches which do not have access to local deposit markets. These are funded under limits from the group's largest banking operations and clearly defined internal and regulatory guidelines and limits which serve to place formal limitations on the transfer of resources between group entities and are necessary to 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 ratios against internal and regulatory requirements;
- maintaining a diverse range of funding sources with adequate 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.

### *Primary sources of funding*

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, which are a primary source of funding, stability depends upon preserving depositor confidence in the group's capital strength and liquidity, and on competitive and transparent pricing.

## Notes on the Financial Statements (continued)

The group also accesses professional markets in order to provide funding for non-banking subsidiaries that do not accept deposits, to maintain a presence in local money markets and to optimise the funding of asset maturities not naturally matched by core deposit funding.

Of total liabilities of £904 billion at 31 December 2008, funding from customers amounted to £370 billion, of which £367 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 32.

Assets available to meet these liabilities, and to cover outstanding commitments to lend (£924 billion), included cash, central bank balances, items in the course of collection and treasury and other bills (£22 billion); loans to banks (£51 billion, including £48 billion repayable within one year); and loans to customers (£298 billion, including £160 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 £175 billion. Of these assets, some £107 billion of debt securities and treasury and other bills had been pledged to secure liabilities.

### *Advances to deposits ratio*

The group emphasises the importance of current accounts and savings accounts 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 group banking entities which restrict their ability to increase loans to customers without corresponding growth in current accounts and savings accounts. This measure is referred to as the 'advances to deposits' ratio. The ratio describes loans and advances to customers as a percentage of the total of core customer current and savings accounts 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 deposits ratio, as are current accounts and savings accounts from customers deemed to be 'non-core'. The definition of a non-core deposit includes a consideration of the size of the customer's total deposit balances. Due to the distinction between core and non-core depositors, the group's measure of advances to deposits will be more restrictive than that which could be inferred from the published financial statements.

### *Advances to deposits ratios*

	The group		The bank	
	2008	2007	2008	2007
	%	%	%	%
Year-end .....	<b>88.9</b>	89.2	<b>106.0</b>	97.5
Maximum .....	<b>93.4</b>	92.2	<b>106.7</b>	101.7
Minimum .....	<b>86.4</b>	86.0	<b>97.5</b>	92.6
Average .....	<b>90.6</b>	89.1	<b>101.5</b>	97.1

Advances to deposits ratio limits are set by the RMM.

The group would meet any unexpected net cash outflows by selling securities and accessing additional funding sources such as interbank or collateralised lending markets.

The group also uses measures other than the advances to deposits ratio to manage liquidity risk, including the ratio of net liquid assets to customer liabilities and projected cash flow scenario analyses.

### *Ratio of net liquid assets to customer liabilities*

Net liquid assets are liquid assets less all funds maturing in the next 30 days from wholesale market sources and from customers who are deemed to be professional. For this purpose, the group defines liquid assets as cash balances, short-term interbank deposits and highly-rated debt securities available for immediate sale and for which a deep and liquid market exists. Customers are deemed 'professional' according to the size of their deposits.

Limits for the ratio of net liquid assets to customer liabilities are set for each bank operating entity.

### Ratio of net liquid assets to customer liabilities

	The group		The bank	
	2008 %	2007 %	2008 %	2007 %
Year-end .....	15.4	14.3	7.1	12.1
Maximum.....	17.9	22.1	14.1	21.5
Minimum .....	12.9	14.3	6.9	12.1
Average.....	15.1	19.0	10.0	15.6

### Projected cash flow scenario analyses

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

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

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

### Contingent liquidity risk

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 over and above their normal utilisation rates. The liquidity risk consequences of increasing levels of drawdown are analysed in the form of projected cash flows under different stress scenarios. The RMM also sets total notional limits for non-cancellable contingent funding commitments by group entity after due consideration of the 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

	The group		The bank	
	2008 £bn	2007 £bn	2008 £bn	2007 £bn
<b>Conduits</b>				
Client-originated assets <sup>1</sup>				
Total lines .....	3.8	4.5	2.1	3.2
Largest individual lines .....	0.7	0.8	0.7	0.5
Assets managed by the group <sup>2</sup> .....	23.9	12.9	23.9	12.9
<b>Single-issuer liquidity facilities</b>				
Five largest <sup>3</sup> .....	4.1	5.0	3.4	2.3
Largest market sector <sup>4</sup> .....	5.0	5.8	5.0	4.2

1 These exposures relate to consolidated multi-seller conduits. These vehicles provide funding to group customers by issuing debt secured by a diversified pool of customer-originated assets.

2 These exposures relate to consolidated securities investment conduits, primarily Solitaire and Mazarin. These vehicles issue debt secured by highly-rated asset-backed securities which are managed by the group.

3 These figures represent the five largest committed liquidity facilities provided to customers other than those facilities to conduits.

4 These figures represent the total of all committed liquidity facilities provided to the largest market sector other than those facilities to conduits.

In times of market stress, the group may choose to provide non-contractual liquidity support to certain group-sponsored vehicles or group-promoted products. This support would only be provided after careful consideration of the potential funding requirement and the impact on the entity's overall liquidity, and is not included in the group's liquidity risk measures until such time as the support becomes legally binding.

## Notes on the Financial Statements (continued)

### Market risk management

The objective of the group's market risk management is to manage and control market risk exposures in order to optimise return on risk while maintaining a market profile consistent with the group's status as a premier provider of financial products and services. Market risk is the risk that movements in market risk 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 those positions arising from market-making, proprietary position-taking and other marked-to-market positions so designated. Non-trading portfolios include positions that arise from the interest rate management of the group's retail and commercial banking assets and liabilities, financial assets 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 152.

The management of market risk is principally undertaken in Global Markets using risk limits approved by the HSBC Group Management Board. Limits are set for portfolios, products and risk types, with market liquidity being a principal factor in determining the level of limits set. Traded Credit and Market Risk, an independent unit within the Group Management Office of HSBC Holdings plc, develops 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 Traded Credit and Market Risk, and monitoring 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 these risks 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 such risks professionally. In certain cases where the market risks cannot be adequately captured by the transfer process, 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.

### Sensitivity analysis

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

#### *Value at risk ('VAR')*

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. The historical simulation models derive plausible future scenarios from historical market rate and price time series, taking account of inter-relationships between different markets and rates, for example between interest rates and foreign exchange rates. The models also incorporate the impact of option features in the underlying exposures.

The historical simulation models used by the group incorporate the following features:

- potential market movements are calculated with reference to data from the last two years;
- historical market rates and prices are calculated with reference to foreign exchange rates and commodity prices, interest rates, equity prices and the associated volatilities;
- VAR is calculated to a 99 per cent confidence level; and
- VAR is calculated 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 one 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 useful guide to risk, VAR should always be viewed in the context of its limitations. For example:

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

### Stress testing

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

Stress testing is performed at a portfolio level, as well as on the consolidated positions of the group, and covers the following scenarios:

- sensitivity scenarios, which consider the impact of market movement on any single risk factor or a set of factors. For example, the impact resulting from a break of a currency peg that is unlikely to be captured within the VAR models;
- technical scenarios, which consider the largest move in each risk factor, without consideration of any underlying market correlation;
- hypothetical scenarios, which consider potential macro economic events; and
- historical scenarios, which incorporate historical observations of market movement during previous periods of stress which would not be captured within VAR.

Stress testing is governed by the ‘Stress Testing Review Group’ forum that coordinates the group stress testing scenarios in conjunction with the regional risk managers. Consideration is given to the actual market risk exposures, along with market events, in determining the stress scenarios.

Stress testing results are reported to senior management and provide them with an assessment of the financial impact such events would have on the profit of the bank. The daily losses experienced during 2008 were within the stress loss scenarios reported to senior management.

### Sensitivity analysis

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

Risk type	Portfolio	
	Trading	Non-trading
Foreign exchange .....	VAR	VAR
Interest rate .....	VAR	VAR
Commodity .....	VAR	N/A
Equity .....	VAR	Sensitivity
		VAR

## Notes on the Financial Statements (continued)

### Value at risk of the trading and non-trading portfolios

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

	£m
<b>Total</b>	
At 31 December 2008 .....	144.5
At 31 December 2007 .....	30.7
	<b>Average</b>
	<b>£m</b>
<b>2008</b> <sup>2</sup> .....	<b>61.2</b>
<b>2007</b> <sup>2</sup> .....	<b>20.7</b>
	<b>Minimum</b>
	<b>£m</b>
<b>2008</b> <sup>2</sup> .....	<b>22.5</b>
<b>2007</b> <sup>2</sup> .....	<b>14.3</b>
	<b>Maximum</b>
	<b>£m</b>
<b>2008</b> <sup>2</sup> .....	<b>151.6</b>
<b>2007</b> <sup>2</sup> .....	<b>34.8</b>

The figures in the tables above exclude non-trading credit VAR. Including non-trading credit VAR, total VAR at 31 December 2008 was £238.7 million (2007: £32.0 million).

