

Annual Reports and Accounts 2013

Presentation of Information

This document comprises the Annual Report and Accounts 2013 for HSBC Bank plc ('the bank') and its subsidiaries (together 'the group'). It contains the Strategic Report, the Report of the Directors and Financial Statements, together with the Independent Auditor's Report, as required by the UK Companies Act 2006. References to 'HSBC' or 'the Group' within this document mean HSBC Holdings plc together with its subsidiaries.

In November 2012, the group sold HSBC Private Banking Holdings (Suisse) SA to HSBC Holdings plc, with the exception of HSBC Private Bank (UK) Limited which remains as part of the group. The consolidated statement of comprehensive income shows the discontinued operation separately from continuing operations for 2012. The commentaries included in the Business Review section have been prepared on a continuing operations basis.

With effect from 1 January 2013, the group's operating segments have been revised to reflect internal changes made to the management structure. The revised segments are consistent with those reported to the bank's Executive Committee, the identified Chief Operating Decision Maker under IFRS 8. Further details are provided in Note 1 'Basis of Preparation' on page 103. All comparatives have been adjusted accordingly.

Additional information, including commentary on 2012 versus 2011 and certain statistical and other information, may be found in a separate document entitled 'Additional Information 2013' and can be found at www.hsbc.co.uk.

Cautionary Statement Regarding Forward-Looking Statements

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

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

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

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Financial Highlights of the group

| | 2013 | 2012 |
|--|---------|---------|
| For the year (£m) | | |
| Profit on ordinary activities before tax ¹ | 3,294 | 1,004 |
| Total operating income | 15,868 | 15,407 |
| Net operating income before loan impairment charges and other credit risk provisions | 12,840 | 12,488 |
| Profit attributable to shareholders of the parent company | 2,495 | 2,384 |
| At year-end (£m) | | |
| Total equity attributable to shareholders of the parent company | 32,370 | 31,675 |
| Risk weighted assets | 185,879 | 193,402 |
| Loans and advances to customers (net of impairment allowances) | 305,032 | 282,685 |
| Customer accounts | 390,017 | 324,886 |
| Capital ratios (%) | | |
| Core Tier 1 ratio | 12.1 | 11.4 |
| Tier 1 ratio | 13.0 | 12.4 |
| Total capital ratio | 18.0 | 17.3 |
| Performance ratios (%) | | |
| Return on average invested capital (on underlying basis) ² | 8.4 | 6.2 |
| Return on average invested capital (on reported basis) | 7.9 | 3.2 |
| Return on average shareholders' funds (equity) of the parent company ³ | 7.9 | 3.5 |
| Post-tax return on average total assets | 0.3 | 0.1 |
| Pre-tax return on average risk-weighted assets | 1.7 | 0.5 |
| Dividend payout ratio ⁴ | 80.2 | 118.4 |
| Credit coverage ratios (%) | | |
| Loan impairment charges as a percentage of total operating income | 6.1 | 8.1 |
| Loan impairment charges as a percentage of average gross customer advances | 0.4 | 0.5 |
| Efficiency and revenue mix ratios (%) | | |
| Cost efficiency ratio ⁵ | 66.8 | 82.0 |
| As a percentage of total operating income: | | |
| - net interest income | 43.9 | 44.8 |
| - net fee income | 21.0 | 24.5 |
| - net trading income | 15.0 | 11.9 |
| Financial ratios (%) | | |
| Ratio of customer advances to customer accounts | 78.2 | 87.0 |
| Average total shareholders' equity to average total assets | 3.8 | 3.4 |

1 Excludes gain on sale of £1,265 million of HSBC Private Banking Holdings (Suisse) SA to HSBC Holdings plc in 2012.

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

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

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

4 Dividends per ordinary share expressed as a percentage of basic earnings per share. Dividends recorded in the financial statements are dividends per ordinary share declared in a year and are not dividends in respect of, or for, that year.

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

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

Purpose and Values

Purpose

The purpose of HSBC Bank plc and its subsidiaries is to connect customers to opportunities, enabling businesses to thrive and economies to prosper, helping people to fulfil their hopes and realise their ambitions. Through its principal activities – making payments, holding savings, providing finance and managing risks – the group plays a vital role in society and the economic system.

HSBC Values and Global Standards

In line with HSBC's ambition to be recognised as the world's leading international bank, HSBC aspires to lead the industry standards for knowing its customers and detecting, deterring and protecting against financial crime. As international markets become more interconnected and complex and as threats to the global financial system grow, the group is further strengthening the policies and practices which govern how and with whom it does business.

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

Be dependable and doing the right thing:

- stand firm for what is right, deliver on commitments, be resilient and trustworthy; and
- take personal accountability, be decisive, use judgment and common sense, empower others.

Be open to different ideas and cultures:

- communicate openly, honestly and transparently, value challenge, learn from mistakes; and
- listen, treat people fairly, be inclusive, value different perspectives.

Be connected with customers, communities, regulators and each other:

- build connections, be externally focused, collaborate across boundaries; and
- care about individuals and their progress, show respect, be supportive and responsive.

HSBC's Values are integral to the selection assessment, recognition and training of staff.

Through the Global Standards programme, HSBC is transforming how it detects, deters and protects against financial crime. The group is implementing a more consistent, comprehensive approach to assessing financial

crime risk in order to help protect HSBC's customers, HSBC's employees and the financial system as a whole.

The process of embedding Global Standards and the supporting controls and capabilities that allow the business to identify and mitigate financial crime risk is underway and will continue into 2014 and beyond. The implementation programme is focused on the following four areas:

- *Data readiness:* creating a complete, cleansed data set to improve the Group's understanding of the customer base and facilitate its financial crime risk assessment. This will provide the basis for transaction monitoring and assist capacity planning to improve the quality and efficiency of the group's know your customer ('KYC') activities.
- *Customer due diligence:* strengthening the rigour with which HSBC researches and evaluates the group's customers and affiliates to better understand them and their activities; improving KYC profiling through enhanced due diligence, customer identification, screening and financial crime risk scoring; and tightening its controls around tax transparency and bearer shares. For instances that exceed its risk appetite, HSBC is putting in place a global customer selection and exit policy.
- *Financial crime compliance:* building HSBC's Financial Crime Compliance organisation with the right people and capabilities to support the business; developing global policies for Anti-Money Laundering ('AML'), sanctions, anti-bribery, corruption and enhancing the monitoring, screening and testing that will allow us to manage financial crime risk more effectively; and designing a new, annual HSBC-wide risk assessment to better understand the financial crime risk HSBC carries in the business and determine the best approach to manage it.
- *Financial intelligence:* establishing a new global network of Financial Intelligence Units that use cutting edge technology to identify and investigate significant cases, trends and strategic issues related to financial crime risks.

The group divides its activities into four business segments: Retail Banking and Wealth Management; Commercial Banking; Global Banking and Markets; and Global Private Banking.

Products and Services

Retail Banking and Wealth Management

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

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

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

Typically, products offered to customers include:

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

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

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

Commercial Banking

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

The group places particular emphasis on international connectivity to meet the needs of its business customers. HSBC aims to be recognised as the leading international trade and business bank by focusing on faster-growing markets, repositioning towards international business and enhancing collaboration across the HSBC Group.

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

Products and Services (continued)

Global Banking and Markets

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

In August 2013, GB&M was reshaped to focus more effectively its resources around clients, to enhance relationships, and to better capture growth opportunities creating greater value for clients and the group.

- **Client Coverage** contains relationship managers, organised by sector, region and country who work to understand client needs and provide holistic solutions by bringing together HSBC's broad array of product capabilities.
- **Markets** provide sales and trading services which are categorised as follows:
 - **Credit and Rates** sell, trade and distribute fixed income securities to clients including corporates, financial institutions, sovereigns, agencies and public sector issuers. They also offer clients risk management solutions.
 - **Foreign Exchange** provides spot and derivative products to meet the investment demands of institutional investors, the hedging needs of SMEs and large corporates, and the needs of RBWM customers in the group's branches.
 - **Equities** provides sales and trading services for clients, including primary issuance, direct market access as well as financing and hedging solutions.
- **Capital Financing** provides financing, and advisory services. Products include debt and equity capital raising, advisory, corporate lending, leveraged finance, asset and structured finance, real estate, infrastructure and project finance, and export credit.
- **Payments and Cash Management** products include non-retail deposit taking, and international, regional and domestic payments and cash management services.
- **Securities Services** provides custody and clearing services and funds administration to both domestic and cross-border investors.
- **Global Trade and Receivables Finance** provides trade services for the group's clients.
- **Balance Sheet Management** is responsible for the management of liquidity and funding. It also manages structural interest rate positions within the Markets limit structure.

Global Private Banking

Global Private Banking ('GPB') provides investment management and trustee solutions to high net worth individuals and their families in the group's priority markets. GPB aims to meet the needs of its clients by providing excellent customer service and offering a comprehensive suite of solutions.

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

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

Strategic Report: Strategic Direction

Introduction

Against the welcome backdrop of generally improving economic conditions, the group was able to make significant further progress during 2013 in contributing to the reshaping of HSBC. The focus of these efforts was twofold; firstly, concentrating on capturing the high quality opportunities from and within HSBC's increasingly distinctive international network and diversified business model; and, secondly, improving risk management and control through eliminating or restructuring businesses with higher inherent risk characteristics. The combination of HSBC's commitment to implementing Global Standards, addressing regulatory changes and managing increased capital discipline has driven a fundamental review of all aspects of its business.

As at 31 December 2013, the bank had 1,132 branches in the United Kingdom and 13 located in the Isle of Man and the Channel Islands. The bank had further branches in Belgium, the Czech Republic, France, Greece, the Hong Kong Special Administrative Region, Ireland, Israel, Italy, Luxembourg, Netherlands, South Africa, Spain and Switzerland.

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

Strategy

The group's strategic direction is embedded in HSBC's strategy which is aligned to two long-term trends:

Economic development – HSBC expects that certain economies in Asia-Pacific, Latin America and the Middle East will have increased more than four-fold in size by 2050, benefiting from demographics and urbanisation, by which time they will be larger than Europe and North America. By 2050, HSBC expects 19 of the 30 largest economies will be from Asia, Latin America, Middle East or Africa.

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

What matters in this environment is:

- being able to take advantage of organic investment opportunities in the most attractive growth markets and maintaining the capacity to invest; and
- having an international network and global product capabilities to capture international trade and movements in capital.

The group's competitive advantages come from:

- its meaningful presence in and long-term commitment to HSBC's key strategic markets;
- its stable funding base;
- its interconnectivity to HSBC's business network, which covers over 90 per cent of global trade and capital flows; and
- its local balance sheet strength and trading capabilities in the most relevant financial hubs.

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

Wealth management and retail with local scale - HSBC will capture opportunities arising from social mobility and wealth creation in the markets in which it is present. The Group will only invest in full scale retail businesses in markets where it can achieve profitable scale.

Network of businesses connecting the world - HSBC is well positioned to capture the growing international trade and capital flows. The Group's global reach and range of services place HSBC in a strong position to serve corporate clients as they grow from small enterprises into large and international corporates.

In Europe the group's aim is to be the leading and most respected international bank connecting Europe with the rest of the world. The group will achieve this by exploring growth opportunities and by focusing on the needs of its customers and the societies it serves, and thereby deliver long-term sustainable value to all its stakeholders. On an operational level the group has developed a strategy for each of four Global Businesses following HSBC's strategic priorities while also focusing on increasing capital and cost efficiency.

Strategic Priorities

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

The group will continually review its operations to determine whether the group should invest in, turn around, continue with or exit underperforming businesses using the HSBC six filters to guide these strategic actions. The first two filters – international connectivity and economic development – determine whether the business is strategically relevant. The next three filters – profitability, efficiency and liquidity – determine whether the financial position of the business is attractive. The sixth filter – the risk of financial crime – governs HSBC's activities in high risk jurisdictions, and is applied to protect it by restricting the scope of its business where appropriate.

Strategic Report: Strategic Direction (continued)

The group is also continuing to refine its operational processes, implement consistent business models and streamline IT. These sustainable savings are intended to facilitate self-funded growth. These arise through the reduction or elimination of complexity, inefficiencies or unnecessary activities, and release capital that can be reinvested in Global Standards and growing the business. HSBC is transitioning from organisational effectiveness to streamlining, which is the next phase of its transformation. While organisational effectiveness was about how HSBC is managed, streamlining is about how the Group operates.

In implementing the operational effectiveness programme, the group concentrated on a number of key elements:

- *people and structure* – implementing an 8x8 reporting structure, moving to a global operating model, and defining and implementing target business models across all global businesses and functions;
- *software development* – improving software development productivity and shifting the mix of employees towards lower-cost locations;
- *process optimisation* – improving the efficiency of its operational activities such as contact centres (including offshoring), trade and payments services; and
- *corporate real estate* – rationalising the property portfolio by leasing and launching facilities management initiatives.

In the second phase, from 2014 to 2016, HSBC will concentrate on streamlining operations, focusing on reducing or eliminating complexity, inefficiencies or unnecessary activities across the Group. Streamlining will be achieved through a combination of simplifying and globalising processes, products, systems and operations. ‘Simplifying’ involves identifying inefficiencies or excessive complexity and redesigning or rationalising processes to make them easier to understand and manage and more efficient. ‘Globalising’ involves developing standard global processes and implementing them around the Group with minimal local variations.

This second phase will be applied to:

- propositions, products and sales channels;
- processes and servicing channels, including production management, multi-channel servicing and operational processes; and
- infrastructure, including real estate, technology, supplier management and global functions.

Finally, HSBC have committed to develop Global Standards shaped by the highest or most effective standards available in any jurisdiction where HSBC operates and to deploy these globally on a consistent

basis. By definition, the impact of Global Standards is organisation-wide, but the principal means by which the Group will drive consistently high standards is through universal application of its HSBC Values, strong systems of governance and the behaviours, performance and recognition of all HSBC’s people in managing high quality customer relationships.

The group continues to reinforce the status and significance of compliance and adherence to these Global Standards by building strong internal controls, developing world class capabilities through communication, training and assurance programmes to make sure employees understand and can meet their responsibilities, and redesigning core elements of how it assesses and rewards senior executives. The implementation of Global Standards is seen as a source of competitive advantage and will allow the group to:

- strengthen its response to the on-going threat of financial crime;
- make consistent – and therefore simplify – the ways by which it monitors and enforces high standards at HSBC;
- strengthen policies and processes that govern how it does business and with whom; and
- ensure that HSBC Values are applied consistently.

Retail Banking and Wealth Management

RBWM continues to build its position as a leading provider of financial services to affluent and mass affluent customers through the Premier and Advance branded propositions. This will be achieved through:

- a simple relationship manager based wealth model enabled with tools and capabilities to attract new clients and deepen existing customer relationships by: (i) acquiring new wealth in faster growing markets and consolidating wealth in developed markets, (ii) growing relationship-led lending, and (iii) investing in customer service;
- the delivery of enhanced digital capabilities which allow customers access to their finances when it is most convenient to them; and
- leveraging global expertise to improve customer service and productivity, to provide a high standard of banking solutions and service to customers efficiently.

Commercial Banking

CMB aims to be the banking partner of choice for international businesses by building on HSBC’s rich heritage, international capabilities and relationships to enable connectivity and support trade and capital flows around the world, thereby strengthening its leading position in international business and trade. The business focuses on three growth priorities:

Strategic Report: Strategic Direction (continued)

- grow coverage in faster growing markets;
- drive revenue growth through the group's international network; and
- grow collaboration revenues.

Global Banking and Markets

GB&M continues to pursue its 'emerging markets-led and financing-focused' strategy, with the objective of being a 'top 5' bank to its priority clients. This strategy has evolved to include a greater emphasis on connectivity between the global businesses and across the regions. The business focuses on four growth priorities:

- leveraging its distinctive geographical network which connects developed and faster-growing regions;
- connecting clients to global growth opportunities;
- continuing to be well positioned in products that will benefit from global trends; and
- enhancing collaboration with other global businesses to appropriately service the needs of the group's international client base.

Global Private Banking

GPB aims to build on HSBC's commercial banking heritage to be the leading private bank for high net worth business owners. The business has two growth priorities:

- repositioning the business to concentrate on home and priority markets, particularly onshore, aligned with Group priorities; and
- capturing growth opportunities from Group collaboration, particularly by accessing owners and principals of CMB and GB&M clients.

Key Performance Indicators

The Board of Directors tracks the group's progress in implementing its strategy with a range of financial and non-financial measures or key performance indicators. Progress is assessed by comparison with the group strategic priorities, operating plan targets and historical performance.

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

Financial KPIs

| | 2013 | 2012 |
|--|------|-------|
| | % | % |
| Risk adjusted revenue growth | 5.6 | (9.3) |
| Cost efficiency ratio | 66.8 | 82.0 |
| Pre-tax return on average risk-weighted assets ratio | 1.7 | 0.5 |
| Core tier 1 capital ratio | 12.1 | 11.4 |

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

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

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

Outcome: The cost efficiency ratio decreased principally due to lower costs, most notably from customer redress programmes, and hedge income from lower adverse fair value movements on own debt attributable to credit spreads.

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

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

Core tier 1 capital ratio – represents the ratio of core tier 1 capital comprising shareholders' equity and related non-controlling interests less regulatory deductions and adjustments to total risk weighted assets. The group seeks to maintain a strong capital base to support the development of its business and meet regulatory capital requirements at all times.

Outcome: The increase in core tier 1 capital to 12.1 per cent primarily reflected the impact of reductions in credit and market risk-weighted assets.

Employee engagement

Strong employee engagement leads to positive commercial outcomes and underpins improved business performance, increased customer satisfaction, higher productivity, talent retention and reduced absenteeism. The group assesses its employees' engagement through the Global People Surveys, which were held annually from 2007 to 2011 and bi-annually thereafter. The latest Survey, in 2013, focused on supporting a values-led high performance culture by assessing if employees were engaged in the Group's purpose and felt able to deliver on its ambition to become the world's leading international bank.

The overall Europe engagement score in 2013 was 60 per cent, which was below the financial services norm. Strong scores were registered in risk awareness (78 per cent, 5 per cent points above the external best-in-class), employee development (58 per cent), leadership capability (58 per cent) and living the HSBC Values (78 per cent). Aspects that require concerted attention

Strategic Report: Strategic Direction (continued)

included pride and advocacy, which had fallen from 2011 levels.

Brand value

HSBC monitors the strength of its brand through an empirical tool (the Brand Equity Index), which combines measurements of perception and recall of a brand's image, packaging, pricing, promotional programmes, products, and user conviction to develop an Index Value that can be tracked over time.

The HSBC brand in the UK scores above the competitive set average and is ranked in second place. In both Turkey and France, the Brand Equity Index is lower than the competitor average.

Customer service and satisfaction

In RBWM, customer satisfaction is measured through an independent market research survey of retail banking, using a Customer Recommendation Index ('CRI') to score performance. In 2013 CRI remains strong in the UK, shows encouraging improvement in Turkey but has fallen in France.

In Commercial Banking, the business continued to measure its corporate client engagement through a survey of key customers, the Client Engagement Programme ('CEP'), conducted by an independent third party. The group benchmarks its performance against leading competitors for its key clients and has been ahead of its peer group in the UK, Germany and Turkey. This is a good achievement in a challenging and dynamic market environment.

Awards

HSBC was recognised in several industry awards throughout 2013. A small selection of those follows:

- 'Best Lender for Lifetime Tracker Mortgages' – 'Moneywise 2013 Mortgage Awards'
 - 'Best First Time Buyer Mortgage Provider' – 'Moneyfacts Awards 2013'
 - 'Best Remortgage Provider 2013' – 'Moneyfacts Award 2013'
 - 'Best Bank Mortgage Provider' Award – 'Moneyfacts Award 2013'
 - 'Five star Defaqto rating 2013 – HSBC Premier Credit Card' - 'Annual Moneyfacts Star Ratings'
 - 'Best Transaction Banking House and Best Cash Management Bank' – 'Euromoney Poll 2013'
 - 'Best Online Banking Provider' – 'Business Moneyfacts Awards 2013'
 - 'Best Service from a Business Bank' – 'Business Moneyfact Awards 2013'
 - 'Best Export Finance Arranger EMEA' – 'Trade Finance Magazine 2013'
 - 'Best Global Emerging Markets Bank' – 'Euromoney Awards for Excellence 2013'
 - 'Best Global Cash Manager' – 'Euromoney Awards for Excellence 2013'
- 'Emerging Asset Manager of the Year' – 'UK Pension Award' 2013
 - 'Best Lender for Discount Rate Mortgages' – 'Moneywise 2013 Mortgage Awards'

Strategic Report: Business Review

Economic background

UK gross domestic product ('GDP') growth rose to 1.9 per cent in 2013, higher than in previous years, though the level of real GDP remained below the level seen prior to the recession. The recovery was driven in part by stronger household consumption. The Bank of England policy rate remained at 0.5 per cent and the Asset Purchase Scheme ceased. The Bank of England announced a 'forward guidance' policy in August whereby it indicated the Bank Rate would not rise until unemployment had fallen towards 7 per cent. Labour market conditions improved more rapidly than expected and the headline unemployment rate fell to 7.1 per cent in December. The annual rate of Consumer Prices Index ('CPI') inflation fell in December to 2.0 per cent, the lowest level of inflation in almost four years.

The eurozone emerged from recession in the second quarter of 2013 with the improvement early in the year driven by Germany and France. However, activity failed to gain momentum since quarterly GDP growth averaged just 2 per cent in the second half of the year. Domestic demand improved on the back of improving real wage growth and a slower pace of austerity but growth remains heavily dependent on external demand. Given the weakness of the economy in early 2013 the European Central Bank ('ECB') cut its refinancing rate from 0.75 per cent to 0.5 per cent in May and then in July adopted a forward guidance policy under which it committed to keep rates "at present or lower levels for an extended period".

Despite the return to growth, CPI inflation fell to 0.7 per cent in October 2013 prompting the ECB to cut the refinancing rate by a further 0.25 per cent in November. A combination of improving growth and the ECB's Outright Monetary Transactions ('OMT') programme, which would enable it to buy eurozone government bonds in times of market stress, helped alleviate the sovereign crisis evident in previous years and bond yields in Italy and Spain fell to the lowest levels since 2010.

In Turkey the annual pace of GDP growth averaged 3.9 per cent in the first three quarters of the year, driven primarily by household spending and public sector fixed investment. Private sector investment contracted in 2013 and CPI inflation rose by 7.4 per cent. Strong domestic demand growth led to a large widening of the current account deficit from 6.0 per cent of GDP in 2012 towards an estimated 7.7 per cent of GDP in 2013.

During the course of the summer the US Federal Reserve hinted that it may 'taper' its Asset Purchase programme. US Treasury yields rose attracting capital back to US asset markets and raised concerns about the ability of countries with large current account deficits to finance these. As a result the Turkish Lira depreciated by 20 per cent against the US dollar over the course of 2013 and the BIST 100 stock index ended the year 13 per cent lower. To address the macroeconomic imbalances in the economy and to provide support for the currency, the central bank of Turkey tightened monetary policy in the third quarter by 125 basis points and sold USD17.6 billion of its FX reserves during the second half of 2013.

Strategic Report: Business Review (continued)

Financial summary

Summary consolidated income statement for the year ended

| | 2013 | 2012 | 2012 |
|---|---------------|--------------------------|----------|
| | £m | £m | £m |
| | | Continuing operations | |
| Net interest income | 6,961 | 6,519 | 6,904 |
| Net fee income | 3,336 | 3,309 | 3,781 |
| Trading income | 2,373 | 1,587 | 1,834 |
| Net income from financial instruments designated at fair value | 900 | 118 | 118 |
| Gains less losses from financial investments | 100 | 335 | 336 |
| Net earned insurance premiums | 2,022 | 2,286 | 2,286 |
| Other operating income | 176 | 144 | 148 |
| Total operating income | 15,868 | 14,298 | 15,407 |
| Net insurance claims incurred and movement in liabilities to policyholders | (3,028) | (2,919) | (2,919) |
| Net operating income before loan impairment and other credit risk provisions | 12,840 | 11,379 | 12,488 |
| Loan impairment charges and other credit risk provisions | (971) | (1,246) | (1,245) |
| Net operating income | 11,869 | 10,133 | 11,243 |
| Total operating expenses ¹ | (8,575) | (9,506) | (10,236) |
| Operating profit | 3,294 | 627 | 1,007 |
| Share of profit in associates and joint ventures | - | (3) | (3) |
| Profit before tax | 3,294 | 624 | 1,004 |
| Tax credit/(expense) | (754) | 220 | 156 |
| Profit for the year before discontinued operations | 2,540 | 844 | 1,160 |
| Gain on sale of discontinued operations ² | - | - | 1,265 |
| Profit for the year | 2,540 | 844 | 2,425 |
| Profit attributable to shareholders of the parent company | 2,495 | 803 | 2,384 |
| Profit attributable to non-controlling interests | 45 | 41 | 41 |

¹ Total operating expenses include notable items as detailed on page 15.

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

Review of business performance

HSBC Bank plc and its subsidiary undertakings reported profit before tax of £3,294 million, £2,290 million or 228 per cent higher than 2012.

On a continuing operations basis, adjusting the 2012 results to exclude the contribution made by HSBC Private Banking Holdings (Suisse) SA, profit before tax increased by £2,670 million or 428 per cent compared with 2012. This was primarily due to lower adverse fair value movements on own debt attributable to credit spreads of £167 million (£1,055 million in 2012) and significantly lower operating expenses from a decrease in charges relating to UK customer redress programmes, an accounting gain of £280 million relating to changes in delivering ill-health benefits to certain employees in the UK and sustainable cost savings in 2013.

Progress continues to be made in aligning the in-country businesses to the respective global business operating models. This is designed to reduce complexity and lower costs in a sustainable way. Total restructuring costs of £96 million were incurred as a result of streamlining the businesses and other initiatives which delivered sustainable cost savings of approximately £370 million.

RBWM continued to make progress in delivering against its strategy. In addition, the business implemented the Global Wealth Incentive Plan to better align customer and business interests. In Turkey, unsecured lending continued to grow, notably in personal lending and cards, while in France there was strong growth in both mortgage and deposit balances.

CMB repositioned its Business Banking segment towards international and internationally aspirant customers, while streamlining and re-engineering core processes to deliver efficiencies, which supported continued investment in corporate banking and Global Trade and Receivables Finance. Following the success of the 2012 International SME Fund, the business launched a further fund in the UK in 2013 and similar SME funds in France and Turkey targeted at international trade customers.

In GB&M, debt capital markets activity in the Credit and Capital Financing businesses was successful in capturing growth in issuance demand which has resulted in leading market positions and an increase in sterling markets share. The business was ranked first by Bloomberg for primary debt capital market issuances in 2013. In France, the business acted as joint book runner of a £5.17 billion hybrid bond for a premier corporate client,

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demonstrating HSBC's ability to deliver large and complex transactions, connecting customers to opportunities.

GPB continued to reposition its business model and target its client base to focus on selected priority markets. In November 2013 the legal ownership of HSBC's Channel Islands Private Banking group was transferred to HSBC Private Bank (UK) Limited from HSBC Private Banking Holdings (Suisse) SA.

The business continued to implement Global Standards and reposition itself through the adoption of new compliance and tax transparency standards.

Items which are significant in a comparison of 2013's results to 2012 have been summarised on page 15. The following commentary is on a continuing operations basis.

Net interest income increased by £442 million or 7 per cent. The income increase in RBWM was from growth in lending balances and margins, notably residential mortgages in the UK and, to a lesser extent, home loans in France. In GB&M, Balance Sheet Management net interest income was higher largely due to interest rate management and net deployment of funds at enhanced levels during the year. In addition, net interest income rose from higher lending spreads in Capital Financing and lower interest paid resulting from legacy portfolio maturities. In CMB, net interest income was also higher, primarily in the UK, from growth in term lending revenues from higher spreads on new and renewed business resulting in increased portfolio margins overall as well as deposit growth in Payments and Cash Management.

Net fee income increased by £27 million or 1 per cent. In CMB the growth in fee income reflected a rise in lending fees in the UK and Germany. In GB&M, net fee income decreased primarily due to higher fees paid to HSBC entities in other regions relating to increased foreign exchange trading activities undertaken for their clients. This was partly offset by increased issuance demand in debt capital markets and event-driven fee income in equity underwriting from increased deal volumes. In RBWM the growth in credit card revenue in Turkey was more than offset by a higher level of fees payable under partnership arrangements and lower creditor insurance fees in the UK.

Trading income increased by £786 million or 50 per cent. Of this increase £344 million was due to lower adverse foreign exchange movements on trading assets held as economic hedges against issued foreign currency debt designated at fair value, compared to 2012. These offset lower favourable foreign exchange movements on the foreign currency debt reported in "*Net (expenses) income from financial instruments designated at fair value*".

In Markets, revenues were higher than 2012 which included a charge of £387 million as a result of a change in estimation methodology in respect of credit valuation adjustments on derivative assets. This was partially offset by lower favourable debit valuation adjustments from the change in estimation methodology in 2012 for derivative liabilities of £45 million compared to £191 million in 2012.

Foreign exchange income benefited from increased client activity in part offset by margin compression and reduced market volatility in the second half of 2013. Equities benefited from increased deal volumes and revaluations gains. Rates revenue decreased, despite new client mandates and improved market share, particularly in European government bonds, as 2012 benefited from tightening spreads following the ECB liquidity intervention. In addition, revenue was also favourable from lower adverse fair value movements from own credit spreads on structured liabilities.

Net income from financial instruments designated at fair value increased by £782 million compared to 2012. This included favourable credit spread-related movements in the fair value of the group's own long-term debt of £888 million as adverse fair value movements were less extensive in 2013 compared to 2012. In addition, net income arising from financial assets held to meet liabilities under insurance and investment contracts increased reflecting higher net investment returns in 2013 than in 2012. These returns reflected favourable equity market movements in the UK and France.

Investment gains or losses arising from equity markets result in a corresponding movement in liabilities to customers, reflecting the extent to which unit-linked policyholders, in particular, participate in the investment performance of the associated asset portfolio. Where these relate to assets held to back insurance contracts or investment contracts with discretionary participation features ('DPFs'), the corresponding movement in liabilities to customers is recorded under '*Net insurance claims incurred and movement in liabilities to policyholders*'.

Other changes in fair value reflected lower favourable foreign exchange movements of £344 million in 2013 compared to 2012 on foreign currency debt designated at fair value and issued as part of our overall funding strategy (offset from assets held as economic hedges in '*Trading income*'), and higher adverse movements due to hedging ineffectiveness in 2013.

Gains less losses from financial investments were £235 million or 70 per cent lower than in 2012. Net gains on the disposal of debt securities fell as 2012 included significant gains on the sale of available-for-sale government debt securities, notably in the UK, arising from the structural interest rate risk management of the balance sheet.

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Net earned insurance premiums decreased by £264 million or 12 per cent. This was mainly as a result of lower sales of investment contracts with DPPs in France. In addition, 2012 benefited from a number of large sales through independent financial adviser channels which are now in run off.

Other operating income was broadly in line with the prior year.

Net insurance claims incurred and movement in liabilities to policyholders increased by £109 million or 4 per cent. This reflected higher investment returns on the assets held to support policyholder contracts where the policyholder bears investment risk from favourable equity market movements in the UK and France. This was partly offset by a decrease in new business written, notably in France, as explained under '*Net earned insurance premiums*'.

Loan impairment charges and other credit risk provisions decreased by £275 million or 22 per cent. In the UK, GB&M reported net releases of credit risk provisions on available-for-sale asset backed securities, compared with impairment charges in 2012, offset in part by higher individually assessed provisions. In addition, there were lower loan impairment charges in CMB due to lower collectively and individually assessed provisions and in RBWM due to lower collectively assessed provisions reflecting recoveries from debt sales. In other European countries, lower individually assessed impairment provisions for CMB in Greece, were partly offset by increases in Turkey, where there was growth in unsecured lending in RBWM, and in the Spanish GB&M and CMB businesses as challenging economic conditions continued to affect the market.

Total operating expenses decreased by £931 million or 10 per cent, primarily due to lower customer redress provisions and a reduction of restructuring costs of £71 million.

These included:

- a charge for additional estimated redress for possible mis-selling in previous years of payment protection

insurance ('PPI') policies of £483 million (£938 million in 2012);

- £166 million in respect of interest rate protection products (£375 million in 2012); and
- £96 million in respect of wealth management products.

In addition litigation-related expenses increased primarily due to Madoff litigation costs in GB&M following settlements reached in Ireland.

Following a consultation process on several employee benefit proposals, the group announced to UK employees that the future service accrual for defined benefit pension members would cease from 1 July 2015. As part of these amendments, the group is changing the basis of delivering ill-health benefits to certain employees, resulting in the recognition of an accounting gain of £280 million. This gain together with lower performance costs in GB&M reduced the level of staff costs compared to 2012.

During 2013 the group maintained its strict cost control discipline and benefited from the delivery of the organisational effectiveness programmes. The number of employees, expressed in fulltime equivalent numbers at the end of 2013 was 3 per cent lower compared to 2012.

Tax expense totalled £754 million in 2013, compared to tax income of £156 million (on a reported basis) in 2012. The effective tax rate for 2013 was 22.9 per cent, compared to a credit of 6.9 per cent (on a reported basis) in 2012. The effective tax rate in 2012 was lower primarily due to a non-taxable intragroup disposal of HSBC Private Banking Holdings (Suisse) SA and losses claimed from HSBC Holdings plc for nil consideration.

Strategic Report: Business Review (continued)

Review of business position

Summary consolidated balance sheet

| | 2013 £m | 2012 £m |
|--|----------------|------------|
| Total assets | 811,695 | 815,481 |
| Cash and balances at central banks | 67,584 | 51,613 |
| Trading assets | 134,097 | 161,516 |
| - reverse repos | 5,607 | 35,951 |
| - other trading assets | 128,490 | 125,565 |
| Financial assets designated at fair value | 16,661 | 15,387 |
| Derivative assets | 137,239 | 177,808 |
| Loans and advances to banks | 53,228 | 32,286 |
| - reverse repos | 30,023 | 13,798 |
| - loans and other receivables | 23,205 | 18,488 |
| Loans and advances to customers | 305,032 | 282,685 |
| - reverse repos | 29,091 | 16,890 |
| - loans and other receivables | 275,941 | 265,795 |
| Financial investments | 75,030 | 71,265 |
| Other | 22,824 | 22,921 |
| Total liabilities | 778,776 | 783,281 |
| Deposits by banks | 50,683 | 39,571 |
| - repos | 20,863 | 6,357 |
| - cash deposits and other accounts | 29,820 | 33,214 |
| Customer accounts | 390,017 | 324,886 |
| - repos | 38,039 | 12,207 |
| - cash deposits and other accounts | 351,978 | 312,679 |
| Trading liabilities | 91,842 | 122,896 |
| - repos | 9,426 | 40,742 |
| - other | 82,416 | 82,154 |
| Financial liabilities designated at fair value | 34,036 | 32,918 |
| Derivative liabilities | 137,352 | 181,095 |
| Debt securities in issue | 32,895 | 40,358 |
| Liabilities under insurance contracts issued | 19,228 | 17,913 |
| Other | 22,723 | 23,644 |
| Total equity | 32,919 | 32,200 |
| Total shareholders' equity | 32,370 | 31,675 |
| Non-controlling interests | 549 | 525 |

Movements in 2013

Total assets were £812 billion, in line with prior year.

The group maintained a strong and liquid balance sheet with the ratio of customer advances to customer accounts at 78.2 per cent (2012: 87.0 per cent).

The group's core tier 1 ratio stood at 12.1 per cent (2012: 11.4 per cent).

In 2013, GB&M changed the way it manages repo and reverse repo activities in the Credit and Rates businesses which were previously being managed in a trading environment. During the year, the repo and reverse repo business activities were organised into trading and non-trading portfolios, with separate risk management procedures. This resulted in an increase in the amount of reverse repos classified as 'Loans and advances to customers' and 'Loans and advances to banks', and a decline in the amount classified as 'Trading assets' by 31 December 2013, compared to previous period-ends. Similarly, by 31 December 2013 there was

an increase in the amount of repos classified as 'Customer accounts' and 'Deposits by banks', with a decline in the amount classified as 'Trading liabilities', compared to previous period-ends. The increase in amortised cost balances and the decrease in trading balances primarily occurred in the UK.

Assets

Cash and balances at central banks rose by 31 per cent as a greater portion of the surplus liquidity was placed with central banks, reflecting growth in deposits in excess of lending opportunities.

Trading assets decreased by 17 per cent. Excluding the change in GB&M's management approach, trading assets were broadly in line with December 2012 levels.

Financial assets designated at fair value increased by 8 per cent due to favourable market movements in insurance operations and the investment of premium income received during the year in the insurance businesses.

Strategic Report: Business Review (continued)

Derivative assets decreased by 23 per cent. Upward movements in yield curves in major currencies led to a decline in the fair value of interest rate contracts, although this was partly offset by a reduction in netting.

Loans and advances to banks increased by 65 per cent predominantly due to GB&M's change in the management approach for reverse repos. Excluding this, there was a £5 billion increase driven by higher placements with financial institutions.

Loans and advances to customers increased by 8 per cent, including a £12 billion increase in reverse repo balances. Excluding these, customer lending balances grew by £10 billion as the group continued to grow its mortgage and home loan portfolios in the UK and France, reflecting the banks competitive offering. In addition, there was an increase in corporate overdraft balances that did not meet the criteria for netting.

Financial investments increased by 5 per cent as part of the group's redeployment of liquidity, mainly into UK government debt securities.

Liabilities

Deposits by banks increased by 28 per cent. Excluding the increase in repo balances there was a fall in balances mainly due to redemptions.

Customer accounts increased by 20 per cent of which 8 per cent related to the change in GB&M's management approach to repo funding. Excluding this impact, customer accounts increased by £39 billion as in the UK

RBWM customers' continued to have a preference for holding higher balances in readily accessible current and savings accounts. In addition there was higher Payments and Cash Management business in GB&M and CMB. Current accounts also grew in GB&M due to higher balances that did not meet the netting criteria.

Trading liabilities decreased by 25 per cent, again largely due to the change in the management approach for repo trade activities.

The derivative businesses are managed within market risk limits and, as a consequence, the decrease in the value of '*Derivative liabilities*' broadly matched that of '*Derivative assets*'.

Debt securities in issue fell by 18 per cent. This was due to net redemptions of debt securities in issue.

Liabilities under insurance contracts increased by 7 per cent. The increase was mainly driven by liabilities to policyholders established for new business together with the impact of an increase in equity markets of unit-linked insurance contracts.

Equity

Total shareholders' equity rose by 2 per cent.

Strategic Report: Business Review (continued)

Performance and Business Review

Profit on ordinary activities before tax

| | 2013 £m | 2012 £m Continuing operations | 2012 £m |
|--|--------------|--|--------------|
| Retail Banking and Wealth Management | 1,177 | 411 | 411 |
| Commercial Banking | 1,333 | 766 | 766 |
| Global Banking and Markets | 1,023 | 642 | 642 |
| Global Private Banking | 140 | 100 | 480 |
| Other/Intersegment | (379) | (1,295) | (1,295) |
| | 3,294 | 624 | 1,004 |

The following items are significant in a comparison of 2013's results against 2012:

Notable items by business segment

| | Retail Banking and Wealth Management £m | Commercial Banking £m | Global Banking and Markets £m | Global Private Banking £m | Other £m | Total £m |
|---|---|-----------------------------|---|------------------------------------|-------------|-------------|
| 2013 | | | | | | |
| UK customer redress programmes | 610 | 91 | 84 | 2 | – | 787 |
| Restructuring and other related costs | 41 | 18 | 6 | 1 | 30 | 96 |
| Operational losses | – | (10) | – | – | – | (10) |
| Gain in change of delivering ill-health benefits .. | (123) | (104) | (53) | – | – | (280) |
| 2012 (continuing operations) | | | | | | |
| UK customer redress programmes | 982 | 162 | 207 | – | – | 1,351 |
| Restructuring and other related costs | 47 | 22 | 36 | 5 | 57 | 167 |
| Operational losses | – | 65 | – | – | – | 65 |
| Other provisions | – | – | – | – | 84 | 84 |

HSBC Bank plc and its subsidiaries reported a profit before tax of £3,294 million, £2,290 million or 228 per cent higher than 2012. On a continuing operations basis profit before tax was £2,670 million or 328 per cent higher than 2012.