### Trading portfolios

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

Market-making and proprietary position-taking is undertaken within Global Banking and Markets. The VAR for such trading activity at 31 December 2008 was £67.7 million (2007: £24.4 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	Total £m
<b>At 31 December 2008</b> .....	<b>17.4</b>	<b>44.2</b>	<b>11.6</b>	<b>27.1</b>	<b>67.7</b>
At 31 December 2007 .....	4.6	18.7	8.2	14.4	24.4
<b>Average</b>					
<b>2008</b> .....	<b>10.0</b>	<b>25.7</b>	<b>8.0</b>	<b>26.2</b>	<b>35.1</b>
<b>2007</b> .....	4.9	12.5	5.0	7.3	16.5
<b>Minimum</b>					
<b>2008</b> .....	<b>4.2</b>	<b>9.2</b>	<b>4.0</b>	<b>13.7</b>	<b>13.0</b>
<b>2007</b> .....	1.9	7.6	2.9	3.1	11.3
<b>Maximum</b>					
<b>2008</b> .....	<b>57.6</b>	<b>103.8</b>	<b>20.4</b>	<b>63.1</b>	<b>80.0</b>
<b>2007</b> .....	12.2	19.6	8.9	17.5	26.6

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

2 The VAR for 2007 has been adjusted on the same basis as group VAR..

### Gap risk

Certain transactions are structured in such a way that the risk to the group is negligible under a wide range of market conditions or events, but there exists a remote possibility that a significant gap event could lead to loss. A gap event is a change in market price from one level to another with no trading opportunity in between, and where the price change breaches the threshold beyond which the risk profile changes from having no open risk to having full exposure to the underlying structure.

Given the characteristics of these transactions, they will make little or no contribution to VAR or to traditional market risk sensitivity measures. The group captures the risks for such transactions within the stress testing scenarios. Gap risk arising is monitored on an ongoing basis, and the group incurred no gap losses arising from movements in the underlying market price on such transactions in 2008.

### *ABS/MBS positions*

The ABS/MBS exposures within the trading portfolios are managed within sensitivity and VAR limits, as described on page 142.

### **Non-trading portfolios**

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 prospective change in future net interest income from non-trading portfolios will be reflected in the current realisable value of these positions should they be sold or closed prior to maturity. In order to manage this risk optimally, market risk in non-trading portfolios is transferred to Global Banking and Markets or to separate books managed under the supervision of the local the ALCO.

The transfer of market risk to trading books managed by Global Banking and Markets or supervised by the ALCO is usually achieved by a series of internal deals between the business units and these books. When the behavioural characteristics of a product differ from its contractual characteristics, the behavioural characteristics are assessed to determine the true underlying interest rate risk. Local ALCOs regularly monitor all such behavioural assumptions and interest rate risk positions, to ensure they comply with interest rate risk limits established by the HSBC Group Management Board.

In certain cases, the non-linear characteristics of products cannot be adequately captured by the risk transfer process. For example, both the flow from customer deposit accounts to alternative investment products and the precise prepayment speeds of mortgages will vary at different interest rate levels. In such circumstances simulation modelling is used to identify the impact of varying scenarios on valuations and net interest income.

Once market risk has been consolidated in Global Banking and Markets or ALCO-managed books, 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.

### *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 £34.2 million at 31 December 2008 (2007: £15.6 million); whilst the average, minimum and maximum during the year was £17.7 million, £13.3 million and £34.4 million respectively (2007: £10.3 million, £6.7 million and £18.1 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 2008 was £2,310 million (2007: £2,691 million) and included private equity holdings of £1,183 million (2007: £1,170 million). Investments in private equity are primarily made through managed funds. Potential new commitments are subject to risk appraisal to ensure that industry and geographical concentrations remain within acceptable levels for the portfolio as a whole. Regular reviews are performed to substantiate the valuation of the investments within the portfolio, and Finance is responsible for reviewing the carrying value of the investments. Money market funds represented £151 million (2007: £923 million) and typically related to funds held for short-term cash management. Investments held to facilitate ongoing business, such as holdings in government-sponsored enterprises and local stock exchanges, represented £187 million (2007: £194 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 2008 would have reduced equity by £231 million (2007: £269 million). For details of the impairment incurred on available-for-sale equity securities see the accounting policies in Note 2(j).

### **Defined benefit pension scheme**

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

## Notes on the Financial Statements (continued)

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, assesses 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 £11.3 billion at 31 December 2008 compared with £12.4 billion at 31 December 2007. Assets of the defined benefit schemes at 31 December 2008 comprised: equity investments 15 per cent (21 per cent at 31 December 2007); debt securities 73 per cent (66 per cent at 31 December 2007) and other (including property) 11 per cent (13 per cent at 31 December 2007).

### Sensitivity of net interest income

A principal part of the group's management of market risk in non-trading portfolios is to monitor the sensitivity of projected net interest income under varying interest rate scenarios (simulation modelling). The group aims, through its management of market risk in non-trading portfolios, to mitigate the impact 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 local businesses and local markets and standard scenarios which are required throughout the group. The standard scenarios are consolidated to illustrate the combined proforma effect on the group's consolidated portfolio valuations and net interest income.

### Structural foreign exchange exposures

Structural foreign exchange exposures represent net investments in subsidiaries, branches or associated undertakings, the functional currencies of which are currencies other than the sterling.

Exchange differences on structural exposures are recorded in the consolidated statement of recognised income and expense. The main operating (or functional) currencies of the group's subsidiaries are sterling, euro, US dollars, Swiss francs, Turkish lira and Maltese lira.

The group's policy is to hedge structural foreign currency exposures only in limited circumstances. The group's structural foreign currency exposures are required to be 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 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.

## Concentrations of market risk exposures

### Analysis of asset backed securities

During the period valuation losses of £11,551 million on available for sale assets were taken to equity. These primarily relate 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 2008				31 December 2007			
	Gross principal <sup>2</sup> £m	CDS gross protection <sup>3</sup> £m	Net Principal exposure <sup>4,10</sup> £m	Carrying Amount <sup>5,10</sup> £m	Gross principal £m	CDS gross protection £m	Net Principal exposure <sup>10</sup> £m	Carrying Amount <sup>10</sup> £m
- High grade <sup>1</sup> .....	38,161	(2,917)	35,244	24,917	40,072	(2,575)	37,497	35,448
- rated C to A .....	10,328	(409)	9,919	4,055	1,146	(182)	964	899
- not publicly rated .....	3,629	(3,498)	131	90	4,294	(3,397)	897	851
Total asset-backed securities .....	52,118	(6,824)	45,294	29,062	45,512	(6,154)	39,358	37,198
		Unrealised gains and losses <sup>6</sup> £m	Realised gains and losses <sup>7</sup> £m		Impairment <sup>8</sup> £m	Fair Value Movements through equity <sup>9</sup> £m		
- High grade <sup>1</sup> .....		(440)	(104)		(29)	(6,565)		
- rated C to A .....		(357)	(6)		(269)	(3,531)		
- not publicly rated .....		(1)	1		-	(2)		
Total asset-backed securities .....		(798)	(109)		(298)	(10,098)		
Other available-for-sale securities .....						(1,453)		
Total .....						(11,551)		

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 Unrealised gains and losses on the net principal exposure (see footnote 4) recognised during the year in the income statement as a result of changes in the fair value of the asset, adjusted for the cumulative amount of transfers to realised gains and losses as a result of the disposal of assets.

7 Realised gains and losses on the net principal exposure (see footnote 4) recognised during the year in the income statement as a result of the disposal of assets.

8 Impairment losses recognised in the income statement in respect of the net principal amount (see footnote 4) of available-for-sale and held-to-maturity assets.

9 Fair value gains and losses on the net principal exposure (see footnote 4) recognised in equity during the year as a result the changes in the fair value of available-for-sale assets, adjusted for transfers from the available-for-sale reserve to the income statement as a result of impairment, and adjusted for transfers to realised gains and losses following the disposal of assets.

10 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 (2008: 1GBP:USD 1.459; 2007: 1GBP:USD 2.006).

Included in the above table is carrying amount of £17,773 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. Impairments losses recognised by capital note holders for the year ended 31 December 2008 amounted to £160 million (2007: nil).

## Notes on the Financial Statements (continued)

### Risk management of insurance operations

The group operates a bancassurance model which provides insurance products for customers with whom the group has a banking relationship. Many of these products are manufactured by group subsidiaries, but where the group considers it operationally more effective, third parties are engaged to manufacture and provide insurance products which the group sells through its banking network. The group works with a limited number of market-leading partners to provide these products. When manufacturing products, the group underwrites the insurance risk and retains the risks and rewards associated with writing insurance contracts. The group's exposure to risks associated with manufacturing insurance contracts in its subsidiaries and its management of these risks are discussed below.

One advantage of the bancassurance model to the group is that, where the group manufactures products to sell to customers, the underwriting profit is retained within the group as is the commission paid by the manufacturer to the bank distribution channel. When the group sells products provided by third parties, it earns a commission. The group sells insurance products across all its customer groups, mainly utilising its retail branches, the internet and phone centres. Personal Financial Services customers attract the majority of sales and comprise the majority of policyholders. The group offers its customers a wide range of insurance and investment products, many of which complement other bank and consumer finance products.

The group's bancassurance business operates across Europe with over 6 legal entities manufacturing insurance products. The majority of these insurance operations are subsidiaries of banking legal entities and comply with their management control procedures. In addition to local management requirements, the insurance operations follow guidelines issued by the Group Insurance Head Office. Implementation of the guidelines is overseen by the Insurance Regional Office. The Group Insurance Head Office is headed by the Group's Managing Director of Insurance, supported by a Chief Operating Officer, Chief Finance Officer and Chief Risk Officer. The Chief Risk Officer was appointed in 2008. The role of Group Insurance Head Office includes setting the control framework for monitoring and measuring insurance risk in line with existing Group practices, and defining insurance-specific policies and guidelines for inclusion in the Group Instruction Manuals.

The Insurance Regional Office (Europe & Middle East) is headed by the Regional Chief Executive Officer ('CEO'), supported by a Deputy Regional CEO, Regional Chief Financial Officer ('CFO') and Regional Chief Risk Officer ('CRO'). The Regional CFO and CRO were appointed during 2008. The role of the Regional Office includes overseeing the effective implementation of HSBC policies and guidelines and monitoring and measuring Insurance Risk in line with HSBC practices. The control framework for monitoring risk includes HSBC's Group Insurance Risk Committee, to which four Group Insurance sub-committees report, focusing on operational risk, insurance risk, market and liquidity risk, and credit risk with the Group Insurance Risk Committee looking at an overview of the status of the significant risks categories in the insurance operations. The group's framework & Risk Committee at Regional level mirror this HSBC framework. The processes and controls employed to monitor individual risks are described under their respective headings below.

### INSURANCE RISK

Insurance risk is a risk, other than financial risk, transferred from the holder of a contract to the issuer. The principal insurance risk faced by the group is that the combined cost of claims, administration and acquisition of the contract may exceed the aggregate amount of premiums received and investment income. The cost of a claim can be influenced by many factors, including mortality and morbidity experience, lapse and surrender rates and, where the policy has a savings element, the performance of the assets held to support the liabilities. Performance of the underlying assets will be impacted by both changes in interest rates and equity prices. This risk is discussed further in the Market Risk section below.

The group manages its exposure to insurance risk by applying formal underwriting, reinsurance and claims-handling procedures designed to ensure compliance with regulations and insurance risk appetite, the latter proposed by local businesses and authorised centrally. This is supplemented by undertaking stress testing. During 2008, insurance manufacturing entities have documented their underwriting authority limits. Those underwriting limits are submitted annually to HSBC's Insurance Head Office.

The insurance contracts sold by the group relate, in the main, to core underlying banking activities such as savings or investment products and credit life products. The group's manufacturing focuses on personal lines, i.e. contracts written for individuals. Personal lines tend to be of higher volume and lower individual value than commercial lines, and this diversifies the insurance risk.

Life and non-life business insurance risks are controlled by high level policies and procedures set centrally, supplemented as appropriate with locally-imposed measures which take account of specific local market conditions and regulatory requirements but reflect local market practices.

For example, manufacturing entities are required to obtain authorisation from HSBC's Insurance Head Office to write certain classes of business, with restrictions applying particularly to commercial and liability non-life insurance.

Local ALCOs are required to monitor certain risk exposures, in particular for life business where the focus is on reviewing the risks associated with the duration and cash flow matching of insurance assets and liabilities.

Reinsurance is also used as a means of mitigating exposure, in particular to aggregations of catastrophe risk. Specific examples are as follows:

- Accident and health insurance. Potential exposure to concentrations of claims arising from particular events, such as earthquakes or a pandemic, are mitigated by the purchase of catastrophe reinsurance.
- Motor insurance. Reinsurance protection is arranged to avoid excessive exposure to larger losses, particularly from personal injury claims.
- Fire and other damage to property. Portfolios at risk from catastrophic losses are protected by reinsurance in accordance with information obtained from professional risk-modelling organisations.

Whilst entering in to a reinsurance arrangement may provide a means of managing insurance risk, such contracts expose the group to counter-party risk, the risk the reinsurer defaults. This risk is discussed further in the Credit Risk section.

The group manages its insurance risks through the application of formal underwriting, reinsurance and claims procedures. These procedures are designed also to ensure compliance with regulations. The group's overall approach to insurance risk is to seek to maintain a good diversification of insurance business by type and to focus on risks that are straightforward to manage and frequently are directly related to the underlying banking activity.

A key feature of insurance business, and life insurance in particular, is the importance of managing the assets, liabilities and risks in a co-ordinated fashion rather than individually. This reflects the greater interdependence of these three elements for life insurance than is generally the case for non-life insurance. Of particular importance for a number of lines of business is the need to match the expected pattern of cash flow, which in some cases (such as annuities) can run for many years.

Both life and non-life business insurance risks are controlled through a combination of local and central procedures and policies. These include a centralised approach to the authorisation to write certain classes of business. Use is also made of risk management committees in order to monitor risk exposures. Market risk limits are also applied centrally as an additional control over the extent of insurance risk that is retained.

As indicated in the specific comments relating to particular classes, use is also made of reinsurance as a means of further mitigating exposure.

The following tables provide an analysis of the insurance risk exposures by type of business. By definition, the group is not exposed to insurance risk on investment contracts, so they have not been included in the insurance risk management analysis.

Life business tends to be longer-term in nature than non-life business and frequently involves an element of savings and investment in the contract. Accordingly, separate tables are provided for life and non-life businesses, reflecting their distinctive risk characteristics. The life insurance risk table provides an analysis of insurance liabilities as the best available overall measure of insurance exposure, because provisions for life contracts are typically set by reference to expected future cash outflows relating to the underlying policies. The table for non-life business uses written premiums as the best available measure of risk exposure.

## Notes on the Financial Statements (continued)

### Analysis of life insurance risk – liabilities to policyholders

	2008 £m	2007 £m
Life (non-linked)		
Insurance contracts with DPF <sup>1</sup> .....	696	469
Credit life .....	173	117
Annuities .....	260	205
Term assurance and other long-term contracts .....	<u>902</u>	<u>337</u>
Total life (non-linked) .....	2,031	1,128
Life (linked) .....	1,061	858
Investment contracts with DPF <sup>1,2</sup> .....	<u>12,157</u>	<u>9,447</u>
Life insurance policyholder liabilities .....	<u>15,249</u>	<u>11,433</u>

1 *Insurance contracts with discretionary participation features ('DPF') give policyholders a 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 and whose amount or timing is contractually at the discretion of the group. The 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 investments contracts with DPF are financial investments, the group continues to account for them as insurance contracts as permitted by IFRS 4.*

The liabilities for long-term contracts are set by reference to a range of assumptions which include lapse and surrender rates, mortality and expense levels. These assumptions are typically set by reference to the entity's own experience. Economic assumptions, such as investment returns and interest rates, are typically set by reference to observable market data. Where the underlying assumptions change, there will be an impact on the liabilities. Sensitivity of the profit after tax and the net assets to changes in both economic and non-economic assumptions are considered later.

The above table of liabilities to life insurance policyholders provides an overall summary of the group's life insurance activity. In particular, the table highlights that the most significant products are investment contracts with DPF issued in France, and unit-linked contracts issued in UK and Malta.

Insurance risk arising from life insurance depends on the type of business, and varies considerably. The principal risks are mortality, morbidity, lapse, surrender and expense levels.

The main contracts which generate exposure to mortality and morbidity risks are term assurance contracts and annuities. These risks are monitored on a regular basis, and are primarily mitigated by medical underwriting and by retaining the ability in certain cases to amend premiums in the light of experience. Expense risk can generally be managed through pricing. The level of expenses in the contract will be one of the items considered when setting premium rates.

### Analysis of non-life insurance risk – net written insurance premiums

	2008 £m	2007 £m
Accident and health .....	8	11
Motor .....	190	183
Fire and other damage .....	80	64
Credit (non-life) .....	51	18
Other (non-life) .....	<u>26</u>	<u>23</u>
Total net written insurance premiums .....	355	299
Net insurance claims incurred and movement in policyholder liabilities .....	<u>306</u>	<u>250</u>

1 *Net written insurance premiums represent gross written premiums less gross written premiums ceded to reinsurers.*

The above table of non-life net written insurance premiums provides an overall summary of the non-life insurance activity of the group. The main risks associated with non-life business are underwriting risk and claims experience risk. Underwriting risk is the risk that the group does not charge premiums appropriate to the cover provided and claims experience risk is the risk that portfolio experience is worse than expected. The group manages these risks through pricing (for example, imposing restrictions and deductibles in the policy terms and conditions), product design, risk selection, claims handling, investment strategy and reinsurance policy. The majority of non-life insurance



contracts are renewable annually and the underwriters have the right to refuse renewal or to change the terms and conditions of the contract at the time.

## FINANCIAL RISKS

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, for example, when the proceeds from financial assets are not sufficient to fund the obligations arising from non-linked insurance and investment contracts. Certain insurance-related activities undertaken by the Group's subsidiaries such as insurance broking, insurance management, pensions and annuities administration and intermediation, are exposed to financial risk, but not to a significant extent.

In addition to policies provided for HSBC-wide application through the Group Instruction Manuals, insurance manufacturing subsidiaries may implement additional risk management procedures which reflect local market conditions and regulatory requirements.

Local regulatory requirements prescribe the type, quality and concentration of assets that the group's insurance manufacturing subsidiaries must maintain to meet insurance liabilities. Within each subsidiary, ALCOs are responsible for ensuring that exposures to financial risks remain within local requirements and risk mandates (as agreed with HSBC Group Insurance Head Office), and ensure compliance with the control framework established centrally through the Group Instruction Manuals.