On a continuing operations basis all business segments reported significantly higher profits in 2013, with RBWM, CMB and GB&M all reporting profits in excess of £1 billion.

GPB reported lower levels of reported profit than 2012. This reflected the sale of HSBC Private Banking Holdings (Suisse) SA in November 2012.

Retail Banking Wealth Management

| | 2013 £m | 2012 £m |
|---|--------------|--------------|
| Net interest income | 3,569 | 3,394 |
| Net fee income | 1,502 | 1,532 |
| Trading income | 147 | 32 |
| Other income | (147) | (52) |
| Net operating income before impairments and provisions | 5,071 | 4,906 |
| Loan impairment charges and other credit risk provisions | (223) | (248) |
| Net operating income | 4,848 | 4,658 |
| Total operating expenses | (3,673) | (4,248) |
| Operating profit | 1,175 | 410 |
| Share of profit in associates and joint ventures | 2 | 1 |
| Profit before tax | 1,177 | 411 |

Profit before tax – by country

| | 2013 £m | 2012 £m |
|--------------------------------|--------------|------------|
| United Kingdom | 995 | 309 |
| France | 182 | 85 |
| Germany | 19 | 18 |
| Turkey | (47) | (20) |
| Malta | 22 | 25 |
| Other | 6 | (6) |
| Profit before tax | 1,177 | 411 |

Overview

RBWM reported a profit before tax of £1,177 million, £766 million or 186 per cent higher than 2012. This was primarily due to a decrease in operating expenses resulting from lower provisions of £372 million relating to customer redress programmes, an accounting gain on changes to staff benefits of £123 million and growth in revenues.

RBWM continued to fulfil the hopes and ambitions of customers by supporting the UK housing market, approving £14.4 billion of new mortgage lending to over 135,000 customers during 2013. This included £3.8 billion to over 30,000 first time buyers. The loan to value ratio on new lending was 59.5 per cent compared with the ratio of the average mortgage portfolio 48.3 per cent. In France, the business increased the market share in home loans confirming the ability to grow the mortgage business in a highly competitive market. In Turkey, unsecured lending continued to grow notably in the credit

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card business through new product features and channel capabilities including mobile banking.

In addition, the business implemented the Global Wealth Incentive Plan to better align customer and business interests.

Financial performance

Net interest income increased by £175 million or 5 per cent, primarily due to higher lending balances and margins, principally in residential mortgages in the UK and home loans in France, with the UK also experiencing growth in customer accounts. This was partially offset by deposit spread compression in 2013.

Net fee income decreased by £30 million or 2 per cent predominantly in the UK due to a higher level of fees payable under partnership arrangements and lower creditor insurance fees. This was partially offset by growth in card revenue in Turkey from business expansion.

Trading income increased by £115 million, mainly due to favourable fair value adjustments on non-qualifying hedges on the French home loans portfolio, as long-term interest rates rose. In addition, there were favourable market movements on derivatives used as economic hedges in the insurance business in France.

Other income decreased by £95 million. Lower levels of net earned premiums and higher levels of claims on credit protection and term-lending policies more than offset the increase in net income from financial assets designated at fair value. In addition, the offset of the net trading gain on economic hedges noted in 'Trading income' also contributed to lower 'Other income'.

Loan impairment charges and other credit risk provisions decreased by £25 million or 10 per cent. A fall in loan impairment charges in the UK as a result of improved delinquency rates and recoveries of previously written off debt were in part offset by an increase in Turkey, reflecting growth in credit card volumes.

Total operating expenses decreased by £575 million or 14 per cent. Excluding the £123 million accounting gain relating to the change of ill-health benefits in 2013 and customer redress provisions of £610 million compared to £982 million in 2012, operating expenses were 2 per cent lower. This reflected the benefits being delivered through re-engineering and streamlining of business processes and were achieved despite the additional cost incurred in respect of new regulation and implementation of the Group's Global Standards. The customer redress provision related primarily to the possible mis-selling of PPI policies and wealth management products.

Commercial Banking

| | 2013 | 2012 |
|---|--------------|--------------|
| | £m | £m |
| Net interest income | 2,144 | 2,037 |
| Net fee income..... | 1,143 | 1,047 |
| Trading income..... | 23 | 26 |
| Other income | 60 | 70 |
| Net operating income before impairments and provisions | 3,370 | 3,180 |
| Loan impairment charges and other credit risk provisions | (601) | (699) |
| Net operating income..... | 2,769 | 2,481 |
| Total operating expenses | (1,437) | (1,715) |
| Operating profit..... | 1,332 | 766 |
| Share of profit in associates and joint ventures | 1 | – |
| Profit before tax | 1,333 | 766 |

Profit before tax – by country

| | 2013 | 2012 |
|--------------------------------|--------------|------------|
| | £m | £m |
| United Kingdom | 1,075 | 529 |
| France | 163 | 128 |
| Germany | 45 | 41 |
| Turkey | 24 | 45 |
| Malta | 33 | 33 |
| Other | (7) | (10) |
| Profit before tax | 1,333 | 766 |

Overview

CMB reported a profit before tax of £1,333 million, £567 million or 74 per cent higher than 2012. Overall revenues rose by 6 per cent primarily due to growth term lending in the UK and higher fee income earned in both the UK and Germany.

CMB continued to help businesses thrive and prosper by further repositioning its Business Banking segment towards international and internationally aspirant customers. The streamlining and re-engineering of core processes delivered efficiencies in a number of areas and supported continued investment in corporate banking and Global Trade and Receivables Finance.

Following the success of the 2012 International SME fund the business launched a further fund in 2013, continuing to support UK businesses that trade or aspire to trade internationally with approved lending of £4.8 billion. This included the renewal of overdraft and other lending facilities. Similarly, the business launched SME funds in France and Turkey, targeted at international trade customers, with approved lending of £1.3 billion in France and £303 million in Turkey.

In addition, the business continued to support the programme of renminbi internationalisation during the year with flagship client events taking place in the UK, France and Germany.

Financial Performance

Net interest income increased by £107 million or 5 per cent mainly in the UK due to growth in term lending

Strategic Report: Business Review (continued)

revenues from higher spreads on new and renewal business and deposit growth in Payments and Cash Management.

Net fee income increased by £96 million or 9 per cent, due to an increase in lending fees in the UK and higher fee income from credit and lending business in Germany.

Loan impairment charges and other credit risk provisions decreased by £98 million or 14 per cent primarily due to lower individually and collectively assessed provisions in the UK and Greece. There were higher levels of individually assessed provisions in Spain.

Total operating expenses decreased by £278 million or 16 per cent compared to 2012. Excluding the £104 million accounting gain relating to the change of ill-health benefits in 2013 and customer redress and operational loss provisions of £81 million compared to £227 million in 2012, operating expenses were 2 per cent lower. This reflected the benefits being delivered through re-engineering and streamlining of business processes. The customer redress and operational losses related to the possible mis-selling of interest rate protection products and closed account balances of dissolved companies respectively.

Global Banking and Markets

| | 2013 | 2012 |
|---|--------------|--------------|
| | £m | £m |
| Net interest income ¹ | 1,101 | 876 |
| Net fee income | 588 | 616 |
| Trading income ¹ | 2,192 | 1,554 |
| Other income | 400 | 973 |
| Net operating income before impairments and provisions | 4,281 | 4,019 |
| Loan impairment charges and other credit risk provisions | (133) | (280) |
| Net operating income | 4,148 | 3,739 |
| Total operating expenses | (3,122) | (3,093) |
| Operating profit | 1,026 | 646 |
| Share of profit in associates and joint ventures | (3) | (4) |
| Profit before tax | 1,023 | 642 |

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

Profit before tax – by country

| | 2013 | 2012 |
|--------------------------------|--------------|------------|
| | £m | £m |
| United Kingdom | 667 | (55) |
| France | 227 | 326 |
| Germany | 115 | 178 |
| Turkey | 70 | 66 |
| Malta | 22 | 20 |
| Other | (78) | 107 |
| Profit before tax | 1,023 | 642 |

Overview

GB&M reported a profit before tax of £1,023 million in the period compared with a profit before tax of £642

million in 2012, an increase of £381 million or 59 per cent.

Overall, revenues rose by 7 per cent, primarily due to higher revenues in Capital Financing. These movements were partially offset by lower revenues in Rates and lower disposal gains on available-for-sale debt securities in Balance Sheet Management.

Financial performance

Net interest income increased by £225 million or 26 per cent compared to 2012, mainly in Balance Sheet Management largely due to interest rate management and net deployment of funds at enhanced levels during the year. In addition, net interest income was higher due to higher lending margins in Capital Financing and lower levels of interest paid on a reduced legacy portfolio.

Net fee income decreased by £28 million or 5 per cent compared to 2012 primarily due to higher levels of fees paid to other HSBC entities in respect to higher volumes of foreign exchange trading activities in other geographical regions. This was partly offset by higher fees earned on increased customer demand in debt capital markets and increase deal volumes in the equity underwriting businesses.

Trading income was £638 million or 41 per cent higher than 2012, of which £344 million was due to foreign exchange movements on trading assets held as economic hedges of foreign debt designated at fair value. A corresponding offset is reported within "Other Income".

In Markets, revenues were higher than 2012 which included a charge of £387 million as a result of a change in estimation methodology in respect of credit valuation adjustments on derivative assets to reflect evolving market practices. This was partially offset by lower favourable debit valuation adjustments on derivative liabilities of £45 million in 2013 (2012: £191 million) also reflecting a refinement in estimation methodology in 2012.

Foreign exchange income benefited from higher client activity and volumes, although this rise was offset in part by margin compression. Equities benefited from increased deal volumes and revaluations gains. Rates revenue decreased despite new mandates and improved market share, particularly in European government bonds as the benefits from tightening spreads following the ECB liquidity intervention in 2012 were not repeated. In addition, revenues benefited from lower adverse fair value movements from own credit spreads on structured liabilities.

Other income decreased by £573 million or 59 per cent primarily reflecting £344 million lower favourable foreign exchange movements on debt designated at fair value offset in 'Trading income' above. In addition lower gains on the disposal of available-for sale debt securities

Strategic Report: Business Review (continued)

in Balance Sheet Management contributed to the decrease.

Loan impairment charges and other credit risk provisions decreased by £147 million or 53 per cent, primarily due to lower net impairments on available-for-sale asset-backed securities. This resulted from an improvement in underlying asset prices; partly offset by higher loan impairment charges in the UK and Spain.

Total operating expenses were in line with 2012 increasing by £29 million. Excluding the £53 million accounting gain relating to the change of ill-health benefits recognised in 2013, provisions of £84 million compared to £207 million in 2012 in relation to the possible mis-selling of interest rate protection products and a decrease in restructuring costs of £30 million, operating expenses were 8 per cent higher. This reflected higher litigation costs relating to the agreed settlements reached in respect to Madoff related claims in Ireland.

Global Private Banking

| | 2013 | 2012 | 2012 ¹ |
|--|------------|-----------------------|-------------------|
| | | Continuing operations | |
| | £m | £m | £m |
| Net interest income | 224 | 212 | 597 |
| Net fee income | 100 | 111 | 583 |
| Trading income | 10 | 7 | 254 |
| Other income | (4) | 3 | 8 |
| Net operating income before impairments and provisions | 330 | 333 | 1,442 |
| Loan impairment charges and other credit risk provisions | (14) | (19) | (18) |
| Net operating income | 316 | 314 | 1,424 |
| Total operating expenses | (176) | (213) | (943) |
| Operating profit | 140 | 101 | 481 |
| Share of profit in associates and joint ventures | - | (1) | (1) |
| Profit before tax | 140 | 100 | 480 |

Profit before tax – by country

| | 2013 | 2012 | 2012 ¹ |
|--------------------------------|------------|-----------------------|-------------------|
| | | Continuing operations | |
| | £m | £m | £m |
| United Kingdom | 99 | 87 | 134 |
| France | 13 | (7) | (7) |
| Germany | 28 | 25 | 25 |
| Turkey | - | - | - |
| Malta | - | - | - |
| Other | - | (5) | 328 |
| Profit before tax | 140 | 100 | 480 |

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

Overview

GPB reported profit before tax of £140 million in 2013 compared to £480 million in 2012, a decrease of 71 per cent.

On a continuing operations basis, GPB reported a profit before tax of £140 million in 2013 compared with £100 million in 2012, an increase of 40 per cent.

Financial performance

The commentary that follows is on a continuing operations basis.

Net interest income was £12 million or 6 per cent higher, due to improved margins in the UK and additional net interest income as a result of the acquisition of HSBC Private Banking (C.I.) Limited in November 2013.

Net fee income was £11 million or 10 per cent lower primarily due to the non-recurrence of fee income following the disposal of Property Vision in 2012, and lower client demand.

Trading income was broadly in line with prior year.

Other income decreased by £7 million in part due to lower net premium income in France.

Total operating expenses decreased by £37 million or 17 per cent compared to 2012. This was due to lower staff costs reflecting a reduction in staff numbers and related costs, reduced performance costs and the recovery of losses arising on a 2001 litigation in France.

Other

| | 2013 | 2012 |
|--|--------------|----------------|
| | £m | £m |
| Net interest income | (73) | (43) |
| Net fee income | 3 | 3 |
| Trading income | (22) | (9) |
| Change in credit spread on long-term debt | (167) | (1,055) |
| Other income | 102 | 118 |
| Net operating income before impairments and provisions | (157) | (986) |
| Loan impairment charges and other credit risk provisions | - | - |
| Net operating (expense)/ income | (157) | (986) |
| Total operating expenses | (222) | (310) |
| Operating (loss)/ profit | (379) | (1,296) |
| Share of profit in associates and joint ventures | - | 1 |
| (Loss)/ profit before tax | (379) | (1,295) |

'Other contains the movements in fair value of own debt, financing operations, central support and functional costs with associated recoveries.

The reported loss before tax in 'Other' was £379 million, compared to a loss before tax of £1,295 million in 2012. This was primarily due to the change in own credit spreads on long-term debt which resulted in a loss of £167 million in 2013 compared with a loss of £1,055 million in 2012.

Strategic Report: Business Review (continued)

Economic Outlook

The bank expects global growth to rise 2.6 per cent in 2014, from 2.1 per cent in 2013. This turnaround reflects a shift from contraction to modest expansion in the eurozone, a rise in growth in the US and UK, and emerging markets growth rising to 4.9 per cent in 2014 from 4.6 per cent.

The bank expects UK GDP to rise by 2.6 per cent in 2014, the fastest growth rate since 2007. An ongoing thawing in credit conditions and stronger demand means investment should rise sharply. Household consumption should also be supported by loose monetary policy and a recovering housing market. UK net trade may be aided by a modest improvement in the eurozone although government spending will continue to be restrained by the fiscal consolidation.

Recent developments in the eurozone economy signal a recovery, although its strength will likely be only gradual and dependent on global trade as there remain significant headwinds to domestic demand. The provision of credit is likely to remain very weak and banks are likely to remain cautious ahead of the ECB's Asset Quality Review ('AQR') and the European Banking Association's stress tests on banks' balance sheets. The continuing credit tightness will in turn hinder investment and consumption growth. Burdened with stubbornly high public debt levels, eurozone countries will need to continue reducing public expenditure, exerting downward pressure on government consumption. As a result of these headwinds, the bank expects the eurozone GDP to grow by only 0.8 per cent in 2014.

Turkey was one of the main countries affected by the US Federal Reserve's announcement in December 2013 to begin tapering its asset purchases. The outflow of capital led to a sharp decline in the Turkish Lira which was intensified by the political unrest after allegations of corruption by government officials. In order to stem capital outflows, the Central Bank of Turkey raised a number of key short-term interests sharply in January 2014. These currency and interest rate moves will help to rebalance the economy although in the near-term the decline of the Turkish Lira will reduce domestic activity and raise inflation. Turkey holds local elections in March and presidential elections in the summer so the bank expects to see a moderate amount of fiscal stimulus through the year. In Turkey, the bank forecasts 2014 GDP growth of 2.2 per cent down from that in 2013.

Strategic Report: Principal Risks and Uncertainties

Principal Risks and Uncertainties

The group continuously monitors and identifies risks. This process, which is informed by its risk factors and the results of its stress testing programme, gives rise to the classification of certain key risks as top or emerging. Changes in the assessment of top and emerging risks may result in adjustments to the group's business strategy and, potentially, its risk appetite.

The group's principal banking risks are credit risk, operational risk, market risk, liquidity and funding risk, compliance risk and reputational risk. The group also incurs insurance risk. The exposure to these risks and the group's risk management are explained in more detail in the Risk section of the Report of the Directors on pages 25 to 76.

Next to these principal banking risks the group has identified the following significant risks which have the potential to have a material impact on the group's financial results or reputation and the sustainability of its long-term business model.

Macro-economic and geopolitical

Emerging markets' slowdown

Growth in a number of emerging markets decelerated during 2013. Weak demand for commodities and raw materials due to subdued economic growth and limited investment activity in mature markets and in mainland China affected all exporting countries. Emerging markets continued to face the risks of fiscal decline and increasing financing requirements. In addition, capital flows were volatile, particularly during the second half of the year, and in several cases lead to a tightening of monetary policy to counter capital outflows. Any consequent rise in interest rates, however, could put growth at risk and increase the risk of a liquidity crisis.

Mature economies are depending on stronger trade growth with emerging markets to help them through difficult economic times domestically. A number of them have implemented austerity measures in order to reduce their deficits and public debt. While austerity is expected to help resolve the sovereign and banking crisis in the medium term, it is limiting growth, increasing unemployment and restricting taxation revenues severely in the short term. This, in turn, is affecting the rest of the world through lower trade.

Potential impacts on the group include:

- Global trade and capital flows may contract as a result of weaker economic growth in some emerging markets, banks deleveraging, expectations of tapering of quantitative easing, the introduction of protectionist measures in certain markets, the emergence of geopolitical risks or increasing redenomination risk. The contraction might curtail the group's profitability.

- While growth in emerging markets as a whole has been constrained by lower world demand and commodity prices, some countries are struggling with domestic issues and could trigger a new crisis of confidence with the potential for increased volatility. Emerging markets have been supported during the last two years by significant capital inflows from advanced economies but a reverse of these capital flows, as happened in mid-2013, would create difficulties for all countries having to finance current account deficits, government debt or both. HSBC closely monitors developments in all markets to ensure insights are shared and appropriate mitigating action is taken as circumstances evolve.

Increased geopolitical risk in certain regions

The group's operations are exposed to risks arising from political instability and civil unrest in a number of countries which may have a wider effect on regional stability and regional and global economies.

Geopolitical risk remains high in the Middle East as a result of the continued violence and unrest in Egypt and the civil war in Syria, which may spill over into neighbouring countries, such as Turkey.

Tensions between Israel and Iran add to the risks in the region, although diplomatic contacts with Iran's new administration may engender an improvement in relations. In Turkey, there is significant political uncertainty and the government is struggling to maintain a credible policy in order to maintain creditors' confidence.

Potential impacts on the group include:

- The group's results are subject to the risk of loss from unfavourable political developments, currency fluctuations, social instability and changes in government policies on matters such as expropriation, authorisations, international ownership, interest-rate caps, foreign exchange transferability and tax in the jurisdictions in which it operates. Actual conflict could put the group's staff in harm's way and bring physical damage to its assets.
- In mitigation, the group has increased its monitoring of the geopolitical and economic outlook, in particular in countries where the group has a material exposures and a physical presence. The internal credit risk rating of sovereign counterparties takes these factors into account and drives the appetite for conducting business in those countries. Where necessary, country limits and exposures are adjusted to reflect this appetite and mitigate these risks as appropriate.

Strategic Report: Principal Risks and Uncertainties (continued)

Eurozone – risk of sovereign and counterparty defaults

Eurozone countries are members of the EU and part of the euro single currency bloc. The peripheral eurozone countries of Greece, Ireland, Italy, Portugal, Spain and Cyprus are those which exhibited levels of market volatility that exceeded other eurozone countries, demonstrating persistent fiscal or political uncertainty in 2013.

Throughout 2012 and 2013, in spite of austerity measures and structural reforms, peripheral euro zone countries continued to exhibit a high ratio of sovereign debt to GDP or short to medium-term maturity concentration of their liabilities.

Although the overall situation has improved, further structural reforms are still needed to contain the threat of the exit of one more countries from the eurozone bloc.

The group's exposure to the peripheral eurozone countries is limited and reduced further in 2013. However, the group is still exposed to counterparties in core European countries which could be affected by any sovereign or currency crisis.

The group's businesses in peripheral eurozone countries are funded from a mix of local deposits, local wholesale sources and intra-Group loans extended from HSBC operations with surplus funds. Intra-Group funding carries the risk that a member country might exit the eurozone and redenominate its national currency, which could result in a significant currency devaluation. The group's eurozone exposures are analysed in more detail on pages 28 to 29. A description of redenomination risk in the event of the exit of a eurozone member is provided on pages 29 to 30.

Potential impacts on the group include:

- The group could incur losses stemming from the exit of one or more countries from the eurozone and the redenomination of their currencies.
- The exposures to European banks may come under stress, heightening the potential for credit and market risk losses, if the sovereign debt and banking system crisis in the region increases the need to recapitalise parts of the sector.

Macro-prudential, regulatory and legal risks

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

manner and to differing timetables across regulatory regimes.

Regulatory developments affecting the business model

Several regulatory changes are likely to affect the group's activities. These changes include:

- The publication on 27 June 2013 of the Capital Requirements Directive ('CRD IV'), which introduced in the EU the Basel III measures that came into effect on 1 January 2014, together with the publication by the PRA on 19 December 2013 of its final rules on implementing CRD IV which apply to firms regulated by the Prudential Regulation Authority ('PRA') in the UK;
- The introduction of new regulatory bodies and powers in Europe comprising, in the UK, the Financial Policy Committee ('FPC'), the PRA, the Financial Conduct Authority ('FCA') and, in particular, the ability of the FPC to seek additional capital for lending to sectors perceived as higher risk; and, in the eurozone, the granting to the ECB of supervisory powers from November 2014;
- Finalisation of the Financial Services (Banking Reform) Act 2013 in the UK to give effect to the recommendations of the Independent Commission on Banking ('ICB') in relation to the future 'ring-fencing' of the UK retail banking business from wholesale banking activities and potential legislative changes across the EU;
- Changes in the regime for the operation of capital markets with increasing standardisation, central clearing, reporting and margin requirements through a number of regulatory initiatives including the European Market Infrastructure Regulation and the revised Markets in Financial Instruments Directive/Regulation;
- Requirements flowing from arrangements for the recovery and resolution of HSBC and its main operating entities (including the bank);
- Continued changes in the manner and standards for the conduct of business, including the effects of the recommendations made by the Parliamentary Commission on Banking Standards (which will be given effect through Part 4 of the Financial Services (Banking Reform) Act 2013);
- The forthcoming ECB Asset Quality Review ('AQR') which may reveal substantial recapitalisation is needed among eurozone banks;
- The tightening of credit controls by regulators in a number of countries on mortgage lending and unsecured portfolios; and
- The continued risk of further changes to regulation relating to remuneration and other taxes.

Strategic Report: Principal Risks and Uncertainties (continued)

Potential impacts on the group include:

- Proposed changes relating to capital and liquidity requirements, remuneration and/or taxes could increase the group's cost of doing business, reducing future profitability.
- Proposed changes in regulations for derivatives and central counterparties, the ICB ring-fencing proposals, recovery and resolution plans, the Volcker Rule and the Foreign Account Tax Compliance Act ('FATCA') may affect the manner in which HSBC conducts activities and structures itself. This has the potential both to increase the costs of doing business and curtail the types of business the group can carry out, with the risk of decreased profitability as a result. The development and implementation of many of these various regulations are in their early stages, and therefore it is not possible to estimate the effect, if any, on the group's operations.
- Mandatory central clearing also brings new risks to HSBC in its role as a clearing member, as the group will be required to underwrite losses incurred by central clearing counterparties from the default of other clearing members and their clients. Hence central clearing brings with it a new element of interconnectedness between clearing members and clients which the group believes may increase rather than reduce its exposure to systemic risk.
- Potential market disruption as a result of the AQR may affect the group directly through the exposure to eurozone banks and sovereigns, and indirectly should there be any diminution in economic activity in the eurozone.
- HSBC is closely engaged with the governments and regulators in the countries in which it operates to help ensure that the new requirements are properly considered and can be implemented in an effective manner. The group is also ensuring that the capital and liquidity plans take into account the potential effects of the changes. Capital allocation and liquidity management disciplines have been expanded to incorporate future increased capital and liquidity requirements and drive appropriate risk management and mitigating actions.

Regulatory commitments and consent orders

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

In December 2012, HSBC Holding plc, the bank's parent company, entered into agreements with US and UK authorities in relation to investigations regarding past inadequate compliance with anti-money laundering ('AML') and sanctions laws.

Among these agreements, HSBC Holdings plc and HSBC Bank USA, N.A. entered into a five-year deferred prosecution agreement (the 'DPA') with the US Department of Justice ('DoJ') and HSBC Holdings plc entered into a two-year deferred prosecution agreement with the New York County District Attorney (the 'DANY DPA').

HSBC Holdings plc also entered into an undertaking with the FSA (revised as the 'FCA Direction') to comply with certain forward-looking obligations with respect to AML and sanctions requirements.

Under the settlement agreements, HSBC made payments totalling US\$1.9bn to US authorities and undertook to continue cooperating fully with US and UK regulatory and law enforcement authorities and take further action to strengthen its compliance policies and procedures.

The agreements with the DoJ, the US Federal Reserve and the FCA Direction require HSBC to retain an independent monitor (who is, for FCA purposes, a 'skilled person' under section 166 of the Financial Services and Markets Act) to evaluate the progress in implementing the obligations under the agreements and FCA Direction and to produce regular assessments of the effectiveness of the group's Compliance function.

On 1 July 2013, the US District Court for the Eastern District of New York approved the US DPA and retained authority to oversee implementation of the same. Michael Cherkasky began his work as Monitor on 22 July 2013, charged with evaluating and reporting upon the effectiveness of the Group's internal controls, policies and procedures as they relate to ongoing compliance with applicable anti-money laundering and sanctions laws. His work is proceeding as anticipated consistent with the timelines and requirements set forth in relevant agreements.

Potential impacts on HSBC include:

- It is difficult to predict the outcome of the regulatory proceedings involving HSBC's businesses. Unfavourable outcomes may have a material adverse effect on the group's reputation, brand and results, including loss of business and withdrawal of funding.
- The Group's significant involvement in facilitating international capital flows and trade exposes the Group to the risk of financial crime or inadvertently breaching restrictions and sanctions imposed by OFAC and other regulators. Through the Global Standards programme, the Group is implementing consistent procedures and controls to detect, deter and protect against financial crime.

In relation to the DPAs, the Group have committed to take or continue to adhere to a number of remedial measures. Breach of the DPA at any time during its

Strategic Report: Principal Risks and Uncertainties (continued)

term may allow the DoJ to prosecute HSBC Holdings plc or HSBC Bank USA N.A. in relation to the matters which are the subject of the US DPA. Breach of the DANY DPA may allow the New York County District Attorney's Office to prosecute HSBC Holdings plc in relation to the matters which are the subject of that DPA. Steps to address many of the requirements of the DPAs and the FCA Direction have either already been taken or are under way. These include simplifying the Group's control structure, strengthening the governance structure with new leadership appointments, revising key policies and establishing bodies to implement single Global Standards shaped by the highest or most effective standards available in any location where the Group operates, as well as substantially increasing spending and staffing in the anti-money laundering and regulatory compliance areas in the past few years. There can be no assurance that these steps will be effective or that HSBC will not have to take additional remedial measures in the future to comply with the terms of the DPAs or the FCA Direction.

Conduct of business

Regulators in the UK and other countries have continued to increase their focus on 'conduct risk' including paying attention to sales processes and incentives, product and investment suitability and more general conduct of business concerns. In the UK, the FCA is making increasing use of existing and new powers of intervention and enforcement, including powers to consider past business undertaken and implement customer compensation and redress schemes or other, potentially significant, remedial work. Additionally, the FCA and other regulators increasingly take actions in response to customer complaints, which may be amplified through the use of social media channels, either specific to an institution or more generally in relation to a particular product. There have been recent examples of this approach in the context of the possible mis-selling of payment protection insurance ('PPI'), of interest rate hedging products to SMEs and of wealth management products.

The Group also remains subject to a number of other regulatory proceedings involving investigations and reviews by various national regulatory, competition and enforcement authorities including in the UK, the US, Canada, the EU, Switzerland and Asia that are conducting investigations and reviews relating to certain past submissions made by panel banks and the process for making submissions in connection with the setting of London interbank offered rates ('Libor'), European interbank offered rates ('Euribor') and other benchmark interest rates. In addition, regulators in the UK, the US, Japan, Hong Kong and certain other jurisdictions are conducting investigations relating to trading on foreign exchange markets. As certain HSBC entities are members of these panels and participate in the foreign exchange market, HSBC and/or its subsidiaries have

been the subject of regulatory demands for information and are cooperating with those investigations and reviews.

Potential impacts on the group include:

- Regulators in the UK and other countries may identify future industry-wide mis-selling or other issues that could affect the group. This may lead from time to time to: (i) significant direct costs or liabilities (including in relation to mis-selling); and (ii) changes in the practices of such businesses which benefit customers at a cost to shareholders. Also, decisions taken in the UK by the Financial Ombudsman Service in relation to customer complaints (or any overseas equivalent with jurisdiction) could, if applied to a wider class or grouping of customers, have a material adverse effect on the operating results, financial condition and prospects of the group.

Dispute risk

The current economic environment has increased the group's exposure to actual and potential litigation. Further details are provided in Note 42 on the Financial Statements.

Potential impacts on the group include:

- Dispute risk gives rise to potential financial loss and significant reputational damage which could adversely affect customer and investor confidence.

Business operations, governance and control

Heightened execution risk

There are a number of factors which may affect the successful delivery of the group's strategy. These include the increasing regulatory pressures and demands and the challenging macroeconomic environment, which may affect the group's ability to achieve planned earnings growth. The implementation of the group's strategy to simplify the business, which involves withdrawing from certain markets, presents disposal risks which must be carefully managed. Implementing organisational changes to support the HSBC strategy, in particular the restructure of the Compliance function into two distinct sub-functions (Financial Crime Compliance and Regulatory Compliance) also requires close management oversight.

Potential impacts on the group include:

- The group's annual planning and stress testing processes consider the effect of potential risks from the external environment on its earnings and capital position and mitigation actions by management.
- The risk of disposal include regulatory breaches, industrial action, loss of key personnel and interruption to systems and processes during

Strategic Report: Principal Risks and Uncertainties (continued)

business transformation, and they can have both financial and reputational implications.

- The size and scope of the change to the group's Compliance function could generate heightened execution and people risk (including significant resourcing demands) and is subject to close management oversight.

Internet crime and fraud

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

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

Potential impacts on the group include:

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

Information security risk

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

Potential impacts on the group are as follows:

- Financial loss and reputational damage which could adversely affect customer and investor confidence. Loss of customer data would also result in regulatory breaches which would result in fines and penalties being incurred. The group has invested

significantly in addressing this risk through increased staff training to raise awareness of requirements and enhanced multi-layered controls protecting information and technical infrastructure.

Data management

The group has received feedback from external stakeholders that it needs a clear data strategy to meet the volume, granularity and frequency and scale of regulatory reporting requirements as well as other internal and external information demands. In addition, the group is required to meet the Basel Committee on Banking Supervision's ('BCBS') data and reporting obligations by the end of 2015.

Potential impacts on the group include:

- Financial institutions that fail to meet their BCBS data obligations by the required deadline may face supervisory measures. Senior management recognise the importance of data management and therefore established a Data Strategy Board in 2012 to define the Group's data strategy and ensure consistent data aggregation, reporting and management across the Group. Key initiatives and projects to deliver the strategy and meet the BCBS data obligations are now in progress.
- Regulators are evaluating the industry on its ability to provide accurate information and may use the industry-developed data maturity model to assess financial services firms.

Model risk

Increasingly stringent regulatory requirements governing the development, parameters applied to and controls over models can have implications for the modelled outcomes, including increases in capital requirements. This risk extends more broadly to the use of models across the group, for example models used in financial reporting, stress testing or pricing. The evolving external economic and legislative environment and changes in customer behaviour can also lead to the assumptions the group has made in models becoming invalid.

Potential impacts on the group include:

- These model risks have the potential to increase the group's capital requirements and make them more volatile. The group continues to address these risks through enhanced model development, independent review and model oversight to ensure the models remain fit for purpose.

Report of the Directors

Introduction

Whilst the crisis in the Eurozone eased during 2013, volatility in financial markets continued, reflecting concerns over the US fiscal cliff and debt ceiling and the potential tapering of quantitative easing. The continuing turmoil in the Middle East and its possible effect on global energy prices, and the widely held view that the world economic recovery remained fragile, increased this volatility further.

Despite this economic environment, underlying business performance was strong across all business segments, supported by lower costs of customer redress provisions and less adverse movements in the fair value of own debt attributable to credit spreads.

Results for 2013

The consolidated profit for the year attributable to the shareholders of the bank was £2,495 million.

Interim dividends of £1,400 million, in lieu of a final dividend in respect of the previous financial year, and £570 million were paid on the ordinary share capital during the year.

A second interim dividend, in lieu of a final dividend, of £630 million was declared after 31 December 2013, payable on 24 February 2014.

Further information about the results is given in the consolidated income statement on page 93. Information about future developments likely to affect the group is given in the Strategic Report.

Risk

As a provider of banking and financial services, the group actively manages risk as a core part of its day-to-day activities. The growth in the group's business during 2013 was achieved while risks were assumed in a measured manner in line with the risk appetite and risks, particularly reputational and operational, were mitigated when they exceeded the group's risk appetite.

The group continues to maintain a very strong liquidity position and is well positioned for the changing regulatory landscape.

The group maintained its conservative risk profile by reducing exposure to the most likely areas of stress:

- The group selectively managed its exposure to sovereign debt and bank counterparties to ensure that the overall quality of the portfolio remained strong;
- The group regularly assessed higher risk countries and adjusted its risk appetite and exposures accordingly; and
- The group repositioned certain portfolios and, in addition, made its client selection filters more robust in managing the risk of financial crime.

Managing Risk

(Unaudited)

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

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

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

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

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

Risk culture

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

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

The risk culture is reinforced by the group's approach to remuneration; individual awards are based on the achievement of both financial and non-financial

Report of the Directors: Risk

(relating to the HSBC Values) objectives which are aligned to the global strategy.

Risk profile

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

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

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

Risk appetite

The Group's risk appetite is set out in the Group's Risk Appetite Statement, which describes the types and levels of risk that the group is prepared to accept in executing its strategy. Quantitative and qualitative metrics are assigned to nine key categories: earnings, capital, liquidity and funding, securitisations, cost of risk, intra-group lending, strategic investments, risk categories and risk diversification and concentration. Measurement against the metrics:

- guides underlying business activity, ensuring it is aligned to risk appetite statements;
- informs risk-adjusted remuneration;
- enables the key underlying assumptions to be monitored and, where necessary, adjusted through subsequent business planning cycles; and
- promptly identifies business decisions needed to mitigate risk.

The risk appetite statement is approved by the HSBC Board following advice from the Risk Committee, and is a key component of the risk management framework. It is central to the annual planning process, in which global businesses, geographical regions and functions are required to articulate their risk appetite statements. These are aligned with the Group strategy, and provide a risk profile of each global business, region or function in the context of the individual risk categories.

Stress testing

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

assess the potential demand for regulatory capital under the various scenarios. The group has also participated in analysis requested by regulatory bodies.

In the course of 2013, the group analysed the impact of several scenarios, including a Global Slow Growth scenario run for the PRA Core Programme exercise. The results of this analysis demonstrated that the group would remain adequately capitalised under this scenario after the application of mitigating management actions.

As part of the group's stress testing framework, a number of macroeconomic and event driven scenarios specific to the European region were considered and reported to senior management. These are based on analysis under a range of scenarios including: deterioration in the French economy, UK leaving the European Union, UK economic stagnation, and a move to Negative Interest Rates in the UK and/or eurozone.

The group also conducts Reverse Stress Testing. Reverse Stress Testing is a process of working backwards to assess a combination of scenarios and idiosyncratic and systemic events that could render its business model unviable.

Reverse stress testing is used as part of the risk management process to help inform management actions and contingency plans to mitigate against potential stresses and vulnerabilities which the group might face.

The group participates, where appropriate, in scenario analyses requested by regulatory bodies. The Bank of England has announced plans to establish a framework for annual simultaneous stress testing of the UK banking system, starting in 2014. This programme is expected to include common scenarios applied across all major UK banks designed by the Financial Policy Committee ('FPC') and bespoke scenarios designed by individual banks and approved by the PRA Board. The group also expects to participate in the forthcoming European Banking Authority ('EBA') stress test programme, which is currently planned for 2014.

In addition, the group is developing a response to the PRA's firm data submission framework ('FDSF'). This is a comprehensive submission of the data necessary to conduct stress tests and to inform the PRA's view of the capital buffer appropriate for the Group. The first data submission was made in the second half of 2013 and the group will continue to provide data on a regular basis according to a schedule agreed with the PRA.

Report of the Directors: Risk (continued)

Areas of special interest

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

Financial crime compliance and regulatory compliance

(Unaudited)

In recent years, the group has experienced increasing levels of compliance risk as regulators and other agencies pursued investigations into historical activities and it continues to work with them in relation to existing issues. This has included the matters giving rise to the DPAs reached with US authorities in relation to investigations regarding inadequate compliance with anti-money laundering and sanctions law, and the related FCA Direction undertaking.

The group has also responded to a number of investigations by the FCA into the possible mis-selling in the UK of certain products, including PPI and interest rate hedging products sold to SMEs. In addition, it has been involved in investigations and reviews by various regulators and competition enforcement authorities relating to certain past submissions made by panel banks and the process for making submissions in connection with the setting of Libor, Euribor and other benchmark interest and foreign exchange rates.

It is clear from both HSBC's own and wider industry experience that the level of activity among regulators and law enforcement agencies in investigating possible breaches of regulations has increased, and that the direct and indirect costs of such breaches can be significant. Coupled with a substantial rise in the volume of new regulation, much of which has some element of extra-territorial reach, and the geographical spread of HSBC's businesses, the group believes that the level of inherent compliance risk that it faces as part of the HSBC Group will continue to remain high for the foreseeable future.

Refinance Risk in Commercial real estate

(Unaudited)

Exposure to commercial real estate lending is concentrated in the UK, where during 2013 the market first stabilised then steadily improved as economic growth returned. This resulted in increased tenant demand with signs that the benefits of recovery were beginning to filter to regional markets outside of London and the South East, which had remained relatively strong throughout the downturn, albeit the recovery is not entirely consistent by geography and property.

It is not untypical for commercial real estate lending to require the repayment of a significant proportion of the principal at maturity. Typically, the mechanism of repayment for the customer is through the acquisition of a new loan to settle the existing debt. Refinance risk arises when a customer is unable to repay such term debt on maturity, or to refinance debt at commercial rates.

This risk is subject to close scrutiny in key commercial real estate markets because refinance risk can arise particularly when a loan is serviced exclusively by the property to which it relates, i.e. when the bank does not, or is not able to, place principal reliance on other cash flows available to the borrower. The group monitors the commercial real estate portfolio, assessing those drivers that may indicate potential issues with refinancing. The principal driver is the vintage of the loan, when origination reflected previous market norms which no longer apply in the current market. Examples are higher loan-to-value ('LTV') ratios and/or lower interest cover ratios. The range of refinancing sources in the local market is also an important consideration, with risk increasing when lenders are restricted to banks and when bank liquidity is limited. In addition, the quality of underlying fundamentals such as the reliability of tenants, ability to let, and the condition of the property are important.

Across the group's commercial real estate portfolios the behaviour of markets and the quality of assets did not cause undue concern in 2013. While the commercial real estate market in the UK has taken some time to recover, the above drivers no longer combine to cause material concerns regarding the group's sensitivity to risks of refinance warranting enhanced management attention. Stronger liquidity in 2013, caused by the return of a broader range of international financiers, significantly eased pressure of the options for refinance.

At 31 December 2013, the UK had £13.8 billion of commercial real estate loans, of which £4.1 billion were due to be refinanced within the next 12 months. Within these balances, cases subject to close monitoring within the Loan Management unit amounted to £1.5 billion; £0.9 billion were disclosed as impaired against which impairment allowances of £0.4 billion have been raised. Where these loans are not considered impaired it is because there is no evidence to indicate that all contractual cash flows will not be recovered or that the loans will need to be refinanced on terms the group would consider below market norms.

Interest-only mortgages

(Unaudited)

Interest-only mortgages totalled £29.6 billion, approximately 37 per cent of UK mortgage balances (see table of 'Mortgage lending by product type' on page 36), of which approximately 50 per cent relates to the first direct 'offset' product. An 'offset' is sold as an interest-only product which allows customers to redraw capital up to their mortgage account limit. Many customers elect to make capital repayments throughout the term of the offset product.

The group's underwriting criteria for interest-only products is consistent with that for equivalent capital repayment products, and such products continue to be typically originated at conservative LTV ratios.

Report of the Directors: Risk (continued)

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

The group runs contact programmes throughout the lifetime of the product to ensure it builds an informed relationship with customers whereby they receive the appropriate support in meeting the final repayment of principal, and understand alternative repayment options available. These contact programmes intensify in the final five years of an interest-only product, and the effectiveness is reviewed by management with enhancements made where appropriate.

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

Eurozone crisis

(Unaudited)

In spite of austerity measures and structural reform throughout 2012 and 2013, the peripheral eurozone countries continued to exhibit a high ratio of sovereign debt to GDP or short to medium-term maturity concentration of their liabilities. However, some of these peripheral eurozone countries showed improvements with Ireland able to access the long-term bond markets and Spain experiencing lower borrowing costs.

In March 2013, Cyprus sought assistance from the Troika (the European Commission, European Central Bank and International Monetary Fund), which ultimately agreed a bailout under conditions requiring a consolidation of banking assets and the 'bail-in' of larger depositors' monies. Capital controls led to some minor disruption of payments from Cyprus. However, the group has limited exposure to the country and no impairments were recorded.

The ECB brought interest rates to record low levels in order to support growth in the eurozone but the very low level of inflation in the region is limiting the impact

of such measures. These measures are putting additional stress on the profitability of the European banking sector.

At 31 December 2013, the group's net exposure to the peripheral eurozone countries was £19.6 billion, including off-balance sheet exposures, £1.4 billion lower than at the end of 2012. This was primarily due to reduction in exposure to sovereign borrowers and agencies in Italy, to banks in Ireland, and to other financial institutions and corporates in Spain. These were partly offset by an increase in exposure to banks in Greece due to reverse repo activity which is backed by high quality bonds.

The group's businesses in peripheral eurozone countries are funded from a mix of local deposits, local wholesale funding and intra-group loans extended from the HSBC operations with surplus funds. A description of redenomination risk in the event of the exit of a eurozone member is provided on page 29.

Risk Management and Contingency planning

(Unaudited)

The group has a well-developed framework for dealing with counterparty and systemic crisis situations, both country specific and regionally, which is complemented by regular specific and enterprise-wide stress testing and scenario planning. The framework functions before, during and after crises and ensures that the group has detailed and evolving operational plans in the event of an adverse situation materialising. It was applied throughout 2013 to ensure that pre-crisis preparation remained apposite and robust. A Cyprus Major Incident Group was effective in dealing with the group's response to the Cyprus sovereign debt crisis.

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

Management continues to closely monitor and manage eurozone bank exposures in the peripheral eurozone countries, and is cautious in lending to this sector.

The group regularly updates its assessment of higher-risk eurozone banks and adjusts its risk appetite accordingly. Where possible, the group also seeks to play a positive role in maintaining credit and liquidity supply.

Report of the Directors: Risk (continued)

Exposure to peripheral eurozone countries

On- and off-balance sheet exposure

(Audited)

| | On- balance sheet exposures £bn | Off- balance sheet exposures £bn | Total gross exposures £bn | Risk miti- gation £bn | Total net exposure £bn | Total net exposure | | | |
|----------------------------|---|--|------------------------------------|--------------------------------|---------------------------------|-------------------------------------|------------|--|-----------------|
| | | | | | | Sovereign and agencies £bn | Banks | Other financial institutions and corporates £bn | Personal £bn |
| At 31 December 2013 | | | | | | | | | |
| Spain | 7.4 | 2.0 | 9.4 | (3.3) | 6.1 | 0.5 | 1.4 | 4.2 | – |
| Ireland | 4.7 | 0.5 | 5.2 | (0.8) | 4.4 | – | 0.5 | 3.9 | – |
| Italy | 7.7 | 1.8 | 9.5 | (5.2) | 4.3 | 0.7 | 0.5 | 3.1 | – |
| Greece | 3.8 | 0.7 | 4.5 | (0.3) | 4.2 | – | 1.3 | 2.3 | 0.6 |
| Portugal | 0.5 | 0.1 | 0.6 | (0.1) | 0.5 | 0.2 | – | 0.3 | – |
| Cyprus | 0.1 | – | 0.1 | – | 0.1 | – | – | 0.1 | – |
| | 24.2 | 5.1 | 29.3 | (9.7) | 19.6 | 1.4 | 3.7 | 13.9 | 0.6 |
| At 31 December 2012 | | | | | | | | | |
| Spain | 8.7 | 1.7 | 10.4 | (3.7) | 6.7 | 0.5 | 1.6 | 4.6 | – |
| Ireland | 5.1 | 0.5 | 5.6 | (0.7) | 4.9 | 0.2 | 1.0 | 3.7 | – |
| Italy | 7.2 | 1.5 | 8.7 | (3.7) | 5.0 | 1.6 | 0.7 | 2.7 | – |
| Greece | 3.7 | 0.4 | 4.1 | (0.5) | 3.6 | 0.1 | 0.4 | 2.5 | 0.6 |
| Portugal | 0.7 | 0.1 | 0.8 | (0.2) | 0.6 | 0.2 | 0.2 | 0.2 | – |
| Cyprus | 0.1 | 0.1 | 0.2 | – | 0.2 | – | – | 0.2 | – |
| | 25.5 | 4.3 | 29.8 | (8.8) | 21.0 | 2.6 | 3.9 | 13.9 | 0.6 |

Redenomination risk

(Unaudited)

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

Based on HSBC's assessment of the likelihood of a eurozone exit of each country and the related exposures HSBC's view remains that HSBC is most at risk if Greece, Italy or Spain left the euro. As a result, only exposures in Greece, Italy and Spain (described as 'in-country') are reported in the table below.

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

- *Foreign exchange losses:* an exit would probably be accompanied by the passing of laws in the country concerned establishing a new local currency and providing for a redenomination of euro assets into the new local currency. The value of assets and liabilities in the country would immediately fall assuming the value of the redenominated currency is less than the original euros when translated into the carrying amounts. It is not possible to predict what the total consequential loss might be as it is uncertain which assets and liabilities would be legally redenominated or the extent of the devaluation. These assets and liabilities predominantly comprise loans and deposits arising from the group's

commercial banking operations in these countries, and the net assets represent the net funding exposure. The table also identifies in-country off-balance sheet exposures as these are at risk of redenomination should they be called, giving rise to a balance sheet exposure. It is to be noted that this analysis can only be an indication as it does not include euro-denominated exposures booked by HSBC outside the countries at risk which are connected with those countries (see 'external contracts' below).

- *External contracts redenomination risk:* contracts entered into between HSBC businesses based outside a country exiting the euro with in-country counterparties or those otherwise closely connected with the relevant country may be affected by redenomination. The effect remains subject to a high level of uncertainty. Factors such as the country law under which the contract is documented, the HSBC entity involved and the payment mechanism may all be relevant to this assessment, as will the precise exit scenario as the consequences for external contracts of a disorderly exit may differ from one sanctioned under EU law. In addition, capital controls could be introduced which may affect the group's ability to repatriate funds including currencies not affected by the redenomination event.

The group continues to identify and monitor potential redenomination risks and, where possible, takes steps to mitigate them and/or reduce its overall exposure to losses that might arise in the event of a redenomination. Management recognises, however, that a euro exit could

Report of the Directors: Risk (continued)

take different forms, depending on the scenario. These could have distinct legal consequences which could significantly alter the potential effectiveness of any mitigation initiatives, and it is accordingly not possible to

predict how effective particular measures may be until they are tested against the precise circumstances of a redenomination event.

In-country funding exposure

(Unaudited)

31 December 2013

| | Denominated in: | | | Total £bn |
|---|-----------------|-------------------|----------------------------|--------------|
| | Euros £bn | US Dollars £bn | Other Currencies £bn | |
| Greece | | | | |
| In-country assets | 0.9 | 0.1 | – | 1.0 |
| In-country liabilities | (0.8) | (0.5) | – | (1.3) |
| Net in-country funding | 0.1 | (0.4) | – | (0.3) |
| Off balance sheet exposure/hedging | (0.1) | – | 0.2 | 0.1 |
| Italy | | | | |
| In-country assets | 0.5 | – | – | 0.5 |
| In-country liabilities ¹ | (1.1) | – | – | (1.1) |
| Net in-country funding | (0.6) | – | – | (0.6) |
| Off balance sheet exposure | 0.6 | – | – | 0.6 |
| Spain | | | | |
| In-country assets | 0.9 | 0.5 | – | 1.4 |
| In-country liabilities | (0.6) | (0.2) | – | (0.8) |
| Net in-country funding | 0.3 | 0.3 | – | 0.6 |
| Off balance sheet exposure | 0.3 | 0.3 | – | 0.6 |

31 December 2012

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

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

Report of the Directors: Risk (continued)

Credit risk

(Audited)

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

There were no material changes to the group's policies and practices for the management of credit risk in 2013.

Of the risks in which the group engages, credit risk generates the largest regulatory capital requirements.

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

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

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

- formulating credit policy. Compliance, subject to approved dispensations, is mandatory for all operating companies which must develop local credit policies consistent with group policies that very closely reflect Group policy;
- guiding operating companies on the group's appetite for credit risk exposure to specified market sectors, activities and banking products and controlling exposures to certain higher-risk sectors;
- undertaking an independent review and objective assessment of risk. Credit risk assesses all commercial non-bank credit facilities and exposures over designated limits, prior to the facilities being committed to customers or transactions being undertaken;
- monitoring the performance and management of portfolios across the group;
- controlling exposure to sovereign entities, banks and other financial institutions, as well as debt securities which are not held solely for the purpose of trading;
- setting policy on large credit exposures, ensuring that concentrations of exposure by counterparty, sector or

geography do not become excessive in relation to the group's capital base, and remain within internal and regulatory limits;

- maintaining and developing the group's risk rating framework and systems through the Regional Model Oversight Committees ('RMOC'), which report to the Risk Management Meeting ('RMM') and oversees risk rating system governance for both wholesale and retail businesses;
- reporting on retail portfolio performance, high risk portfolios, risk concentrations, large impaired accounts, impairment allowances and stress testing results and recommendations to the group's RMM, the group's Audit Committee and the Board; and
- acting on behalf of the group as the primary interface, for credit-related issues, with the Bank of England, the PRA, local regulators, rating agencies, analysts and counterparts in major banks and non-bank financial institutions.

Credit quality

(Audited)

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

The group's risk rating system facilitates the internal ratings-based ('IRB') approach under Basel II adopted by the Group to support calculation of the minimum credit regulatory capital requirement. For further details, see 'Credit quality of financial instruments' on page 39.

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

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

Periodic risk-based audits of operating companies' credit processes and portfolios are undertaken by the Internal Audit function. Internal Audit discusses with management any risk ratings it considers to be inappropriate; following which its final recommendations for revised ratings must be adopted.

Impairment assessment

It is the group's policy that each operating company creates allowances for impaired loans promptly and consistently. Impairment allowances may be assessed and created either for individually significant accounts or, on

Report of the Directors: Risk (continued)

a collective basis, for groups of individually significant accounts for which no evidence of impairment has been individually identified or for high-volume groups of homogeneous loans that are not considered individually significant.

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

Concentrations of credit risk exposure

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

These include portfolio and counterparty limits, approval and review controls, and stress testing.

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

Maximum exposure to credit risk

The following table presents the maximum exposure to credit risk from balance sheet and off-balance sheet financial instruments, before taking account any collateral held or other credit enhancements (where such credit enhancements do not meet offsetting requirements). For financial assets recognised on the balance sheet, the maximum exposure to credit risk equals their carrying amount; for financial guarantees granted, it is the maximum amount that the group would have to pay if the guarantees were called upon. For loan commitments and other credit-related commitments that are irrevocable over the life of the respective facilities, it is generally the full amount of the committed facilities.

Report of the Directors: Risk (continued)*Maximum exposure to credit risk**(Audited)**The group*

| | At 31 December 2013 | | | At 31 December 2012 | | |
|--|------------------------|------------------|--|------------------------|------------------|--|
| | Maximum exposure £m | Offset £m | Exposure to credit risk (net) £m | Maximum exposure £m | Offset £m | Exposure to credit risk (net) £m |
| Cash and balances at central banks..... | 67,584 | – | 67,584 | 51,613 | – | 51,613 |
| Items in the course of collection from other banks.. | 1,948 | – | 1,948 | 1,961 | – | 1,961 |
| Trading assets ¹ | 98,090 | (1,075) | 97,015 | 138,624 | (10,327) | 128,297 |
| treasury and other eligible bills | 2,623 | – | 2,623 | 2,258 | – | 2,258 |
| debt securities | 56,414 | – | 56,414 | 54,576 | – | 54,576 |
| loans and advances to banks | 16,067 | – | 16,067 | 32,655 | – | 32,655 |
| loans and advances to customers | 22,986 | (1,075) | 21,911 | 49,135 | (10,327) | 38,808 |
| Financial assets designated at fair value ¹ | 6,947 | – | 6,947 | 7,151 | – | 7,151 |
| treasury and other eligible bills | – | – | – | – | – | – |
| debt securities | 6,903 | – | 6,903 | 7,122 | – | 7,122 |
| loans and advances to banks..... | 44 | – | 44 | 29 | – | 29 |
| loans and advances to customers..... | – | – | – | – | – | – |
| Derivatives ² | 137,239 | (112,931) | 24,308 | 177,808 | (141,162) | 36,646 |
| Loans and advances held at amortised cost ³ | 358,260 | (67,932) | 290,328 | 314,971 | (54,641) | 260,330 |
| loans and advances to banks..... | 53,228 | (1,493) | 51,735 | 32,286 | (1,992) | 30,294 |
| loans and advances to customers..... | 305,032 | (66,439) | 238,593 | 282,685 | (52,649) | 230,036 |
| Financial investments ¹ | 74,024 | – | 74,024 | 70,237 | – | 70,237 |
| treasury and other similar bills | 2,196 | – | 2,196 | 5,203 | – | 5,203 |
| debt securities | 71,828 | – | 71,828 | 65,034 | – | 65,034 |
| Other assets | 7,439 | – | 7,439 | 6,704 | – | 6,704 |
| endorsements and acceptances | 703 | – | 703 | 779 | – | 779 |
| accrued income and other | 6,736 | – | 6,736 | 5,925 | – | 5,925 |
| Financial guarantees | 11,846 | – | 11,846 | 11,660 | – | 11,660 |
| Loan commitments and other credit-related commitments..... | 123,017 | – | 123,017 | 115,725 | – | 115,725 |
| | 886,394 | (181,938) | 704,456 | 896,454 | (206,130) | 690,324 |

Report of the Directors: Risk (continued)

Maximum exposure to credit risk

(Audited)

The bank

| | At 31 December 2013 | | | At 31 December 2012 | | |
|--|------------------------|------------------|--|------------------------|------------------|--|
| | Maximum exposure £m | Offset £m | Exposure to credit risk (net) £m | Maximum exposure £m | Offset £m | Exposure to credit risk (net) £m |
| Cash and balances at central banks | 60,996 | – | 60,996 | 45,262 | – | 45,262 |
| Items in the course of collection from other banks | 1,374 | – | 1,374 | 1,213 | – | 1,213 |
| Trading assets ¹ | 66,865 | (1,075) | 65,790 | 115,949 | (10,327) | 105,622 |
| treasury and other eligible bills | 643 | – | 643 | 1,120 | – | 1,120 |
| debt securities | 28,821 | – | 28,821 | 30,084 | – | 30,084 |
| loans and advances to banks | 16,568 | – | 16,568 | 38,258 | – | 38,258 |
| loans and advances to customers | 20,833 | (1,075) | 19,758 | 46,487 | (10,327) | 36,160 |
| Financial assets designated at fair value ¹ | 3,983 | – | 3,983 | 4,373 | – | 4,373 |
| debt securities | 3,983 | – | 3,983 | 4,373 | – | 4,373 |
| loans and advances to banks | – | – | – | – | – | – |
| Derivatives ² | 112,623 | (77,990) | 34,633 | 140,340 | (88,947) | 51,393 |
| Loans and advances held at amortised cost ³ | 281,746 | (59,561) | 222,185 | 242,774 | (47,492) | 195,282 |
| loans and advances to banks | 41,566 | – | 41,566 | 17,207 | – | 17,207 |
| loans and advances to customers | 240,180 | (59,561) | 180,619 | 225,567 | (47,492) | 178,075 |
| Financial investments ¹ | 44,594 | – | 44,594 | 36,116 | – | 36,116 |
| treasury and other similar bills | 1,927 | – | 1,927 | 4,922 | – | 4,922 |
| debt securities | 42,667 | – | 42,667 | 31,194 | – | 31,194 |
| Other assets | 4,722 | – | 4,722 | 4,280 | – | 4,280 |
| endorsements and acceptances | 343 | – | 343 | 525 | – | 525 |
| accrued income and other | 4,379 | – | 4,379 | 3,755 | – | 3,755 |
| Financial guarantees | 9,366 | – | 9,366 | 9,318 | – | 9,318 |
| Loan commitments and other credit-related commitments | 80,417 | – | 80,417 | 77,640 | – | 77,640 |
| | 666,686 | (138,626) | 528,060 | 677,265 | (146,766) | 530,499 |

1 Reported amounts exclude equity instruments.

2 The derivative offset amount in the 'maximum exposure to credit risk table' relates to exposures where the counterparty has an offsetting derivative exposure with the group, a master netting agreement is in place and the credit risk exposure is managed on a net basis, or the position is specifically collateralised, normally in the form of cash. At 31 December 2013, the total amount of such offsets was £113 billion (2012: £141 billion), of which £93 billion (2012: £122 billion) were offsets under a master netting arrangement, £17 billion (2012: £19 billion) were received in cash and £3 billion (2012: £0.1 billion) were other collateral. These amounts do not qualify for net presentation for accounting purposes as settlement may not actually be made on a net basis.

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

Collateral and other credit enhancements held

Loans and advances held at amortised cost

(Audited)

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

decision and pricing. In the event of a default, the group may utilise the collateral as a source of repayment.

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

Report of the Directors: Risk (continued)

The group may also manage its risk by employing other types of collateral and credit risk enhancements, such as second charges, other liens and unsupported guarantees, but the valuation of such mitigants is less certain and their financial effect has not been quantified. In particular, loans shown in the tables below as not collateralised may benefit from such credit mitigants.

Consequently, the figures in the tables below only quantify the value of fixed charges held over a specific asset (or assets) of a borrower where the group have a history of enforcing, and are able to enforce, the collateral in satisfying a debt in the event of a borrower failing to meet their contractual obligations and where the collateral is cash or can be realised in the form of cash by sale in an established market.

Personal Lending

Residential mortgages including loan commitments by level of collaterals (Audited)

The group

| | At 31 December 2013 £m | At 31 December 2012 £m |
|---|---------------------------|---------------------------|
| Fully collateralised | 88,249 | 86,583 |
| Less than 25% loan to value ('LTV') | 6,521 | 6,872 |
| 25% to 50% LTV | 26,126 | 22,009 |
| 51% to 75% LTV | 40,165 | 37,358 |
| 76% to 90% LTV | 13,262 | 16,392 |
| 91% to 100% LTV | 2,175 | 3,952 |
| Partially collateralised greater than 100% LTV | 917 | 1,835 |
| collateral value | 571 | 1,587 |
| Total residential mortgages | 89,166 | 88,418 |

The bank

| | At 31 December 2013 £m | At 31 December 2012 £m |
|---|---------------------------|---------------------------|
| Fully collateralised | 83,364 | 80,782 |
| Less than 25% loan to value ('LTV') | 6,268 | 6,430 |
| 25% to 50% LTV | 24,922 | 20,677 |
| 51% to 75% LTV | 37,703 | 34,461 |
| 76% to 90% LTV | 12,692 | 15,713 |
| 91% to 100% LTV | 1,779 | 3,501 |
| Partially collateralised greater than 100% LTV | 744 | 1,383 |
| collateral value | 479 | 1,210 |
| Total residential mortgages | 84,108 | 82,165 |

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

The LTV ratio is calculated as the gross on-balance sheet carrying amount of the loan and any off-balance sheet loan commitment at the balance sheet date divided by the value of collateral. The value of collateral is determined using professional valuations and house price

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

Report of the Directors: Risk (continued)*Mortgage lending by product type*
(Unaudited)

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

| | UK £m | Continental Europe £m |
|--|----------|-----------------------------|
| At 31 December 2013 | | |
| Total residential mortgage lending | 79,955 | 3,927 |
| Total impairment allowances on residential mortgage lending | (222) | (43) |
| Interest-only (including endowment) mortgages | 29,585 | 33 |
| Affordability mortgages, including adjustable rate mortgages | 1 | 306 |
| Other | 57 | - |
| Total interest-only and affordability mortgages | 29,643 | 339 |
| As a percentage of total mortgage lending | 37.1% | 8.6% |
| At 31 December 2012 | | |
| Total residential mortgage lending..... | 78,514 | 4,030 |
| Total impairment allowances on residential mortgage lending | (262) | (40) |
| Interest-only (including endowment) mortgages..... | 30,719 | 31 |
| Affordability mortgages, including ARMs..... | 1 | 330 |
| Other..... | 60 | - |
| Total interest-only and affordability mortgages | 30,780 | 361 |
| As a percentage of total mortgage lending..... | 39.2% | 9.0% |

Other personal lending

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

Corporate and commercial and financial non-bank lending
(Audited)

Collateral held is analysed separately for commercial real estate and for other corporate and commercial and

financial (non-bank) lending. This reflects the differing nature of collateral held on these portfolios. In each case, the analysis includes off-balance sheet commitments.

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

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

| | At 31 December 2013 £m | At 31 December 2012 £m |
|---|---------------------------|---------------------------|
| Rated CRR ¹ 1 to 7 | 18,972 | 20,398 |
| Uncollateralised | 2,943 | 4,374 |
| Fully collateralised | 14,418 | 14,114 |
| Partially collateralised | 1,611 | 1,910 |
| - collateral value (partially collateralised) | 1,105 | 1,720 |
| Rated CRR ¹ 8 to 10 | 2,855 | 2,271 |
| Uncollateralised | 408 | 259 |
| Fully collateralised | 1,132 | 1,032 |
| Partially collateralised | 1,315 | 980 |
| - collateral value (partially collateralised) | 947 | 581 |
| Total commercial real estate loans and advances | 21,827 | 22,669 |

¹ Customer risk rating ('CRR').

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

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

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

Report of the Directors: Risk (continued)

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

| | At 31 December 2013 | At 31 December 2012 |
|---|---------------------|---------------------|
| | £m | £m |
| Uncollateralised | 3,397 | 2,996 |
| Fully collateralised | 473 | 889 |
| - LTV ratio less than 25% | 25 | 42 |
| - 25% to 50% | 76 | 115 |
| - 51% to 75% | 158 | 179 |
| - 76% to 90% | 108 | 115 |
| - 90% to 100% | 106 | 438 |
| Partially collateralised | 819 | 836 |
| - collateral value | 415 | 519 |
| Total rated CRR/EL 8 to 10 | 4,689 | 4,721 |

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

It should be noted that the table above excludes other types of collateral which are commonly taken for corporate and commercial lending such as unsupported guarantees and floating charges over the assets of a customer's business. While such mitigants have value, often providing rights in insolvency, their assignable value is insufficiently certain and are therefore assigned no value in these disclosures.

As with commercial real estate, the value of real estate collateral included in the table above is determined through professional valuation. The frequency of

reevaluation is undertaken on a similar basis to commercial real estate loans and advances; however, for financing activities in corporate and commercial lending that are not predominantly commercial real estate oriented, collateral value is not as strongly correlated to principal repayment performance. Collateral values will generally be refreshed when an obligor's general credit performance deteriorates and it is necessary to assess the likely performance of secondary sources of repayment should reliance upon them prove necessary. For this reason, the table above reports values only for customers with CRR 8 to 10, reflecting that these loans and advances generally have valuations which are of comparatively recent vintage. For the purposes of the table above, cash is valued at its nominal value and marketable securities at their fair value.

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

Collateral and other credit enhancements obtained

(Audited)

| | The group | | The bank | |
|---|-----------|------|----------|------|
| | 2013 | 2012 | 2013 | 2012 |
| | £m | £m | £m | £m |
| Nature of assets | | | | |
| Residential property ¹ | 28 | 33 | 15 | 21 |

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

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

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

Report of the Directors: Risk (continued)**Loans and advances to customers by industry sector***(Audited)**The group*

| | At 31 December 2013 | | At 31 December 2012 | |
|--|---|---|---|---|
| | Gross loans and advances to customers £m | Gross loans by industry sector as a % of total gross loans % | Gross loans and advances to customers £m | Gross loans by industry sector as a % of total gross loans % |
| Personal | | | | |
| Residential mortgages | 83,882 | 27.20% | 82,544 | 28.87% |
| Other personal | 25,257 | 8.19% | 23,222 | 8.12% |
| | 109,139 | 35.39% | 105,766 | 36.99% |
| Corporate and commercial | | | | |
| Commercial, industrial and international trade | 79,826 | 25.89% | 78,176 | 27.34% |
| Commercial real estate | 18,755 | 6.08% | 20,504 | 7.17% |
| Other property-related | 4,421 | 1.43% | 4,580 | 1.60% |
| Government | 2,020 | 0.66% | 1,481 | 0.52% |
| Other commercial | 39,051 | 12.66% | 32,283 | 11.29% |
| | 144,073 | 46.72% | 137,024 | 47.92% |
| Financial | | | | |
| Non-bank financial institutions | 52,662 | 17.08% | 40,539 | 14.18% |
| Settlement accounts | 935 | 0.30% | 316 | 0.11% |
| | 53,597 | 17.38% | 40,855 | 14.29% |
| Other | 1,559 | 0.51% | 2,286 | 0.80% |
| Total gross loans and advances | 308,368 | 100.00% | 285,931 | 100.00% |

The bank

| | At 31 December 2013 | | At 31 December 2012 | |
|--|---|---|---|---|
| | Gross loans and advances to customers £m | Gross loans by industry sector as a % of total gross loans % | Gross loans and advances to customers £m | Gross loans by industry sector as a % of total gross loans % |
| Personal | | | | |
| Residential mortgages | 77,747 | 32.08% | 76,440 | 33.46% |
| Other personal | 8,963 | 3.70% | 8,939 | 3.91% |
| | 86,710 | 35.78% | 85,379 | 37.37% |
| Corporate and commercial | | | | |
| Commercial, industrial and international trade | 59,375 | 24.49% | 58,363 | 25.55% |
| Commercial real estate | 11,210 | 4.63% | 12,613 | 5.52% |
| Other property-related | 3,048 | 1.26% | 2,999 | 1.31% |
| Government | 1,448 | 0.60% | 987 | 0.43% |
| Other commercial | 30,756 | 12.69% | 24,798 | 10.85% |
| | 105,837 | 43.67% | 99,760 | 43.66% |
| Financial | | | | |
| Non-bank financial institutions | 47,980 | 19.79% | 41,030 | 17.95% |
| Settlement accounts | 281 | 0.12% | 36 | 0.02% |
| | 48,261 | 19.91% | 41,066 | 17.97% |
| Other | 1,559 | 0.64% | 2,286 | 1.00% |
| Total gross loans and advances | 242,367 | 100.00% | 228,491 | 100.00% |

Report of the Directors: Risk (continued)

Loans and advances to banks

(Audited)

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

Loans and advances to banks by level of collateral

(Audited)

| | At 31 December 2013 £m | At 31 December 2012 £m |
|---|---------------------------|---------------------------|
| Uncollateralised | 21,928 | 21,368 |
| Fully collateralised | 31,716 | 15,775 |
| Partially collateralised | 41 | 39 |
| - collateral value | 2 | 37 |
| Total loans and advances to banks | <u>53,685</u> | <u>37,182</u> |

The collateral used in the assessment of the above relates primarily to cash and marketable securities. Certain products such as reverse repurchase and stock borrowing are effectively collateralised and have been included in the table above, details of which are disclosed in Note 36 'Assets charged as security for liabilities and collateral accepted as security for assets'.

Derivatives

(Audited)

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

Items in the course of collection from other banks

(Audited)

Settlement risk arises in any situations where a payment in cash, securities or equities is made with the expectation of a corresponding receipt of cash, securities or equities.

Daily settlement limits are established for counterparties to cover the aggregate of transactions with each counterparty on any single day.

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

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

(Audited)

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

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

Credit quality of financial instruments

(Audited)

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

Report of the Directors: Risk (continued)

Credit quality

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

¹ The EL percentage is derived through a combination of Probability of Default ('PD') and Loss Given Default ('LGD') and may exceed 100 per cent in circumstances where the LGD is above 100 per cent reflecting the cost of recoveries.

Quality classification definitions

(Audited)

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

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

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

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

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

Risk rating scales

(Audited)

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

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

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

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

Report of the Directors: Risk (continued)

Distribution of financial instruments by credit quality

(Audited)

The group

| | 31 December 2013 | | | | | | | Total £m | |
|--|-------------------------------|--------------|--------|--------------------|------------------------|-----------------------------------|----------------|-------------|--------------------------------|
| | Neither past due nor impaired | | | | Sub- Standard £m | Past due not impaired £m | Impaired £m | | Impairment allowances £m |
| | Strong £m | Medium £m | | Satisfactory £m | | | | | |
| Cash and balances at central banks | 67,584 | - | - | - | - | - | - | 67,584 | |
| Items in the course of collection from other banks | 1,948 | - | - | - | - | - | - | 1,948 | |
| Trading assets | 69,228 | 18,062 | 10,289 | 511 | - | - | - | 98,090 | |
| - treasury and other eligible bills | 1,182 | 1,267 | 174 | - | - | - | - | 2,623 | |
| - debt securities | 45,892 | 7,145 | 2,991 | 386 | - | - | - | 56,414 | |
| - loans and advances to banks | 9,469 | 2,762 | 3,720 | 116 | - | - | - | 16,067 | |
| - loans and advances to customers | 12,685 | 6,888 | 3,404 | 9 | - | - | - | 22,986 | |
| Financial assets designated at fair value | 2,599 | 243 | 4,101 | 4 | - | - | - | 6,947 | |
| - treasury and other eligible bills | - | - | - | - | - | - | - | - | |
| - debt securities | 2,557 | 243 | 4,099 | 4 | - | - | - | 6,903 | |
| - loans and advances to banks | 42 | - | 2 | - | - | - | - | 44 | |
| - loans and advances to customers | - | - | - | - | - | - | - | - | |
| Derivatives | 109,827 | 20,714 | 6,186 | 512 | - | - | - | 137,239 | |
| Loans and advances held at amortised cost | 210,690 | 77,706 | 55,063 | 8,813 | 1,452 | 7,893 | (3,357) | 358,260 | |
| - loans and advances to banks | 40,601 | 7,969 | 3,272 | 1,383 | - | 24 | (21) | 53,228 | |
| - loans and advances to customers | 170,089 | 69,737 | 51,791 | 7,430 | 1,452 | 7,869 | (3,336) | 305,032 | |
| Financial investments | 63,005 | 5,662 | 2,122 | 1,731 | - | 1,504 | - | 74,024 | |
| - treasury and other eligible bills | 834 | 1,108 | 254 | - | - | - | - | 2,196 | |
| - debt securities | 62,171 | 4,554 | 1,868 | 1,731 | - | 1,504 | - | 71,828 | |
| Other assets | 4,967 | 431 | 1,765 | 257 | 5 | 14 | - | 7,439 | |
| - endorsements and acceptances | 387 | 16 | 300 | - | - | - | - | 703 | |
| - accrued income and other | 4,580 | 415 | 1,465 | 257 | 5 | 14 | - | 6,736 | |

Report of the Directors: Risk (continued)

The group

31 December 2012

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

Report of the Directors: Risk (continued)

The bank

31 December 2013

| | Neither past due nor impaired | | | | | | | Total £m |
|--|-------------------------------|------------|--------------------|------------------------|-----------------------------------|----------------|--------------------------------|-------------|
| | Strong £m | Medium | | Sub- Standard £m | Past due not impaired £m | Impaired £m | Impairment allowances £m | |
| | | Good £m | Satisfactory £m | | | | | |
| Cash and balances at central banks..... | 60,996 | – | – | – | – | – | – | 60,996 |
| Items in the course of collection from other banks | 1,374 | – | – | – | – | – | – | 1,374 |
| Trading assets | 48,701 | 10,837 | 6,833 | 494 | – | – | – | 66,865 |
| – treasury and other eligible bills | 532 | – | 111 | – | – | – | – | 643 |
| – debt securities | 23,779 | 2,424 | 2,232 | 386 | – | – | – | 28,821 |
| – loans and advances to banks | 12,657 | 1,960 | 1,852 | 99 | – | – | – | 16,568 |
| – loans and advances to customers | 11,733 | 6,453 | 2,638 | 9 | – | – | – | 20,833 |
| Financial assets designated at fair value | 2 | – | 3,981 | – | – | – | – | 3,983 |
| – debt securities | 2 | – | 3,981 | – | – | – | – | 3,983 |
| – loans and advances to banks | – | – | – | – | – | – | – | – |
| Derivatives | 88,217 | 18,499 | 5,443 | 464 | – | – | – | 112,623 |
| Loans and advances held at amortised cost | 172,280 | 56,568 | 40,597 | 7,870 | 562 | 6,072 | (2,203) | 281,746 |
| – loans and advances to banks | 29,277 | 4,545 | 4,886 | 2,127 | – | 747 | (16) | 41,566 |
| – loans and advances to customers | 143,003 | 52,023 | 35,711 | 5,743 | 562 | 5,325 | (2,187) | 240,180 |
| Financial investments | 42,756 | 1,151 | 534 | 43 | – | 110 | – | 44,594 |
| – treasury and other similar bills | 628 | 1,099 | 200 | – | – | – | – | 1,927 |
| – debt securities | 42,128 | 52 | 334 | 43 | – | 110 | – | 42,667 |
| Other assets | 3,775 | 390 | 554 | 3 | – | – | – | 4,722 |
| – endorsements and acceptances | 44 | 7 | 292 | – | – | – | – | 343 |
| – accrued income and other | 3,731 | 383 | 262 | 3 | – | – | – | 4,379 |

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

31 December 2012

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

Report of the Directors: Risk (continued)

Past due but not impaired gross financial instruments

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

indicators of impairment and the value of collateral is sufficient to repay both the principal debt and all potential interest for at least one year, or short-term trade facilities past due more than 90 days for technical reasons such as delays in documentation but there is no concern over the creditworthiness of the counterparty. When groups of loans are collectively assessed for impairment, collective impairment allowances are recognised for loans classified as past due but not impaired.

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

(Audited)

The group

| | Up to 29 days £m | 30-59 days £m | 60-89 days £m | 90-179 days £m | Over 180 days £m | Total £m |
|--|------------------------|---------------------|---------------------|----------------------|------------------------|--------------|
| At 31 December 2013 | | | | | | |
| Loans and advances held at amortised cost | 1,044 | 244 | 150 | 9 | 5 | 1,452 |
| Other assets | 3 | 1 | – | – | 1 | 5 |
| | 1,047 | 245 | 150 | 9 | 6 | 1,457 |
| At 31 December 2012 | | | | | | |
| Loans and advances held at amortised cost | 900 | 331 | 149 | 16 | 7 | 1,403 |
| Other assets | 3 | – | – | – | 1 | 4 |
| | 903 | 331 | 149 | 16 | 8 | 1,407 |

The bank

| | Up to 29 days £m | 30-59 days £m | 60-89 days £m | 90-179 days £m | Over 180 days £m | Total £m |
|--|------------------------|---------------------|---------------------|----------------------|------------------------|-------------|
| At 31 December 2013 | | | | | | |
| Loans and advances held at amortised cost | 351 | 129 | 82 | – | – | 562 |
| At 31 December 2012 | | | | | | |
| Loans and advances held at amortised cost | 371 | 143 | 101 | – | – | 615 |

Forbearance strategies and renegotiated loans

(Audited)

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

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

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

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

The group discloses loan forbearance as 'renegotiated loans', which represent payment

Report of the Directors: Risk (continued)

arrangement concessions granted which the group would not normally consider, as a result of financial difficulties of a customer.

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

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

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

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

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

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

Renegotiated loans and advances to customers

(Audited)

| | At 31 December 2013 | | | | At 31 December 2012 | | | |
|--|---------------------------------|---------------------------------|----------------|----------------|---------------------------------|---------------------------------|----------------|----------------|
| | Not past due nor impaired £m | Past due but not impaired £m | Impaired £m | Total £m | Not past due nor impaired £m | Past due but not impaired £m | Impaired £m | Total £m |
| Retail | | | | | | | | |
| Residential Mortgages | 399 | 150 | 551 | 1,100 | 420 | 131 | 622 | 1,173 |
| Other personal | 144 | 23 | 85 | 252 | 297 | 39 | 82 | 418 |
| Commercial real estate | 396 | 23 | 1,148 | 1,567 | 713 | – | 1,382 | 2,095 |
| Corporate and commercial | 690 | 94 | 2,045 | 2,829 | 877 | 57 | 1,325 | 2,259 |
| Financial | 56 | – | 86 | 142 | 5 | – | 199 | 204 |
| Governments | – | – | – | – | – | – | – | – |
| Total renegotiated loans and advances to customers | 1,685 | 290 | 3,915 | 5,890 | 2,312 | 227 | 3,610 | 6,149 |
| Impairment allowances: | | | | | | | | |
| Collectively assessed | | | | (27) | | | | (15) |
| Individually assessed | | | | (1,101) | | | | (1,063) |
| Total impairment allowance on renegotiated loans | | | | (1,128) | | | | (1,078) |

Impaired loans

(Audited)

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

- Wholesale loans and advances classified as CRR9, or CRR10. These grades are assigned when the bank considers that either the customer is unlikely to pay its credit obligations in full, without recourse to security, or when the customer is past due 90 days or more on any material credit obligation to the HSBC Group.
- Retail loans and advances classified as Expected Loss EL9 or EL10. These grades are assigned to retail loans and advances greater than 90 days or more past due unless individually they have been assessed as not impaired; or

Report of the Directors: Risk (continued)

- renegotiated loans and advances that have been subject to a change in contractual cash flows as a result of a concession which the group would not otherwise consider, and where it is probable that without the concession the borrower would be unable to meet its contractual payment obligations in full,

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

Impaired loans and advances to customers and banks by industry sector

(Audited)

| | Impaired loans and advances at 31 December 2013 | | | Impaired loans and advances at 31 December 2012 | | |
|--------------------------------|--|--------------------------------|--------------|--|--------------------------------|--------------|
| | Individually assessed £m | Collectively assessed £m | Total £m | Individually assessed £m | Collectively assessed £m | Total £m |
| Banks | 24 | – | 24 | 40 | – | 40 |
| Customers | 6,847 | 1,022 | 7,869 | 6,131 | 647 | 6,778 |
| Personal | 735 | 1,003 | 1,738 | 845 | 618 | 1,463 |
| Corporate and commercial | 5,789 | 19 | 5,808 | 4,941 | 29 | 4,970 |
| Financial | 323 | – | 323 | 345 | – | 345 |
| | 6,871 | 1,022 | 7,893 | 6,171 | 647 | 6,818 |

Impairment allowances and charges on loans and advances to customers

(Audited)

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

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

| | As at 31 December | |
|---|-------------------|------------|
| | 2013 £m | 2012 £m |
| Gross loans and advances | | |
| Individually assessed impaired loans ¹ | 6,847 | 6,131 |
| Collectively assessed ² | 301,521 | 279,800 |
| Impaired loans ¹ | 1,022 | 647 |
| Non-impaird loans ³ | 300,499 | 279,153 |
| Total gross loans and advances | 308,368 | 285,931 |
| Impairment allowances | | |
| Individually assessed | 2,402 | 2,327 |
| Collectively assessed | 934 | 919 |
| Total impairment allowances | 3,336 | 3,246 |
| Individually assessed allowances as a percentage of individually assessed loans and advances | 35.1% | 38.0% |
| Collectively assessed allowances as a percentage of collectively assessed loans and advances | 0.31% | 0.33% |

- Impaired loans and advances are those classified as CRR 9, CRR 10, EL 9 or EL 10 and all retail loans 90 days or more past due.
- Collectively assessed loans and advances comprise homogeneous groups of loans that are not considered individually significant, and loans subject to individual assessment where no impairment has been identified on an individual basis, but on which a collective impairment allowances has been calculated to reflect losses which have been incurred but not yet identified.
- Collectively assessed loans and advances not impaired are those classified as CRR1 to CRR8 and EL1 to EL8 but excluding retail loans 90 days past due.