The following table analyses the assets held in the group's insurance manufacturing subsidiaries at 31 December 2008 by type of liability, and provides a view of the exposure to financial risk:

### *Financial assets held by insurance manufacturing operations*

	<b>At 31 December 2008</b>				
	<b>Life linked contracts £m</b>	<b>Life non-linked contracts £m</b>	<b>Non-life insurance £m</b>	<b>Other assets £m</b>	<b>Total £m</b>
Financial assets designated at fair value					
Treasury bills .....	21	17	–	5	43
Debt securities .....	1,578	502	–	709	2,789
Equity securities .....	2,681	2,895	–	231	5,807
	<b>4,280</b>	<b>3,414</b>	<b>–</b>	<b>945</b>	<b>8,639</b>
Available-for-sale:					
Treasury bills .....	–	–	83	82	165
Other eligible bills .....	–	–	187	86	273
Debt securities .....	–	9,044	14	5	9,063
Equity securities .....	–	–	–	18	18
	<b>–</b>	<b>9,044</b>	<b>284</b>	<b>191</b>	<b>9,519</b>
Derivatives .....	118	42	–	17	177
Other financial assets .....	359	1,002	387	826	2,574
	<b>4,757</b>	<b>13,502</b>	<b>671</b>	<b>1,979</b>	<b>20,909</b>

## Notes on the Financial Statements (continued)

	At 31 December 2007				
	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 .....	25	–	–	–	25
Debt securities .....	2,873	502	–	943	4,318
Equity securities .....	3,482	3,211	–	340	7,033
	<u>6,380</u>	<u>3,713</u>	<u>–</u>	<u>1,283</u>	<u>11,376</u>
Available-for-sale:					
Treasury bills .....	–	–	57	59	116
Other eligible bills .....	–	–	88	86	174
Debt securities .....	–	6,133	152	145	6,430
Equity securities .....	–	–	7	–	7
	<u>–</u>	<u>6,133</u>	<u>304</u>	<u>290</u>	<u>6,727</u>
Derivatives .....	150	39	–	15	204
Other financial assets .....	439	298	375	350	1,462
	<u>6,969</u>	<u>10,183</u>	<u>679</u>	<u>1,938</u>	<u>19,769</u>

The table demonstrates that for linked contracts, the group typically designates assets at fair value. For non-linked contracts, the classification of the assets is driven by the nature of the underlying contract.

The table also shows that approximately 57 per cent of financial assets was invested in debt securities at 31 December 2008 with 28 per cent invested in equity securities.

In life linked insurance, premium income less charges levied is invested in a portfolio of assets. The group manages the financial risk of this product on behalf of the policyholders by holding appropriate assets in segregated funds or portfolios to which the liabilities are linked. The group typically retains some exposure to market risk as the market value of the linked assets influences the fees charged by the group and thereby affects the recoverability of expenses incurred by the group in managing the product. The assets held to support life linked liabilities represented 23 per cent of the total financial assets of the group's insurance manufacturing subsidiaries at the end of 2008 (2007: 35 per cent).

### MARKET RISK

Market risk can be further sub-categorised into interest rate risk and equity risk. Each of these categories is discussed further below.

#### *Interest rate risk*

The group's insurance underwriting subsidiaries are exposed to interest rate risk when there is a mismatch in terms of duration or yields between the assets and liabilities.

The group manages the interest rate risk arising from its insurance underwriting subsidiaries by establishing limits centrally. These govern the sensitivity of the net present values of expected cash flows from subsidiaries' assets and liabilities to a one basis point parallel upward shift in the discount curve used to calculate values. Adherence to these limits is monitored by local ALCOs. Interest rate risk is also assessed by measuring the impact of defined movements in interest yield curves on the profits after tax and net assets of the insurance underwriting subsidiaries. An immediate and permanent movement in interest yield curves as at 31 December 2008 in all territories in which the group's insurance subsidiaries operate would have the following impact on the profit for the year and net assets at that date:

	2008		2007	
	Impact on profit for the year £m	Impact on net assets £m	Impact on profit for the year £m	Impact on net assets £m
+ 100 basis points shift in yield curves .....	32	10	(2)	(14)
– 100 basis points shift in yield curves .....	(38)	(17)	4	17

The interest rate sensitivities set out above are illustrative only and employ simplified scenarios. It should be noted that the effects may not be linear and therefore the results cannot be extrapolated. The sensitivities do not incorporate

actions that could be taken by management to mitigate the effect of the interest rate movements, nor do they take account of any resultant changes in policyholder behaviour.

#### *Equity risk*

Equity risk is the risk of changes in the fair value of an equity instrument. The group manages the equity risk arising from its holdings of equity securities centrally by setting limits on the maximum market value of equities that each insurance underwriting subsidiary may hold. Equity risk is also monitored by estimating the effect of predetermined movements in equity prices on the profit and total net assets of the insurance underwriting subsidiaries. The following table illustrates the impact on the aggregated profit for the year and net assets of a reasonably possible 10 per cent variance in equity prices:

	2008		2007	
	Impact on profit for the year £m	Impact on net assets £m	Impact on profit for the year £m	Impact on net assets £m
10 per cent increase in equity prices .....	3	3	8	8
10 per cent decrease in equity prices.....	(4)	(4)	(7)	(7)

These equity sensitivities are illustrative only and employ simplified scenarios. It should be noted that the effects may not be linear and therefore the results cannot be extrapolated. They do not allow for the effect of management actions which may mitigate the equity price decline, nor for any resultant changes, such as in policyholder behaviour, that might accompany such a fall.

#### **CREDIT RISK**

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 £10.7 billion (2007: £8.1 billion) non-linked bond portfolio. The exposure of the income statement to the effect of changes in credit spreads is small (see the table above). 89 per cent (2007: 82 per cent) of the financial assets held by insurance subsidiaries are classified as available for sale, and consequently any changes in the fair value of these financial investments would have no impact on the profit after tax to the extent that the financial assets are not deemed impaired.

The exposure to credit risk products and the management of the risks associated with credit protection products are included in the analyses of life and non-life insurance risk on page 150.

Management of the group's insurance manufacturing subsidiaries is responsible for the credit risk, quality and performance of their investment portfolios. Investment credit mandates and limits are set locally by the insurance manufacturing subsidiaries and approved by their local insurance ALCO and Credit Risk function before receiving concurrence centrally from HSBC Group Credit Risk. The form and content of the mandates accord with centrally-set investment credit risk guidance regarding credit quality, industry sector concentration and liquidity restrictions, but allow for local regulatory and country-specific conditions. 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 Offices and reported to HSBC's Group Credit Risk function, the Group Insurance Credit Risk Meeting and the Group Insurance Risk Committee. Stress testing is performed by the HSBC Group Insurance Head Office on the investment credit exposures using credit spread sensitivities and default probabilities. The stresses are reported to the HSBC Group Insurance Credit Risk Committee.

As noted above, the group can, to a certain extent, share investment losses with policyholders which dilutes the impact to the group. However, in circumstances where losses can not be passed to policyholders, for example – where a contract includes a guarantee, losses which would result in a breach of the guaranteed benefits due to the policyholder are borne by the group.

In response to adverse credit market conditions various initiatives were introduced during 2008 to better manage and report credit risk. These included an Early Warning Report which is produced on a weekly basis to identify investments which may be at risk of future impairment. This report is circulated to Senior Management in Group Insurance Head Office and the Regional Chief Financial Officers and Risk Officers, and risk reduction strategies are implemented when considered appropriate. Similarly a Watch List of investments where there are current credit

## Notes on the Financial Statements (continued)

concerns is produced and circulated weekly. It is anticipated that 2009 will see an increase in corporate defaults and downgrades by the Rating Agencies due to a prolonged global economic downturn,

### Credit quality

The following table presents an analysis of treasury bills, other eligible bills and debt securities within the group's insurance business by rating agency designation, based on Standard & Poor's ratings or their equivalent. Only assets supporting non-linked liabilities are included in the table as financial risk on assets supporting linked liabilities is predominantly borne by the policyholder. 77.6 per cent (2007: 82.2 per cent) of the assets included in the table are invested in AA or AAA rated investments.

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

	Neither past due nor impaired			Past due but not impaired £m	Impaired £m	Impair- ment allowances £m	Total £m
	Strong £m	Medium £m	Sub- standard £m				
<b>At 31 December 2008</b>							
<b>Supporting liabilities under non-linked insurance and investment contracts</b>							
Financial assets designated at fair value .....	368	151	-	-	-	-	519
– treasury and other eligible bills .....	17	-	-	-	-	-	17
– debt securities .....	351	151	-	-	-	-	502
Financial investments .....	9,133	195	-	-	-	-	9,328
– treasury and other similar bills .....	270	-	-	-	-	-	270
– debt securities .....	8,863	195	-	-	-	-	9,058
	<b>9,501</b>	<b>346</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>9,847</b>
<b>Supporting shareholders' funds</b>							
Financial assets designated at fair value .....	702	12	-	-	-	-	714
– treasury and other eligible bills .....	5	-	-	-	-	-	5
– debt securities .....	697	12	-	-	-	-	709
Financial investments .....	173	-	-	-	-	-	173
– treasury and other similar bills .....	168	-	-	-	-	-	168
– debt securities .....	5	-	-	-	-	-	5
	<b>875</b>	<b>12</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>887</b>
<b>Total</b>							
Financial assets designated at fair value .....	1,070	163	-	-	-	-	1,233
– treasury and other eligible bills .....	22	-	-	-	-	-	22
– debt securities .....	1,048	163	-	-	-	-	1,211
Financial investments .....	9,306	195	-	-	-	-	9,501
– treasury and other similar bills .....	438	-	-	-	-	-	438
– debt securities .....	8,868	195	-	-	-	-	9,063
	<b>10,376</b>	<b>358</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>10,734</b>