Report of the Directors: Risk (continued)

Impairment allowances on loans and advances to customers and banks by industry sector

(Audited)

| | At 31 December 2013 | | | At 31 December 2012 | | |
|--------------------------------|--|--|------------------------|--|--|------------------------|
| | Individually assessed allowances £m | Collectively assessed allowances £m | Total allowances £m | Individually assessed allowances £m | Collectively assessed allowances £m | Total allowances £m |
| Banks | 21 | – | 21 | 24 | – | 24 |
| Customers | 2,402 | 934 | 3,336 | 2,327 | 919 | 3,246 |
| Personal | 256 | 585 | 841 | 296 | 565 | 861 |
| Corporate and commercial | 1,947 | 341 | 2,288 | 1,841 | 346 | 2,187 |
| Financial | 199 | 8 | 207 | 190 | 8 | 198 |
| | 2,423 | 934 | 3,357 | 2,351 | 919 | 3,270 |

Impairment allowances as a percentage of gross loans and advances¹

(Audited)

The group

| | At 31 December | |
|---|----------------|-----------|
| | 2013 % | 2012 % |
| <i>Banks</i> | | |
| Individually assessed impairment allowances | 0.09 | 0.13 |
| <i>Customers</i> | | |
| Individually assessed impairment allowances | 0.86 | 0.87 |
| Collectively assessed impairment allowances | 0.34 | 0.34 |
| | 1.29 | 1.34 |

The bank

| | At 31 December | |
|---|----------------|-----------|
| | 2013 % | 2012 % |
| <i>Banks</i> | | |
| Individually assessed impairment allowances | 0.06 | 0.13 |
| <i>Customers</i> | | |
| Individually assessed impairment allowances | 0.74 | 1.04 |
| Collectively assessed impairment allowances | 0.24 | 0.27 |
| | 1.04 | 1.44 |

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

Report of the Directors: Risk (continued)

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

(Audited)

The group

| | Banks | Customers | | Total £m |
|---|--------------------------------|--------------------------------|--------------------------------|--------------|
| | Individually assessed £m | Individually assessed £m | Collectively assessed £m | |
| At 1 January 2013 | 24 | 2,327 | 919 | 3,270 |
| Amounts written off | (3) | (822) | (561) | (1,386) |
| Recoveries of loans and advances written off in previous years | – | 32 | 374 | 406 |
| Charge to income statement | – | 859 | 243 | 1,102 |
| Disposal of subsidiary | – | – | – | – |
| Foreign exchange and other movements | – | 6 | (41) | (35) |
| At 31 December 2013 | 21 | 2,402 | 934 | 3,357 |
| At 1 January 2012 | 32 | 2,429 | 920 | 3,381 |
| Amounts written off | (7) | (942) | (526) | (1,475) |
| Recoveries of loans and advances written off in previous years | – | 35 | 179 | 214 |
| Charge to income statement | – | 875 | 338 | 1,213 |
| Disposal of subsidiary | – | (18) | (2) | (20) |
| Foreign exchange and other movements | (1) | (52) | 10 | (43) |
| At 31 December 2012 | 24 | 2,327 | 919 | 3,270 |

The bank

| | Banks | Customers | | Total £m |
|---|--------------------------------|--------------------------------|--------------------------------|--------------|
| | Individually assessed £m | Individually assessed £m | Collectively assessed £m | |
| At 1 January 2013 | 19 | 2,325 | 599 | 2,943 |
| Amounts written off | (3) | (1,438) | (473) | (1,914) |
| Recoveries of loans and advances written off in previous years | – | 32 | 331 | 363 |
| Charge to income statement | – | 717 | 76 | 793 |
| Foreign exchange and other movements | – | 12 | 6 | 18 |
| At 31 December 2013 | 16 | 1,648 | 539 | 2,203 |
| At 1 January 2012 | 26 | 2,786 | 602 | 3,414 |
| Amounts written off | (8) | (820) | (380) | (1,208) |
| Recoveries of loans and advances written off in previous years | – | 35 | 135 | 170 |
| Charge to income statement | 1 | 348 | 231 | 580 |
| Foreign exchange and other movements | – | (24) | 11 | (13) |
| At 31 December 2012 | 19 | 2,325 | 599 | 2,943 |

Report of the Directors: Risk (continued)

Movement in impairment allowances by industry sector

(Unaudited)

| | 2013 £m | 2012 £m | 2011 £m | 2010 £m | 2009 £m |
|---|--------------|--------------|--------------|--------------|--------------|
| Impairment allowances at 1 January | 3,270 | 3,381 | 3,580 | 3,649 | 2,545 |
| Amounts written off | (1,386) | (1,475) | (1,627) | (1,824) | (1,580) |
| Personal | (559) | (499) | (996) | (834) | (1,012) |
| – residential mortgages | (53) | (17) | (15) | (31) | (25) |
| – other personal | (506) | (482) | (981) | (803) | (987) |
| Corporate and commercial | (801) | (902) | (612) | (980) | (508) |
| – commercial, industrial and international trade | (430) | (416) | (345) | (247) | (275) |
| – commercial real estate and other property-related | (184) | (238) | (165) | (648) | (93) |
| – other commercial | (187) | (248) | (102) | (85) | (140) |
| Financial ¹ | (26) | (74) | (19) | (10) | (60) |
| Recoveries of amounts written off in previous years | 406 | 214 | 297 | 159 | 170 |
| Personal | 374 | 180 | 268 | 136 | 133 |
| – residential mortgages | 16 | 21 | 13 | 19 | 17 |
| – other personal | 358 | 159 | 255 | 117 | 116 |
| Corporate and commercial | 32 | 32 | 27 | 22 | 32 |
| – commercial, industrial and international trade | 11 | 11 | 11 | 11 | 30 |
| – commercial real estate and other property-related | 4 | 6 | 5 | 4 | 2 |
| – other commercial | 17 | 15 | 11 | 7 | – |
| Financial ¹ | – | 2 | 2 | 1 | 5 |
| Charge to income statement | 1,102 | 1,213 | 1,222 | 1,633 | 2,619 |
| Personal | 215 | 250 | 415 | 803 | 1,130 |
| – residential mortgages | (9) | (34) | 60 | 99 | 100 |
| – other personal | 224 | 284 | 355 | 704 | 1,030 |
| Corporate and commercial | 921 | 974 | 798 | 709 | 1,329 |
| – commercial, industrial and international trade | 518 | 420 | 261 | 322 | 543 |
| – commercial real estate and other property-related | 276 | 279 | 310 | 232 | 626 |
| – other commercial | 127 | 275 | 227 | 155 | 160 |
| Financial ¹ | (34) | (11) | 9 | 121 | 160 |
| Governments | – | – | – | – | – |
| Exchange and other movements | (35) | (63) | (91) | (37) | (105) |
| Impairment allowances at 31 December | 3,357 | 3,270 | 3,381 | 3,580 | 3,649 |
| Impairment allowances against banks: | | | | | |
| – individually assessed | 21 | 24 | 32 | 50 | 57 |
| Impairment allowances against customers: | | | | | |
| – individually assessed | 2,402 | 2,327 | 2,429 | 2,248 | 2,312 |
| – collectively assessed | 934 | 919 | 920 | 1,282 | 1,280 |
| Impairment allowances at 31 December | 3,357 | 3,270 | 3,381 | 3,580 | 3,649 |
| Impairment allowances against customers as a percentage of loans and advances to customers | % | % | % | % | % |
| – individually assessed | 0.80 | 0.83 | 0.84 | 0.78 | 0.84 |
| – collectively assessed | 0.31 | 0.33 | 0.32 | 0.45 | 0.47 |
| At 31 December | 1.11 | 1.16 | 1.16 | 1.23 | 1.31 |

¹ Includes movements in impairment allowances against banks.

Report of the Directors: Risk (continued)

Individually and collectively assessed charge to impairment allowances by industry segment

(Unaudited)

| | 2013 | | |
|---|-----------------------------|-----------------------------|-------------|
| | Individually assessed £m | Collectively assessed £m | Total £m |
| Banks | – | – | – |
| Personal | 8 | 207 | 215 |
| – Residential mortgages | (3) | (6) | (9) |
| – Other personal | 11 | 213 | 224 |
| Corporate and commercial | 886 | 35 | 921 |
| – Commercial, industrial and international trade | 505 | 13 | 518 |
| – Commercial real estate and other property-related | 260 | 16 | 276 |
| – Other commercial | 121 | 6 | 127 |
| Financial | (35) | 1 | (34) |
| Total charge to income statement | 859 | 243 | 1,102 |

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

Net loan impairment charge to the income statement

(Unaudited)

| | 2013 £m | 2012 £m | 2011 £m | 2010 £m | 2009 £m |
|--|------------|------------|------------|------------|------------|
| Individually assessed impairment allowances | | | | | |
| New allowances | 1,148 | 1,233 | 1,042 | 1,157 | 1,654 |
| Release of allowances no longer required | (257) | (323) | (236) | (256) | (167) |
| Recoveries of amounts previously written off | (32) | (35) | (19) | (22) | (44) |
| | 859 | 875 | 787 | 879 | 1,443 |
| Collectively assessed impairment allowances | | | | | |
| New allowances net of allowance required | 802 | 693 | 881 | 1,008 | 1,445 |
| Release of allowances no longer required | (185) | (176) | (168) | (117) | (143) |
| Recoveries of amounts previously written off | (374) | (179) | (278) | (137) | (126) |
| | 243 | 338 | 435 | 754 | 1,176 |
| Total charge for impairment losses | 1,102 | 1,213 | 1,222 | 1,633 | 2,619 |
| Banks | – | – | (7) | 2 | 35 |
| Customers | 1,102 | 1,213 | 1,229 | 1,631 | 2,584 |
| Charge for impairment losses as a percentage of closing gross loans and advances | 0.30 | 0.38 | 0.36 | 0.47 | 0.81 |
| At 31 December | £m | £m | £m | £m | £m |
| Impaired loans | 7,893 | 6,818 | 7,514 | 6,783 | 6,623 |
| Impairment allowances | 3,357 | 3,270 | 3,381 | 3,580 | 3,649 |

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

(Unaudited)

| | 2013 % | 2012 % | 2011 % | 2010 % | 2009 % |
|---|-----------|-----------|-----------|-----------|-----------|
| Net allowances net of allowances releases | 0.61 | 0.53 | 0.53 | 0.72 | 1.11 |
| Recoveries | (0.16) | (0.08) | (0.10) | (0.06) | (0.07) |
| Total charge for impairment losses | 0.45 | 0.45 | 0.43 | 0.66 | 1.04 |
| Amount written off net of recoveries | 0.40 | 0.46 | 0.46 | 0.67 | 0.63 |

Report of the Directors: Risk (continued)

Securitisation exposures and other structured products

(Audited)

This section contains information about the group's exposure to the following:

- Asset backed securities ('ABSs'), including mortgage-backed securities ('MBSs') and related collateralised debt obligations ('CDOs'); and
- Leveraged finance transactions.

Also included within this section is information on the Global Banking and Markets legacy credit activities in respect of Solitaire and the securities investment conduits ('SICs')

Analysis of asset-backed securities

(Audited)

| | Gross principal exposure ¹ £m | Gross principal protection ² £m | Net principal exposure ^{3,5} £m | Carrying Amount ^{4,5} £m | Of which held through consolidated SEs £m |
|-----------------------------------|---|---|---|--------------------------------------|--|
| At 31 December 2013 | | | | | |
| Mortgage-related assets: | | | | | |
| Sub-prime residential | 2,583 | – | 2,583 | 2,080 | 1,683 |
| US Alt-A residential | 3,204 | – | 3,204 | 2,083 | 1,770 |
| Other residential | 2,234 | – | 2,234 | 1,608 | 915 |
| Commercial property | 4,273 | – | 4,273 | 3,899 | 3,113 |
| Leveraged finance-related assets: | 3,301 | – | 3,301 | 3,196 | 2,607 |
| Student loan-related assets: | 2,876 | 60 | 2,816 | 2,329 | 2,114 |
| Other assets: | 6,786 | 4,585 | 2,201 | 1,587 | 598 |
| | 25,257 | 4,645 | 20,612 | 16,782 | 12,800 |
| At 31 December 2012 | | | | | |
| Mortgage-related assets: | | | | | |
| Sub-prime residential | 2,534 | – | 2,534 | 1,814 | 1,387 |
| US Alt-A residential | 3,939 | – | 3,939 | 2,194 | 1,852 |
| Other residential | 1,954 | – | 1,954 | 1,582 | 892 |
| Commercial property | 5,698 | – | 5,698 | 5,140 | 3,677 |
| Leveraged finance-related assets: | 3,656 | – | 3,656 | 3,396 | 2,662 |
| Student loan-related assets: | 3,439 | 62 | 3,377 | 2,645 | 2,301 |
| Other assets: | 7,775 | 5,188 | 2,587 | 1,975 | 694 |
| | 28,995 | 5,250 | 23,745 | 18,746 | 13,465 |

1 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.

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

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

4 Carrying amount of the Net Principal exposure. As at 31 December 2013 the carrying amount of the Gross Principal Exposure is £21,367 million (2012: £23,870 million).

5 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 (2013: 1GBP: USD 1.6531; 2012: 1GBP: USD 1.6163).

Included in the above table are securities with a carrying amount of £7,364 million (2012: £7,311 million) held through the SICs, excluding Solitaire, 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 the third party capital notes investors. The carrying amount of the capital notes liability at the year ended 31 December 2013 was £276 million (2012: £154 million).

Report of the Directors: Risk (continued)

At each reporting date, the group assesses whether there is any objective evidence of impairment in the value of the ABSs held by the SICs. Impairment charges incurred on these assets are offset by a credit to the impairment line for the amount of the loss allocated to capital note holders, subject to the carrying amount of the capital notes being sufficient to offset the loss.

Where the aggregate impairment charge exceeds the carrying value of the capital notes, liability write-backs of £13 million (2012: charge of £76 million) were attributed to the group.

Structured entities

The group enters into certain transactions with customers in the ordinary course of business which involve the establishment of structured entities ('SEs') to facilitate or secure customer transactions.

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

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

Securities investment conduits

Solitaire, the group's principal securities investment conduit ('SIC'), 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 structured investment vehicles ('SIVs') in 2008.

Multi-seller conduits

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

Money market funds

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

Non-money market investment funds

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

Securitisations

The group uses SEs 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.

Other

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

Third party sponsored SEs

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

Additional off-balance sheet arrangements and commitments

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

Leveraged finance transactions

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

Liquidity and funding risk

(Audited)

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

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

The group requires its operating entities to maintain strong liquidity positions and to manage the liquidity profiles of their assets, liabilities and commitments with the objective of ensuring that their cash flows are balanced appropriately and that all their anticipated obligations can be met when due.

Report of the Directors: Risk (continued)

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

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

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

The group's liquidity and funding management process includes:

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

event of difficulties arising from systemic or other crises, while minimising adverse long-term implications for the business.

Liquidity and funding in 2013

(Unaudited)

The liquidity position of the group strengthened in 2013, and it continued to enjoy strong inflows of customer deposits and maintained good access to wholesale markets. The group's loans and advances to customers during 2013 grew by 8 per cent and customer deposits by 20 per cent. HSBC UK recorded a decrease in its advances to core funding ('ACF') ratio to 100% at 31 December 2013 (2012: 106%) mainly because core deposits increased more than advances.

Liquidity regulation

(Unaudited)

The European adoption of the Basel Committee framework via legislative texts known as the Capital Requirements Regulation ('the Regulation') and the Capital Requirements Directive ('CRD IV') were published in June 2013. This requires the reporting of the liquidity coverage ratio ('LCR') and the net stable funding ratio ('NSFR') from March 2014. The regulatory LCR outlined in the regulation document has been initially set at 60 per cent from January 2015, increasing to 100 per cent by January 2018, although individual member states are able to set a higher standard. HSBC expects the PRA to set an 80 per cent standard in January 2015. During 2013, additional guidance was given on the definition of the LCR, much of which takes the form of an impact assessment and recommendations that have been submitted to the European Commission by the EBA. HSBC expects these recommendations to be materially adopted by the Commission into the final LCR delegated act on 30 June 2014. Regarding the finalisation of the NSFR metric, in January 2014 the Basel Committee on Banking Supervision issued a consultation document on a revised framework. This is intended to be implemented as a minimum standard at the beginning of January 2018.

The management of liquidity risk

(Audited)

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

Inherent liquidity risk categorisation

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

Report of the Directors: Risk (continued)

Advances to core funding ratio

The group emphasises the importance of core customer deposits as a source of funds to finance lending to customers and discourages reliance on short-term professional funding. This is achieved by placing limits on banking entities which restrict their ability to increase loans and advances to customers without corresponding growth in core customer deposits or long term debt funding. This measure is referred to as the 'advances to core funding' ratio.

Advances to core funding ratios¹
(Audited)

| | At 31 December | |
|--|----------------|-------------|
| | 2013 (%) | 2012 (%) |
| <i>HSBC UK²</i> | | |
| Year end | 100 | 106 |
| Maximum | 107 | 106 |
| Minimum | 100 | 100 |
| Average | 104 | 104 |
| <i>HSBC France</i> | | |
| Year end | 108 | 97 |
| Maximum | 114 | 97 |
| Minimum | 98 | 81 |
| Average | 106 | 88 |
| <i>Total of other principal group entities³</i> | | |
| Year end | 93 | 92 |
| Maximum | 97 | 93 |
| Minimum | 92 | 82 |
| Average | 94 | 88 |

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

² The HSBC UK entity shown comprises; HSBC Bank plc (including all overseas branches), Marks and Spencer Financial Services Limited, HFC Bank Limited and HSBC Trust Company (UK) Limited and from 1 April 2013 Private Bank (UK) Limited is managed as a single operating entity, in line with the application of UK liquidity regulation as agreed with the PRA.

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

Core deposits

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

Projected cash flow scenario analyses

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

bases. 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.

Advances to core funding ratio limits are set by the RMM. The ratio describes current loans and advances to customers as a percentage of the total of core customer deposits and term funding with a remaining term to maturity in excess of one year. Loans and advances to customers which are part of reverse repurchase arrangements, and where the group receives securities which are deemed to be liquid, are excluded from the advances to core funding ratio.

Stressed coverage ratios

(Audited)

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

At 31 December 2013, the one-month and three-month stressed coverage ratios for the principal entities shown in the table below were in excess of the 100 per cent target.

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

Report of the Directors: Risk (continued)

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

| | Stressed one-month coverage ratios at 31 December | | Stressed three-month coverage ratios at 31 December | |
|--|---|-------------|---|-------------|
| | 2013 (%) | 2012 (%) | 2013 (%) | 2012 (%) |
| <i>HSBC UK</i> | | | | |
| Year end | 106 | 114 | 109 | 103 |
| Maximum | 114 | 117 | 109 | 103 |
| Minimum | 100 | 108 | 101 | 101 |
| Average | 106 | 112 | 103 | 102 |
| <i>HSBC France</i> | | | | |
| Year end | 110 | 112 | 103 | 104 |
| Maximum | 112 | 118 | 104 | 108 |
| Minimum | 103 | 107 | 100 | 102 |
| Average | 108 | 111 | 103 | 105 |
| <i>Total of other principal group entities</i> | | | | |
| Year end | 106 | 114 | 102 | 106 |
| Maximum | 113 | 118 | 106 | 107 |
| Minimum | 104 | 106 | 102 | 102 |
| Average | 108 | 112 | 103 | 104 |

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

Liquid assets

(Audited)

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

Liquid assets are held and managed on a standalone operating entity basis. The vast majority of liquid assets shown are held directly by each operating entity's Balance Sheet Management function, primarily for the purpose of managing liquidity risk, in line with the Group's liquidity and funding risk management framework.

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

Liquid assets (Audited)

| | Estimated liquidity value at 31 December | |
|--|--|------------|
| | 2013 £m | 2012 £m |
| <i>HSBC UK</i> | | |
| Level 1 | 90,980 | 80,712 |
| Level 2 | 317 | 186 |
| Level 3 | 19,594 | 14,726 |
| Non-government assets | - | - |
| | 110,891 | 95,624 |
| <i>HSBC France</i> | | |
| Level 1 | 12,087 | 14,065 |
| Level 2 | 98 | 1,567 |
| Level 3 | 2,268 | 452 |
| Non-government assets | - | - |
| | 14,453 | 16,084 |
| <i>Total of other principal group entities</i> | | |
| Level 1 | 8,091 | 7,275 |
| Level 2 | 614 | 1,269 |
| Level 3 | 1,144 | 734 |
| Non-government assets | - | - |
| | 9,849 | 9,278 |

Report of the Directors: Risk (continued)

The Group's liquid asset policy is to apply a more granular classification of liquid assets. These classifications are as follows:

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

All assets held within the liquid asset portfolio are unencumbered.

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

Contingent liquidity risk arising from committed lending facilities

(Audited)

The group provides customers with committed facilities, including committed backstop lines to conduit vehicles sponsored by the group and standby facilities to corporate

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

| | The group | |
|--|-------------|-------------|
| | 2013 £bn | 2012 £bn |
| Conduit | | |
| Client-originated assets ¹ | | |
| – total lines | 7.6 | 6.3 |
| – largest individual lines | 0.4 | 0.4 |
| Assets managed by the group..... | 7.8 | 11.2 |
| Single-issuer liquidity facilities | | |
| – five largest ² | 2.7 | 3.7 |
| – largest market sector ³ | 5.8 | 6.8 |

1 *These exposures relate to Regency multi-seller conduit. This vehicle provides funding to group customers by issuing debt secured by a diversified pool of customer-originated assets.*

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

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

Primary sources of funding

(Audited)

Current accounts and savings deposits payable on demand or at short notice form a significant part of the group's funding, and the group places considerable importance on maintaining their stability. For deposits, stability depends upon preserving depositor confidence in the group's capital strength and liquidity, and on competitive and transparent pricing. The group's liquidity risk framework includes both monitoring depositor concentration to avoid undue reliance on large individual depositors and also limits the concentration of deposits from GB&M counterparties. The group also accesses professional markets in order to obtain funding for non-

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

The group-managed asset exposures relate to consolidated securities investment conduits, primarily Solitaire and Mazarin. These vehicles issue debt secured by asset backed-securities which are managed by the group. At 31 December 2013, the commercial paper issued by Solitaire and Mazarin was entirely funded by the group.

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

banking subsidiaries that do not accept deposits, to align asset and liability maturities and currencies and to maintain a presence in local money markets.

An analysis of cash flows payable by the group and bank under financial liabilities by remaining contractual maturities at the balance sheet date is included in Note 33 'Maturity analysis of assets and liabilities'.

The funding sources and uses table, which provides a consolidated view of how the balance sheet is funded, should be read in the light of the group's risk management framework, which requires its operating entities to manage liquidity and funding risk on a stand-alone basis. The table analyses the group balance sheet

Report of the Directors: Risk (continued)

according to the assets that primarily arise from operating activities and the sources of funding primarily supporting these activities. The assets and liabilities that do not arise from operating activities are presented as a net balancing source or deployment of funds.

In 2013, the level of customer accounts continued to exceed the level of loans and advances to customers.

Funding sources and deployment (Audited)

The group

| | At 31 December | |
|---|----------------|----------------|
| | 2013 £m | 2012 £m |
| Sources | | |
| Customer accounts | 390,017 | 324,886 |
| – repos | 38,039 | 12,207 |
| – cash deposits and other accounts | 351,978 | 312,679 |
| Deposits by banks | 50,683 | 39,571 |
| – repos | 20,863 | 6,357 |
| – cash deposits and other accounts | 29,820 | 33,214 |
| Debt securities issued | 32,895 | 40,358 |
| Liabilities of disposal groups held for sale | – | – |
| Subordinated liabilities | 10,785 | 10,350 |
| Financial liabilities designated at fair value | 34,036 | 32,918 |
| Liabilities under insurance contracts issued | 19,228 | 17,913 |
| Trading liabilities | 91,842 | 122,896 |
| – repos | 9,426 | 40,742 |
| – stock lending | 6,936 | 3,991 |
| – other | 75,480 | 78,163 |
| Total equity | 32,919 | 32,200 |
| | 662,405 | 621,092 |

Excluding the impact of repos from customer accounts and reverse repos from loans and advances to customers, the adjusted advances to deposit ratio at 31 December 2013 for the group was 78 per cent (2012: 85 per cent). The positive funding gap was predominantly deployed into liquid assets, cash and balances with central banks and financial investments, as required by the Group's liquidity and funding risk management framework.

| | At 31 December | |
|--|----------------|----------------|
| | 2013 £m | 2012 £m |
| Uses | | |
| Loans and advances to customers | 305,032 | 282,685 |
| – reverse repos | 29,091 | 16,890 |
| – loans or other receivables | 275,941 | 265,795 |
| Loans and advances to banks | 53,228 | 32,286 |
| – reverse repos | 30,023 | 13,798 |
| – loans or other receivables | 23,205 | 18,488 |
| Assets held for sale | 33 | 109 |
| Trading assets | 134,097 | 161,516 |
| – reverse repos | 5,607 | 35,951 |
| – stock borrowing | 6,241 | 6,863 |
| – other trading assets | 122,249 | 118,702 |
| Financial investments | 75,030 | 71,265 |
| Cash and balances at central banks | 67,584 | 51,613 |
| Net deployment in other balance sheet assets and liabilities | 27,401 | 21,618 |
| | 662,405 | 621,092 |

Wholesale term debt maturity profile

(Unaudited)

The maturity profile of the wholesale term debt obligations is set out in the table below 'Wholesale funding principal cash flows payable by the group under financial liabilities by remaining contractual maturities'.

The balances in the table will not agree directly with those in the consolidated balance sheet as the table

presents gross cash flows relating to principal payments and not the balance sheet carrying value, which includes debt securities and subordinated liabilities measured at fair value.

Wholesale funding cash flows payable by the group under financial liabilities by remaining contractual maturities
(Unaudited)

| | Due within 1 month £m | Due between 1 and 3 months £m | Due between 3 and 6 months £m | Due between 6 and 9 months £m | Due between 9 months and 1 year £m | Due between 1 and 2 years £m | Due between 2 and 5 years £m | Due after 5 years £m | Total £m |
|--------------------------------------|--------------------------------|---|---|---|---|--|--|-------------------------------|---------------|
| At 31 December 2013 | | | | | | | | | |
| Debt securities issued | 12,697 | 4,213 | 6,376 | 5,039 | 4,816 | 8,148 | 15,275 | 11,767 | 68,331 |
| – unsecured CDs and CP | 3,333 | 2,635 | 4,454 | 1,016 | 2,580 | – | – | – | 14,018 |
| – unsecured senior MTNs | 2,618 | 1,035 | 1,301 | 2,325 | 1,632 | 6,880 | 10,945 | 7,585 | 34,321 |
| – unsecured senior structured notes | 400 | 543 | 621 | 640 | 604 | 1,132 | 1,966 | 1,996 | 7,902 |
| – secured covered bonds | – | – | – | 756 | – | 136 | 1,662 | 2,007 | 4,561 |
| – secured ABCP | 6,281 | – | – | – | – | – | – | – | 6,281 |
| – secured ABS | – | – | – | 302 | – | – | 702 | – | 1,004 |
| – others | 65 | – | – | – | – | – | – | 179 | 244 |
| Subordinated liabilities | – | 17 | 40 | 10 | – | 31 | 214 | 11,521 | 11,833 |
| – subordinated debt securities | – | 17 | 40 | 10 | – | 31 | 214 | 10,498 | 10,810 |
| – preferred securities | – | – | – | – | – | – | – | 1,023 | 1,023 |
| | 12,697 | 4,230 | 6,416 | 5,049 | 4,816 | 8,179 | 15,489 | 23,288 | 80,164 |
| At 31 December 2012 | | | | | | | | | |
| Debt securities issued | 10,913 | 7,884 | 9,692 | 3,275 | 5,711 | 9,424 | 18,056 | 9,097 | 74,052 |
| – unsecured CDs and CP | 1,628 | 3,312 | 3,004 | 100 | 370 | – | – | – | 8,414 |
| – unsecured senior MTNs | – | 3,079 | 6,226 | 2,844 | 4,821 | 7,359 | 12,570 | 5,363 | 42,262 |
| – unsecured senior structured notes | 149 | 323 | 413 | 313 | 377 | 597 | 2,586 | 3,183 | 7,941 |
| – secured covered bonds | – | – | – | – | – | 773 | 1,632 | 511 | 2,916 |
| – secured ABCP | 9,022 | 1,170 | – | – | – | – | – | – | 10,192 |
| – secured ABS | 10 | – | – | – | 134 | 422 | 877 | 24 | 1,467 |
| – others | 104 | – | 49 | 18 | 9 | 273 | 391 | 16 | 860 |
| Subordinated liabilities | 4 | – | 28 | – | 6 | 27 | 153 | 11,182 | 11,400 |
| – subordinated debt securities | 4 | – | 28 | – | 6 | 27 | 153 | 10,185 | 10,403 |
| – preferred securities | – | – | – | – | – | – | – | 997 | 997 |
| | 10,917 | 7,884 | 9,720 | 3,275 | 5,717 | 9,451 | 18,209 | 20,279 | 85,452 |

Report of the Directors: Risk (continued)

Encumbered and unencumbered assets

(Unaudited)

The objective of this disclosure is to facilitate an understanding of available and unrestricted assets that could be used to support potential future funding and collateral needs.

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

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

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

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

(Unaudited)

| | 2013 £m | 2012 £m |
|--|------------|------------|
| Total on-balance sheet assets | 811,695 | 815,481 |
| Less: | | |
| – reverse repo/ stock borrowing receivables and derivative assets | (208,200) | (231,044) |
| – other assets that cannot be pledged as collateral | (83,249) | (99,722) |
| Total on-balance sheet assets that can support funding and collateral needs | 520,246 | 484,715 |
| Add: | | |
| – fair value of collateral received in relation to reverse repo/ stock borrowing that is available to sell or repledge | 108,471 | 122,502 |
| – fair value of collateral received in relation to derivatives that is available to sell or repledge | 2,773 | 224 |
| Total assets that can support future funding and collateral needs | 631,490 | 607,441 |
| Less: | | |
| – on-balance sheet assets pledged | (91,443) | (116,904) |
| – re-pledging of collateral received in relation to reverse repo/ stock borrowing | (79,844) | (80,072) |
| – re-pledging of collateral received in relation to derivatives | 336 | – |
| Total assets available to support funding and collateral needs | 460,539 | 410,465 |

Market risk

(Audited)

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

The group separates exposures to market risk into trading or non-trading portfolios.

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

For market risk arising in the group's insurance business, refer to page 70.

Monitoring and limiting market risk exposure

(Audited)

The group's objective is to manage and control market risk exposures while maintaining a market profile consistent with the group's risk appetite. The management of market risk is principally undertaken in Markets using risk limits allocated from the risk appetite,

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

Each operating entity is required to assess the market risks which arise on each product in the business and, where there is a risk that can be hedged in the markets, to transfer them to the local Markets unit for management. Where market risk is identified but there is no viable hedge in the market then the risk is managed under the supervision of the local Asset and Liability Management Committee ('ALCO'). The aim is to ensure that all market risks are consolidated within operations which have the necessary skills, tools, management and governance to manage them professionally. In certain cases where the market risks cannot be fully transferred, the group identifies the impact of varying scenarios on valuations or on net interest income resulting from any residual risk positions.

Report of the Directors: Risk (continued)

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

Value at risk and stressed value at risk

(Audited)

VAR is a technique that estimates the potential losses 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. Stressed VAR is primarily used for regulatory capital purposes but is integrated into the risk management process to facilitate efficient capital management and to highlight possible high-risk positions based on previous market volatility.

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

The historical simulation models used incorporate the following features:

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

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

The group routinely validates the accuracy of the VAR models by back-testing the hypothetical daily profit and loss results, adjusted to remove non-modelled items such as fees and commissions, against the corresponding VAR numbers. The expectation is, on average, to see losses in excess of VAR 1 per cent of the time over a one-year period.

The actual number of losses in excess of VAR over this period can therefore be used to gauge how well the

models are performing. In 2013, there were no loss exceptions for the group. Although a valuable guide to risk, VAR should always be viewed in the context of its limitations. For example:

- the use of historical data as a proxy for estimating future events may not encompass all potential events, particularly those which are extreme in nature;
- the use of a holding period assumes that all positions can be liquidated or the risks offset during that period. This may not fully reflect the market risk arising at times of severe illiquidity, when the holding period may be insufficient to liquidate or hedge all positions fully;
- the use of a 99 per cent confidence level, by definition does not take into account losses that might occur beyond this level of confidence;
- VAR is calculated on the basis of exposures outstanding at the close of business and therefore does not necessarily reflect intra-day exposures; and
- VAR is unlikely to reflect loss potential on exposures that only arise under significant market movements.

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

The RNIV framework aims to manage and capitalise material market risks that are not adequately covered in the VAR model. Risks covered by RNIV represent 13 per cent of RWAs (*unaudited*) as at 31 December 2013 and include those resulting from underlying risk factors which are not observable on a daily basis across asset classes and products, such as dividend risk and correlation risks. Risk factors are reviewed on a regular basis and either incorporated directly in the VAR models, where possible, or quantified through VAR-based RNIV approach, or a stress test approach within the RNIV framework. The severity of the scenarios is calibrated to be in line with the capital adequacy requirements. The outcome of the VAR-based RNIV is included in the VAR calculation and back-testing; a stressed VAR RNIV is also computed for the risk factors considered in the VAR-based RNIV approach.

The fair value of Level 3 assets in trading portfolios, comprising trading securities and derivatives, is immaterial. Market risk arising from Level 3 assets is managed by various market risk techniques such as stress testing and notional limits to limit the exposure.

Report of the Directors: Risk (continued)

Sensitivity analysis

(Unaudited)

Sensitivity measures are used to monitor the market risk positions within each risk type, for example, the present value of a basis point movement in interest rates for interest rate risk. Sensitivity limits are set for portfolios, products and risk types, with the depth of the market being one of the principal factors in determining the level of limits set.

Stress testing

(Audited)

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

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

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

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

Representative scenarios utilised for stress testing at the regional and global levels have included the following:

China hard landing: This scenario is designed to capture the effect of an economic slowdown in mainland China and in other emerging markets. The objective of this scenario is to quantify the impact of market reactions to an economic deterioration in Asia followed by Latin America. Under such an event, investors' risk aversion and drops in commodity prices are assumed to affect a range of market factors. Credit spreads and yield curves would rise while stock prices would fall, particularly in

the regions of focus. Emerging currencies would mostly depreciate against the US dollar.

US selective default: This scenario assumes that the US debt ceiling cannot be raised any higher and the US government defaults on a specific set of treasury bonds. This type of event is considered in two stages. A direct impact is assessed from missing coupons and bond principals. A secondary impact captures wider market reactions such as a sharp rise of short-term US interest rates, a widening of credit spreads, a flight to alternative safe havens to the US debt and the US dollar and a general risk aversion in emerging markets.

Currency de-peg: The managed peg of the Hong Kong dollar, renminbi and Middle Eastern currencies to the US dollar is assumed to break down. Wide and sudden exchange rate shocks for each currency pair are designed to capture the impact on the group's exposures.

Stress testing results are submitted to the GMB and Risk Management Committee ('RMC') meetings in order to provide senior management with an assessment of the financial effect such events would have. Risk management either provides recommendations to maintain exposures which are deemed to be acceptable or proposes mitigating actions that bring risk within its appetite.

In addition, a reverse stress test exercise is based upon the premise that there is a fixed loss. The stress test process identifies which scenarios lead to this loss. The rationale behind the reverse stress test is to understand scenarios which are beyond normal business settings that could have contagion and systemic implications.

Stressed VAR and stress testing, together with reverse stress testing and the management of gap risk (see pages 63 to 64), provide management with insights regarding the 'tail risk' beyond VAR. HSBC appetite for tail risk is limited.

Market risk reporting measures

(Audited)

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

| Risk type | Portfolio | |
|--------------------------------------|-----------|-----------------|
| | Trading | Non-trading |
| Foreign exchange and commodity | VAR | VAR |
| Interest rate | VAR | VAR/Sensitivity |
| Equity | VAR | Sensitivity |
| Credit spread..... | VAR | VAR |
| Structural foreign exchange..... | n/a | Sensitivity |

Structural foreign exchange risk is monitored using sensitivity analysis (see page 65). The reporting of commodity risk is consolidated with foreign exchange risk. There is no commodity risk in the non-trading portfolios. The interest rate risk on the fixed-rate securities issued by HSBC Holdings plc is not included in the Group VAR. The management of this risk is described on page 65.

Report of the Directors: Risk (continued)**Trading portfolios***(Audited)***Risk measurement and control**

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

*Value at risk of the trading portfolios**(Audited)**Trading value at risk*

| | 2013 | 2012 |
|-------------------------|-------------|------|
| | £m | £m |
| As at 31 December | 26.7 | 45.3 |
| Average | 28.3 | 43.7 |
| Minimum | 20.2 | 28.5 |
| Maximum | 45.2 | 76.1 |

This is analysed in the table below by risk type:

*VAR by risk type for trading activities**(Audited)*

| | Foreign exchange and commodity | Interest rate | Equity | Credit | Portfolio diversification¹ | Total² |
|----------------------------------|---|--------------------------|---------------|---------------|--|--------------------------|
| | £m | £m | £m | £m | £m | £m |
| At 31 December 2013 | 7.8 | 17.7 | 4.9 | 7.6 | (11.3) | 26.7 |
| At 31 December 2012 | 11.5 | 22.1 | 10.8 | 7.7 | (6.8) | 45.3 |
| Average | | | | | | |
| 2013 | 7.2 | 19.2 | 3.1 | 9.1 | (10.3) | 28.3 |
| 2012 | 13.0 | 24.5 | 6.3 | 14.8 | (14.9) | 43.7 |
| Minimum | | | | | | |
| 2013 | 3.6 | 14.5 | 1.5 | 5.9 | | 20.2 |
| 2012 | 4.8 | 17.1 | 2.0 | 5.8 | | 28.5 |
| Maximum | | | | | | |
| 2013 | 13.4 | 37.0 | 8.9 | 13.5 | | 45.2 |
| 2012 | 29.0 | 34.6 | 16.2 | 46.7 | | 76.1 |

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

2 The total VAR is non-additive across risk types due to diversification effect, and includes VAR RNIV.

The total VAR for trading activity at 31 December 2013 was lower than at 31 December 2012 primarily due to the defensive risk profile of the equity and foreign exchange businesses, together with a reduced exposure and volatility on equity dividends. These contributions and a higher diversification benefit across asset classes led to VAR trending lower during the period, even though a less defensive profile towards the end of the year resulted in a rising VAR.

Stressed value at risk of the trading portfolios*(Unaudited)*

Stressed VAR is primarily used for regulatory capital purposes but is integrated into the risk management process to facilitate efficient capital management and to highlight potentially risky positions based on previous market volatility. Stressed VAR complements other risk measures by providing the potential losses arising from market turmoil. Calculations are based on a continuous

Report of the Directors: Risk (continued)

one-year period of stress for the trading portfolio, based on the assessment at the Group level of the most volatile period in recent history.

The stressed VAR of trading portfolios was as follows:

Stressed VAR (one-day equivalent)

| | 2013 | 2012 |
|----------------------|------|------|
| | £m | £m |
| At 31 December | 30.1 | 99.2 |

Stressed VAR for trading portfolios reduced significantly mainly due to the defensive positions taken by the Equity and Foreign Exchange businesses at the start of 2013, together with a reduced exposure and volatility on equity dividends. As a result, the overall risk profile minimized the losses from highly volatile periods and led to a relatively low stressed VAR when compared with trading VAR. Stressed VAR increased towards the end of the year due to a less defensive profile in the same businesses. Of the £69.1 million reduction, £21.2 million was due to a change in the consolidation method.

Gap risk

(Unaudited)

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

Given their characteristics, these transactions make little or no contribution to VAR or to traditional market risk sensitivity measures. The group captures their risks within its stress testing scenarios and monitors gap risk on an ongoing basis. It regularly considers the probability of gap loss, and fair value adjustments are booked against this risk where significant.

Gap risk derived from certain transactions in legacy portfolios continued to be managed down during 2013. The residual exposure is immaterial. The group did not incur any material gap loss in 2013.

Non-trading portfolios

(Audited)

Risk measurement and control

The principal objective of market risk management of non-trading portfolios is to optimise net interest income.

Interest rate risk in non-trading portfolios arises principally from mismatches between the future yield

on assets and their funding cost, as a result of interest rate changes. Analysis of this risk is complicated by having to make assumptions on embedded optionality within certain product areas such as the incidence of mortgage prepayments, and from behavioural assumptions regarding the economic duration of liabilities which are contractually repayable on demand such as current accounts, and the re-pricing behaviour of managed rate products.

The group's control of market risk in the non-trading portfolios is based on transferring the assessed market risk of non-trading assets and liabilities created outside BSM or Markets, to the books managed by Balance Sheet Management ('BSM'), provided the market risk can be neutralised. The net exposure is typically managed by BSM through the use of fixed rate government bonds (liquid asset held in available for sale books) and interest rate swaps. The interest rate risk arising from fixed rate government bonds held within available for sale portfolios is reflected within the group's non-traded VAR. Interest rate swaps used by BSM are typically classified as either a fair value hedge or a cash flow hedge and included within the group's non-traded VAR. Any market risk that cannot be neutralised in the market is managed by local ALCO in segregated ALCO books.

The group's funds transfer pricing policies give rise to a two stage funds transfer pricing approach, reflecting the fact that the group separately manages interest rate risk and liquidity and funding risk, under different assumptions. The funds transfer pricing policies have been developed to be consistent with the Group's risk management frameworks. Each operating entity is required to apply the Group's transfer pricing policy framework to determine for each material currency the most appropriate interest rate transfer pricing curve, a liquidity premium curve (spread over the interest rate risk transfer pricing curve) and a liquidity recharge assessment (spread under/over the interest rate risk transfer pricing curve).

The interest rate risk transfer pricing policy seeks to ensure that all market interest rate risk arising structurally from non-trading (banking book) assets and liabilities, which can be neutralised externally in the market or neutralised internally by off-setting transfers, is transferred to BSM to be managed centrally, as a non-traded market risk. The transfer price curve used is required to best reflect how BSM in each operating entity would be able to neutralise the interest rate risk in the market at the point of transfer. For each material currency each operating entity employs a single interest rate risk transfer pricing curve and a single liquidity premium curve. Where market re-pricing basis risk can be identified between an external asset or external liability and the re-pricing basis of the interest rate risk transfer pricing curve, the basis risk can be transferred

Report of the Directors: Risk (continued)

to BSM as non-traded market risk, provided BSM can neutralise the basis risk in the market.

VAR of the non-trading portfolios (Audited)

| | 2013 | 2012 |
|-------------------------|------|-------|
| | £m | £m |
| As at 31 December | 44.8 | 61.2 |
| Average | 54.4 | 97.1 |
| Minimum | 44.8 | 57.1 |
| Maximum | 65.4 | 171.0 |

This is analysed in the table below by risk type:

| | Interest rate | Credit spread | Portfolio diversification | Total |
|---------------|---------------|---------------|---------------------------|-------------|
| | £m | £m | £m | £m |
| 2013 | 44.9 | 29.4 | (29.4) | 44.8 |
| Average | 41.6 | 41.3 | (28.5) | 54.4 |
| Minimum | 32.0 | 27.0 | | 44.8 |
| Maximum | 63.2 | 52.6 | | 65.4 |
| 2012 | 33.8 | 54.6 | (27.2) | 61.2 |
| Average | 38.8 | 101.3 | (43.0) | 97.1 |
| Minimum | 29.7 | 54.6 | | 57.1 |
| Maximum | 56.8 | 188.4 | | 171.0 |

The decrease of non-trading VAR during 2013 was primarily due to the reduced contribution of credit spread risks, as a result of lower volatilities and credit spread baselines utilised in the VAR calculations.

Credit spread risk for available-for-sale debt securities

The risk associated with movements in credit spreads is primarily managed through sensitivity limits, stress testing and VAR. The VAR shows the effect on income from a one-day movement in credit spreads over a two-year period, calculated to a 99% confidence interval.

Credit spread VAR for available-for-sale debt securities, excluding those held in insurance operations, is included in the group non-trading VAR. However, SICs, which are off balance sheet, are not included.

At 31 December 2013, the sensitivity of equity capital to the effect of movements in credit spreads on the available-for-sale debt securities, including the gross exposure for the SICs consolidated within the balance sheet, based on credit spread VAR, was £49.8 million (2012: £76.0 million). This sensitivity was calculated before taking into account losses which would have been absorbed by the capital note holders. Excluding the gross exposure for SICs consolidated in the balance sheet, this exposure reduced to £29.4 million (2012: £54.6 million).

The decrease in this sensitivity at 31 December 2013 compared with 31 December 2012 was mainly due to the effect of lower volatility and level of credit spreads observed during 2013.

At 31 December 2013, the capital note holders would absorb the first £1.4 billion (2012: £1.4 billion) of any losses incurred by the SICs prior to the group incurring any equity losses. As at 31 December 2013

£7m of losses have been recorded by the group as a result of the capital note value in one of the SICs being wiped out by impairments.

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 £16.6 million at 31 December 2013 (2012: £24.8 million); while the average, minimum and maximum during the year was £24.6 million, £16.5 million and £29.7 million respectively (2012: £32.9 million, £17.3 million and £37.7 million).

Equity securities held as available-for-sale

Potential new commitments are subject to risk appraisal to ensure that industry and geographical concentrations remain within acceptable levels for the portfolio. Regular reviews are performed to substantiate the valuation of the investments within the portfolio and investments held to facilitate on-going business, such as holdings in government-sponsored enterprises and local stock exchanges.

Market risk arises on equity securities held as available-for-sale. The fair value of these securities at 31 December 2013 was £1,006 million (2012: £1,029 million).

The fair value of the constituents of equity securities held as available-for-sale can fluctuate considerably. For details of the impairment incurred on available-for-sale equity securities see the accounting policies in Note 2(i).

Structural foreign exchange exposures

(Unaudited)

Structural foreign exchange exposures represent net investments in subsidiaries, branches and associates, the functional currencies of which are currencies other than sterling. An entity's functional currency is that of the primary economic environment in which the entity operates.

Exchange differences on structural exposures are recognised in other comprehensive income.

The group hedges structural foreign currency exposures only in limited circumstances. The group's structural foreign exchange exposures are managed with the primary objective of ensuring, where practical, that the group's consolidated capital ratios and the capital ratios of individual banking subsidiaries are largely protected from the effect of changes in exchange rates. This is usually achieved by ensuring that, for each subsidiary bank, the ratio of structural exposures in a given currency to risk-weighted assets denominated in that currency is broadly equal to the capital ratio of the subsidiary in question.

Report of the Directors: Risk (continued)

The group may also transact hedges where a currency in which the group have structural exposures is considered likely to revalue adversely and it is possible in practice to transact a hedge. Any hedging is undertaken using forward foreign exchange contracts which are accounted for under IFRSs as hedges of a net investment in a foreign operation, or by financing with borrowings in the same currencies as the functional currencies involved.

For details of structural foreign exchange exposures see Note 35 'Foreign exchange exposures'.

Sensitivity of net interest income

(Unaudited)

A principal element of the group's management of market risk in non-trading portfolios is monitoring the sensitivity of projected net interest income under varying interest rate scenarios (simulation modelling). The group aims to mitigate the effect of prospective interest rate movements which could reduce future net interest income, while balancing the cost of hedging such activities on the current revenue stream.

The group applies a combination of scenarios and assumptions relevant to their local businesses, and standard scenarios which are required throughout HSBC. The latter are consolidated to illustrate the combined pro forma effect on the consolidated net interest income.

Defined benefit pension scheme

(Audited)

Market risk also arises within the group's defined benefit pension schemes to the extent that the obligations of the schemes are not fully matched by assets with determinable cash flows. Pension scheme obligations fluctuate with changes in long-term interest rates, inflation, salary increases and the longevity of scheme members. Pension scheme assets will include equities and debt securities, the cash flows of which change as equity prices and interest rates vary. There are risks that market movements in equity prices and interest rates could result in assets which are insufficient over time to cover the level of projected obligations and these, in turn, could increase with a rise in inflation and members living longer. Management, together with the trustees who act on behalf of the pension scheme beneficiaries, assess these risks using reports prepared by independent external actuaries and takes action and, where appropriate, adjust investment strategies and contribution levels accordingly.

The present value of the group's defined benefit pension schemes' liabilities was £18.5 billion at 31 December 2013 compared with £16.9 billion at 31 December 2012. Assets of the defined benefit schemes at 31 December 2013 comprised: equity investments 15 per cent (13 per cent at 31 December 2012); debt securities 55 per cent (58 per cent at 31 December 2012), contractually linked instruments 9 per cent (0 per

cent at 31 December 2012), property 4 per cent (5 per cent at 31 December 2012), derivatives 9 per cent (18 per cent at 31 December 2012) and 'other' 8 per cent (6 per cent at 31 December 2012).

Operational risk

(Unaudited)

Operational risk is the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events, including legal risk (along with accounting, tax, security and fraud, people, systems, projects, operations and organisational change risk). It arises from day to day operations or external events, is relevant to every aspect of the group's business, and covers a wide spectrum of issues, in particular legal, compliance, security and fraud. Losses and reputational damage arising from breaches of regulation and law, unauthorised activities, error, omission, inefficiency, fraud, systems failure or external events all fall within the definition of operational risk, and its scope covers both prudential and conduct risk matters.

Responsibility for minimising operational risk lies with group's management and staff. Each country, business unit and function is required to implement appropriate internal controls to manage the operational risks of the business and operational activities for which they are responsible.

Operational risk management framework

The Operational Risk function and the operational risk management framework ('ORMF') assist management in discharging their responsibilities.

The ORMF defines minimum standards and processes, and the governance structure for operational risk and internal control across the Group. To implement the ORMF, a 'three lines of defence' model is used for the management of risk, as described below:

The first line of defence is the business who are responsible for ensuring that all key risks within their operations are identified, mitigated and monitored by appropriate internal controls within an overall control environment. Every employee is responsible for the risks that are a part of their day-to-day jobs.

The second line of defence consists of the Functions, such as Risk (including Regulatory and Financial Crime Compliance), Finance and HR who are responsible for providing oversight and challenge of the activities conducted by the first line.

The third line of defence covers the role of Internal Audit, who provide independent assurance over the first and second lines of defence.

The ORMF consists of a number of components, including:

- Risk and Control Assessments ('RCAs'), which are used to identify and assess the material business risks and controls;

Report of the Directors: Risk (continued)

- Key Indicators, which are used to help monitor the risks and controls;
- Top Risk Analysis, which provide management with a quantified view of specific operational risks;
- Internal incidents, which are used to forecast typical losses; and
- External data, which is used to inform the group's risk assessments.

Management continues to refine ORMF activities and further embed the use of the framework across the group.

Articulating the risk appetite for material operational risks helps the bank's management understand the level of risk that it is willing to accept. Monitoring operational risk exposure against the approved risk appetite measures on a regular basis, and implementing risk acceptance processes, drives risk awareness in a forward-looking manner. It assists management in determining whether further action is required to proactively manage operational risks within acceptable levels. Appropriate means of mitigation and controls include:

- making specific changes to strengthen the internal control environment;
- investigating whether cost-effective insurance cover is available to mitigate the risk; and
- other means of protecting us from loss.

A centralised database is used to record the results of the operational risk management process. RCAs are input and maintained by business units, and action plans monitored. To ensure that operational risk losses are consistently reported and monitored at country, regional and group level, all business units/functions are required to report individual losses when the net loss is expected to exceed US\$10,000. Reviews (for lessons learnt and root causes) are performed around significant incidents/losses or when trends arise, to improve processes and controls.

Legal risk

Each operating company is required to have processes and procedures to manage legal risk that conform to Group standards. Legal risk falls within the definition of operational risk and includes:

- contractual risk, which is the risk of a group company suffering financial loss, legal or regulatory action or reputational damage because its rights and/or obligations under a contract to which it is a party are technically defective;
- dispute risk, which is the risk of a group company suffering financial loss or reputational damage due to adverse dispute environment or management of disputes;

- legislative risk, which is the risk that a group company fails to adhere to the laws of the jurisdictions in which it operates; and
- non-contractual rights risk, which is the risk that a group company's assets are not properly owned or protected or are infringed by others, or a group company infringes another party's rights.

The group has a legal function, headed by the General Counsel for Europe, to assist management in controlling legal risk. The function provides legal advice and support in managing claims against the group's companies, as well as in respect of non-routine debt recoveries or other litigation against third parties. There are legal departments in a number of countries in which the group operates.

The group's operating companies must notify the appropriate legal department immediately any litigation is either threatened or commenced against the group or an employee. Any claims which exceed £1.5 million must be advised to the General Counsel for Europe. The General Counsel for Europe must also be immediately advised of any action by a regulatory authority, where the proceedings are criminal, or where the claim might materially affect the group's reputation.

In addition, the group's operating companies are required to submit semi annual returns detailing outstanding claims where the claim (or group of similar claims) exceeds US\$10 million, where the action is by a regulatory authority, where the proceedings are criminal or where the claim might materially affect the group's reputation. These returns are used for reporting to various committees within the group.

Compliance risk

Compliance risk falls within the definition of operational risk. All group companies are required to observe the letter and spirit of all relevant laws, codes, rules, regulations and standards of good market practice. These rules, regulations, other standards and group policies include those relating to anti-money laundering, anti-bribery and corruption, conduct of business, market conduct, counter-terrorist financing and sanctions compliance.

In 2013, the Group appointed a new Head of Group Financial Crime Compliance with particular expertise and experience in US law and regulation. When the Group appointed a new Global Head of Regulatory Compliance in April 2013 the Group restructured its previous Compliance sub-function within Global Risk into two new sub-functions: Financial Crime Compliance and Regulatory Compliance, jointly supported by Compliance Shared Services. The Group structure has been replicated by the group during the year.

This restructuring allows the Group to:

- manage different types of regulatory and financial crime compliance risk more effectively;

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- focus the group's efforts appropriately in addressing the issues highlighted by regulatory investigations and reviews, internal audits and risk assessments of its past business activities; and
- ensure it has in place clear, robust accountability and appropriate expertise and processes for all areas of compliance risk.

Financial Crime Compliance will focus on setting policy and managing risks in the following areas:

- anti-money laundering, counter terrorist financing and proliferation finance;
- sanctions; and
- anti-bribery and corruption.

Regulatory Compliance will focus on setting policy and managing risks in the following areas:

- conduct of business;
- market conduct; and
- general regulatory compliance management including stakeholder support.

In 2013, the group continued to experience increasing levels of compliance risk as regulators and other agencies pursued investigations into historic activities and as the group continued to work with them in relation to already identified issues. These included:

- the mis-selling of interest rate derivative products to SMEs in the UK and the settlement of claims by the group to provide appropriate redress;
- investigations related to certain past submissions made by panel banks in connection with the setting of LIBOR, EURIBOR and other interest rates. As certain HSBC entities are members of such panels, HSBC Holdings and certain of its subsidiaries have been the subject of regulatory demands for information; and
- ongoing investigations by US regulatory and law enforcement authorities into Group compliance with anti-money laundering laws, the BSA and OFAC sanctions. The Group has previously disclosed these matters and has co-operated with relevant US authorities since 2010.

Group security and fraud risk

Security and Fraud Risk, Europe, which has responsibility for physical risk, fraud, information and contingency risk, takes functional direction from Group Security and Fraud Risk. This enables management to identify and mitigate the permutations of these and other non-financial risks across the countries in which the group operates. All group companies manage their risk in accordance with standards set by Security and Fraud Risk, Europe, which also provide expert advice and support.

Risk management of insurance operations

(Audited)

The group operates an integrated bancassurance model which provides wealth and protection insurance products principally for customers with whom the group has a banking relationship. Insurance products are sold through all global businesses, predominantly by Retail Banking and Wealth Management and Commercial Banking, through branches and direct channels.

The insurance contracts the group sells relate to the underlying needs of the group's banking customers, which it can identify from its point-of-sale contacts and customer knowledge. The majority of sales are of savings and investment products and term and credit life contracts. By focusing largely on personal and SME lines of business, the group is able to optimise volumes and diversify individual insurance risks.

In 2013 the group has ceased distribution of pension and investment products through independent financial advisors in the UK. In the UK the group focusses on growing the protection business.

Where the group has the operational scale and risk appetite, mostly in life insurance, these insurance products are manufactured by the group's companies. Manufacturing insurance allows the group to retain the risks and rewards associated with writing insurance contracts as both the underwriting profit and the commission paid by the manufacturer to the bank distribution channel are kept within the group.

Where the group does not have the risk appetite or operational scale to be an effective manufacturer, a handful of leading external insurance companies are engaged in order to provide insurance products to the group's customers through its banking network and direct channels. These arrangements are generally structured with the group's exclusive strategic partners and earn the group a combination of commissions, fees and a share of profits.

The majority of the risk in the group's insurance business derives from manufacturing activities and can be categorised between financial risks, including market risk, credit risk and liquidity risk and insurance risk.

Insurance manufacturers set their own control procedures in addition to complying with guidelines issued by the Group Insurance. Country level oversight is exercised by local Risk Management Committees. Country Chief Risk Officers have direct reporting lines into local Insurance Chief Executive Officers and functional reporting lines into the Group Insurance Chief Risk Officer, who has overall accountability for risk management in insurance operations. The Group Insurance Executive Committee oversees the framework globally and is accountable to the Risk Management Committee on risk matters.

Report of the Directors: Risk (continued)

In addition, local ALCOs monitor and review the duration and cash flow matching of insurance assets and liabilities.

All insurance products, whether manufactured internally or by a third party, are subjected to a product approval process prior to introduction.

Risk management of insurance operations in 2013

This section provides disclosures on the risks arising from insurance manufacturing operations including financial risks such as market risk, credit risk and liquidity risk, and insurance risk.

Risks in these operations are managed within the insurance entities using methodologies and processes appropriate to the insurance activities, but remain subject to oversight at Group level.

Financial risks of insurance operations

The group's insurance businesses are exposed to a range of financial risks which can be categorised into:

- Market risk – risks arising from changes in the fair values of financial assets or their future cash flows from fluctuations in variables such as interest rates, foreign exchange rates and equity prices;

- Credit risk – risk of financial loss following the default of third parties to meet their obligations; and
- Liquidity risk – risk of not being able to make payments to policyholders as they fall due as a result of insufficient assets that can be realised as cash.

Local regulatory requirements prescribe the type, quality and concentration of assets that the group's insurance manufacturing companies must maintain to meet insurance liabilities. These requirements complement Group-wide policies.

The following table analyses the assets held in the group's insurance manufacturing companies by type of contract, and provides a view of the exposure to financial risk. For unit-linked contracts, which pay benefits to policyholders which are determined by reference to the value of the investments supporting the policies, the group typically designate assets at fair value; for non-linked contracts, the classification of the assets is driven by the nature of the underlying contract.

Financial assets held by insurance manufacturing subsidiaries (Audited)

| | At 31 December 2013 | | | |
|--|-----------------------------|----------------------------|--------------------|---------------|
| | Unit-linked contracts £m | Non-linked contracts £m | Other assets £m | Total £m |
| Financial assets designated at fair value | | | | |
| Debt securities | 2,265 | 544 | 25 | 2,834 |
| Equity securities | 5,311 | 3,871 | 530 | 9,712 |
| | 7,576 | 4,415 | 555 | 12,546 |
| Financial investments - available-for-sale | | | | |
| Debt securities | – | 10,113 | 823 | 10,936 |
| Equity securities | – | – | – | – |
| | – | 10,113 | 823 | 10,936 |
| Derivatives | 5 | 130 | 30 | 165 |
| Other financial assets | 262 | 1,408 | 203 | 1,873 |
| | 7,843 | 16,066 | 1,611 | 25,520 |

Report of the Directors: Risk (continued)

| | At 31 December 2012 | | | |
|--|--------------------------------|-------------------------------|-----------------------|---------------|
| | Unit-linked contracts £m | Non-linked contracts £m | Other assets £m | Total £m |
| Financial assets designated at fair value | | | | |
| Debt securities | 1,983 | 565 | 101 | 2,649 |
| Equity securities | 4,493 | 3,428 | 313 | 8,234 |
| | <u>6,476</u> | <u>3,993</u> | <u>414</u> | <u>10,883</u> |
| Financial investments - available-for-sale | | | | |
| Debt securities | – | 10,011 | 577 | 10,588 |
| Equity securities | – | 4 | 12 | 16 |
| | <u>–</u> | <u>10,015</u> | <u>589</u> | <u>10,604</u> |
| Derivatives | 10 | 72 | 43 | 125 |
| Other financial assets | 379 | 868 | 191 | 1,438 |
| | <u>6,865</u> | <u>14,948</u> | <u>1,237</u> | <u>23,050</u> |

Approximately 54 per cent of financial assets were invested in debt securities at 31 December 2013 (2012: 57 per cent), with 38 per cent invested in equity securities (2012: 36 per cent).

Under unit-linked insurance contracts, premium income less charges levied is invested in a portfolio of assets. The group manages the financial risks of this product on behalf of the policyholders by holding appropriate assets in segregated funds or portfolios to which the liabilities are linked. These assets represented 31 per cent of the total financial assets of the group's insurance manufacturing companies at the end of 2013 (2012: 30 per cent).

The remaining financial risks are managed either solely on behalf of the shareholder, or jointly on behalf of the shareholder and policyholders where discretionary participation features exist.

Market risk of insurance operations

Market risk arises when mismatches occur between product liabilities and the investment assets which back them. For example, mismatches between asset and liability yields and maturities give rise to interest rate risk.

The main features of products manufactured by the group's insurance manufacturing companies which generate market risk, and the market risk to which these features expose the companies, are discussed below.

Long-term insurance or investment products may incorporate benefits that are guaranteed. Interest rate risk arises to the extent that yields on the assets supporting guaranteed investment returns are lower than the investment returns implied by the guarantees payable to policyholders.

The proceeds from insurance and investment products with DPFs are primarily invested in bonds with

a proportion allocated to other asset classes in order to provide customers with the potential for enhanced returns. Subsidiaries with portfolios of such products are exposed to the risk of falls in the market prices when they cannot be fully reflected in the discretionary bonuses. An increase in market volatility could also result in an increase in the value of the guarantee to the policyholder.

Long-term insurance and investment products typically permit the policyholder to surrender the policy or let it lapse at any time. When the surrender value is not linked to the value realised from the sale of the associated supporting assets, the subsidiary is exposed to market risk. In particular, when customers seek to surrender their policies when asset values are falling, assets may have to be sold at a loss to fund redemptions.

For unit-linked contracts, market risk is substantially borne by the policyholder, but market risk exposure typically remains as fees earned for management are related to the market value of the linked assets.

Each insurance manufacturing subsidiary manages market risk by using some or all of the following techniques:

- for products with DPFs, adjusting bonus rates to manage the liabilities to policyholders. The effect is that a significant portion of the market risk is borne by the policyholder;
- structuring asset portfolios to support liability cash flows;
- using derivatives, to a limited extent, to protect against adverse market movements or better match liability cash flows;
- for new products with investment guarantees, considering the cost when determining the level of premiums or the price structure;

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- periodically reviewing products identified as higher risk, which contain investment guarantees and embedded optionality features linked to savings and investment products;
- including features designed to mitigate market risk in new products;
- exiting, to the extent possible, investment portfolios whose risk is considered unacceptable; and
- repricing of premiums charged to policyholders.

The group's insurance manufacturing companies monitor exposures against mandated limits regularly and report these quarterly to Group Insurance. Exposures are aggregated and reported on a quarterly basis to senior risk management forums in Group Insurance.

Standard measures for quantifying market risks are as follows:

- for interest rate risk, the sensitivities of the net present values of asset and expected liability cash flows, in total and by currency, to a one basis point parallel upward shift in the discount curves used to calculate the net present values;
- for equity price risk, the total market value of equity holdings and the market value of equity holdings by region and country; and
- for foreign exchange risk, the total net short foreign exchange position and the net foreign exchange positions by currency.

The standard measures are relatively straightforward to calculate and aggregate, but they have limitations. The

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

| | 2013 | | 2012 | |
|---|-------------------------------------|------------------------------|-------------------------------------|------------------------------|
| | Effect on profit for the year £m | Effect on total equity £m | Effect on profit for the year £m | Effect on total equity £m |
| + 100 basis points parallel shift in yield curves | (1) | (12) | (3) | (14) |
| – 100 basis points parallel shift in yield curves | (30) | (19) | (21) | (9) |
| 10 per cent increase in equity prices | 16 | 16 | 15 | 15 |
| 10 per cent decrease in equity prices | (17) | (17) | (16) | (16) |
| Sensitivity to credit spread increases | – | (2) | – | (2) |

Credit risk of insurance operations

Credit risk can give rise to losses through default and can lead to volatility in income statement and balance sheet figures through movements in credit spreads, principally on the £11.5 billion (2012: £11.3 billion) non-linked bond portfolio.

As tabulated above, the sensitivity of the net profit after tax of the group's insurance manufacturing companies to the effects of changes in credit spreads is £nil (2012: £nil). The sensitivity is calculated using simplified assumptions based on a one-day movement in credit spreads over a two-year period. A confidence level

most significant one is that a parallel shift in yield curves of one basis point does not capture the non-linear relationships between the values of certain assets and liabilities and interest rates. Non-linearity arises, for example, from investment guarantees and product features which enable policyholders to surrender their policies. The group bears the shortfall if the yields on investments held to support contracts with guaranteed benefits are less than the investment returns implied by the guaranteed benefits.

The group recognises these limitations and augments its standard measures with stress tests which examine the effect of a range of market rate scenarios on the aggregate annual profits and total equity of the insurance manufacturing companies after taking into consideration tax and accounting treatments where material and relevant. The results of these stress tests are reported to the Group Insurance and Risk Committees every quarter.

The following table illustrates the effect of selected interest rates, equity price and credit spread scenarios on the profits for the year and total equity of insurance manufacturing subsidiaries. Where appropriate, the impact of the stress on the present value of the in-force long-term insurance business asset ('PVIF') is included in the results of the sensitivity tests. The relationship between the profit and total equity and the risk factors is non-linear and, therefore, the results disclosed should not be extrapolated to measure sensitivities to different levels of stress. The sensitivities are stated before allowance for the effect of management actions which may mitigate the effect of changes in market rates, and for any factors such as policyholder behaviour that may change in response to changes in market risk.

of 99 per cent, consistent with the Group's VAR, has been applied. The results are relatively insensitive to credit spread increases due to the high rate of policy holder participation on non-linked business.

Management of the group's insurance manufacturing companies is responsible for the credit risk, quality and performance of their investment portfolios. The assessment of creditworthiness of issuers and counterparties is based primarily upon internationally recognised credit ratings and other publicly available information.

Report of the Directors: Risk (continued)

Investment credit exposures are monitored against limits by the local insurance manufacturing subsidiaries, and are aggregated and reported to Group Insurance Credit Risk and Group Credit Risk. Stress testing is performed by Group Insurance on the investment credit exposures using credit spread sensitivities and default probabilities. A number of tools are used to manage and monitor credit risk. These include a Credit Watch Report which contains a watch list of investments with current credit concerns and is circulated fortnightly to senior management in Group Insurance and to the individual Country Chief Risk Officers to identify investments which may be at greater risk of future impairment.

Treasury bills, other eligible bills and debt securities in the group's insurance manufacturing companies (Audited)

| | At 31 December 2013 | | | At 31 December 2012 | | |
|--|---------------------|-----------------------------|--------------------------|---------------------|-----------------------------|--------------------------|
| | Strong £m | Good/ Satisfactory £m | Total ² £m | Strong £m | Good/ Satisfactory £m | Total ² £m |
| Financial assets designated at fair value ¹ | 418 | 151 | 569 | 549 | 117 | 666 |
| – treasury and other eligible bills | – | – | – | – | – | – |
| – debt securities | 418 | 151 | 569 | 549 | 117 | 666 |
| Financial investments | 9,286 | 1,650 | 10,936 | 9,100 | 1,488 | 10,588 |
| – treasury and other similar bills | – | – | – | – | – | – |
| – debt securities | 9,286 | 1,650 | 10,936 | 9,100 | 1,488 | 10,588 |
| | 9,704 | 1,801 | 11,505 | 9,649 | 1,605 | 11,254 |

1 Impairment is not measured for debt securities designated at fair value, as assets in such portfolios are managed according to movements in fair value, and the fair value movement is taken directly through the income statement.

2 Total is the maximum exposure to credit risk on the treasury bills, other eligible bills and debt securities in the group's insurance companies.

Credit risk also arises when assumed insurance risk is ceded to reinsurers. The split of liabilities ceded to reinsurers and outstanding reinsurance recoveries, analysed by credit quality, is shown below. The group's

exposure to third parties under the reinsurance agreements is included in this table.

Reinsurers' share of liabilities under insurance contracts (Audited)

| | Strong £m | Good/ Satisfactory £m | Past due not impaired £m | Total ^{1,2} £m |
|---------------------------------------|--------------|-----------------------------|--------------------------------|----------------------------|
| At 31 December 2013 | | | | |
| Unit-linked insurance contracts | 43 | – | – | 43 |
| Non-linked insurance contracts | 447 | 2 | – | 449 |
| Total | 490 | 2 | – | 492 |
| Reinsurance debtors | 7 | – | – | 7 |
| At 31 December 2012 | | | | |
| Unit-linked insurance contracts | 34 | – | – | 34 |
| Non-linked insurance contracts | 458 | 4 | – | 462 |
| Total | 492 | 4 | – | 496 |
| Reinsurance debtors | 5 | – | – | 5 |

1 No amounts reported within Reinsurers' share of liabilities under insurance contracts were classified as sub-standard or impaired.

2 Total is the maximum exposure to credit risk in respect of reinsurers' share of liabilities under insurance contracts.

Report of the Directors: Risk (continued)

Liquidity risk of insurance operations

It is an inherent characteristic of almost all insurance contracts that there is uncertainty over the amount of claims liabilities that may arise, and the timing of their settlement, creating liquidity risk.

There are three aspects to liquidity risk of insurance operations. The first arises in normal market conditions and is referred to as funding liquidity risk; specifically, the capacity to raise sufficient cash when needed to meet payment obligations. Secondly, market liquidity risk arises when the size of a particular holding may be so large that a sale cannot be completed at the market price. Finally, standby liquidity risk refers to the capacity to meet payment terms in abnormal conditions.

The group's insurance manufacturing companies primarily fund cash outflows arising from claim liabilities from the following sources of cash inflows:

- premiums from new business, policy renewals and recurring premium products;
- interest and dividends on investments and principal repayments of maturing debt investments;
- cash resources; and
- the sale of investments.

The group's insurance manufacturing companies manage liquidity risk by utilising some or all of the following techniques:

- matching cash inflows with expected cash outflows using specific cash flow projections or more general asset and liability matching techniques such as duration matching;

- maintaining sufficient cash resources;
- investing in good credit-quality investments with deep and liquid markets to the degree to which they exist;
- monitoring investment concentrations and restricting them where appropriate, for example, by debt issues or issuers; and
- establishing committed contingency borrowing facilities.

Each of these techniques contributes to mitigating the three types of liquidity risk of insurance operations described above.

Every quarter, the group's insurance manufacturing companies are required to complete and submit liquidity risk reports to the Group Insurance for collation and review. Liquidity risk is assessed in these reports by measuring changes in expected cumulative net cash flows under a series of stress scenarios designed to determine the effect of reducing expected available liquidity and accelerating cash outflows. This is achieved, for example, by assuming new business or renewals are lower, and surrenders or lapses are greater, than expected.

The following tables show the expected undiscounted cash flows for insurance contract liabilities and the remaining contractual maturity of investment contract liabilities. A significant proportion of the group's non-life insurance business is viewed as short-term, with the settlement of liabilities expected to occur within one year of the period of risk. There is a greater spread of expected maturities for the life business where, in a large proportion of cases, the liquidity risk is borne in conjunction with policyholders (wholly owned by the policyholders in the case of unit-linked business).

Expected maturity of insurance contract liabilities (Audited)

| | Expected cash flows (undiscounted) | | | | |
|---|------------------------------------|-----------------|------------------|---------------------|--------------|
| | Within 1 year £m | 1-5 years £m | 5-15 years £m | Over 15 years £m | Total £m |
| At 31 December 2013 | | | | | |
| Non-linked insurance ¹ | 44 | 234 | 394 | 393 | 1,065 |
| Unit-linked insurance | 271 | 839 | 973 | 697 | 2,780 |
| Total | 315 | 1,073 | 1,367 | 1,090 | 3,845 |
| At 31 December 2012 | | | | | |
| Non-linked insurance ¹ | 95 | 187 | 378 | 316 | 976 |
| Unit-linked insurance | 170 | 584 | 829 | 599 | 2,182 |
| Total | 265 | 771 | 1,207 | 915 | 3,158 |

¹ Non-linked insurance includes remaining non-life business.

Report of the Directors: Risk (continued)

Remaining contractual maturity of investment contract liabilities (Audited)

| | Liabilities under investment contracts by insurance underwriting subsidiaries | | | | | |
|---------------------------------------|---|-----------------|------------------|---------------------|----------------------------|---------------|
| | Within 1 year £m | 1-5 years £m | 5-10 years £m | Over 10 years £m | Undated ¹ £m | Total £m |
| At 31 December 2013 | | | | | | |
| Unit-linked investment contracts..... | 130 | 471 | 515 | 1,364 | 2,819 | 5,299 |
| Investment contracts with DPF..... | – | – | – | – | 15,987 | 15,987 |
| Total..... | 130 | 471 | 515 | 1,364 | 18,806 | 21,286 |
| At 31 December 2012 | | | | | | |
| Unit-linked investment contracts..... | 112 | 418 | 452 | 1,275 | 2,558 | 4,815 |
| Investment contracts with DPF..... | – | – | – | – | 15,078 | 15,078 |
| Total..... | 112 | 418 | 452 | 1,275 | 17,636 | 19,893 |

¹ In most cases, policyholders have the option to terminate their contracts at any time and receive the surrender values of their policies. These may be significantly lower than the amounts shown above.

Insurance risk

Insurance risk is the risk, other than financial risk, of loss transferred from the holder of the insurance contract to the issuer (the group). Insurance risk is principally measured in terms of liabilities under the contracts.

The insurance risk profile of the group's life insurance manufacturing businesses has not changed materially during 2013 despite the increase in liabilities to policyholders on these contracts to £19.2 billion (2012: £17.9 billion). This growth in liabilities largely resulted from market value gains on underlying financial assets in addition to new business generated during 2013.

A principal risk faced by the group is that, over time, the cost of acquiring and administering a contract, claims and benefits may exceed the aggregate amount of premiums received and investment income. The cost of claims and benefits can be influenced by many factors, including mortality and morbidity experience, lapse and surrender rates, expense rates and, if the policy has a savings element, the performance of the assets held to support the liabilities.

Insurance risks are controlled by high level policies and procedures set both centrally and locally, taking into account, where appropriate, local market conditions and regulatory requirements. Formal underwriting, reinsurance and claims-handling procedures designed to ensure compliance with regulations are applied, and supplemented with stress testing.

As well as exercising underwriting controls, reinsurance is also used as a means of mitigating exposure to insurance risk. Where the group manages exposure to insurance risk through the use of third-party reinsurers, the associated revenue and manufacturing profit is ceded to the reinsurers. Although reinsurance provides a means of managing insurance risk, such contracts expose the group to credit risk, the risk of default by the reinsurer (see page 72).

A principal tool used by the group to manage its exposure to insurance risk, in particular for life insurance contracts, is asset and liability matching. In certain

markets in which the group operates it is neither possible nor appropriate to follow a perfect asset and liability matching strategy. For long dated non-linked contracts in particular this results in a duration mismatch between assets and liabilities. The group therefore structures portfolios to support projected liabilities from non-linked contracts. In the absence of insurable events occurring, unit-linked contracts match assets more directly with liabilities. This results in the policyholder bearing the majority of the financial risk exposure.

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

Analysis of life insurance risk – liabilities to policy holders (Audited)

| | 2013 £m | 2012 £m |
|--|---------------|---------------|
| Non-linked insurance ¹ | | |
| – Insurance contracts with DPF ² | 230 | 219 |
| – Credit life | 79 | 99 |
| – Annuities | 376 | 363 |
| – Term assurance and other long-term contracts | 151 | 135 |
| – Non-life insurance | – | 9 |
| Total non-linked insurance | 836 | 825 |
| Unit-linked insurance | 2,405 | 2,010 |
| Investment contracts with DPF ^{2,3} | 15,987 | 15,078 |
| Liabilities under insurance contracts | 19,228 | 17,913 |

¹ Non-linked insurance includes remaining non-life business.

² Insurance contracts and investment contracts with DPFs give policyholders the contractual right to receive, as a supplement to their guaranteed benefits, additional benefits that are likely to be a significant portion of the total contractual benefits, but whose amount or timing is contractually at the discretion of the group. These additional benefits are contractually based on the performance of a specified pool of contracts or assets, or the profit of the company issuing the contracts.

³ Although investment contracts with DPFs 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 around these drivers, typically reflecting each entity's own experience. Economic assumptions, such as investment returns and interest rates, are usually based on observable market

Report of the Directors: Risk (continued)

data. Changes in underlying assumptions affect the liabilities.

Present value of in-force long-term insurance business

The group's life insurance business is accounted for using the embedded value approach which, inter alia, provides a risk and valuation framework. The sensitivity of PVIF long-term asset to changes in economic and non-economic assumptions is described in Note 21.

Other material risks

(Unaudited)

Pension risk

Pension risk is the risk that contributions from Group companies and members fail to generate sufficient funds to meet the cost of accruing benefits for the future service of active members, and the risk that the performance of assets held in pension funds is insufficient to cover existing pension liabilities. Pension risk arises from investments delivering an inadequate return, economic conditions leading to corporate failures, adverse changes in interest rates or inflation, or members living longer than expected (longevity risk).

The group operates a number of pension plans throughout Europe. Some of them are defined benefit plans, of which the largest is the HSBC Bank (UK) Pension Scheme ('the principal plan').

In order to fund the benefits associated with these plans, group companies (and, in some instances, employees) make regular contributions in accordance with advice from actuaries and in consultation with the scheme's trustees (where relevant). The defined benefit plans invest these contributions in a range of investments designed to meet their long-term liabilities.

The level of these contributions has a direct impact on the group's cash flow and is set to ensure that there are sufficient funds to meet the cost of the accruing benefits for the future service of active members. Higher contributions will be required when plan assets are considered insufficient to cover the existing pension liabilities as a deficit exists. Contribution rates are typically revised annually or triennially, depending on the plan. The agreed contributions to the principal plan are revised triennially.