	Neither past due nor impaired			Past due but not impaired £m	Impaired £m	Impairment allowances £m	Total £m
	Strong £m	Medium £m	Sub-standard £m				
At 31 December 2007							
Supporting liabilities under non-linked insurance and investment contracts							
Financial assets designated at fair value .....	911	211	–	–	–	–	1,122
– treasury and other eligible bills .....	–	–	–	–	–	–	–
– debt securities .....	911	211	–	–	–	–	1,122
Financial investments .....	6,435	137	–	–	–	–	6,572
– treasury and other similar bills .....	146	–	–	–	–	–	146
– debt securities .....	6,289	137	–	–	–	–	6,426
	<u>7,346</u>	<u>348</u>	<u>–</u>	<u>–</u>	<u>–</u>	<u>–</u>	<u>7,694</u>
Supporting shareholders' funds							
Financial assets designated at fair value .....	369	13	–	–	–	–	382
– treasury and other eligible bills .....	59	–	–	–	–	–	59
– debt securities .....	310	13	–	–	–	–	323
Financial investments .....	88	–	–	–	–	–	88
– treasury and other similar bills .....	85	–	–	–	–	–	85
– debt securities .....	3	–	–	–	–	–	3
	<u>457</u>	<u>13</u>	<u>–</u>	<u>–</u>	<u>–</u>	<u>–</u>	<u>470</u>
Total							
Financial assets designated at fair value .....	1,280	224	–	–	–	–	1,504
– treasury and other eligible bills .....	59	–	–	–	–	–	59
– debt securities .....	1,221	224	–	–	–	–	1,445
Financial investments .....	6,523	137	–	–	–	–	6,660
– treasury and other similar bills .....	231	–	–	–	–	–	231
– debt securities .....	6,292	137	–	–	–	–	6,429
	<u>7,803</u>	<u>361</u>	<u>–</u>	<u>–</u>	<u>–</u>	<u>–</u>	<u>8,164</u>

*Issuers of treasury bills, other eligible bills and debt securities in the group's insurance subsidiaries*

	Treasury bills £m	Other eligible bills £m	Debt securities £m	Total £m
At 31 December 2008				
Governments .....	187	16	2,361	2,564
Local authorities .....	–	–	151	151
Asset-backed securities .....	–	–	–	–
Corporates and other .....	–	257	7,762	8,019
	<u>187</u>	<u>273</u>	<u>10,274</u>	<u>10,734</u>
At 31 December 2007				
Governments .....	116	–	2,035	2,151
Local authorities .....	–	–	70	70
Asset-backed securities .....	–	–	–	–
Corporates and other .....	–	174	5,770	5,944
	<u>116</u>	<u>174</u>	<u>7,875</u>	<u>8,165</u>

Credit risk also arises when part of the insurance risk incurred by the group is assumed by reinsurers. The credit risk exposure to reinsurers is monitored by the Regional Insurance Office and the HSBC Group Insurance Head Office and is reported quarterly to the Group Insurance Risk Committee and the Group Insurance Credit Risk Committee. The split of liabilities ceded to reinsurers and outstanding reinsurance recoveries, analysed by Standard & Poor's reinsurance credit rating data or their equivalent, is shown below. The group's exposure to third parties under the reinsurance agreement described above is included in this table.

## Notes on the Financial Statements (continued)

### Reinsurance

	Neither past due nor impaired			Past due but not impaired £m	Impaired £m	Impairment allowances £m	Total £m
	Strong £m	Medium £m	Sub-standard £m				
<b>Reinsurers' share of liabilities under insurance contracts</b>							
<b>At 31 December 2008</b>							
Linked insurance contracts .....	7	–	–	–	–	–	7
Non-linked insurance contracts .....	602	9	–	–	–	–	611
Total .....	609	9	–	–	–	–	618
Reinsurance debtors .....	11	–	–	–	–	–	11
<b>At 31 December 2007</b>							
Linked insurance contracts .....	17	11	–	–	–	–	28
Non-linked insurance contracts .....	401	99	–	–	–	–	500
Total .....	418	110	–	–	–	–	528
Reinsurance debtors .....	9	–	–	–	–	–	9

### LIQUIDITY RISK

It is an inherent characteristic of almost all insurance contracts that there is uncertainty over the amount and the timing of settling claims liabilities that may arise, and this leads to liquidity risk. The group's insurance manufacturing subsidiaries 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, debt issues or issuers; and
- establishing committed contingency borrowing facilities.

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 in the case of unit-linked business).

The following tables show the expected undiscounted cash flows for insurance contract liabilities and the remaining contractual maturity of investment contract liabilities:

#### Expected maturity of insurance contract liabilities

	Expected cash flows (undiscounted)				Total £m
	Within 1 year £m	1-5 years £m	5-15 years £m	Over 15 years £m	
<b>At 31 December 2008</b>					
Non-life insurance .....	456	407	19	–	882
Life insurance (non-linked) .....	732	618	570	301	2,221
Life insurance (linked) .....	80	233	475	453	1,241
Total .....	1,268	1,258	1,064	754	4,344
<b>At 31 December 2007</b>					
Non-life insurance .....	402	381	36	–	819
Life insurance (non-linked) .....	329	294	424	217	1,264
Life insurance (linked) .....	75	301	411	191	978
Total .....	806	976	871	408	3,061

Remaining contractual maturity of investment contract liabilities

	Liabilities under investment contracts by insurance underwriting subsidiaries			Total £m
	Linked investment contracts £m	Non-linked investment contracts £m	Investment contracts with DPF £m	
<b>At 31 December 2008</b>				
Remaining contractual maturity:				
– due within 1 year .....	117	–	–	117
– due between 1 and 5 years .....	419	–	–	419
– due between 5 and 10 years .....	330	–	–	330
– due after 10 years .....	1,123	–	–	1,123
– undated <sup>1</sup> .....	1,627	24	12,157	13,808
<b>Total .....</b>	<b>3,616</b>	<b>24</b>	<b>12,157</b>	<b>15,797</b>
<b>At 31 December 2007</b>				
Remaining contractual maturity:				
– due within 1 year .....	137	–	–	137
– due between 1 and 5 years .....	615	–	–	615
– due between 5 and 10 years .....	475	–	–	475
– due after 10 years .....	1,679	–	–	1,679
– undated <sup>1</sup> .....	2,899	36	9,447	12,382
<b>Total .....</b>	<b>5,805</b>	<b>36</b>	<b>9,447</b>	<b>15,288</b>

1 In cases, policyholders have the option to terminate their contracts at any time and receive the surrender values of their policies. These may be significantly lower than the amounts shown above.

**Present value of in-force long-term insurance business**

The group's life insurance business is accounted for using the embedded value approach, which, *inter alia*, provides a comprehensive framework for the evaluation of insurance and related risks. The present value of the in-force long-term ('PVIF') asset at 31 December 2008 was £579 million (2007: £444 million). The present value of the shareholder's interest in the profits expected to emerge from the book of in-force policies at 31 December 2008 can be stress-tested to assess the ability of the life business book to withstand adverse developments. A key feature of the life insurance business is the importance of managing the assets, liabilities and risks in a coordinated fashion rather than individually. This reflects greater interdependence of these three elements for life insurance than is generally the case for non-life insurance.

*Sensitivity of PVIF to changes in economic assumptions*

The following table shows the effect on the PVIF of reasonably possible changes in the main economic assumptions, namely changes in the risk-free and risk discount rates, across all insurance underwriting subsidiaries:

	PVIF at 31 December	
	2008 £m	2007 £m
+ 100 basis points shift in risk-free rate .....	15	9
– 100 basis points shift in risk-free rate .....	(14)	(20)
+ 100 basis points shift in risk discount rate .....	(26)	(21)
– 100 basis points shift in risk discount rate .....	28	23

Due to certain characteristics of the contracts, the relationships may be non-linear and the results of the stress-testing disclosed above should not be extrapolated to higher levels of stress. In calculating the various scenarios, all assumptions are held stable except when testing the effect of the shift in the risk-free rate, when consequential changes to investment returns, risk discount rates and bonus rates are also incorporated. The sensitivities shown are before actions that could be taken by management to mitigate effects and before consequential changes in policyholder behaviour.

**Non-economic assumptions**

The policyholder liabilities and PVIF are determined by reference to non-economic assumptions which include, for non-life manufacturers, claims costs and expense rates and, for life manufacturers, mortality and/or morbidity, lapse

## Notes on the Financial Statements (continued)

rates and expense rates. The table below shows the sensitivity of profit for the year to, and net assets at, 31 December 2008 to reasonably possible changes in these non-economic assumptions at that date across all insurance manufacturing subsidiaries, with comparatives for 2007.

Claims costs 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 of an increase in mortality or morbidity on profit depends on the type of business being written. For a portfolio of term assurance contracts, an increase in mortality usually has a negative effect on profit as the number of claims increases. For a portfolio of annuity contracts, an increase in mortality rates typically has a positive effect on profit as the period over which the benefit is being paid to the policyholder is shortened. However, when an annuity contract includes life cover, the positive effect on profit of the increase in mortality may be offset by the benefits payable under the life insurance.

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. For a portfolio of annuity contracts, an increase in lapse rates has a positive effect on profit as the obligation to pay future benefits on the lapsed contracts is extinguished.

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.

### *Sensitivity to changes in non-economic assumptions*

The sensitivity of profit for the year and net assets to reasonably possible changes in non-economic conditions across all insurance underwriting subsidiaries is as follows:

	Effect on:		Effect on:	
	Profit for the year to 31 December 2008 £m	Net assets at 31 December 2008 £m	Profit for the year to 31 December 2007 £m	Net assets at 31 December 2007 £m
20 % increase in claims costs .....	(34)	(34)	(32)	(32)
20 % decrease in claims costs .....	34	34	32	32
10 % increase in mortality and/or morbidity rates .....	(2)	(2)	6	6
10 % decrease in mortality and/or morbidity rates .....	4	4	(9)	(9)
50 % increase in lapse rates .....	(84)	(84)	(28)	(28)
50 % decrease in lapse rates .....	130	130	45	45
10 % increase in expense rates .....	(19)	(19)	(5)	(5)
10 % decrease in expense rates .....	18	18	5	5

### **Special purpose entities (including on- and off-balance sheet arrangements)**

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, some of which have been included in the group's consolidated balance sheet. The group's 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.