A deficit in a defined benefit plan may arise from a number of factors, including:

- investments delivering a return below that required to provide the projected plan benefits. This could arise, for example, when there is a fall in the market value of equities, or when increases in long-term interest rates cause a fall in the value of fixed income securities held;

- the prevailing economic environment leading to corporate failures, thus triggering write-downs in asset values (both equity and debt);
- a change in either interest rates or inflation which causes an increase in the value of the scheme liabilities; and
- scheme members living longer than expected (known as longevity risk).

A plan's investment strategy is determined after taking into consideration the market risk inherent in the investments and its consequential impact on potential future contributions. The long-term investment objectives of both the group and, where relevant and appropriate, the trustees are:

- to limit the risk of the assets failing to meet the liabilities of the plans over the long-term; and
- to maximise returns consistent with an acceptable level of risk so as to control the long-term costs of the defined benefit plans.

In pursuit of these long-term objectives, a benchmark is established for the allocation of the defined benefit plan assets between asset classes. In addition, each permitted asset class has its own benchmarks, such as stock market or property valuation indices and, where relevant, desired levels of out-performance. The benchmarks are reviewed at least triennially within 18 months of the date at which an actuarial valuation is made, or more frequently if required by local legislation or circumstances. The process generally involves an extensive asset and liability review.

Ultimate responsibility for investment strategy rests with either the trustees or, in certain circumstances, a management committee. The degree of independence of the trustees from the group varies in different jurisdictions. For example, the principal plan, which accounts for approximately 97 per cent of the obligations of the group's defined benefit pension plans, is overseen by a corporate trustee who regularly monitors the market risks inherent in the scheme.

The principal plan holds a diversified portfolio of investments to meet future cash flow liabilities arising from accrued benefits as they fall due to be paid. The trustee of the principal plan is required to produce a written Statement of Investment Principles which governs decision-making about how investments are made.

In 2006, the bank and the trustee of the principal plan agreed to change the investment strategy to reduce the investment risk. The target asset allocations for this strategy in 2006, and as revised in 2011, demonstrating the ongoing evolution of the strategy, are shown below. The strategy is to hold the majority of assets in bonds, with the remainder in a more diverse range of investments, and includes a commitment to undertake a programme of swap arrangements (see Note 43) by which

Report of the Directors: Risk (continued)

the principal plan makes LIBOR-related interest payments in exchange for the receipt of cash flows which are based on projected future benefit payments to be made from the principal plan.

| | 2013 & 2011 | 2006 |
|---------------------------------------|----------------|-------|
| | % | % |
| Equities | 15.5 | 15.0 |
| Bonds | 60.5 | 50.0 |
| Alternative assets ¹ | 9.5 | 10.0 |
| Property | 9.0 | 10.0 |
| Cash | 5.5 | 15.0 |
| | 100.0 | 100.0 |

¹ In 2013 and 2011, alternative assets include ABSs, MBSs and infrastructure assets. In 2006, alternative assets included loans and infrastructure assets.

Following a consultation process on various employee benefit proposals, the bank announced to employees in the UK that the future service accrual for defined benefit members would cease from 1 July 2015. As part of these amendments, the bank is changing the basis of delivering ill-health benefits to certain employees, resulting in the recognition of an accounting gain of £280 million.

Reputational risk

Reputation risk is the risk that illegal, unethical or inappropriate behaviour by the group itself, members of staff or clients or representatives of the group will damage HSBC's reputation, leading potentially to a loss of business, fines or penalties. Reputational risk encompasses negative reaction not only to activities which may be illegal or against regulations, but also to activities that may be counter to societal standards, values and expectations. It arises from a wide variety of causes, including how the group conducts its business and the way in which clients to whom it provides financial services, and bodies who represent HSBC, conduct themselves.

All employees must safeguard the reputation of the group by maintaining the highest standards of conduct at all times and by being aware of issues, activities or associations that might pose a threat to the reputation of the group. The long-term success of the group is closely linked to the confidence of its stakeholders. Safeguarding and building upon the group's reputation is the responsibility of every employee. Any lapse in standards of integrity, compliance, customer service or operating efficiency represents a potential reputational risk.

The group always aspires to the highest standards of conduct and, as a matter of routine, takes account of reputational risks to its business. Reputational risks can arise from a wide variety of causes, including Environmental, Social and Governance ('ESG') issues and operational risk events. As a banking group, a good reputation depends not only upon the way in which the group conducts its business, but also the way in which clients, to whom financial services are provided, conduct

themselves. Accordingly second order reputational risks are also regularly reviewed within the group.

Standards on all major aspects of business are set for the Group and for individual subsidiaries, businesses and functions. Reputational risks, including ESG matters, are considered and assessed by regional and local committees and management during the formulation of policy and the establishment of the Group's standards. These policies, which form an integral part of the internal control system, are communicated through manuals and statements of policy and are promulgated through internal communications and training. The policies cover ESG issues and set out operational procedures in all areas of reputational risk, including money laundering deterrence, counter-terrorist financing, environmental impact, anti-corruption measures and employee relations.

The policy manuals address risk issues in detail and co-operation between departments and businesses is required to ensure a strong adherence to the group's risk management system and sustainability practices.

Conduct risk

Conduct risk is defined as both the risk of the group treating its customers unfairly and that of delivering inappropriate outcomes for customers. The HSBC Values are central to the group's approach to managing conduct risk which is embedded in the way business is undertaken and has evolved over a number of years, most noticeably in the UK with the focus on making better products, selling them properly and keeping them sold. In light of the development of the regulatory approach with an increased focus on conduct risk, further enhancements are underway across all business lines including values-based training programmes, improved management information to inform business decision making and revised incentivisation strategies. Many of the activities identified are being implemented through the on-going programmes of the wealth risk framework, Global Standards and local business and risk initiatives.

Report of the Directors: Capital Management

Capital management and allocation

(Audited)

Capital management

The group's capital management approach is driven by its strategic and organisational requirements, taking into account the regulatory, economic and commercial environment in which it operates.

It is the group's policy to maintain a strong capital base to support the development of its business and to meet regulatory capital requirements. To achieve this, the group manages its own capital within the context of an annual capital plan which is approved by the Board that determines the optimal amount and mix of capital required to support planned business growth and meet local regulatory capital requirements. HSBC Holdings plc is the sole provider of equity capital to the group and also provides non-equity capital where necessary. Capital generated in excess of planned requirements is returned to the HSBC Holdings plc in the form of dividends.

The group's policy is underpinned by its capital management framework, which enables the group to manage its capital in a consistent manner. The framework incorporates a number of capital measures which govern the management and allocation of capital within the group. These capital measures include invested capital, economic capital and regulatory capital defined by the group as follows:

- invested capital is the equity capital provided to the bank by HSBC;
- economic capital is the internally calculated capital requirement which is deemed necessary by the group to support the risks to which it is exposed; and
- regulatory capital is the minimum level of capital which the group is required to hold in accordance with the rules set by the PRA for the bank and the group and by the local regulators for individual subsidiary companies.

The following risks managed through the capital management framework have been identified as material: credit, market, operational, interest rate risk in the banking book, pension fund, insurance and residual risks.

Stress testing is incorporated into the capital management framework and is an important component of understanding the sensitivities of the core assumptions in the group's capital plans to the adverse effect of extreme, but plausible, events. Stress testing allows senior management to formulate its response, including risk mitigating actions, in advance of conditions starting to reflect the stress scenarios identified. The actual market stresses experienced by the financial system in recent years have been used to inform the capital planning process and further develop the stress scenarios employed by the group.

Other stress tests are also carried out, both at the request of regulators and by the regulators themselves using their prescribed assumptions. The group takes into account the results of all such regulatory stress testing when undertaking its internal capital management assessment.

In June 2013, the European Commission published the final Regulation and Directive, known collectively as CRD IV, to give effect to the Basel III framework in the EU.

In December 2013, the PRA issued its final rules on CRD IV in a Policy Statement PS 7/13. In its final rules, the PRA opted for an acceleration of the CRD IV end point definition of CET1. Despite the final PRA rules, there remains continued uncertainty around the precise amount of capital that banks will be required to hold. This relates to the quantification and interaction of capital buffers and Pillar 2, where further PRA consultations are due in 2014. Furthermore, there are a notable number of draft and unpublished EBA technical and implementation standards due in 2014 which will potentially impact the bank's capital position and RWAs.

The group's approach to managing its capital position has been to ensure the bank, regulated subsidiaries and the group exceed current regulatory requirements and is well placed to meet the expected regulatory requirements from the implementation of CRD IV. The group continually reviews its capital targets, reflecting any changes as they develop.

Capital measurement

The PRA is the supervisor of the bank and lead supervisor of the group. The PRA sets capital requirements and receives information on the capital adequacy for the bank and the group. The bank and the group complied with the PRA's capital adequacy requirements throughout 2013.

Individual banking subsidiaries are directly regulated by their local banking supervisors, who set and monitor local capital adequacy requirements.

In 2013, the group calculated capital using the Basel II framework, as amended for CRD III, commonly known as Basel 2.5. The Capital Requirements Directive ('CRD') implemented Basel II in the EU and the Financial Services Authority ('FSA') and its successor bodies then gave effect to the CRD by including the requirements of the CRD in its own rulebooks.

Basel II is structured around three 'pillars':

- Pillar 1: minimum capital requirements;
- Pillar 2: Supervisory Review and Evaluation Process; and
- Pillar 3: market discipline.

Report of the Directors: Capital Management (continued)

There were no material changes to the group's policies and practices for capital measurement in 2013.

Risk-weighted assets

(Unaudited)

During 2013, RWAs reduced by £7 billion to £186 billion due to movements in credit and market risk. Credit risk RWAs decreased by £4 billion. This reduction was primarily attributable to reduced securitisation exposures and updates to methodology and regulatory policy in the calculation of corporate and commercial customer RWAs. Market Risk RWAs declined by £4 billion, primarily through lower risk levels following reductions in exposures and improvements in market conditions.

Regulatory capital

The group's capital comprises tier 1 capital and tier 2 capital:

- tier 1 capital is divided into core tier 1 and other tier 1 capital. Core tier 1 capital is comprised of shareholders' equity from which are deducted the book values of goodwill and intangible assets and other regulatory adjustments for items reflected in shareholders' equity which are treated differently for the purposes of capital adequacy. Qualifying capital instruments such as non-cumulative perpetual preference shares and hybrid capital securities are included in other tier 1 capital; and
- tier 2 capital comprises qualifying subordinated loan capital, allowable collective impairment allowances and unrealised gains arising on the fair valuation of equity instruments held as available for-sale. Tier 2 capital also includes reserves arising from the revaluation of properties.

The PRA's rules set limits on the amount of hybrid capital instruments that can be included in tier 1 capital relative to core tier 1 capital and also limits total tier 2 capital to no more than tier 1 capital.

The basis of consolidation for financial accounting purposes is described on page 103 and differs from that used for regulatory purposes. Investments in banking associates, which are equity accounted in the financial accounting consolidation, are proportionally consolidated for regulatory purposes. Subsidiaries and associates engaged in insurance and non-financial activities are excluded from the regulatory consolidation and are deducted from regulatory capital. The regulatory consolidation also excludes SEs where significant risk has been transferred to third parties. Exposures to these SEs are risk weighted as securitisation positions for regulatory purposes.

Pillar 1 capital requirements

Pillar 1 covers the capital resources requirements for credit risk (including counterparty credit risk and securitisations), market risk and operational risk. These

requirements are expressed in terms of risk-weighted assets.

Credit risk capital requirements

Basel II applies three approaches of increasing sophistication to the calculation of pillar 1 credit risk capital requirements. The most basic, the standardised approach, requires banks to use external credit ratings to determine the risk weightings applied to rated counterparties and group other counterparties into broad categories and apply standardised risk weightings to these categories. The next level, the internal ratings-based ('IRB') foundation approach, allows banks to calculate their credit risk capital requirement on the basis of their internal assessment of the probability that a counterparty will default ('PD'), but subjects their quantified estimates of exposure at default ('EAD') and loss given default ('LGD') to standard supervisory parameters. Finally, the IRB advanced approach allows banks to use their own internal assessment in both determining PD and quantifying EAD and LGD.

The capital resources requirement, which is intended to cover unexpected losses, is derived from a formula specified in the regulatory rules, which incorporates these factors and other variables such as maturity and correlation. Expected losses under the IRB approaches are calculated by multiplying PD by EAD and LGD. Expected losses are deducted from capital to the extent that they exceed accounting impairment allowances.

For credit risk, the group has adopted the IRB advanced approach for the majority of its business, with the remainder on either IRB foundation or standardised approaches or under exemption from IRB treatment.

Counterparty credit risk

Counterparty credit risk arises for over-the-counter derivatives and securities financing transactions. It is calculated in both the trading and non-trading books and is the risk that the counterparty to a transaction may default before completing the satisfactory settlement of the transaction. Three approaches to determining counterparty credit risk exposure values are defined by Basel II: standardised, mark-to-market and internal model method. These exposure values are used to determine capital requirements under one of the credit risk approaches: standardised, IRB foundation and IRB advanced.

The group uses the mark-to-market and internal model method approaches for counterparty credit risk. The longer-term aim is to migrate more positions from mark-to-market to the internal model method approach.

Securitisation

Securitisation positions are held in both the trading book and the non-trading book. For non-trading book securitisation positions, Basel II specifies two methods for calculating credit risk requirements, these being the standardised and IRB approaches. Both approaches rely

Report of the Directors: Capital Management (continued)

on the mapping of rating agency credit ratings to risk weights, which range between 7 per cent and 1,250 per cent. Positions that would otherwise be weighted at 1,250 per cent are deducted from capital.

Within the IRB approach, the Ratings Based Method is used for the majority of the non-trading book securitisation positions, and the Internal Assessment Approach for unrated liquidity facilities and programme-wide enhancements for asset-backed securitisations. The majority of securitisation positions in the trading book are treated for capital purposes as if they are held in the non-trading book under the standardised or IRB approaches.

Other traded securitisation positions, known as correlation trading are included within an internal model separately approved by the PRA.

Market risk capital requirement

Market risk is the risk that movements in market risk factors, including foreign exchange, commodity prices, interest rates, credit spread and equity prices will reduce group's income or the value of its portfolios. The market risk capital requirement is measured using internal market risk models where approved by the PRA, or the PRA's standard rules.

Under Basel 2.5, the group's market risk models comprise VAR, stressed VAR, incremental risk charge and correlation trading under the comprehensive risk measure.

Operational risk capital requirement

Basel II includes a capital requirement for operational risk, again utilising three levels of sophistication. The capital required under the basic indicator approach is a simple percentage of gross revenues, whereas under the standardised approach it is one of three different percentages of gross revenues allocated to each of eight defined business lines. Both these approaches use an average of the last three financial years' revenues. Finally, the advanced measurement approach uses banks' own statistical analysis and modelling of operational risk data to determine capital requirements.

The group has adopted the standardised approach in determining its operational risk capital requirements.

Pillar 2 capital requirement

The group conducts an Internal Capital Adequacy Assessment Process ('ICAAP') to determine a forward looking assessment of its capital requirements given its business strategy, risk profile, risk appetite and capital plan. This process incorporates the risk management processes and governance of the firm. A range of stress tests are applied to the base capital plan. These, coupled with the group's risk management practices are used to assess its capital adequacy requirements.

The group provides ICAAP documentation to the PRA summarising the ICAAP process and capital adequacy conclusions. This forms part of the basis of the

PRA's Supervisory Review and Evaluation Process ('SREP'), which occurs periodically to enable the PRA to define the minimum capital requirements for the bank and the group. For 2013 the PRA set a capital resources floor for the bank based on its definition for core tier 1 capital.

Pillar 3 disclosure requirements

Pillar 3 of Basel II is related to market discipline and aims to make firms more transparent by requiring them to publish a report giving a comprehensive view of their risk profile including specific details of their risks, capital and management of these. Pillar 3 disclosures will be published as a separate document on the bank's website.

Regulation and Supervision

(Unaudited)

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

Basel III

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

The Basel III rules set out the minimum common equity tier 1 ratio requirement of 4.5 per cent and an additional capital conservation buffer requirement of 2.5 per cent, to be phased in sequentially from 1 January 2013, becoming fully effective on 1 January 2019. Any additional countercyclical capital buffer requirements will also be phased in, starting in 2016 to a proposed maximum level of 2.5 per cent effective on 1 January 2019, although individual jurisdictions may choose to implement larger countercyclical capital buffers.

In addition to the criteria detailed in the Basel III proposals, the Basel Committee issued further minimum requirements in January 2011 to ensure that all classes of capital instruments fully absorb losses at the point of non-viability before taxpayers are exposed to loss. Instruments issued on or after 1 January 2013 may only be included in regulatory capital if the new requirements are satisfied. The current capital treatment of securities issued prior to this date, not meeting these requirements, will be phased out over a 10-year period commencing on 1 January 2013.

The Basel III framework also introduced the leverage ratio as a non-risk-based backstop limit, to supplement risk-based capital requirements. It aims to constrain the build-up of excess leverage in the banking sector, introducing additional safeguards against model risk and measurement errors. The ratio is a volume-based

Report of the Directors: Capital Management (continued)

measure calculated as Basel III tier 1 capital divided by total on-balance sheet and off-balance sheet exposures.

Basel III provides for a transitional period for the introduction of the leverage ratio, comprising a supervisory monitoring period that started in 2011 and a parallel run period which will last from 1 January 2013 until 1 January 2017. The parallel run will be used to assess whether the proposed ratio of 3% is appropriate, with a view to migrating to a Pillar 1 requirement from 1 January 2018. The leverage ratio is subject to a supervisory monitoring period which commenced on 1 January 2011, and a parallel run period which will last from 1 January 2013 until 1 January 2017.

Further calibration of the leverage ratio will be carried out in the first half of 2017 with a view to migrating to a Pillar 1 requirement from 1 January 2018. In January 2014, the Basel Committee published its finalised leverage ratio framework, along with the public disclosure requirements applicable from 1 January 2015.

CRD IV

Commencing 1 January 2014, the CRD IV rule changes introduce a revised definition of regulatory capital, primarily focused on common equity tier 1 ('CET1') capital as the predominant form of going concern capital, with a greater quantum to be held by banks. There are increased capital deductions and new regulatory adjustments affecting this higher tier of capital. The new rules also introduce increased RWA requirements, mainly for Counterparty Credit Risk ('CCR').

The most significant impacts on CET1 capital are the proposed deduction of equity holdings in banks, financial institutions and insurance entities and the excess of expected losses over impairment allowances resulting in a reallocation of current deductions to this higher tier of capital and new rules for calculating the amounts to be deducted and the introduction of an additional valuation adjustment of balance sheet positions measured at market or fair value using specified standards for prudent valuation.

CRD IV also requires banks to maintain a number of additional capital buffers to be met by CET1 capital. These new capital requirements include a Capital Conservation Buffer designed to ensure banks build up capital outside periods of stress that can be drawn down when losses are incurred, currently set at 2.5 per cent, and an institution specific Countercyclical Capital Buffer ('CCB'), to protect against future losses where unsustainable levels of leverage, debt or credit growth pose a systemic threat. Additionally, CRD IV set out a Systemic Risk Buffer ('SRB') for the banking system as a whole to mitigate structural macro-prudential risk. If applicable, the SRB will be set at a minimum of 1 per cent. The Capital Conservation Buffer and the CCB are to be phased in subject to national transposition in the UK.

The most significant impact on RWAs is a new capital charge to cover risk of mark to market losses on expected counterparty risk, referred to as a regulatory

credit valuation adjustment ('CVA') risk capital charge, calculated on a full range of OTC (i.e. non-exchange traded) derivative counterparties. Other changes will impose increases in the asset value correlation multiplier for financial counterparties, additional requirements for collateralised counterparties, margin period of risk and new requirements for exposures to central clearing counterparties resulting in a higher CCR charge.

Under CRD IV, the final calibration and legislative proposal for a leverage ratio are expected to be determined following a review of the revised Basel Committee proposals and the basis of the EBA's assessment of the impact and effectiveness of the leverage ratio during a monitoring period from 1 January 2014 until 30 June 2016. In December 2013, the PRA issued its final rules on CRD IV in a Policy Statement PS 7/13. This transposes the various areas of national discretion within the final CRD IV legislation into UK law. Whilst CRD IV allows for the majority of regulatory adjustments and deductions from CET1 to be implemented on a gradual basis from 1 January 2014 to 1 January 2018, the PRA's transposition of the national discretions does not to make use of those transitional provisions.

Despite final PRA rules uncertainty remains around the precise amount of capital that banks will be required to hold. This relates to the quantification and interaction of capital buffers and Pillar 2, where further PRA consultations are due in 2014. In addition, many Technical Standards and guidelines have been issued by the EBA in draft form for consultation or are pending publication in 2014. These must be adopted by the European Commission for them to become legally enforceable. This provides further uncertainty as to the precise capital requirements under CRD IV.

In December 2013, the EBA published a draft final consultation on the Regulatory Technical Standard for 'Own Funds – Part III' which elaborates on the capital calculation of holdings of common equity instruments of financial sector entities. This is currently under review and may have a material impact on our capital position.

Other regulatory proposals

The ability of banks' internal models to adequately capture the risk of a portfolio has been an on-going area of regulatory focus. During 2013, the PRA proposed a framework to UK banks to be applied in assessing low-default wholesale portfolios. This framework will impose LGD and exposure at default ('EAD') floors based on the foundation approach for portfolios with less than 20 events of default (per country). In December 2013, the PRA confirmed that floors would be implemented across two portfolios by the end of March 2014.

In December 2013, the PRA issued its Supervisory Statement SS13/13 in relation to Market Risk. This requires banks to identify risks not adequately captured by models and to hold additional funds against these risks

Report of the Directors: Capital Management (continued)

under its Risks not in VAR ('RNIV') framework. In assessing these risks, no offsetting or diversification will be allowed across risk factors. To align with this requirement, the group is currently reviewing and revising its methodology.

In October 2013, the Bank of England published a discussion paper 'A framework for stress testing the UK banking system'. The framework replaces the current stress testing for the Pillar 2 capital planning buffer ('the PRA buffer') with annual concurrent stress tests, the results of which are expected to inform the setting of the PRA buffer, the CCB, the SCR and other FPC recommendations to the PRA. The PRA is expected to further consult on Pillar 2 in 2014.

Until outstanding consultations are published and guidance issued, there remains uncertainty as to the interaction between these buffers, the exact buffer requirements and what, if any, will be the final capital impact.

UK regulatory reform

The UK financial services regulatory structure has undergone substantial reform following the abolition of the FSA and establishment of three new regulatory bodies from 1 April 2013. These three bodies comprise the FPC of the Bank of England, the PRA and the FCA. The bank is a 'dual-regulated' firm, subject to prudential regulation by the PRA and to conduct regulation by the FCA.

These reforms have also provided the new regulatory bodies with additional powers.

- The FPC has been granted powers to give directions to the FCA or the PRA on the exercise of their supervisory powers, and may make recommendations within the BoE, to HM Treasury, to the FCA or the PRA or to 'other persons'.
- From 2014 the FPC is also responsible for decisions on the countercyclical capital buffer ('CCB'), a CRD IV requirement, to be applied to certain financial institutions. The CCB is a macro-prudential tool at the disposal of national authorities that can be deployed when the FPC judges that threats to financial stability have arisen in the UK increasing system-wide risk, and to protect the banking sector from future potential losses. Should a CCB be required, it is expected that the additional capital required would be in the range of 0-2.5 per cent of risk-weighted assets, although national supervisors have powers under CRD IV to increase this capital add-on.
- In addition, the FPC has been granted direction power, under the new legislation, over sectoral capital requirements ('SCR's). The SCR tool would allow the FPC to change capital requirements above minimum regulatory standards on exposures held by all UK banks to three broad sectors judged to pose a risk to the system as a whole (residential property, including mortgages; commercial property; and

exposures to the financial sector), as well as more granular sub-sectors (for example, to mortgages with high loan-to-value or loan-to-income ratios at origination). This will include both banking book and trading book exposures and ignores the domicile of the ultimate borrower.

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

Structural banking reform

In December 2013, the UK's Financial Services (Banking Reform) Act 2013 received Royal Assent, becoming primary legislation. It implements the recommendations of the Independent Commission on Banking and of the Parliamentary Commission on Banking Standards, which inter alia establishes a framework for 'ring-fencing' the UK retail banking from wholesale banking activities and sets out requirements for greater loss absorbency capacity. A consultation has also taken place on draft secondary legislation setting out further details of the implementation but the underlying rules from supervisory authorities are not yet available. The UK government intends to complete the legislative and rule-making process by the end of this Parliament in May 2015 and to have reforms in place by 2019.

In January 2014, following a consultation period, the European Commission published its own legislative proposals on the structural reform of the European banking sector which would ban proprietary trading in financial instruments and commodities, and enable supervisors to require trading activities such as market-making, complex derivatives and securitisation operations to be undertaken in a separate subsidiary from deposit taking activities.

The ring-fenced deposit taking entity would be subject to separation from the trading entity including capital and management structures, issuance of own debt and arms-length transactions between entities. The proposals allow for derogation from these requirements for super-equivalent national regimes but it is not currently clear if the UK laws will qualify for this treatment. On the current basis, it is understood that non-EU subsidiaries of the group which could be separately resolved without a threat to the financial stability of the EU would be excluded from the proposals.

The proposals will now be subject to discussion in the European Parliament and the Council of Ministers (representing the EU member states) and are not expected to be finalised in 2014. The implementation date for any separation under the final rules would depend upon the date on which the final legislation is agreed. The group continues to monitor these developments.

Report of the Directors: Capital Management (continued)

Capital structure¹ at 31 December

| | 2013 £m | 2012 £m |
|---|----------------|----------------|
| Composition of regulatory capital (Audited) | | |
| Tier 1 capital | | |
| Shareholders' equity ² | 31,992 | 31,840 |
| Shareholders' equity per balance sheet | 32,370 | 31,675 |
| Preference share & related premium | (431) | (431) |
| Other equity instruments | - | - |
| Deconsolidation of special purpose entities ³ | 53 | 596 |
| Non controlling interests | 399 | 375 |
| Non-controlling interests per balance sheet | 549 | 525 |
| Of which representing non-controlling interests in preference shares | (150) | (150) |
| Regulatory adjustments to the accounting basis | (1,388) | (1,833) |
| Unrealised (gains)/losses on available-for-sale debt securities ⁴ | (451) | (163) |
| Own credit spread | 218 | 89 |
| Defined benefit pension fund adjustment ⁵ | (946) | (1,219) |
| Cash flow hedging reserve | 13 | (259) |
| Reserves arising from revaluation of property & unrealised gains on available-for-sale equities | (221) | (226) |
| Other regulatory adjustments | (1) | (55) |
| Deductions | (8,565) | (8,294) |
| Goodwill capitalised & intangible assets | (7,218) | (7,107) |
| 50% of securitisation positions | (902) | (922) |
| 50% of excess expected losses over impairment allowances | (477) | (288) |
| 50% of tax credit adjustment for excess expected losses | 32 | 23 |
| Total Core tier 1 capital | 22,438 | 22,088 |
| Other tier 1 capital before deductions | 2,353 | 2,363 |
| Preference shares & related premium | 581 | 581 |
| Hybrid capital securities | 1,772 | 1,782 |
| Deductions | (683) | (434) |
| Unconsolidated investments ⁶ | (715) | (457) |
| 50% of tax credit adjustment for excess expected losses | 32 | 23 |
| Total Tier 1 capital | 24,108 | 24,017 |
| Tier 2 capital | | |
| Total qualifying tier 2 capital before deductions | 11,582 | 11,634 |
| Reserves arising from unrealised gains on revaluation of property & available-for-sale equities | 221 | 226 |
| Collective impairment allowances ⁷ | 139 | 271 |
| Perpetual subordinated debt | 2,683 | 2,743 |
| Term subordinated debt | 8,539 | 8,394 |
| Total deductions other than from tier 1 capital | (2,147) | (2,187) |
| Unconsolidated investments ⁶ | (715) | (971) |
| 50% of securitisation positions | (902) | (922) |
| 50% of excess expected losses over impairment allowances | (477) | (288) |
| Other deductions | (53) | (6) |
| Total regulatory capital | 33,543 | 33,464 |
| Risk-weighted assets (Unaudited) | | |
| Credit and counterparty risk | 145,909 | 149,970 |
| Market risk | 17,931 | 21,566 |
| Operational risk | 22,039 | 21,866 |
| Total | 185,879 | 193,402 |
| Capital ratios (Unaudited) | | |
| Core tier 1 ratio | 12.1 | 11.4 |
| Tier 1 ratio | 13.0 | 12.4 |
| Total capital ratio | 18.0 | 17.3 |

1 Based on Basel II requirements.

2 Includes externally verified profits for the year to 31 December 2013. Does not include the interim dividend of £630 million declared by the Board of Directors after 31 December 2013.

3 Mainly comprises unrealised losses on available-for-sale debt securities owned by deconsolidated special purpose entities.

4 Under PRA rules unrealised gains/losses on available-for-sale debt securities must be excluded from capital resources.

5 PRA rules require banks to exclude from capital resources any surplus in a defined benefit pension scheme.

6 Mainly comprise investments in insurance entities.

7 Under PRA rules collective impairment allowances on loan portfolios under the standardised approach may be included in tier 2 capital.

Report of the Directors: Governance

Corporate Governance Report

The statement of corporate governance practices set out on pages 83 to 90 and information incorporated by reference constitutes the Corporate Governance Report of HSBC Bank plc.

The Directors serving as at the date of this report are set out below.

Directors

J F Trueman[†], 71

Deputy Chairman

Chairman of the Risk Committee and a member of the Audit Committee.

A Director since 2004 and Deputy Chairman since 19 December 2013. Chairman of HSBC Private Bank (UK) Limited. Formerly Deputy Chairman of S. G. Warburg & Co.

A M Keir, 55

Chief Executive

Chief Executive and a Director since 1 October 2013. A Group Managing Director since 2011. A director of HSBC Trinkaus & Burkhardt AG since 31 August 2013 and of HSBC France since 10 December 2013. Formerly Global Head of Commercial Banking, HSBC Holdings plc. Joined HSBC in 1981.

P Antika^{*}, 53

A Director since 2011. Consultant, Antika Partners. Formerly Chief Executive of HSBC Bank AS, Turkey from 1993 to 2010 and a Group General Manager of HSBC Holdings plc from 1995 until her retirement in 2011.

S N Cooper, 46

A Director since 18 April 2013. A Group Managing Director since 1 October 2013. Chief Executive, Global Commercial Banking, HSBC Holdings plc. Formerly Deputy Chairman and Chief Executive of HSBC Bank Middle East Limited, Chairman of HSBC Bank Egypt S.A.E. and HSBC Bank Oman S.A.O.G. Joined HSBC in 1989.

Dame Denise Holt[†], 64

A member of the Risk Committee.

A Director since 2011. Chairman of Marks and Spencer Financial Services plc since 12 December 2013 and a director of Marks and Spencer Financial Services plc since 1 August 2013. A director of Marks and Spencer Savings and Investments Limited and Marks & Spencer Unit Trust Management Limited since 1 August 2013. Formerly a senior British Ambassador with 40 years' experience of working in Government, including postings in Ireland, Mexico, Brazil and, most recently, as British Ambassador to Spain from 2007 until her retirement in 2009.

S W Leathes[†], 66

Chairman of the Audit Committee and a member of the Risk Committee.

A Director since May 2012. A director of HSBC Trinkaus & Burkhardt AG since 31 August 2013 and a member of the Audit and Risk Committees of HSBC Trinkaus & Burkhardt AG since 26 September 2013. Formerly Vice-Chairman of Barclays Capital and Group Finance Director of S.G. Warburg Group plc.

Dame Mary Marsh[†], 67

A Director since 2009. A member of the Corporate Sustainability Committee of HSBC Holdings plc until 31 December 2013. Director of the Clore Social Leadership Programme and non-executive director and Chair of the International Skills Standards Organisation. Formerly Chief Executive of the NSPCC.

R E S Martin[†], 53

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

T B Moulouguet[†], 62

A member of the Audit Committee and the Risk Committee.

A Director since July 2012. A director and Chairman of the Audit and Risk Committees, HSBC France. A director of Fitch Rating Group Inc; Fimalac; Groupe Lucien Barrière and Valéo. Formerly Executive Vice President and Chief Financial Officer of Renault Group.

A P S Simoes, 38

Deputy Chief Executive, Head of UK and Retail Banking and Wealth Management, Europe

A Director since February 2012. A Group General Manager since January 2011. A director of HSBC France. Formerly Group Head of Strategy and Planning. Joined HSBC in 2007.

A M Thomson[†], 67

A member of the Audit Committee and the Risk Committee.

A Director since 18 April 2013. Chairman of Hays plc, Bodycote plc and Polypipe Limited. Non-Executive director and Chairman of the Audit Committee of Alstom SA, France. Formerly Group Finance Director, Smiths Group plc.

[†] *Independent non-executive Director.*

^{*} *Non-executive Director.*

Secretary

J H McKenzie, 60

Joined HSBC in 1987.

Registered Office: 8 Canada Square, London E14 5HQ

Report of the Directors: Governance (continued)

Board of Directors

The objectives of the management structures within the bank, headed by the Board of Directors and led by the Chairman, are to deliver sustainable value to shareholders. Implementation of the strategy set by the Board is delegated to the bank's Executive Committee.

The Board meets regularly and Directors receive information between meetings about the activities of committees and developments in the bank's business. All Directors have full and timely access to all relevant information and may take independent professional advice if necessary.

The names of Directors serving at the date of this report and brief biographical particulars for each of them are set out on page 83.

All Directors, including those appointed by the Board to fill a casual vacancy, are subject to annual re-election at the bank's Annual General Meeting. Non-executive Directors have no service contracts.

J F Trueman was appointed Deputy Chairman on 19 December 2013. A M Keir was appointed as a Director and Chief Executive on 1 October 2013. S N Cooper was appointed as a Director on 18 April 2013. A M Thomson was appointed as an independent non-executive Director on 18 April 2013.

J W Leng resigned as Chairman and as a Director on 31 December 2013. B Robertson resigned as Chief Executive and as a Director on 30 September 2013. A R D Monro-Davies and P M Shawyer resigned as Directors on 25 April 2013 and 6 January 2014 respectively.

Directors' emoluments

Details on the emoluments of the Directors of the bank for 2013, disclosed in accordance with the Companies Act, are shown in Note 7 'Employee compensation and benefits'.

Board committees

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

As at the date of this report, the following are the principal committees:

Audit Committee

The Audit Committee meets regularly with the bank's senior financial and internal audit management and the external auditor to consider, inter alia, the bank's financial reporting, the nature and scope of audit reviews and the effectiveness of the systems of internal control.

The members of the Audit Committee are S W Leathes (Chairman), T B Moulouguet, A M Thomson and J F Trueman. All of the members of the Audit Committee who served during 2013 are independent non-executive Directors.

S W Leathes was appointed Chairman of the Committee on 1 April 2013 in succession to J F Trueman who remains as a member.

Risk Committee

The Risk Committee meets regularly with the bank's senior financial, risk, internal audit and compliance management and the external auditor to consider, inter alia, risk reports and internal audit reports and the effectiveness of compliance.

The members of the Risk Committee are J F Trueman (Chairman), D M Holt, S W Leathes, T B Moulouguet and A M Thomson. All of the members of the Risk Committee who served during 2013 are independent non-executive Directors.

Chairman's Committee

The Chairman's Committee, established by resolution of the Board in June 2013, has responsibility for: (i) Nominations: leading the process for Board appointments and for identifying and nominating, for the approval of the Board, candidates for appointment to the Board; (ii) Values: driving the implementation of HSBC's Values and business principles and compliance with Group standards and policies throughout the bank; and (iii) Remuneration: reviewing the over-arching principles, parameters and governance framework of the Group's remuneration policy and the remuneration of the bank's senior executives.

The current members of the Chairman's Committee are S W Leathes, R E S Martin and J F Trueman.

Executive Committee

The Executive Committee meets regularly and operates as a general management committee under the direct authority of the Board, exercising all of the powers, authorities and discretions of the Board in so far as they concern the management and day to day running of the bank, in accordance with such policies and directions as the Board may from time to time determine. The members of the Executive Committee include the bank's executive Directors, A M Keir (Committee Chairman) and A P S Simoes.

Remuneration Committee

The functions of the Remuneration Committee are fulfilled by the Remuneration Committee of the Board of the bank's parent company, HSBC Holdings plc.

Report of the Directors: Governance (continued)

Internal control

The Directors are responsible for maintaining and reviewing the effectiveness of risk management and internal control systems and for determining the nature and extent of the significant risks it is willing to take in achieving its strategic objectives. To meet this requirement and to discharge its obligations under the 'Handbook of Rules and Guidance' issued by the Financial Conduct Authority, procedures have been designed for safeguarding assets against unauthorised use or disposal; for maintaining proper accounting records; and for ensuring the reliability and usefulness of financial information used within the business or for publication. These procedures can only provide reasonable and not absolute assurance against material misstatement, errors, losses or fraud.

These procedures are designed to provide effective internal control within the group and accord with the Financial Reporting Council's guidance for directors issued in its revised form in 2005 and which is the subject of a recent consultation which closed in January 2014. They have been in place throughout the year and up to 24 February 2014, the date of approval of the *Annual Report and Accounts 2013*.

Key risk management and internal control procedures include the following:

- **Group standards:** Functional, operating, financial reporting and certain management reporting standards are established by HSBC global function management committees, for application throughout the Group. These are supplemented by operating standards set by functional and local management as required for the type of business and geographical location of each subsidiary.
 - **Delegation of authority within limits set by the Board:** Authority to operate the bank and responsibility for financial performance against plans and capital expenditure is delegated to the Chief Executive who has responsibility for overseeing the establishment and maintenance of systems of control appropriate to the business and who has the authority to delegate such duties and responsibilities as he sees fit. The appointments to the most senior positions within the group require the approval of the Board of Directors of HSBC Holdings.
 - **Risk identification and monitoring:** Systems and procedures are in place in the group to identify, control and report on the major risks facing the group including credit, market, liquidity and funding, capital, financial management, model, reputational, pension, strategic, sustainability and operational risk (including accounting, tax, legal, regulatory compliance, financial crime compliance, fiduciary, security and fraud, systems operations, project and people risk). Exposure to these risks is monitored by risk management committees; asset, liability and capital management committees; and executive committees. The group's operational risk profile and the effective implementation of the group's operational risk management framework is monitored by the bank's RMM. The minutes of this meeting are submitted to the Group RMM.
 - **Changes in market conditions/practices:** Processes are in place to identify new risks arising from changes in market conditions/practices or customer behaviours, which could expose the group to heightened risk of loss or reputational damage.
 - **Strategic plans:** Periodic strategic plans are prepared for global businesses, functions and certain geographical regions, including the home and priority growth markets in Europe. The geographic plans are designed to align closely with Group strategy, with significant input and ultimate endorsement by the Directors of the bank. These strategic plans set the direction and pace of development of individual businesses and also cover key business initiatives that will enable the business to deliver its operating result.
- The bank also prepares annual operating plans which concern financial performance and are informed by detailed analysis of risk appetite, the impact of key initiatives deriving from the strategic planning process, economic forecasts and anticipated customer behaviour.
- **Disclosure Committee:** The Disclosure Committee reviews material public disclosures made by the bank for any material errors, misstatements or omissions. The integrity of disclosures is underpinned by structures and processes within the Finance and Risk functions that support expert and rigorous analytical review of financial reporting complemented by certified reviews by the business and functions.
 - **Financial reporting:** The group's financial reporting process for preparing the consolidated *Annual Report and Accounts 2013* is controlled using documented accounting policies and reporting formats, supported by a chart of accounts with detailed instructions and guidance on reporting requirements, issued by Group Finance to the bank and all reporting entities within the group in advance of each reporting period end. The submission of financial information from each reporting entity is subject to certification by the responsible financial officer and analytical review procedures at reporting entity and group levels.
 - **Responsibility for risk management:** Management of businesses and functions are primarily accountable for managing, measuring and

Report of the Directors: Governance (continued)

monitoring their risks and controls. Policies and procedures are in place as part of the Three Lines of Defence model to ensure weaknesses are escalated to senior management and addressed.