The group sponsors the formation of entities which are designed to accomplish certain narrow and well-defined objectives, such as securitising financial assets or affecting a lease, and this requires a form of legal structure that restricts the assets and liabilities within the structure to the single purpose for which it was established. The group consolidates these SPEs when the substance of the relationship indicates that the group controls them. In assessing control, all relevant factors are considered, including qualitative and quantitative aspects. The group re-assesses the required consolidation accounting tests whenever there is a change in the substance of the relationship between the group and an SPE. The most significant categories of SPE are discussed in more detail below.



## **Structured investment vehicles and conduits**

### ***Structured Investment Vehicles ('SIVs')***

SIVs are SPEs which invest in diversified portfolios of interest-earning assets, generally funded through issues of commercial paper ('CP'), medium term notes ('MTN') and other senior debt to take advantage of the spread of differentials between the assets in the SIV and the funding cost. Prior to the implementation of Basel II, it was capital efficient to many bank investors to invest in highly-rated investment securities in this way. The group sponsored establishment of two SIVs, Cullinan Finance Limited ('Cullinan') and Asscher Finance Limited ('Asscher') in 2005 and 2007, respectively, and in November 2007 the group consolidated the SIVs.

Subsequently the SIVs were restructured and the group established three new securities investment conduits ('SICs') to take on the assets held in SIVs. Mazarin Funding Limited ('Mazarin'), an asset backed CP conduit, and Barion Funding Limited ('Barion'), a term-funding vehicle, were set up in respect of Cullinan; and Malachite Funding Limited ('Malachite'), a term-funding vehicle, was set up in respect of Asscher.

### ***Conduits***

The group sponsors and manages two types of conduits which issue CP; multi-seller securities and SICs. The group has consolidated these conduits from inception because it is exposed to the majority of risks and rewards of ownership.

#### ***Securities investment conduits***

Solitaire purchases highly rated ABSs to facilitate tailored investment opportunities. The group's other SICs, Mazarin, Barion and Malachite, evolved from the restructuring of the group's sponsored SIVs as discussed above.

#### ***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 for example, to finance discrete pools of third-party originated trade and vehicle finance loan receivables.

## **Money market funds**

The group has established, manages and has investments in a number of money market funds which provide customers with tailored investment opportunities with a set of narrow and well-defined objectives. The group consolidates a fund when the group's holding is of sufficient size to represent the majority of the risks and rewards of ownership or when the substance of the relation indicates that the group controls the fund.

## **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 SPEs**

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

### ***Structured credit transactions***

The group provides structured credit transactions to third-party professional and institutional investors who wish to obtain exposure, sometimes on a leveraged basis, to a reference portfolio of debt instruments. In such structures, the investor receives returns referenced to the underlying portfolio by purchasing notes issued by the SPEs. The group enters into contracts with the SPEs, generally in the form of derivatives, in order to pass the required risks and rewards of the reference portfolios to the SPEs. The group's risk in relation to the derivative contracts with the SPEs is managed within the group's trading market risk framework.

## Notes on the Financial Statements (continued)

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### *Other uses of SPEs*

The group participates in Public-Private Partnerships to provide financial support for infrastructure projects initiated by government authorities. The funding structure is commonly achieved through the use of SPEs. The group consolidates these SPEs when it is exposed to the majority of risks and rewards of the vehicles.

The group's Asset and Structured Finance ('ASF') business specialises in leasing and arranging finance for aircraft and other physical assets, which it is customary to ring-fence through the use of SPEs, and in structured loans and deposits, where SPEs introduce cost efficiencies. The group consolidates these SPEs when the substance of the relationship indicates that the group controls the SPE.

### *Third party sponsored SPEs*

The group's exposure to third party sponsored SIVs, conduits and securitisations have arisen through normal banking arrangements on standard market terms through standby liquidity facility commitments.

## **Other off-balance sheet arrangements**

### *Financial guarantees, letters of credit and similar undertakings*

Note 39 describes various types of guarantees and discloses the maximum potential future payments under such arrangements.

### *Commitments to lend*

The group generally has the right to change or terminate any conditions of a personal customer's overdraft, credit card or other credit line upon notification to the customer. In respect of corporate commitments to lend, in most cases the group's position will be protected through restrictions on access to funding in the event of material adverse change

### *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.

### 39 Contingent liabilities, commitments and guarantees

	The group		The bank	
	2008 £m	2007 £m	2008 £m	2007 £m
<b>Guarantees and other contingent liabilities</b>				
Guarantees and irrevocable letters of credit pledged as collateral security .....	21,310	18,972	13,787	10,816
Other contingent liabilities .....	110	75	–	–
	<b>21,420</b>	<b>19,047</b>	<b>13,787</b>	<b>10,816</b>
<b>Commitments<sup>1</sup></b>				
Documentary credits and short-term trade-related transactions .....	2,204	1,621	861	447
Forward asset purchases and forward deposits placed .....	493	38	–	–
Undrawn note issuing and revolving underwriting facilities .....	–	19	–	–
Undrawn formal standby facilities, credit lines and other commitments to lend <sup>2</sup> .....	151,694	144,341	102,626	101,879
	<b>154,391</b>	<b>146,019</b>	<b>103,487</b>	<b>102,326</b>

1 Excluding capital commitments, which are separately disclosed below.

2 Based on original contractual maturity.

The table above discloses the nominal principal amounts of contingent liabilities, commitments and guarantees. 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.

#### Financial Services Compensation Scheme

The Financial Services Compensation Scheme ('FSCS') has provided compensation to consumers following the collapse of a number of deposit takers such as Bradford & Bingley plc, Heritable Bank plc, Kaupthing Singer & Friedlander Limited, Landsbanki 'Icesave' and London Scottish Bank plc. 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 16 December 2008 stood at £19.7 billion. The bank is also obligated to pay its share of forecast management expenses based on the bank's market share of deposits protected under the FSCS. The bank has accrued £86 million as at 31 December 2008 in respect of the share of forecast management expense, including interest costs, for the 2008/9 and 2009/10 levy years. This accrual is based on the bank's estimated share of total market protected deposits at 31 December 2007 and 2008, respectively. However, the ultimate FSCS levy to the industry as a result of the 2008 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, the level of protected deposits and the population of FSCS members at the time.

#### Guarantees

The group provides guarantees and similar undertakings on behalf of both third party customers and other entities within the group. These guarantees are generally provided in the normal course of the group's banking business. The principal types of guarantees provided, and the maximum potential amount of future payments which the group could be required to make, were as follows:

## Notes on the Financial Statements (continued)

*The group*

	At 31 December 2008		At 31 December 2007	
	Guarantees in favour of third parties £m	Guarantees by the group in favour of other HSBC group entities £m	Guarantees in favour of third parties £m	Guarantees by the group in favour of other HSBC group entities £m
<b>Guarantee type</b>				
Financial guarantee contracts <sup>1</sup> .....	9,972	996	8,957	1,266
Standby letters of credit which are financial guarantee contracts <sup>2</sup> .....	791	57	752	68
Other direct credit substitutes <sup>3</sup> .....	244	3	191	6
Performance bonds <sup>4</sup> .....	2,395	43	1,751	29
Bid bonds <sup>4</sup> .....	75	2	129	4
Standby letters of credit related to particular transactions <sup>4</sup> .....	486	–	412	–
Other transaction-related guarantees <sup>4</sup> .....	5,891	26	5,215	71
Other items .....	439	–	196	–
<b>Total</b> .....	<b>20,293</b>	<b>1,127</b>	<b>17,603</b>	<b>1,444</b>

*The bank*

	At 31 December 2008		At 31 December 2007	
	Guarantees in favour of third parties £m	Guarantees by the bank in favour of other HSBC group entities £m	Guarantees in favour of third parties £m	Guarantees by the bank in favour of other HSBC group entities £m
<b>Guarantee type</b>				
Financial guarantee contracts <sup>1</sup> .....	7,057	2,693	6,382	1,069
Standby letters of credit which are financial guarantee contracts <sup>2</sup> .....	5	–	–	–
Other direct credit substitutes <sup>3</sup> .....	–	–	1	–
Performance bonds <sup>4</sup> .....	898	36	648	22
Bid bonds <sup>4</sup> .....	17	2	19	3
Standby letters of credit related to particular transactions <sup>4</sup> .....	76	–	74	–
Other transaction-related guarantees <sup>4</sup> .....	2,651	24	2,461	16
Other items .....	328	–	121	–
<b>Total</b> .....	<b>11,032</b>	<b>2,755</b>	<b>9,706</b>	<b>1,110</b>

- 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 *Standby letters of credit which are financial guarantee contracts are irrevocable obligations on the part of the group and/or the bank to pay third parties when customers fail to make payments when due.*
- 3 *Other direct credit substitutes include re-insurance letters of credit and trade-related letters of credit issued without provision for the issuing entity to retain title to the underlying shipment.*
- 4 *Performance bonds, bid bonds, standby letters of credit and other transaction-related guarantees are undertakings by which the obligation on the group and/or the bank to make payment depends on the outcome of a future event.*

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

At 31 December 2008, the group had commitments to purchase, within one year, land and buildings and other fixed assets from a number of suppliers for a value of £368 million (2007: £282 million).

### Joint ventures and associates

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

## 40 Lease commitments

### Finance lease commitments

The group leases land and buildings (including branches) and equipment from third parties under finance lease arrangements to support its operations.

	2008			2007		
	Total future minimum payments £m	Interest charges £m	Present value £m	Total future minimum payments £m	Interest charges £m	Present value £m
No later than one year .....	21	(20)	1	13	(12)	1
Later than one year and no later than five years .....	97	(92)	5	51	(51)	–
Later than five years .....	504	(178)	326	415	(87)	328
	<b>622</b>	<b>(290)</b>	<b>332</b>	<b>479</b>	<b>(150)</b>	<b>329</b>

At 31 December 2008 future minimum sublease payments of £314 million (2007: £232 million) were expected to be received under non-cancellable subleases at the balance sheet date.

### Operating lease commitments

At 31 December 2008, 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	
	2008 £m	2007 £m
Future minimum lease payments under non-cancellable operating leases expiring:		
– no later than one year .....	122	110
– later than one year and no later than five years .....	394	367
– later than five years .....	533	540
	<b>1,049</b>	<b>1,017</b>

In 2008, £105 million (2007: £117 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

	2008			2007		
	Total future minimum payments £m	Unearned finance income £m	Present value £m	Total future minimum payments £m	Unearned interest income £m	Present value £m
Lease receivables:						
– no later than one year .....	1,209	(152)	1,057	729	(141)	588
– later than one year and no later than five years .....	2,829	(584)	2,245	2,222	(493)	1,729
– later than five years .....	4,367	(1,444)	2,923	3,502	(1,146)	2,356
	<b>8,405</b>	<b>(2,180)</b>	<b>6,225</b>	<b>6,453</b>	<b>(1,780)</b>	<b>4,673</b>

## Notes on the Financial Statements (continued)

At 31 December 2008, unguaranteed residual values of £108 million (2007: £85 million) had been accrued, and the accumulated allowance for uncollectible minimum lease payments receivable amounted to nil (2007: Nil).

In 2008, £ nil (2007: Nil) was received as contingent rents and recognised in 'Other operating income'.

### Operating lease receivables

The group leases a variety of different assets to third parties under operating and finance lease arrangements, including rolling stock, property, aircraft and general plant and machinery.

	<b>Equipment</b>	
	<b>2008</b>	2007
	<b>£m</b>	£m
Future minimum lease payments under non-cancellable operating leases expiring:		
– no later than one year .....	<b>290</b>	237
– later than one year and no later than five years .....	<b>429</b>	670
– later than five years .....	<b>76</b>	199
	<b>795</b>	1,106

## 41 Litigation

On 27 July 2007, the UK Office of Fair Trading ('OFT') issued High Court legal proceedings against a number of UK financial institutions, including HSBC Bank plc, to determine the legal status and enforceability of certain of the charges applied to their personal customers in relation to unauthorised overdrafts (the 'charges'). Pending the resolution of the proceedings, the Financial Services Authority ('FSA') has granted firms (including HSBC Bank plc) a Waiver enabling them to place relevant complaints about the charges on hold and the County Courts have stayed all individual customer claims.

Certain preliminary issues in these proceedings have been heard in the Commercial Division of the High Court. This has confirmed that HSBC Bank plc's current and historic charges are capable of being tested for fairness but are not capable of being penalties. HSBC Bank plc (and all the other financial institutions involved in the legal proceedings) appealed the findings that the charges are capable of being tested for fairness. The Court of Appeal delivered its judgment on 26 February 2009, confirming the decision of the High Court that the charges of HSBC Bank plc (and all of the other financial institutions involved in the legal proceedings) are capable of being tested for fairness. HSBC Bank plc is considering applying for leave to appeal to the House of Lords.

The proceedings remain at an early stage and may, allowing for further appeals on the issues, take some time to conclude. A wide range of outcomes is possible, depending upon the outcome of any appeal to the House of Lords and, to the extent applicable, upon the Court's assessment of the fairness of each charge across the period under review. Since July 2001, there have been a variety of charges applied by HSBC Bank plc across different charging periods under the then existing contractual arrangements. HSBC Bank plc considers the charges to be and to have been valid and enforceable, and intends strongly to defend its position.

If, contrary to the bank's current assessment, the Court should ultimately (after appeals) reach an adverse decision that results in a liability for it, a large number of different outcomes is possible, each of which would have a different financial impact. Given that there is limited authority on how an assessment of fairness should be conducted, the bank's estimate of the potential financial impact could be in the order of £350 million, as published in the *Interim Report 2008*. To make an estimate of the potential financial impact at this stage with any precision is extremely difficult, owing to (among other things) the complexity of the issues, the number of permutations of possible outcome, and the early stage of the proceedings. In addition, the assumptions made by the bank may prove to be incorrect.

On 11 December 2008, Bernard L. Madoff ('Madoff') was arrested and charged in the United States District Court for the Southern District of New York with one count of securities fraud. That same day, the SEC filed securities fraud charges against Madoff and his firm Bernard L. Madoff Investment Securities LLC (Madoff Securities), a broker dealer and investment advisor registered with the SEC. The criminal complaint and SEC complaint each alleged that Madoff had informed senior Madoff Securities employees, in substance, that his investment advisory business was a fraud. On 15 December 2008, on the application of the Securities Investor Protection Corporation, the United States District Court for the Southern District of New York appointed a trustee for the liquidation of the business of Madoff Securities, and removed the liquidation proceeding to the United States Bankruptcy Court for the Southern District of New York. On 9 February 2009, on Madoff's consent, the United States District Court for the Southern District of New York entered a partial judgment in the SEC action, permanently enjoining Madoff from

violating certain antifraud provisions of the U.S. securities laws, ordering Madoff to pay disgorgement, prejudgment interest and a civil penalty in amounts to be determined at a later time, and continuing certain other relief previously imposed, including a freeze on Madoff's assets. The relevant U.S. authorities are continuing their investigations into the alleged fraud. There remains significant uncertainty as to the facts of the alleged fraud and the extent of any assets of, and remaining within, Madoff Securities.

Various non-US HSBC group companies provide custodial, administration and similar services to a number of funds incorporated outside the United States of America whose assets were invested with Madoff Securities. Based on information provided by Madoff Securities, as at 30 November 2008, the aggregate net asset value of these funds (which would include principal amounts invested and unrealised gains) was £5.6 billion.

Proceedings concerning Madoff and Madoff Securities have already been issued in various jurisdictions against numerous defendants and the group expects further proceedings to be brought, including by the Madoff Securities trustee. Various group companies have been named as defendants in suits in the United States seeking class action status and cases in the Commercial List of the Irish courts. All of the cases where group companies are named as a defendant are at a very early stage. The group considers that it has good defences to these claims and will continue to defend them vigorously. The group is unable reliably to estimate the liability, if any, that might arise as a result of such claims.

Various group companies have also received requests for information from various regulatory authorities in connection with the alleged fraud by Madoff. The group companies are co-operating with these requests for information.

These actions apart, the group is party to legal actions in a number of jurisdictions arising out of its normal business operation. The group considers that none of the actions is material, and none is expected to result in a significant adverse effect on the financial position of the group, either individually or in the aggregate. Management believes that adequate provisions have been made in respect of the litigation arising out of its normal business operations. The group has not disclosed any contingent liability associated with these legal actions because it is not practical to do so.

## 42 Related party transactions

The ultimate parent company of the group is HSBC Holdings plc, which is incorporated in England.

The group's related parties include the parent, fellow subsidiaries, associates, joint ventures, post-employment benefit plans for the benefit of HSBC employees, key management personnel, close family members of Key Management Personnel and entities which are controlled, jointly controlled or significantly influenced 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 Board of Directors of HSBC Bank plc and HSBC Holdings plc and Group Managing Directors of HSBC Holdings plc.

#### Compensation of Directors and other Key Management Personnel

	2008	2007
	£000	£000
Short-term employee benefits .....	4,231	6,665
Post-employment benefits .....	65	395
Termination benefits .....	–	–
Share-based payment .....	2,357	4,432
	<u>6,653</u>	<u>11,492</u>

## Notes on the Financial Statements (continued)

### Shareholdings and options of Directors' and other Key Management Personnel

	<b>Balance at 31 December 2008</b>	Balance at 31 December 2007
Number of share options from equity participation plans held by Directors and other key management personnel (and their connected persons) .....	<b>1,033,747</b>	958,232
Number of shares held by Directors and other key management personnel (and their connected persons) .....	<b>17,498,156</b>	16,625,206

### Transactions, arrangements and agreements including Directors and other Key Management Personnel

The table below set out transactions which fall to be disclosed under IAS 24 'Related Party Disclosures' between the group and the Key Management Personnel of both the bank and its parent company, HSBC Holdings plc, and their connected persons or controlled companies.

	<u>2008</u>			<u>2007</u>		
	Number of persons	Highest balance during the year <sup>1</sup> £000	Balance at 31 December <sup>1</sup> £000	Number of persons	Highest balance during the year <sup>1</sup> £000	Balance at 31 December <sup>1</sup> £000
<b>Key Management Personnel and connected persons and companies controlled by them</b>						
Loans .....	70	103,594	49,776	110	379,869	271,991
Credit cards .....	59	452	196	47	635	267
Guarantees .....	5	6,753	5,684	17	14,811	13,224

<sup>1</sup> 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 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, arrangements and agreements including Directors and officers (Companies Act 1985)

In addition to the requirements of IAS 24, particulars of transactions, arrangements and agreements entered into by HSBC Bank plc and its subsidiaries with Directors and connected persons and companies controlled by them and with officers of HSBC Bank plc are required to be disclosed pursuant to section 232 of the Companies Act 1985. 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.