- **IT operations:** Centralised functional control is exercised over all IT developments and operations. Common systems are employed for similar business processes wherever practicable.
- **Functional management:** Global functional management is responsible for setting policies, procedures and standards for the following risks: credit, market, liquidity, capital, financial management, model, reputational, pension, strategic, sustainability and operational risk (including accounting, tax, legal, regulatory compliance, financial crime compliance, fiduciary, information security, security and fraud, systems and people risk). Authorities to enter into credit and market risk exposures are delegated with limits to line management of group companies. The concurrence of the appropriate global function is required, however, to credit proposals with specified higher risk characteristics. Credit and market risks are measured and reported on in subsidiaries and aggregated for review of risk concentrations on a Group-wide basis.
- **CEO Attestation Process:** Operational Risk coordinate the annual CEO Attestation process under which the Chief Executive Officers of the group's material subsidiaries confirm on behalf of their subsidiaries that the internal control framework has been reviewed through the CEO Attestation process and significant open issues identified with action plans in place to address weaknesses for review by the Risk Committee and the Audit Committee. These issues are then tracked by the Operational Risk and Internal Control (ORIC) teams for the relevant businesses through reports to their ORIC committees and quarterly updates on progress to Regional Operational Risk.
- **Internal Audit:** The establishment and maintenance of appropriate systems of risk management and internal control is primarily the responsibility of business management. The Internal Audit function, which is centrally controlled, provides independent and objective assurance in respect of the adequacy of the design and operating effectiveness of the framework of risk management, control and governance process across the group, focussing on the areas of greatest risk to HSBC using a risk-based approach.
- **Internal Audit recommendations:** Executive management is responsible for ensuring that recommendations made by the Internal Audit function are implemented within an appropriate and

agreed timetable. Confirmation to this effect must be provided to Internal Audit.

- **Reputational risk:** Policies to guide the bank, subsidiary companies and management at all levels in the conduct of business to safeguard the Group's reputation are established by the Group, subsidiary company boards and committees, board committees and senior management. Reputational risks can arise from almost any aspect of the Group's operations including environmental, social and governance issues or as a consequence of operational risk events or as a result of employees acting in a manner inconsistent with the HSBC values. HSBC's reputation depends upon the way in which it conducts its business and may be affected by the way in which clients, to which it provides financial services, conduct their business or use financial products and services.

The Risk Committee and the Audit Committee have kept under review the effectiveness of this system of internal control and have reported regularly to the Board of Directors. In carrying out their reviews, the committees receive regular business and operational risk assessments; regular reports from the heads of key risk functions, which cover all internal controls, both financial and non-financial; semi-annual confirmations from senior executives that there have been no material losses, contingencies or uncertainties caused by weaknesses in internal controls; internal audit reports; external audit reports; prudential reviews; and regulatory reports.

The Risk Committee monitors the status of top and emerging risks which impact or may impact the group and considers whether the mitigating actions put in place are appropriate. In addition, when unexpected losses have arisen or when incidents have occurred which indicate gaps in the control framework or in adherence to HSBC Group policies, the Risk Committee reviews special reports, prepared at the instigation of management, which analyse the cause of the issue, the lessons learned and the actions proposed by management to address the issue.

The Directors, through the Audit and Risk Committees, have conducted an annual review of the effectiveness of the group's system of risk management and internal control covering all material controls, including financial, operational and compliance controls and risk management systems, the adequacy of resources, qualifications and experience of staff of the accounting and financial reporting function and their training programmes and budget. The Audit and Risk Committees have received confirmation that executive management has taken or is taking the necessary actions to remedy any failings or weaknesses identified through the operation of the group's framework of controls.

The Audit Committee has non-executive responsibility for oversight of risk management and

Report of the Directors: Governance (continued)

internal controls over financial reporting and the Risk Committee has non-executive responsibility for oversight of risk management and internal controls other than over financial reporting.

Health and safety

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

Group policies, standards and guidance for the management of health and safety are set by global Corporate Real Estate. Achieving these in each country in which the Group operates is the responsibility of the Chief Operating Officer of that country with support and coordination provided by the Health and Safety Coordinator for that country.

In terms of physical and geopolitical risk, Global Security and Fraud Risk provide regular Security Risk Assessments to assist management in judging the level of terrorist and violent criminal threat. Regional Security and Fraud Risk functions conduct regular security reviews of all Group buildings to ensure measures to protect staff, buildings, assets and information are appropriate to the level of threat.

HSBC remains committed to maintaining its preparedness and to ensuring the highest standards of health and safety wherever in the world the Group operates.

Diversity and inclusion

The Group continues to be committed to providing equal opportunities to employees and encouraging an inclusive workplace in line with the Group's brand promise.

HSBC actively encourages applications to join the bank from a diverse range of backgrounds. In the UK this is supported by its award-winning work experience programme for students. HSBC has also recently launched an enhanced programme for students in the UK in the "Not in Education, Employment or Training" category, which will provide those students who successfully meet our professional standards the opportunity to join HSBC.

In September 2011 HSBC became the first major bank in the UK to establish an apprenticeship programme for its non-graduate direct entry population. Since launch, 1,600 employees have registered to join the programme. The scheme won the National Apprenticeship Service Newcomer Employer of the Year Award in 2013. The

regulator Ofsted awarded HSBC a '2' good rating in 2013 for the scheme.

Progress in this area is measured by the Diversity & Inclusion questions which are part of the Group's employee engagement survey (please see 'employee engagement' section for additional information). According to the results, 72 per cent of the employees who completed the survey believe that they work in an environment where they can succeed regardless of their background and characteristics.

HSBC is making a strong, commercial and sustainable shift towards a more inclusive and meritocratic environment. During 2013 the UK business invested in developing its leaders to consider the sustainable behaviours required to navigate between the risk and growth environment.

A number of leadership teams have attended the Inclusive Leadership programme that enables leaders to become aware of personal and organisational biases and the impact these have on the way our teams feel about meritocracy and the commitment the UK business will make to support their career development.

Antonio Simoes, Deputy Chief Executive and Head of UK and Retail Banking and Wealth Management, Europe, topped the list of the 50 most inspiring LGBT senior business executives, as compiled by OUTstanding in Business, a UK-based LGBT professional network and was voted Diversity Champion of the Year at the European Diversity Awards.

Employees with disabilities

The group continues to recruit, train and develop disabled employees and make reasonable adjustments to employment terms and the working environment for employees that are disabled or become disabled during their employment.

The bank continues to support the commitments of the two tick symbol employability campaign to interview disabled candidates who meet the minimum job criteria. The symbol is a recognition given by Jobcentre Plus to employers who have agreed to make certain positive commitments regarding the employment, retention, training and career development of disabled people.

Employee involvement

As a large organisation with a unified strategic purpose, it is vital that HSBC involves and engages its employees.

Among various means of achieving this, coordinated communications to HSBC employees are key. A dedicated global team is responsible for strategy, alignment and delivery of all central communications to HSBC employees and supporting teams are in place for the continental European and UK audiences.

Report of the Directors: Governance (continued)

Within HSBC's employee communications channel portfolio, the global and country staff websites are those most used by employees and therefore are the primary vehicles for systematic dissemination of news and video content relating to HSBC strategy, values, policy and employee matters and industry activity. Feedback and 'listening' channels are increasingly used to ensure communications and certain business activities are responsive to employee views and concerns.

In the UK, HSBC works with a number of elected employee consultation bodies, along with recognising Unite, an accredited trade union, for collective bargaining purposes for specific groups of employees. Within individual European countries there are a variety of consultation mechanisms with both trade unions and works councils and, in some countries, specific Collective Bargaining agreements. The purpose of each of these relationships is to provide information on matters that may affect employees and to consult over these matters to ensure that employees' views are taken into account when making decisions. Meetings are held on a regular and ad hoc basis with each body. Through these consultation mechanisms, HSBC ensures that it meets its statutory obligations for information and consultation, along with helping to inform the decision-making process through the input and consideration of a wide range of ideas and opinions.

Subject to fulfilment of a service requirement, all employees in the UK have been invited annually to participate in HSBC Holdings' Sharesave plan. The Sharesave plan provides employees with an opportunity to buy shares in HSBC Holdings plc at a future date at a discounted option price set immediately prior to the invitation period. Employees are also able to buy shares from their pre-tax salary via the Share Incentive Plan up to a maximum of £125 per month. Both of these HMRC-approved plans provide an accessible way for employees to have a stake in the business and the wider HSBC Group through share ownership and actively encourage employees to engage with the company's performance.

To help achieve HSBC's goals, the association between individual, team, business area and company performances must be demonstrated. Therefore, in addition to HSBC's day-to-day communications, specific mechanisms are in place to explain and familiarise employees with internal and external factors affecting the company's performance. These include regular editorials from HSBC's economists, business reviews by senior managers, financial news stories and a share price tracker. Focus is particularly given internally to HSBC's Annual and Interim Results, with dedicated communications and online content designed to provide relevance and understanding for employees.

Employee engagement

'Employee engagement' describes employees' emotional and intellectual commitment to any organisation. HSBC's bi-annual survey of employees shows that they value HSBC's commitment to sustainable business practices and view the bank as being a leader in this regard.

As an HSBC Group member, the bank has a well-established framework for employees to provide feedback and develop action plans at local and national levels to improve the working experience and engagement.

In 2013, our bi-annual Global People Survey was undertaken to monitor employee engagement. The engagement score in the UK was 61 per cent, while the European overall score was 60 per cent. According to the results, 69 per cent of the employees who completed the survey indicated that employees are encouraged to try new ideas and new ways of doing things to increase the effectiveness of the organisation. The next Global People Survey will be in 2015.

In the UK, the bank has continued to use numerous complementary programmes to involve and seek feedback from employees, including: Best Place to Suggest, Idea of the Month, My Health & Wellbeing and a social networking tool. Employees can also comment on many of HSBC's internal blogs and communications. Antonio Simoes, Deputy Chief Executive, Head of UK and Retail Banking and Wealth Management, Europe, operates a Connected communication forum enabling employees to hear from him on a variety of topics and for them to post comments and feedback.

Corporate sustainability

Sustainability Governance

The Corporate Sustainability Committee of the HSBC Holdings Board was responsible during 2013 for advising the Board, committees of the Board and executive management on corporate sustainability policies across the Group including environmental, social and ethical issues. Dame Mary Marsh, an independent non-executive Director of the bank, was a co-opted member of the Corporate Sustainability Committee. The Committee has been demised by resolution of the HSBC Holdings Board with effect from 31 December 2013. A Conduct & Values Committee has been established which undertakes some of the responsibilities of the Corporate Sustainability Committee.

Corporate Sustainability exists as a global function. Senior executives are charged with implementing sustainable business practice in all major regions. Responsibility for this is included in the HSBC Global Standards Manual and through induction and developmental training. Local teams are in charge of

Report of the Directors: Governance (continued)

embedding corporate sustainability strategies within banking activities.

HSBC Holdings plc reports on its progress in developing and implementing its sustainability strategy annually in the *HSBC Sustainability Report*, which is independently verified and prepared using the Global Reporting Initiative framework. The *HSBC Sustainability Report 2013* will be issued on 23 May 2014 and will be available at www.hsbc.com/sustainability.

Corporate sustainability

HSBC recognises that environmental, social and economic issues can impact on the Group's long term success as a business. Corporate Sustainability means achieving sustainable profit growth so that HSBC can continue to reward shareholders and employees, build long-lasting relationships with customers and suppliers, pay taxes and duties in those countries where it operates and invest in communities for future growth.

The way the Group does business is as important as what it does. The Group's responsibility to its customers, employees and shareholders as well as the countries and communities in which it operates goes far wider than simply being profitable.

HSBC's continuing financial success depends, in part, on its ability to identify and address certain factors which present risks or opportunities for the business. These can affect reputation, drive employee engagement, help manage the risks of lending, create savings through eco-efficiency and secure new revenue streams. These generally fall into the four broad areas discussed below.

Business finance

HSBC aims to build long-term customer relationships around the world through the provision of a consistent and high quality service and customer experience. HSBC uses the benefits of its scale, financial strength, geographic reach and strong brand value to achieve this.

HSBC aims to take advantage of the opportunities and manage the risks presented by emerging global trends by developing sustainable business models to address these. When setting strategy, HSBC considers factors such as population growth; increased longevity; urbanisation and the resulting resource constraints and rising atmospheric CO₂ levels.

Operational environmental efficiency

HSBC focuses its environmental initiatives primarily on addressing and responding to issues associated with climate change, including energy use, water and waste management. Climate change has the potential to materially affect HSBC's customers and, by extension, HSBC's long-term success, introducing new risks to business activity. At the end of 2011, HSBC committed to a series of targets stretching through to 2020, which will

further reduce HSBC's impact on the environment. Work began in 2012 to achieve these targets.

Community Investment

HSBC has a long-standing commitment to the communities in which it operates. HSBC's operations bring benefits to local people and businesses through employment, training, purchasing and investment. Beyond its core business, HSBC aims to encourage social and economic opportunity through community investment activities.

HSBC's focus is on education and the environment, which it believes are essential building blocks for the development of communities and are prerequisites for economic growth. These philanthropic programmes aim to involve employees in the work of local non-governmental organisations and charities. In 2013, HSBC launched the three year £30 million "Opportunity Partnership", to help transform the lives of 25,000 disadvantaged young people in the UK through education, training and work.

During 2013, the bank supported community activities in the UK through charitable donations and UK employees volunteered around 60,700 hours in work time. In 2013, the UK business gave £4.8 million in charitable donations and in addition the Group Community Investment spend in the UK was £25.1 million.

Sustainability risk

We recognise that businesses can have an impact on the environment and communities around them. For over 10 years we have been developing, implementing and refining our approach to working with our business customers to understand and manage these issues. We assess and support customers in six sensitive sectors using our own policies and, in financing for projects, using the Equator Principles as a starting point. By extending their application to all relevant corporate loans and providing independent assurance on their implementation, we go beyond the minimum requirements of the Equator Principles framework. Our sustainability risk framework is based on robust policies, formal processes and well-trained, empowered people.

In 2013, HSBC was approached by non-governmental organisations ('NGOs') raising concerns regarding the implementation of our forest land and forest products sector policy. We welcome constructive feedback from NGOs and campaign groups and regularly engage with a number of them on matters of shared interest. If our clients do not comply fully with our policies or cannot show that they are on a credible path to do so, we will exit our relationship with them.

Report of the Directors: Governance (continued)

Auditor

Auditor KPMG Audit plc has expressed its willingness to continue in office and the Board recommends that it be reappointed. A resolution proposing the reappointment of KPMG Audit plc as auditor of the bank and giving authority to the Directors to determine its remuneration will be submitted to the forthcoming Annual General Meeting.

Conflicts of interest and indemnification of Directors

The bank's Articles of Association give the Board authority to approve Directors' conflicts and potential conflicts of interest. The Board has adopted a policy and procedures for the approval of Directors' conflicts or potential conflicts of interest. The Board's powers to authorise conflicts are operating effectively and the procedures are being followed. A review of situational conflicts which have been authorised, including the terms of authorisation, is undertaken by the Board annually.

The Articles of Association provide that Directors are entitled to be indemnified out of the assets of the company against claims from third parties in respect of certain liabilities arising in connection with the performance of their functions, in accordance with the provisions of the UK Companies Act 2006. Such indemnity provisions have been in place during the financial year but have not been utilised by the Directors. All Directors have the benefit of directors' and officers' liability insurance.

Statement on going concern

The financial statements are prepared on a going concern basis, as the Directors are satisfied that the group and bank have the resources to continue in business for the

foreseeable future. In making this assessment, the Directors have considered a wide range of information relating to present and future conditions. Further information relevant to the assessment is provided in the Strategic Report and Report of the Directors, in particular:

A description of the group's strategic direction and principal risks and uncertainties.

A summary of financial performance and review of business performance.

The group's approach to capital management and allocation.

In addition, the objectives, policies and processes for managing credit, liquidity and market risk are set out in the *'Report of the Directors: Risk'*.

The Directors have also considered future projections of profitability, cash flows and capital resources in making their assessment.

Disclosure of information to the Auditor

The Directors who held office at the date of approval of this Directors' report confirm that, so far as they are each aware, there is no relevant audit information of which the bank's auditors are unaware; and each Director has taken all the steps that he ought to have taken as a Director to make himself aware of any relevant audit information and to establish that the company's auditors are aware of that information.

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

Registered number 14259

24 February 2014

Statement of Directors' Responsibilities in Respect of the *Annual Report and Accounts 2013* and the Financial Statements

The following statement, which should be read in conjunction with the Auditor's statement of their responsibilities set out in their report on the next page, is made with a view to distinguishing for shareholders the respective responsibilities of the Directors and of the Auditor in relation to the financial statements.

The Directors are responsible for preparing the *Annual Report and Accounts 2013*, comprising the consolidated financial statements of HSBC Bank plc and its subsidiaries (the 'group') and parent company financial statements for HSBC Bank plc (the 'bank') in accordance with applicable laws and regulations.

Company law requires the Directors to prepare group and parent company financial statements for each financial year. The Directors are required to prepare the group financial statements in accordance with IFRSs as adopted by the EU and have elected to prepare the bank financial statements on the same basis.

Under company law the Directors must not approve the financial statements unless they are satisfied that they give a true and fair view of the state of affairs of the group and parent company and of their profit or loss for that period. In preparing each of the group and parent company financial statements, the Directors are required to:

- select suitable accounting policies and then apply them consistently;
- make judgments and estimates that are reasonable and prudent; and
- state whether they have been prepared in accordance with IFRSs as adopted by the EU.

The Directors are required to prepare the financial statements on the going concern basis unless it is not appropriate. Since the Directors are satisfied that the group has the resources to continue in business for the foreseeable future, the financial statements continue to be prepared on a going concern basis.

The Directors have responsibility for ensuring that sufficient accounting records are kept that disclose with reasonable accuracy at any time the financial position of the bank and enable them to ensure that its financial statements comply with the Companies Act 2006.

The Directors have general responsibility for taking such steps as are reasonably open to them to safeguard the assets of the group and to prevent and detect fraud and other irregularities.

The Directors have responsibility for the maintenance and integrity of the *Annual Report and Accounts* as they appear on the bank's website. UK legislation governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

Each of the Directors, the names of whom are set out in the '*Report of Directors: Governance*' section on page 83 of this *Annual Report and Accounts 2013*, confirm to the best of their knowledge:

- in accordance with rule 4.1.12(3)(a) of the Disclosure Rules and Transparency Rules, the consolidated financial statements, which have been prepared in accordance with IFRSs as issued by the IASB and as endorsed by the EU, have been prepared in accordance with the applicable set of accounting standards and give a true and fair view of the assets, liabilities, financial position and profit or loss of the bank and the undertakings included in the consolidation taken as a whole; and
- the management report represented by the Strategic Report and the Report of the Directors has been prepared in accordance with rule 4.1.12(3)(b) of the Disclosure Rules and Transparency Rules, and includes a fair review of the development and performance of the business and the position of the bank and the undertakings included in the consolidation as a whole, together with a description of the principal risks and uncertainties that the group faces.

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

24 February 2014

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

We have audited the financial statements of HSBC Bank plc ('the bank') for the year ended 31 December 2013 set out on pages 93 to 215. The financial reporting framework that has been applied in their preparation is applicable law and International Financial Reporting Standards (IFRSs) as adopted by the EU and, as regards the parent company financial statements, as applied in accordance with the provisions of the Companies Act 2006.

This report is made solely to the bank's member, as a body, in accordance with Chapter 3 of Part 16 of the Companies Act 2006. Our audit work has been undertaken so that we might state to the bank's member those matters we are required to state to them in an 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

As explained more fully in the Directors' Responsibilities Statement set out on page 91, the directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view. Our responsibility is to audit, and express an opinion on, the financial statements in accordance with applicable law and International Standards on Auditing (UK and Ireland). Those standards require us to comply with the Auditing Practices Board's Ethical Standards for Auditors.

Scope of the audit of the financial statements

A description of the scope of an audit of financial statements is provided on the Financial Reporting Council's website at www.frc.org.uk/auditscopeukprivate.

Opinion on financial statements

In our opinion:

- the financial statements give a true and fair view of the state of the group's and of the parent company's affairs as at 31 December 2013 and of the group's profit for the year then ended;
- the group financial statements have been properly prepared in accordance with IFRSs as adopted by the EU;
- the parent company financial statements have been properly prepared in accordance with IFRSs as adopted by the EU and as applied in accordance with the provisions of the Companies Act 2006; and
- the financial statements have been prepared in accordance with the requirements of the Companies Act 2006 and, as regards the group financial statements, Article 4 of IAS Regulation.

Opinion on other matter prescribed by the Companies Act 2006

In our opinion the information given in the Strategic Report and the Directors' Report for the financial year for which the financial statements are prepared is consistent with the financial statements.

Matters on which we are required to report by exception

We have nothing to report in respect of the following matters where the Companies Act 2006 requires us to report to you if, in our opinion:

- adequate accounting records have not been kept by the parent company, or returns adequate for our audit have not been received from branches not visited by us; or
- the parent company financial statements are not in agreement with the accounting records and returns; or
- certain disclosures of directors' remuneration specified by law are not made; or
- we have not received all the information and explanations we require for our audit.

Nicholas Edmonds, Senior Statutory Auditor

for and on behalf of KPMG Audit Plc, Statutory Auditor
Chartered Accountants
London, England

24 February 2014

Financial Statements

Consolidated income statement for the year ended 31 December 2013¹

| | 2013 | | 2012 | |
|---|----------------|--------------------------------|----------------------------------|-----------------|
| | Total £m | Continuing operations £m | Discontinued operations £m | Total £m |
| Interest income | 10,008 | 10,214 | 460 | 10,674 |
| Interest expense | (3,047) | (3,695) | (75) | (3,770) |
| Net interest income | 6,961 | 6,519 | 385 | 6,904 |
| Fee income | 4,723 | 4,522 | 533 | 5,055 |
| Fee expense | (1,387) | (1,213) | (61) | (1,274) |
| Net fee income | 3,336 | 3,309 | 472 | 3,781 |
| Trading income excluding net interest income | 1,694 | 645 | 247 | 892 |
| Net interest income on trading activities | 679 | 942 | – | 942 |
| Net trading income | 2,373 | 1,587 | 247 | 1,834 |
| Net income from financial instruments designated at fair value | 900 | 118 | – | 118 |
| Gains less losses from financial investments | 100 | 335 | 1 | 336 |
| Dividend income | 18 | 15 | 1 | 16 |
| Net earned insurance premiums | 2,022 | 2,286 | – | 2,286 |
| Other operating income | 158 | 129 | 3 | 132 |
| Total operating income | 15,868 | 14,298 | 1,109 | 15,407 |
| Net insurance claims incurred and movement in liabilities to policyholders | (3,028) | (2,919) | – | (2,919) |
| Net operating income before loan impairment charges and other credit risk provisions | 12,840 | 11,379 | 1,109 | 12,488 |
| Loan impairment charges and other credit risk provisions | (971) | (1,246) | 1 | (1,245) |
| Net operating income | 11,869 | 10,133 | 1,110 | 11,243 |
| Employee compensation and benefits | (3,838) | (4,353) | (436) | (4,789) |
| General and administrative expenses | (4,195) | (4,626) | (280) | (4,906) |
| Depreciation and impairment of property, plant and equipment | (331) | (353) | (13) | (366) |
| Amortisation and impairment of intangible assets | (211) | (174) | (1) | (175) |
| Total operating expenses | (8,575) | (9,506) | (730) | (10,236) |
| Operating profit | 3,294 | 627 | 380 | 1,007 |
| Share of (loss)/profit in associates and joint ventures | – | (3) | – | (3) |
| Profit before tax | 3,294 | 624 | 380 | 1,004 |
| Tax credit/(expense) | (754) | 220 | (64) | 156 |
| Profit for the year before gain on disposal of discontinued operations | 2,540 | 844 | 316 | 1,160 |
| Gain on sale of discontinued operations | – | – | 1,265 | 1,265 |
| Profit for the year | 2,540 | 844 | 1,581 | 2,425 |
| Profit attributable to shareholders of the parent company | 2,495 | 803 | 1,581 | 2,384 |
| Profit attributable to non-controlling interests | 45 | 41 | – | 41 |

¹ In November 2012, the group sold HSBC Private Banking Holdings (Suisse) SA to HSBC Holdings plc. The ownership of HSBC Private Bank (UK) Limited remains within the group. The comparative numbers in the income statement and the statement of comprehensive income has been presented to show the discontinued operation separately from continuing operations.

The accompanying notes on pages 103 to 215 and the audited sections of the 'Report of the Directors: Risk' on pages 25 to 76 and the 'Report of the Directors: Capital Management' on pages 77 to 82 form an integral part of these financial statements.

Financial Statements (continued)

Consolidated statement of comprehensive income for the year ended 31 December 2013

| | 2013 | 2012 | | Total £m |
|--|-------------|--------------------------------|----------------------------------|-------------|
| | Total £m | Continuing operations £m | Discontinued operations £m | |
| Profit for the year | 2,540 | 844 | 1,581 | 2,425 |
| Other comprehensive income | | | | |
| Items that will be reclassified subsequently to profit or loss when specific conditions are met | | | | |
| Available-for-sale investments | | | | |
| – fair value gains | 420 | 2,378 | 136 | 2,514 |
| – fair value losses/(gains) transferred to the income statement on disposal | 223 | (342) | 89 | (253) |
| – amounts transferred to the income statement in respect of impairment losses | 115 | 444 | 1 | 445 |
| – income taxes | 2 | (88) | (29) | (117) |
| Cash flow hedges | | | | |
| – fair value gains | 46 | 217 | 6 | 223 |
| – fair value (gains) transferred to the income statement..... | (423) | (181) | (12) | (193) |
| – income taxes | 109 | (7) | – | (7) |
| Exchange differences and other..... | 39 | (224) | (1,486) | (1,710) |
| Items that will not be reclassified subsequently to profit or loss | | | | |
| Actuarial (losses)/gains on defined benefit plans | | | | |
| – before income taxes | (957) | 89 | 8 | 97 |
| – income taxes | 251 | 1 | (2) | (1) |
| Other comprehensive income for the year, net of tax | (175) | 2,287 | (1,289) | 998 |
| Total comprehensive income for the year..... | 2,365 | 3,131 | 292 | 3,423 |
| Total comprehensive income for the year attributable to: | | | | |
| – shareholders of the parent company..... | 2,319 | 3,098 | 292 | 3,390 |
| – non-controlling interests | 46 | 33 | – | 33 |
| | 2,365 | 3,131 | 292 | 3,423 |

The accompanying notes on pages 103 to 215 and the audited sections of the 'Report of the Directors: Risk' on pages 25 to 76 and the 'Report of the Directors: Capital Management' on pages 77 to 82 form an integral part of these financial statements.

Financial Statements (continued)

Consolidated statement of financial position at 31 December 2013

| | Notes | 2013 £m | 2012 £m |
|---|-------|----------------|------------|
| ASSETS | | | |
| Cash and balances at central banks | | 67,584 | 51,613 |
| Items in the course of collection from other banks | | 1,948 | 1,961 |
| Trading assets | 15 | 134,097 | 161,516 |
| Financial assets designated at fair value | 16 | 16,661 | 15,387 |
| Derivatives | 17 | 137,239 | 177,808 |
| Loans and advances to banks | 32 | 53,228 | 32,286 |
| Loans and advances to customers | 32 | 305,032 | 282,685 |
| Financial investments | 18 | 75,030 | 71,265 |
| Other assets | 24 | 6,621 | 6,366 |
| Current tax assets | | 210 | 200 |
| Prepayments and accrued income | | 2,584 | 2,584 |
| Interests in associates and joint ventures | 20 | 67 | 67 |
| Goodwill and intangible assets | 21 | 7,934 | 7,826 |
| Property, plant and equipment | 22 | 2,004 | 2,024 |
| Deferred tax assets | 10 | 222 | 274 |
| Retirement benefit assets | 7 | 1,234 | 1,619 |
| Total assets | | 811,695 | 815,481 |
| LIABILITIES AND EQUITY | | | |
| Liabilities | | | |
| Deposits by banks | 32 | 50,683 | 39,571 |
| Customer accounts | 32 | 390,017 | 324,886 |
| Items in the course of transmission to other banks | | 960 | 1,017 |
| Trading liabilities | 25 | 91,842 | 122,896 |
| Financial liabilities designated at fair value | 26 | 34,036 | 32,918 |
| Derivatives | 17 | 137,352 | 181,095 |
| Debt securities in issue | 32 | 32,895 | 40,358 |
| Other liabilities | 27 | 5,850 | 6,846 |
| Current tax liabilities | | 89 | 122 |
| Liabilities under insurance contracts issued | 28 | 19,228 | 17,913 |
| Accruals and deferred income | | 2,990 | 3,250 |
| Provisions | 29 | 1,707 | 1,641 |
| Deferred tax liabilities | 10 | 24 | 99 |
| Retirement benefit liabilities | 7 | 318 | 319 |
| Subordinated liabilities | 30 | 10,785 | 10,350 |
| Total liabilities | | 778,776 | 783,281 |
| Equity | | | |
| Called up share capital | 37 | 797 | 797 |
| Share premium account | | 20,427 | 20,025 |
| Other reserves | | 921 | 394 |
| Retained earnings | | 10,225 | 10,459 |
| Total equity attributable to shareholders of the parent company | | 32,370 | 31,675 |
| Non-controlling interests | | 549 | 525 |
| Total equity | | 32,919 | 32,200 |
| Total equity and liabilities | | 811,695 | 815,481 |

The accompanying notes on pages 103 to 215 and the audited sections of the 'Report of the Directors: Risk' on pages 25 to 76 and the 'Report of the Directors: Capital Management' on pages 77 to 82 form an integral part of these financial statements.

A P S Simoes, Director

24 February 2014

Financial Statements (continued)

Consolidated cash flow statement for the year ended 31 December 2013

| | Notes | 2013 £m | 2012 £m |
|---|-------|----------------|----------------|
| Cash flows from operating activities | | | |
| Profit before tax | | 3,294 | 1,004 |
| Adjustments for: | | | |
| – non-cash items included in profit before tax | 38 | 2,684 | 3,988 |
| – change in operating assets | 38 | (53,006) | (34,029) |
| – change in operating liabilities | 38 | 61,035 | 23,887 |
| – elimination of exchange differences ¹ | | (623) | 4,162 |
| – net gain from investing activities | | (130) | (344) |
| – share of loss in associates and joint ventures | | – | 3 |
| – contributions paid to defined benefit plans | | (393) | (197) |
| – tax paid | | (363) | (171) |
| Net cash generated from/(used in) operating activities | | <u>12,498</u> | <u>(1,697)</u> |
| Cash flows from investing activities | | | |
| Purchase of financial investments | | (32,298) | (47,431) |
| Proceeds from the sale and maturity of financial investments | | 32,472 | 54,772 |
| Purchase of property, plant and equipment | | (322) | (347) |
| Proceeds from the sale of property, plant and equipment | | 14 | 30 |
| Purchase of goodwill and intangible assets | | (199) | (229) |
| Proceeds from the sale of intangible assets | | 3 | 3 |
| Net cash outflow from acquisition of businesses and subsidiaries | | (406) | – |
| Proceeds from disposal of subsidiaries | | 12 | 51 |
| Net cash disposed of on sale of subsidiaries | | – | (10,008) |
| Purchases of HSBC Holdings plc shares to satisfy share-based payment transactions | | – | (3) |
| Net cash used in investing activities | | <u>(724)</u> | <u>(3,162)</u> |
| Cash flows from financing activities | | | |
| Issue of ordinary share capital | | 402 | – |
| Subordinated liabilities issued | | 542 | 473 |
| Subordinated liabilities repaid | | (7) | (350) |
| Net cash outflow from increase in stake of subsidiaries | | – | (2) |
| Dividends paid to shareholders | | (2,014) | (2,821) |
| Dividends paid to non-controlling interests | | (22) | (20) |
| Net cash used in financing activities | | <u>(1,099)</u> | <u>(2,720)</u> |
| Net increase/(decrease) in cash and cash equivalents | | 10,675 | (7,579) |
| Cash and cash equivalents at 1 January | | 98,158 | 108,440 |
| Effect of exchange rate changes on cash and cash equivalents | | (64) | (2,703) |
| Cash and cash equivalents at 31 December | 38 | <u>108,769</u> | <u>98,158</u> |

¹ Adjustment to bring changes between opening and closing balance sheet amounts to average rates. This is not done on a line-by-line basis, as details cannot be determined without unreasonable expense.

The accompanying notes on pages 103 to 215 and the audited sections of the 'Report of the Directors: Risk' on pages 25 to 76 and the 'Report of the Directors: Capital Management' on pages 77 to 82 form an integral part of these financial statements.

Consolidated statement of changes in equity for the year ended 31 December 2013

| | 2013 | | | | | | | | |
|--|-------------------------------------|------------------------|----------------------------|---|--|--------------------------------------|---|--|-----------------------|
| | Other reserves | | | | | | | | |
| | Called up Share capital £m | Share premium £m | Retained earnings £m | Available- for-sale fair value reserve £m | Cash flow hedging reserve ³ £m | Foreign exchange reserve £m | Total share- holders' equity £m | Non- controlling interests £m | Total equity £m |
| At 1 January | 797 | 20,025 | 10,459 | (131) | 259 | 266 | 31,675 | 525 | 32,200 |
| Profit for the year | – | – | 2,495 | – | – | – | 2,495 | 45 | 2,540 |
| Other comprehensive income (net of tax) | – | – | (707) | 765 | (268) | 34 | (176) | 1 | (175) |
| Available-for-sale investments | – | – | – | 765 | – | – | 765 | (5) | 760 |
| Cash flow hedges | – | – | – | – | (268) | – | (268) | – | (268) |
| Actuarial gains/(losses) on defined benefit plans | – | – | (707) | – | – | – | (707) | 1 | (706) |
| Exchange differences and other | – | – | – | – | – | 34 | 34 | 5 | 39 |
| Total comprehensive income for the year | – | – | 1,788 | 765 | (268) | 34 | 2,319 | 46 | 2,365 |
| Share capital issued, net of costs ¹ | – | 402 | – | – | – | – | 402 | – | 402 |
| Dividends to shareholders | – | – | (2,014) | – | – | – | (2,014) | (22) | (2,036) |
| Net impact of equity-settled share-based payments ² | – | – | 4 | – | – | – | 4 | – | 4 |
| Change in business combinations and other movements | – | – | (11) | – | (4) | – | (15) | – | (15) |
| Tax on items taken directly to equity - current | – | – | (1) | – | – | – | (1) | – | (1) |
| At 31 December | 797 | 20,427 | 10,225 | 634 | (13) | 300 | 32,370 | 549 | 32,919 |

1 All new capital subscribed during the year was issued to HSBC Holdings plc. See Note 37 for further details.

2 Includes deferred tax of £ (8) million.

3 Movements in the cash flow hedging reserve include amounts transferred to the income statement of £423 million comprising a £232 million loss taken to 'Net interest income' and a £191 million loss taken to 'Net trading income'.

The accompanying notes on pages 103 to 215 and the audited sections of the 'Report of the Directors: Risk' on pages 25 to 76 and the 'Report of the Directors: Capital Management' on pages 77 to 82 form an integral part of these financial statements.

| | 2012 | | | | | | | | |
|--|-------------------------------------|------------------------|----------------------------|---|--|--------------------------------------|---|--|-----------------------|
| | Other reserves | | | | | | Total share- holders' equity £m | Non- controlling interests £m | Total equity £m |
| | Called up Share capital £m | Share premium £m | Retained earnings £m | Available- for-sale fair value reserve £m | Cash flow hedging reserve ³ £m | Foreign exchange reserve £m | | | |
| At 1 January | 797 | 20,025 | 10,805 | (2,793) | 236 | 2,020 | 31,090 | 514 | 31,604 |
| Profit for the year | – | – | 2,384 | – | – | – | 2,384 | 41 | 2,425 |
| Other comprehensive income (net of tax) | – | – | 101 | 2,578 | 23 | (1,696) | 1,006 | (8) | 998 |
| Available-for-sale investments | – | – | – | 2,578 | – | – | 2,578 | 11 | 2,589 |
| Cash flow hedges | – | – | – | – | 23 | – | 23 | – | 23 |
| Actuarial gains/(losses) on defined benefit plans | – | – | 101 | – | – | – | 101 | (5) | 96 |
| Exchange differences and other | – | – | – | – | – | (1,696) | (1,696) | (14) | (1,710) |
| Total comprehensive income for the year | – | – | 2,485 | 2,578 | 23 | (1,696) | 3,390 | 33 | 3,423 |
| Dividends to shareholders | – | – | (2,821) | – | – | – | (2,821) | (20) | (2,841) |
| Net impact of equity-settled share-based payments ¹ | – | – | 14 | – | – | – | 14 | – | 14 |
| Disposal of subsidiaries ² | – | – | (26) | 84 | – | (58) | – | (2) | (2) |
| Tax on items taken directly to equity - current | – | – | 2 | – | – | – | 2 | – | 2 |
| At 31 December | 797 | 20,025 | 10,459 | (131) | 259 | 266 | 31,675 | 525 | 32,200 |

¹ Includes deferred tax of £18 million.

² Relates to the sale of HSBC Private Banking Holdings (Suisse) SA. See Note 41 for further details.

³ Movements in the cash flow hedging reserve include amounts transferred to the income statement of £193 million comprising a £211 million loss taken to 'Net interest income' and a £18 million loss taken to 'Net trading income'.

The accompanying notes on pages 103 to 215 and the audited sections of the 'Report of the Directors: Risk' on pages 25 to 76 and the 'Report of the Directors: Capital Management' on pages 77 to 82 form an integral part of these financial statements.

Financial Statements (continued)

HSBC Bank plc statement of financial position at 31 December 2013

| | Notes | 2013 £m | 2012 £m |
|--|-------|----------------|----------------|
| ASSETS | | | |
| Cash and balances at central banks | | 60,996 | 45,262 |
| Items in the course of collection from other banks | | 1,374 | 1,213 |
| Trading assets | 15 | 101,287 | 137,999 |
| Financial assets designated at fair value | 16 | 3,983 | 4,373 |
| Derivatives | 17 | 112,623 | 140,340 |
| Loans and advances to banks | 32 | 41,566 | 17,207 |
| Loans and advances to customers | 32 | 240,180 | 225,567 |
| Financial investments | 18 | 45,048 | 36,603 |
| Other assets | 24 | 4,558 | 4,688 |
| Current tax assets | | 424 | 168 |
| Prepayments and accrued income | | 1,185 | 1,174 |
| Interests in associates and joint ventures | 20 | 62 | 62 |
| Investments in subsidiary undertakings | 23 | 11,206 | 11,031 |
| Goodwill and intangible assets | 21 | 891 | 879 |
| Property, plant and equipment | 22 | 1,224 | 1,241 |
| Deferred tax assets | 10 | 88 | 204 |
| Retirement benefit assets | 7 | 1,234 | 1,619 |
| Total assets | | 627,929 | 629,630 |
| LIABILITIES AND EQUITY | | | |
| Liabilities | | | |
| Deposits by banks | 32 | 52,514 | 30,129 |
| Customer accounts | 32 | 312,080 | 256,341 |
| Items in the course of transmission to other banks | | 422 | 334 |
| Trading liabilities | 25 | 62,414 | 104,946 |
| Financial liabilities designated at fair value | 26 | 22,006 | 23,513 |
| Derivatives | 17 | 114,710 | 143,921 |
| Debt securities in issue | 32 | 19,576 | 24,970 |
| Other liabilities | 27 | 3,827 | 5,248 |
| Current tax liabilities | | 142 | 30 |
| Accruals and deferred income | | 1,724 | 1,758 |
| Provisions | 29 | 1,271 | 1,250 |
| Deferred tax liabilities | 10 | 2 | 2 |
| Retirement benefit liabilities | 7 | 144 | 153 |
| Subordinated liabilities | 30 | 9,903 | 9,968 |
| Total liabilities | | 600,735 | 602,563 |
| Equity | | | |
| Called up share capital | 37 | 797 | 797 |
| Share premium account | | 20,427 | 20,025 |
| Other reserves | | (372) | (343) |
| Retained earnings | | 6,342 | 6,588 |
| Total equity | | 27,194 | 27,067 |
| Total equity and liabilities | | 627,929 | 629,630 |

The accompanying notes on pages 103 to 215 and the audited sections of the 'Report of the Directors: Risk' on pages 25 to 76 and the 'Report of the Directors: Capital Management' on pages 77 to 82 form an integral part of these financial statements.