For 2007, officers comprised the members of the bank's Executive Committee who served during the year and the Company Secretary. For 2008, officers comprised the members of the Executive Committee and its successor, the European Management Committee, who served during the year, and the Company Secretary.



The table below sets out transactions which fall to be disclosed under section 232 of the Companies Act 1985.

	2008		2007 <sup>1</sup>	
	Number of persons	Balance at 31 December £000	Number of persons	Balance at 31 December £000
<i>The group</i>				
<b>Directors</b>				
Loans .....	14	1,690	12	1,478
Credit cards .....	13	65	20	51
Guarantees .....	–	–	1	12
<b>Officers</b>				
Loans .....	19	7,039	22	6,488
Credit cards .....	19	81	21	108
Guarantees .....	–	–	–	–

<sup>1</sup> Comparative figures for 2007 have been restated to show Directors, excluding their connected persons following a change to section 232 and Part 2 of Schedule 6 of the Companies Act.

## (b) Transactions with other related parties

### Associates and joint ventures

#### *The group*

	2008		2007	
	Highest balance during the year <sup>1</sup> £m	Balance at 31 December 2008 <sup>1</sup> £m	Highest balance during the year <sup>1</sup> £m	Balance at 31 December 2007 <sup>1</sup> £m
Amounts due from joint ventures .....				
– subordinated .....	–	–	–	–
– unsubordinated .....	202	110	216	202
Amounts due from associates .....				
– subordinated .....	–	–	19	–
– unsubordinated .....	–	–	33	–
Amounts due to joint ventures .....	20	12	20	20
Amounts due to associates .....	1	–	166	1

<sup>1</sup> 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*

	2008		2007	
	Highest balance during the year <sup>1</sup> £m	Balance at 31 December 2008 <sup>1</sup> £m	Highest balance during the year <sup>1</sup> £m	Balance at 31 December 2008 <sup>1</sup> £m
Amounts due from joint ventures				
– subordinated .....	–	–	–	–
– unsubordinated .....	161	110	161	161
Amounts due from associates				
– subordinated .....	–	–	–	–
– unsubordinated .....	–	–	1	–
Amounts due to joint ventures .....	12	10	4	4
Amounts due to associates .....	1	–	29	1

<sup>1</sup> 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.

## Notes on the Financial Statements (continued)

### 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.

	2008		2007	
	Highest balance during the year <sup>1</sup> £m	Balance at the year end <sup>1</sup> £m	Highest balance during the year <sup>1</sup> £m	Balance at the year end <sup>1</sup> £m
<b>Assets</b>				
Trading assets .....	214	53	37	7
Financial assets designated at fair value .....	21	21	15	15
Derivatives .....	–	–	–	–
Loans and advances to banks .....	–	–	–	–
Loans and advances to customers .....	343	56	60	33
Financial investments .....	58	58	1	1
Other assets .....	–	–	–	–
	<b>2008</b>		<b>2007</b>	
	Highest balance during the year <sup>1</sup> £m	Balance at the year end <sup>1</sup> £m	Highest balance during the year <sup>1</sup> £m	Balance at the year end <sup>1</sup> £m
<b>Liabilities</b>				
Trading liabilities .....	22	17	13	12
Deposits by banks .....	–	–	–	–
Customer accounts .....	8,582	3,406	3,308	2,931
Derivatives .....	–	–	–	–
Subordinated amounts due .....	3,047	3,047	1,577	1,577
Guarantees .....	–	–	–	–
			<b>For the year ended 31 December 2008 £m</b>	<b>For the year ended 31 December 2007 £m</b>
<b>Income Statement</b>				
Interest income .....			1	–
Interest expense .....			117	111
Dividend income .....			6	14
Fee income .....			–	–
Fee expense .....			–	–
Trading income .....			–	–
Other operating income .....			18	–
General and administrative expenses .....			82	48

<sup>1</sup> The disclosure of the year-end balance and the highest balance during the year is considered the most meaningful information to represent transactions during the year.

### Transactions detailed below include amounts due to/from fellow subsidiaries of HSBC Holdings plc

	2008		2007	
	Highest balance during the year <sup>1</sup> £m	Balance at the year end <sup>1</sup> £m	Highest balance during the year <sup>1</sup> £m	Balance at the year end <sup>1</sup> £m
<b>Assets</b>				
Trading assets .....	9,718	8,369	9,895	7,453
Derivatives .....	72,434	30,669	24,494	7,445
Loans and advances to banks .....	5,444	5,267	5,968	5,968
Loans and advances to customers .....	3,252	3,252	1,646	1,102
Financial investments .....	7,277	7,277	5,829	5,829
Other assets .....	7,497	212	1,983	716

	2008		2007	
	Highest balance during the year <sup>1</sup> £m	Balance at the year end <sup>1</sup> £m	Highest balance during the year <sup>1</sup> £m	Balance at the year end <sup>1</sup> £m
<b>Liabilities</b>				
Trading liabilities .....	25,241	25,241	19,563	17,345
Deposits by banks .....	9,116	7,594	6,962	6,095
Customer accounts .....	1,715	559	2,131	1,429
Derivatives .....	70,444	29,022	26,536	8,966
Guarantees .....	996	996	151	116
			<b>For the year ended 31 December 2008 £m</b>	<b>For the year ended 31 December 2007 £m</b>
<b>Income Statement</b>				
Interest income .....			495	556
Interest expense .....			269	379
Dividend income .....			–	–
Fee income .....			81	99
Fee expense .....			188	135
Trading income .....			392	316
Other operating income .....			15	27
General and administrative expenses .....			142	120

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 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.

	2008		2007	
	Highest balance during the year <sup>1</sup> £m	Balance at the year end <sup>1</sup> £m	Highest balance during the year <sup>1</sup> £m	Balance at the year end <sup>1</sup> £m
<b>Assets</b>				
Trading assets .....	36,824	27,184	40,138	40,138
Derivatives .....	56,747	32,375	8,341	8,341
Loans and advances to banks .....	4,982	2,521	5,026	3,798
Loans and advances to customers .....	18,397	18,313	7,930	7,594
Financial investments .....	851	851	–	–
Other assets .....	–	–	–	–
<b>Liabilities</b>				
Trading liabilities .....	19,690	11,479	16,153	13,567
Deposits by banks .....	21,560	21,560	12,695	10,827
Customer accounts .....	11,876	11,580	11,470	11,470
Derivatives .....	56,143	33,368	8,056	8,056
Subordinated amounts due .....	622	622	–	–
Guarantees .....	1,761	1,761	998	998

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.

## Notes on the Financial Statements (continued)

Transactions detailed below include amounts due to/from HSBC Bank plc and HSBC Holdings plc.

	2008		2007	
	Highest balance during the year <sup>1</sup> £m	Balance at the year end <sup>1</sup> £m	Highest balance during the year <sup>1</sup> £m	Balance at the year end <sup>1</sup> £m
<b>Assets</b>				
Trading assets .....	214	53	37	7
Derivatives .....	–	–	–	–
Loans and advances to banks .....	–	–	–	–
Loans and advances to customers .....	137	56	60	33
Financial investments .....	–	–	–	–
Other assets .....	–	–	–	–
<b>Liabilities</b>				
Trading liabilities .....	22	17	13	12
Deposits by banks .....	–	–	–	–
Customer accounts .....	3,680	3,398	3,289	2,919
Derivatives .....	–	–	–	–
Subordinated amounts due .....	3,047	3,047	1,577	1,577
Guarantees .....	–	–	–	–

<sup>1</sup> The disclosure of the year-end balance and the highest balance during the year is considered the most meaningful information to represent transactions during the year.

Transactions detailed below include amounts due to/from HSBC Bank plc and fellow subsidiaries of HSBC Holdings plc.

	2008		2007	
	Highest balance during the year <sup>1</sup> £m	Balance at the year end <sup>1</sup> £m	Highest balance during the year <sup>1</sup> £m	Balance at the year end <sup>1</sup> £m
<b>Assets</b>				
Trading assets .....	9,258	7,486	8,803	6,634
Derivatives .....	43,907	23,192	5,335	5,255
Loans and advances to banks .....	4,557	3,662	4,890	4,329
Loans and advances to customers .....	3,085	3,085	982	982
Financial investments .....	–	–	–	–
Other assets .....	3,561	231	204	36
<b>Liabilities</b>				
Trading liabilities .....	23,613	23,613	19,497	16,272
Deposits by banks .....	5,980	3,146	4,323	4,200
Customer accounts .....	1,418	378	1,850	1,147
Derivatives .....	38,799	21,559	5,826	5,826
Guarantees .....	931	931	113	70

<sup>1</sup> 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 2008, fees of £10.9 million (2007: £15.9 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 £281 million (2007: £215 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.

HSBC Bank (UK) Pension Scheme (the 'Scheme') has entered into swap transactions with the bank to manage the inflation and interest rate sensitivity of the liabilities. At 31 December 2008, the gross notional value of the swaps was £12,132 million (2007: £10,543 million), the swaps had a negative fair value of £1,220 million to the bank (2007: negative fair value of £124 million) and the bank had delivered collateral of £1,682 million (2007: £378 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.

## **43 Events after the balance sheet date**

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There have been no material events after the balance sheet date which would require disclosure or adjustment to the 31 December 2008 financial statements.

On 30 January 2009, HSBC Holdings plc subscribed £527 million for one ordinary share of £1 credited as fully paid in the ordinary share capital of the bank.

These accounts were approved by the Board of Directors on 2 March 2009 and authorised for issue.

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Published by HSBC Bank plc, London, which is regulated by the Financial services authority  
Registered in England: number 14259



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