A P S Simoes, Director

24 February 2014

Financial Statements (continued)

HSBC Bank plc cash flow statement for the year ended 31 December 2013

| | <i>Notes</i> | 2013 | 2012 |
|---|--------------|-----------------|----------|
| | | £m | £m |
| Cash flows from operating activities | | | |
| Profit before tax | | 2,913 | 2,132 |
| Adjustments for: | | | |
| – non-cash items included in profit before tax | 38 | 2,008 | 3,752 |
| – change in operating assets | 38 | (52,222) | (20,023) |
| – change in operating liabilities | 38 | 67,495 | 19,029 |
| – elimination of exchange differences ¹ | | 1,407 | (464) |
| – net gain from investing activities | | (117) | (317) |
| – contributions paid to defined benefit plans | | (387) | (150) |
| – tax (paid)/received..... | | (169) | 251 |
| Net cash generated from operating activities | | 20,928 | 4,210 |
| Cash flows from investing activities | | | |
| Purchase of financial investments | | (28,472) | (26,873) |
| Proceeds from the sale and maturity of financial investments | | 19,488 | 31,641 |
| Purchase of property, plant and equipment | | (227) | (175) |
| Proceeds from the sale of property, plant and equipment | | 3 | 10 |
| Purchase of goodwill and intangible assets | | (184) | (202) |
| Net cash outflow from acquisition of businesses and subsidiaries..... | | (406) | (707) |
| Proceeds from disposal and liquidation of businesses | | 447 | – |
| Net cash (used in)/generated from investing activities | | (9,351) | 3,694 |
| Cash flows from financing activities | | | |
| Issue of ordinary share capital | | 402 | – |
| Subordinated liabilities issued | | 542 | 350 |
| Subordinated liabilities repaid | | (542) | (350) |
| Net cash outflow from increase in stake of subsidiaries..... | | (207) | (2) |
| Dividends paid to shareholders | | (2,011) | (2,816) |
| Net cash used in financing activities | | (1,816) | (2,818) |
| Net increase in cash and cash equivalents | | 9,761 | 5,086 |
| Cash and cash equivalents at 1 January | | 78,661 | 75,356 |
| Effect of exchange rate changes on cash and cash equivalents | | (405) | (1,781) |
| Cash and cash equivalents at 31 December | 38 | 88,017 | 78,661 |

1 Adjustment to bring changes between opening and closing balance sheet amounts to average rates. This is not done on a line-by-line basis, as details cannot be determined without unreasonable expense.

The accompanying notes on pages 103 to 215 and the audited sections of the 'Report of the Directors: Risk' on pages 25 to 76 and the 'Report of the Directors: Capital Management' on pages 77 to 82 form an integral part of these financial statements.

HSBC Bank plc statement of changes in equity for the year ended 31 December 2013

| | 2013 | | | | | | | Total equity £m |
|--|-------------------------------------|------------------------|--------------------------------------|----------------------------|---|--|--------------------------------------|--------------------|
| | Called up share capital £m | Share premium £m | Other equity instruments £m | Retained earnings £m | Other reserves | | | |
| | | | | | Available- for-sale fair value reserve £m | Cash flow hedging reserve ³ £m | Foreign exchange reserve £m | |
| At 1 January | 797 | 20,025 | – | 6,588 | (377) | 167 | (133) | 27,067 |
| Profit for the year | – | – | – | 2,485 | – | – | – | 2,485 |
| Other comprehensive income (net of tax) | – | – | – | (709) | 62 | (175) | 86 | (736) |
| Available-for-sale investments | – | – | – | – | 62 | – | – | 62 |
| Cash flow hedges | – | – | – | – | – | (175) | – | (175) |
| Actuarial gains on defined benefit plans | – | – | – | (709) | – | – | – | (709) |
| Exchange differences and other | – | – | – | – | – | – | 86 | 86 |
| Total comprehensive income for the year | – | – | – | 1,776 | 62 | (175) | 86 | 1,749 |
| Share capital issued, net of costs ¹ | – | 402 | – | – | – | – | – | 402 |
| Dividends to shareholders | – | – | – | (2,011) | – | – | – | (2,011) |
| Net impact of equity-settled share-based payments ² | – | – | – | (3) | – | – | – | (3) |
| Change in business combinations and other movements | – | – | – | (8) | (2) | – | – | (10) |
| Tax on items taken directly to equity - current | – | – | – | – | – | – | – | – |
| At 31 December | 797 | 20,427 | – | 6,342 | (317) | (8) | (47) | 27,194 |

¹ All new capital subscribed during the year was issued to HSBC Holdings plc. See Note 37 for further details.

² Includes deferred tax of £(9)million.

³ Movements in the cash flow hedging reserve includes amounts transferred to the income statement of £317 million comprising a £181million loss taken to 'Net interest income' and a £131million loss taken to 'Net trading income'.

The accompanying notes on pages 103 to 215 and the audited sections of the 'Report of the Directors: Risk' on pages 25 to 76 and the 'Report of the Directors: Capital Management' on pages 77 to 82 form an integral part of these financial statements.

| | 2012 | | | | | | | Total equity £m |
|--|----------------------------------|------------------------|-----------------------------------|----------------------------|---|--|--------------------------------------|--------------------|
| | Called up share capital £m | Share premium £m | Other equity instruments £m | Retained earnings £m | Other reserves | | | |
| | | | | | Available- for-sale fair value reserve £m | Cash flow hedging reserve ² £m | Foreign exchange reserve £m | |
| At 1 January | 797 | 20,025 | – | 5,454 | (457) | 138 | (21) | 25,936 |
| Profit for the year | – | – | – | 3,751 | – | – | – | 3,751 |
| Other comprehensive income (net of tax) | – | – | – | 136 | 80 | 29 | (112) | 133 |
| Available-for-sale investments | – | – | – | – | 80 | – | – | 80 |
| Cash flow hedges | – | – | – | – | – | 29 | – | 29 |
| Actuarial gains on defined benefit plans | – | – | – | 136 | – | – | – | 136 |
| Exchange differences and other | – | – | – | – | – | – | (112) | (112) |
| Total comprehensive income for the year | – | – | – | 3,887 | 80 | 29 | (112) | 3,884 |
| Dividends to shareholders | – | – | – | (2,816) | – | – | – | (2,816) |
| Net impact of equity-settled share-based payments ¹ | – | – | – | 60 | – | – | – | 60 |
| Other | – | – | – | 3 | – | – | – | 3 |
| Tax on items taken directly to equity - current | – | – | – | – | – | – | – | – |
| At 31 December | 797 | 20,025 | – | 6,588 | (377) | 167 | (133) | 27,067 |

¹ Includes deferred tax of £18 million.

² Movements in the cash flow hedging reserve include an amount transferred to the income statement of £189 million loss taken to 'Net interest income'

The accompanying notes on pages 103 to 215 and the audited sections of the 'Report of the Directors: Risk' on pages 25 to 76 and the 'Report of the Directors: Capital Management' on pages 77 to 82 form an integral part of these financial statements.

Notes on the Financial Statements

1 Basis of preparation

(a) Compliance with International Financial Reporting Standards

The consolidated financial statements of the group and the separate financial statements of HSBC Bank plc have been prepared in accordance with International Financial Reporting Standards ('IFRSs') as issued by the International Accounting Standards Board ('IASB') and as endorsed by the EU. EU-endorsed IFRSs may differ from IFRSs as issued by the IASB if, at any point in time, new or amended IFRSs have not been endorsed by the EU.

At 31 December 2013, there were no unendorsed standards effective for the year ended 31 December 2013 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 2013 are prepared in accordance with IFRSs as issued by the IASB.

IFRSs comprise accounting standards issued by the IASB and its predecessor body as well as interpretations issued by the IFRS Interpretations Committee ('IFRIC') and its predecessor body.

Standards adopted during the year ended 31 December 2013

On 1 January 2013, the group adopted the following significant new standards and amendments to standards for which the financial effect is insignificant to these consolidated financial statements:

- IFRS 10 'Consolidated Financial Statements', IFRS 11 'Joint Arrangements', IFRS 12 'Disclosure of Interests in Other Entities' and amendments to IFRS 10, IFRS 11 and IFRS 12 'Transition Guidance' are required to be applied retrospectively.
- Under IFRS 10, there is one approach for determining consolidation for all entities, based on the concepts of power, variability of returns and their linkage. This replaces the approach which applied to previous financial statements which emphasised legal control or exposure to risks and rewards, depending on the nature of the entity. The group controls and consequently consolidates an entity when it is exposed, or has rights, to variable returns from its involvement with the entity and has the ability to affect those returns by exercising its power over the entity.

In accordance with the transitional provisions of IFRS 10, we reviewed the population of investments in entities as at 1 January 2013 to determine whether entities previously consolidated or unconsolidated in accordance with IAS 27 'Consolidated and Separate Financial Statements' and SIC 12 'Consolidation – Special Purpose Entities' changed their consolidation status as a result of applying IFRS 10. The result of this review was that the effect of applying the requirements of IFRS 10 did not have a material effect on these consolidated financial statements. Therefore no restatements are necessary on application of IFRS 10.

- IFRS 11 places more focus on the investors' rights and obligations than on the structure of the arrangement when determining the type of joint arrangement with which the group is involved, unlike the previous approach, and introduces the concept of a joint operation. The application of IFRS 11 did not have a material effect on these consolidated financial statements.
- IFRS 12 is a comprehensive standard on disclosure requirements for all forms of interests in other entities, including for unconsolidated structured entities. The disclosure requirements of IFRS 12 do not require comparative information to be provided for periods prior to initial application. New disclosures are provided in Note 41.
- IFRS 13 'Fair Value Measurement' establishes a single framework for measuring fair value and introduces new requirements for disclosure of fair value measurements. IFRS 13 is required to be applied prospectively from the beginning of the first annual period in which it is applied. The disclosure requirements of IFRS 13 do not require comparative information to be provided for periods prior to initial application. Disclosures are provided in Note 31.
- Amendments to IFRS 7 'Disclosures – Offsetting Financial Assets and Financial Liabilities' require disclosure of the effect or potential effects of netting arrangements on an entity's financial position. The amendment requires disclosure of recognised financial instruments that are subject to an enforceable master netting arrangement or similar agreement. The amendments have been applied retrospectively. Disclosures are provided in Note 34.
- Amendments to IAS 19 'Employee Benefits' ('IAS 19 revised') are required to be applied retrospectively.

Notes on the Financial Statements (continued)

The main effect of IAS 19 revised for the group is that it replaces the interest cost on the plan liability and expected return on plan assets with a finance cost comprising the net interest on the net defined benefit liability or asset. This finance cost is determined by applying to the net defined benefit liability or asset the same discount rate used to measure the defined benefit obligation. The difference between the actual return on plan assets and the return included in the finance cost component reflected in the income statement is presented in other comprehensive income. The effect of this change is to increase or decrease the pension expense by the difference between the current expected return on plan assets and the return calculated by applying the relevant discount rate.

During 2013, the group adopted a number of interpretations and amendments to standards which had an insignificant effect on the consolidated financial statements of the group and the separate financial statements of HSBC Bank plc.

(b) Presentation of information

Disclosures under IFRS 4 'Insurance Contracts' ('IFRS 4') and IFRS 7 'Financial Instruments: Disclosures' ('IFRS 7') concerning the nature and extent of risks relating to insurance contracts and financial instruments have been included in the audited sections of the 'Report of the Directors: Risk' on pages 25 to 76.

Capital disclosures under IAS 1 'Presentation of Financial Statements' ('IAS 1') have been included in the audited sections of the 'Report of the Directors: Capital Management' on pages 77 to 82.

Disclosures relating to the group's securitisation activities and structured products have been included in the audited section of 'Report of the Directors: Risk' on pages 52 to 53.

In publishing the parent company financial statements here together with the group financial statements, the bank has taken advantage of the exemption in section 408(3) of the Companies Act 2006 not to present its individual income statement, individual statement of comprehensive income and related notes that form a part of these financial statements.

The functional currency of the bank is Sterling, which is also the presentation currency of the consolidated financial statements of the group.

(c) Consolidation

The consolidated financial statements of the group comprise the financial statements of HSBC Bank plc and its subsidiaries made up to 31 December.

The group controls and consequently consolidates an entity when it is exposed, or has the rights, to variable returns from its involvement with the entity and has the ability to affect those returns through its power over the entity. The group is considered to have power over an entity when it has existing rights that give it the current ability to direct the relevant activities. For the group to have power over an entity, it must have the practical ability to exercise those rights. In the rare situations where potential voting rights exist, these are taken into account if the group has the practical ability to exercise those rights.

Where voting rights are not relevant in deciding whether the group has power over an entity, the assessment of control is based on all facts and circumstances. The group may have power over an entity even though it holds less than a majority of the voting rights, if it holds additional rights arising through other contractual arrangements or substantive potential voting rights which give it power.

When assessing whether to consolidate investment funds, the group reviews all facts and circumstances to determine whether the group, as fund manager, is acting as agent or principal. The group may be deemed to be a principal and hence controls and consolidates the funds, when it acts as fund manager and cannot be removed without cause, has variable returns through significant unit holdings and/or a guarantee and is able to influence the returns of the funds through its power.

The acquisition method of accounting is used when subsidiaries are acquired by the group. The cost of an acquisition is measured at the fair value of the consideration, including contingent consideration, given at the date of exchange. Acquisition-related costs are recognised as an expense in the income statement in the period in which they are incurred. The acquired identifiable assets, liabilities and contingent liabilities are generally measured at their fair values at the date of acquisition. Goodwill is measured as the excess of the aggregate of the consideration transferred, the amount of non-controlling interest and the fair value of the acquirer's previously held equity interest, if any, over the net of the amounts of the identifiable assets acquired and the liabilities assumed. The amount of non-controlling interest is measured either at fair value or at the non-controlling

Notes on the Financial Statements (continued)

interest's proportionate share of the acquiree's identifiable net assets. In a business combination achieved in stages, the previously held equity interest is remeasured at the acquisition-date fair value with the resulting gain or loss recognised in the income statement. In the event that the amounts of net assets acquired is in excess of the aggregate of the consideration transferred, the amount of non-controlling interest and the fair value of the group's previously held equity interest, the difference is recognised immediately in the income statement.

Changes in a parent's ownership interest in a subsidiary that do not result in a loss of control are treated as transactions between equity holders and are reported in equity.

Entities that are controlled by the group are consolidated from the date that the group obtains control until the date the group loses control of the entity.

The group performs a re-assessment of consolidation whenever there is a change in the facts and circumstances of determining the control of any entity.

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.

Disclosures of interests in unconsolidated structured entities provide information on involvement in these entities which exposes the group to variability of returns from the performance of the other entity. Involvement is considered on a case by case basis, taking into account the nature of the entity's activity. This could include holding debt and equity instruments, or the provision of structured derivatives, but excludes involvement that exist only because of a typical customer supplier relationship, such as market making transactions to facilitate secondary trading or senior lending in the normal course of business.

(d) Future accounting developments

In addition to the projects to complete financial instrument accounting, discussed below, the IASB is continuing to work on projects on insurance and lease accounting which could represent significant changes to accounting requirements in the future.

Amendments issued by the IASB and endorsed by the EU

In December 2011, the IASB issued amendments 'Offsetting Financial Assets and Financial Liabilities (Amendments to IAS 32)' which clarified the requirements for offsetting financial instruments and addressed inconsistencies in current practice when applying the offsetting criteria in IAS 32 'Financial Instruments: Presentation'. The amendments are effective for annual periods beginning on or after 1 January 2014 with early adoption permitted and are required to be applied retrospectively.

Based on the assessment performed to date, we do not expect the amendments to IAS 32 to have a material effect on the group's financial statements.

Amendments issued by the IASB but not endorsed by the EU

During 2012 and 2013, the IASB issued various amendments to IFRS that are effective from 1 January 2014 and which are expected to have an insignificant effect on the consolidated financial statements of the group.

In November 2009, the IASB issued IFRS 9 'Financial Instruments' which introduced new requirements for the classification and measurement of financial assets. In October 2010, the IASB issued an amendment to IFRS 9 incorporating requirements for financial liabilities. Together, these changes represent the first phase in the IASB's planned replacement of IAS 39 'Financial Instruments: Recognition and Measurement.' IFRS 9 classification and measurement requirements are to be applied retrospectively but prior periods need not be restated.

In November 2013, The IASB issued proposed amendments to IFRS 9 in respect of classification and measurement. Since the final requirements for classification and measurement are uncertain, it remains impracticable to quantify the effects of IFRS 9 as at the date of publication of these financial statements.

The second phase in the IASB's project to replace IAS 39 will address the impairment of financial assets. It is proposed to replace the 'incurred loss' approach to the impairment of financial assets carried at amortised cost in

Notes on the Financial Statements (continued)

IAS 39 with an expected credit loss approach and require that the expected credit loss approach be applied to other categories of financial instrument, including loan commitment and financial guarantees. The final requirements for impairment of financial assets are expected to be published in 2014.

The third phase of the project addresses general hedge accounting. Macro hedging is not included in the IFRS 9 project and will be considered separately. In November 2013, the IASB issued amendments to IFRS 9 in respect of the general hedge accounting requirements, transition and effective date. As a result of these amendments, it is confirmed that all phases of IFRS 9 (except for changes to the presentation of gains and losses for certain liabilities measured at fair value) must be applied from the same effective date. This effective date has not yet been set by the IASB but is not expected to be earlier than 1 January 2017. The revised hedge accounting requirements are applied prospectively and the group is currently assessing the impact they may have on the financial statements.

2 Summary of significant accounting policies

(a) Interest income and expense

Interest income and expense for all financial instruments except for those classified as held-for-trading or designated at fair value (other than debt securities issued by the group and derivatives managed in conjunction with those debt securities) 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 excluding future credit losses. The calculation includes all amounts paid or received by the group that are an integral part of the effective interest rate of a financial instrument, including transaction costs and all other premiums or discounts.

Interest on impaired financial assets is recognised using the rate of interest used to discount the future cash flows for the purpose of measuring the impairment loss.

(b) Non interest income

Fee income is earned from a diverse range of services provided by the group to its customers. Fee income is accounted for as follows:

- income earned on the execution of a significant act is recognised as revenue when the act is completed (for example, fees arising from negotiating, or participating in the negotiation of, a transaction for a third party, such as an arrangement for the acquisition of shares or other securities);
- income earned from the provision of services is recognised as revenue as the services are provided (for example, asset management, portfolio and other management advisory and service fees); and
- income which forms an integral part of the effective interest rate of a financial instrument is recognised as an adjustment to the effective interest rate (for example, certain loan commitment fees) and recorded in 'Interest income' (Note 2(a)).

Net trading income comprises all gains and losses from changes in the fair value of financial assets and financial liabilities held for trading, together with related interest income, expense and dividends.

Net income from financial instruments designated at fair value includes:

- all gains and losses from changes in the fair value of financial assets and financial liabilities designated at fair value through profit or loss including liabilities under investment contracts;
- all gains and losses from changes in the fair value of derivatives that are managed in conjunction with financial assets and liabilities designated at fair value through profit or loss; and
- interest income and expense and dividend income in respect of:
 - financial assets and liabilities designated at fair value through profit or loss; and
 - derivatives managed in conjunction with the above,

Notes on the Financial Statements (continued)

except for interest arising from the group's issued debt securities and derivatives managed in conjunction with those debt securities, which is recognised in 'Interest expense'. (Note 2(a)).

Dividend income is recognised when the right to receive payment is established. This is the ex-dividend date for listed equity securities and usually the date when shareholders have approved the dividend for unlisted equity securities.

(c) Operating Segments

The group has revised its operating segments to: Retail Banking and Wealth Management, Commercial Banking, Global Banking and Markets, Global Private Banking and Other, effective 1 January 2013. This follows the sale of HSBC Private Banking (Suisse) SA in November 2012 and a reorganisation of reporting lines. Global Private Banking includes HSBC Private Bank (UK) Limited and Private Banking businesses in France.

The revised segments are consistent with those reported to the group's Executive Committee, the identified Chief Operating Decision Maker ('CODM') under IFRS 8.

Measurement of segmental assets, liabilities, income and expenses is in accordance with the group's accounting policies. Segmental income and expenses include transfers between segments and these transfers are conducted on arm's length terms and conditions. Shared costs are included in segments on the basis of the actual recharges made.

(d) Valuation of financial instruments

All financial instruments are recognised initially at fair value. In the normal course of business, the fair value of a financial instrument on initial recognition is the transaction price (that is, the fair value of the consideration given or received). In certain circumstances, however, the fair value will be based on other observable current market transactions in the same instrument, without modification or repackaging, or on a valuation technique whose variables include only data from observable markets, such as interest rate yield curves, option volatilities and currency rates. When such evidence exists, the group recognises a trading gain or loss on inception of the financial instrument, being the difference between the transaction price and the fair value. When unobservable market data have a significant impact on the valuation of financial instruments, the entire initial difference in fair value indicated by the valuation model from the transaction price is not recognised immediately in the income statement but is recognised over the life of the transaction on an appropriate basis, or when the inputs become observable, or the transaction matures or is closed out, or when the group enters into an offsetting transaction.

The fair value of financial instruments is generally measured by the individual financial instrument. However, in cases where the group manages a group of financial assets and financial liabilities on the basis of its net exposure to either market risks or credit risk, the group measures the fair value of the group of financial instruments on a net basis, but presents the underlying financial assets and liabilities separately in the financial statements, unless they satisfy the IFRS offsetting criteria as described on page 116.

Subsequent to initial recognition, the fair values of financial instruments measured at fair value are measured in accordance with the group's valuation methodologies, which are described in Note 31 and Note 32.

(e) Loans and advances to banks and customers

Loans and advances to banks and customers include loans and advances originated by the group which are not classified either as held for trading or designated at fair value. Loans and advances are recognised when cash is advanced to borrowers. They are derecognised when either the borrower repays its obligations, or the loans are sold or written off, or substantially all the risks and rewards of ownership are transferred. They are initially recorded at fair value plus any directly attributable transaction costs and are subsequently measured at amortised cost using the effective interest method, less impairment losses. Where exposures are hedged by derivatives designated and qualifying as fair value hedges, the carrying value of the loans and advances so hedged includes a fair value adjustment for the hedged risk only.

Loans and advances are reclassified to 'Assets held for sale' when their carrying amounts are to be recovered principally through sale, they are available for sale in their present condition and their sale is highly probable; however, such loans and advances continue to be measured in accordance with the policy described above.

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

Notes on the Financial Statements (continued)

for trading and measured at fair value through profit and loss. Where it is not the group's intention to trade the loan, a provision on the loan commitment is only recorded where it is probable that the group will incur a loss. This may occur, for example, where a loss of principal is probable or the interest rate charged on the loan is lower than the cost of funding. On inception the loan, the hold portion is recorded at its fair value and subsequently measured at amortised cost using the effective interest method. However, where the initial fair value is lower than the cash amount advanced (for example, due to the rate of interest charged on the loan being below the market rate of interest), the write down is charged to the income statement. The write down will be recovered over the life of the loan, through the recognition of interest income using the effective interest method, unless the loan becomes impaired. The write down is recorded as a reduction to other operating income.

Financial assets which have been reclassified out of the fair value through profit and loss category into the loans and receivables category are initially recorded at the fair value at the date of reclassification. The reclassified assets are subsequently measured at amortised cost, using the effective interest rate determined at the date of reclassification.

(f) Impairment of loans and advances

Losses for impaired loans are recognised promptly when there is objective evidence that impairment of a loan or portfolio of loans has occurred. Impairment losses are calculated on individual loans and on groups of loans assessed collectively. Impairment losses are recorded as charges to the income statement. The carrying amount of impaired loans on the balance sheet is reduced through the use of impairment allowance accounts. Losses which may arise from future events are not recognised.

Individually assessed loans and advances

The factors considered in determining that a loan is individually significant for the purposes of assessing impairment include:

- the size of the loan;
- the number of loans in the portfolio;
- the importance of the individual loan relationship and how this is managed; and
- whether volumes of defaults and losses are sufficient to enable a collective assessment methodology to be applied.

Loans considered as individually significant are typically to corporate and commercial customers and are for larger amounts, which are managed on an individual relationship basis. Retail lending portfolios are generally assessed for impairment on a collective basis as the portfolios generally consist of large pools of homogeneous loans.

For all loans that are considered individually significant, the group assesses on a case-by-case basis at each balance sheet date whether there is any objective evidence that a loan is impaired. The criteria used by the group to determine that there is such objective evidence include:

- known cash flow difficulties experienced by the borrower;
- past due contractual payments of either principal or interest;
- the probability that the borrower will enter bankruptcy or other financial realisation; and
- a significant downgrading in credit rating by an external credit rating agency.

For those loans where objective evidence of impairment exists, impairment losses are determined considering the following factors:

- the group's aggregate exposure to the customer;
- the viability of the customer's business model and its capability to trade successfully out of financial difficulties and generate sufficient cash flow to service its debt obligations;
- the amount and timing of expected receipts and recoveries;
- the likely dividend available on liquidation or bankruptcy;
- the extent of other creditors' commitments ranking ahead of, or *pari passu* with, the group and the likelihood of other creditors continuing to support the company;

Notes on the Financial Statements (continued)

- the complexity of determining the aggregate amount and ranking of all creditor claims and the extent to which legal and insurance uncertainties are evident;
- the realisable value of security (or other credit mitigants) and likelihood of successful repossession;
- the likely deduction of any costs involved in recovery of amounts outstanding;
- the ability of the borrower to obtain and make payments in, the currency of the loan if not denominated in local currency; and
- when available, the secondary market price of the debt.

The realisable value of security is determined based on the current market value when the impairment assessment is performed. The value is not adjusted for expected future increases in market prices however adjustments are made to reflect local conditions, such as forced sale discounts.

Impairment losses are calculated by discounting the expected future cash flows of a loan, which includes expected future receipts of contractual interest, at the loan's original effective interest rate, and comparing the resultant present value with the loan's current carrying amount. The impairment allowances on individually significant accounts are reviewed at least quarterly and more regularly when circumstances require. This normally encompasses re-assessment of the enforceability of any collateral held and the timing and amount of actual and anticipated receipts. Individually assessed impairment allowances are only released when there is reasonable and objective evidence of a reduction in the established loss estimate.

Collectively assessed loans and advances

Impairment is assessed on a collective basis in two circumstances:

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

Incurring 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 impairment. 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 or product);
- the estimated period between impairment occurring and the loss being identified and evidenced by the establishment of an appropriate allowance against the individual loan; and
- management's experienced judgement as to whether current economic and credit conditions are such that the actual level of inherent losses at the balance sheet date is likely to be greater or less than that suggested by historical experience.

The period between a loss occurring and its identification is estimated by local management for each identified portfolio. The factors that may influence this estimation include economic and market conditions, customer behaviour, portfolio management information, credit management techniques and collection and recovery experiences in the market. As it is assessed empirically on a periodic basis the estimated period between a loss occurring and its identification may vary over time as these factors change.

Notes on the Financial Statements (continued)

Homogeneous groups of loans and advances

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

- when appropriate empirical information is available, the group uses roll-rate methodology. This methodology employs statistical analyses of historical data and experience of delinquency and default to estimate the amount of loans that will eventually be written off as a result of the events occurring before the balance sheet date, which the group is not able to identify on an individual loan basis, and that can be reliably estimated. Under this methodology, loans are grouped into ranges according to the number of days past due and statistical analysis is used to estimate the likelihood that loans in each range will progress through the various stages of delinquency and ultimately prove irrecoverable. Current economic conditions are also evaluated when calculating the appropriate level of allowance required to cover inherent loss. The estimated loss is the difference between the present value of expected future cash flows, discounted at the original effective interest rate of the portfolio, and the carrying amount of the portfolio. In certain highly developed markets, sophisticated models also take into account behavioural and account management trends as revealed in, for example, bankruptcy and rescheduling statistics.
- when the portfolio size is small or when information is insufficient or not reliable enough to adopt a roll-rate methodology, the group adopts a basic approach based on historical experience

In normal circumstances, historical experience provides the most objective and relevant information from which to assess inherent loss within each portfolio, though sometimes it provides less relevant information about the inherent loss in a given portfolio at the balance sheet date, for example, when there have been changes in economic, regulatory or behavioural conditions which result in the most recent trends in portfolio risk factors being not fully reflected in the statistical models. In these circumstances, the risk factors are taken into account by adjusting the impairment allowances derived solely from historical loss experience.

These additional portfolio risk factors may include recent loan portfolio growth and product mix, unemployment rates, bankruptcy trends, geographic concentrations, loan product features (such as the ability of borrowers to repay adjustable-rate loans where reset interest rates give rise to increases in interest charges), economic conditions such as national and local trends in housing markets and interest rates, portfolio seasoning, account management policies and practices, current levels of write-offs, adjustments to the period of time between loss identification and write-off, changes in laws and regulations and other items which can affect customer payment patterns on outstanding loans, such as natural disasters. These risk factors, where relevant, are taken into account when calculating the appropriate level of impairment allowances by adjusting the impairment allowances derived solely from historical loss experience.

Roll rates, loss rates and the expected timing of future recoveries are regularly benchmarked against actual outcomes to ensure they remain appropriate.

Write-off of loans and advances

Loans (and the related impairment allowance account) are normally written off, either partially or in full, when there is no realistic prospect of recovery. Where loans are secured, this is generally after receipt of any proceeds from the realisation of security. In circumstances where the net realisable value of any collateral has been determined and there is no reasonable expectation of further recovery, write off may be earlier.

Reversals of impairment

If the amount of an impairment loss decreases in a subsequent period and the decrease can be related objectively to an event occurring after the impairment was recognised, the excess is written back by reducing the loan impairment allowance account accordingly. The write-back is recognised in the income statement.

Reclassified loans and advances

Where financial assets have been reclassified out of the fair value through profit or loss category to the loans and receivables category, the effective interest rate determined at the date of reclassification is used to calculate any impairment losses.

Notes on the Financial Statements (continued)

Following reclassification, where there is a subsequent increase in the estimates of future cash receipts as a result of increased recoverability of those cash receipts, the effect of that increase is recognised as an adjustment to the effective interest rate from the date of change in the estimate rather than as an adjustment to the carrying amount of the asset at the date of change in the estimate.

Assets acquired in exchange for loans

Non-financial assets acquired in exchange for loans as part of an orderly realisation are recorded as assets held for sale and reported in 'Other assets' if the carrying amounts of the assets are recovered principally through sale, the assets are available for sale in their present condition and their sale is highly probable. The asset acquired is recorded at the lower of its fair value less costs to sell and the carrying amount of the loan (net of impairment allowance) at the date of exchange. No depreciation is charged in respect of assets held for sale. Any subsequent write-down of the acquired asset to fair value less costs to sell is recognised in the income statement, in 'Other operating income'. Any subsequent increase in the fair value less costs to sell, to the extent this does not exceed the cumulative write down, is also recognised in 'Other operating income', together with any realised gains or losses on disposal.

Renegotiated loans

Loans subject to collective impairment assessment whose terms have been renegotiated are no longer considered past due, but are treated as up to date loans for measurement purposes once the minimum numbers of payments required under the new arrangements have been received. Renegotiated loans are considered when calculating collective impairment provisions, either through management's judgment or by segregation from other parts of the loan portfolio, to recognise that higher rates of losses are often encountered in this segment of the portfolio. Loans subject to individual impairment assessment, whose terms have been renegotiated, are subject to ongoing review to determine whether they remain impaired or should be considered past due. The carrying amount of loans that have been classified as renegotiated retain this classification until maturity or derecognition. Interest is recorded on renegotiated loans taking into account the new contractual terms following renegotiation.

A loan that is renegotiated is derecognised if the existing agreement is cancelled and a new agreement made on substantially different terms, or if the terms of an existing agreement are modified, such that the renegotiated loan is substantially a different financial instrument.

(g) 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 or incurred 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 the financial instruments and are normally derecognised when either sold (assets) or extinguished (liabilities). Measurement is initially at fair value, with transaction costs taken to the income statement. Subsequently their fair values are remeasured and gains and losses from changes therein are recognised in the income statement in 'Net trading income'.

(h) 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.

Notes on the Financial Statements (continued)

Financial assets and financial liabilities under unit-linked insurance and unit-linked investment contracts

Liabilities to customers under linked contracts are determined based on the fair value of the assets held in the linked funds, with changes recognised in the income statement. If no designation was made for the assets relating to the customer liabilities they would be classified as available-for-sale and the changes in fair value would be recorded directly in other comprehensive income. These financial instruments are managed on a fair value basis and information is provided to management on that basis. Designation at fair value of the financial assets and liabilities under investment contracts allows the changes in fair values to be recorded in the income statement and presented in the same line.

- applies to groups of financial assets, financial liabilities or combinations thereof that are managed and their performance evaluated on a fair value basis in accordance with a documented risk management or investment strategy and where information about the groups of financial instruments is reported to management on that basis. Under this criterion, certain financial assets held to meet liabilities under insurance contracts are the main class of financial instrument so designated. The group has documented risk management and investment strategies designed to manage such assets at fair value, taking into consideration the relationship of assets to liabilities in a way that mitigates market risks. Reports are provided to management on the fair value of the assets. Fair value measurement is also consistent with the regulatory reporting requirements under the appropriate regulations for these insurance operations.
- relates to financial instruments containing one or more embedded derivatives that significantly modify the cash flows resulting from those financial instruments, including certain debt issues and debt securities held.

The fair value designation, once made, is irrevocable. Designated financial assets and financial liabilities are recognised when the group enters into the contractual provisions of the arrangements with counterparties, which is generally on trade date, and are normally derecognised when either sold (assets) or extinguished (liabilities). Measurement is initially at fair value, with transaction costs taken directly to the income statement. Subsequently, the fair values are remeasured and gains and losses from changes therein are recognised in the income statement in 'Net income from financial instruments designated at fair value'.

(i) Financial investments

Treasury bills, debt securities and equity shares intended to be held on a continuing basis, other than those designated at fair value, are classified as available-for-sale or held-to-maturity. Financial investments are recognised on trade date, when the group enters into contractual arrangements with counterparties to purchase securities, and are normally derecognised when either the securities are sold or the borrowers repay their obligations.

- (i) Available-for-sale financial assets are initially measured at fair value plus direct and incremental transaction costs. They are subsequently remeasured at fair value and changes therein are recognised in other comprehensive income in "Available-for-sale investments – fair value gains/ (losses)" until the financial assets are either sold or become impaired. When available-for-sale financial assets are sold, cumulative gains or losses previously recognised in other comprehensive income are recognised in the income statement as 'Gains less losses from financial investments'.

Interest income is recognised on available-for-sale debt securities using the effective interest method, calculated over the asset's expected life. Premiums and/or discounts arising on the purchase of dated investment securities are included in the calculation of their effective interest rates. Dividends are recognised in the income statement when the right to receive payment has been established.

At each balance sheet date an assessment is made of whether there is any objective evidence of impairment in the value of a financial asset. Impairment losses are recognised if, and only if, there is objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the financial asset (a 'loss event') and that loss event (or events) has an impact on the estimated future cash flows of the financial asset that can be reliably estimated.

If the available-for-sale financial asset is impaired, the difference between the financial asset's acquisition cost (net of any principal repayments and amortisation) and the current fair value, less any previous impairment loss recognised in the income statement, is removed from other comprehensive income and recognised in the income statement.

Impairment losses for available-for-sale debt securities are recognised within 'Loan impairment charges and other credit risk provision' in the income statement and impairment losses for available-for-sale equity

Notes on the Financial Statements (continued)

securities are recognised within 'Gains less losses from financial investments' in the income statement. The impairment methodologies for available-for-sale financial assets are set out in more detail below.

- Available-for-sale debt securities: When assessing available-for-sale debt securities for objective evidence of impairment at the reporting date, the group considers all available evidence, including observable data or information about events specifically relating to the securities which may result in a shortfall in recovery of future cash flows. These events may include a significant financial difficulty of the issuer, a breach of contract such as a default, bankruptcy or other financial reorganisation, or the disappearance of an active market for the debt security because of financial difficulties relating to the issuer.

These types of specific event and other factors such as information about the issuers' liquidity, business and financial risk exposures, levels of and trends in default for similar financial assets, national and local economic trends and conditions, and the fair value of collateral and guarantees may be considered individually, or in combination, to determine if there is objective evidence of impairment of a debt security.

In addition, when assessing available-for-sale asset-backed securities ('ABS's) for objective evidence of impairment, the group considers the performance of underlying collateral and the extent and depth of market price declines. Changes in credit ratings are considered but a downgrade of a security's credit rating is not, of itself, evidence of impairment. The primary indicators of potential impairment are considered to be adverse fair value movements, and the disappearance of an active market for a security.

- Available-for-sale equity securities: Objective evidence of impairment for available-for sale equity securities may include specific information about the issuer as detailed above, but may also include information about significant changes in technology, markets, economics or the law that provides evidence that the cost of the equity securities may not be recovered.

A significant or prolonged decline in the fair value of the asset below its cost is also objective evidence of impairment. In assessing whether it is significant, the decline in fair value is evaluated against the original cost of the asset at initial recognition. In assessing whether it is prolonged, the decline is evaluated against the period in which the fair value of the asset has been below its original cost at initial recognition.

Once an impairment loss has been recognised on an available-for-sale financial asset, the subsequent accounting treatment for changes in the fair value of that asset differs depending on the nature of the available-for-sale financial asset concerned:

- for an available-for-sale debt security, a subsequent decline in the fair value of the instrument is recognised in the income statement when there is further objective evidence of impairment as a result of further decreases in the estimated future cash flows of the financial asset. Where there is no further objective evidence of impairment, the decline in the fair value of the financial asset is recognised in other comprehensive income. If the fair value of the debt security increases in a subsequent period and the increase can be objectively related to an event occurring after the impairment loss was recognised in the income statement the impairment loss is reversed through the income statement to the extent of the increase in fair value.
- for an available-for-sale equity security, all subsequent increases in the fair value of the instrument are treated as a revaluation and are recognised directly in other comprehensive income. Impairment losses recognised on the equity security are not reversed through the income statement. Subsequent decreases in the fair value of the available-for-sale equity security are recognised in the income statement, to the extent that further cumulative impairment losses have been incurred in relation to the acquisition cost of the equity security.

- (ii) Held-to-maturity investments are non-derivative financial assets with fixed or determinable payments and fixed maturities that the group positively intends, and is able, to hold until maturity. Held-to-maturity investments are initially recorded at fair value plus any directly attributable transaction costs, and are subsequently measured at amortised cost using the effective interest method, less any impairment losses.

(j) 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

Notes on the Financial Statements (continued)

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', 'Loans and advances to customers' or 'Trading assets' as appropriate. The difference between the sale and repurchase price is treated as interest and recognised over the life of the agreement for loans and advances to banks and customers and as net trading income for trading assets.

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'.

(k) Derivatives and hedge accounting

Derivatives are recognised initially, and are subsequently remeasured, at fair value. Fair values of exchange-traded derivatives are obtained from quoted market prices. Fair values of over-the-counter derivatives are obtained using valuation techniques, including discounted cash flow models and option pricing models.

Derivatives may be embedded in other financial instruments, for example, a convertible bond with an embedded conversion option. Embedded derivatives are treated as separate derivatives when their economic characteristics and risks are not clearly and closely related to those of the host contract; the terms of the embedded derivative would meet the definition of a stand-alone derivative if they were contained in a separate contract, and the combined contract is not held for trading nor designated at fair value. These embedded derivatives are measured at fair value with changes therein recognised in the income statement.

Derivatives are classified as assets when their fair value is positive, or as liabilities when their fair value is negative. Derivative assets and liabilities arising from different transactions are offset only if the transactions are with the same counterparty, a legal right of offset exists, and the parties intend to settle the cash flows on a net basis.

The method of recognising fair value gains or losses depends on whether derivatives are held for trading or are designated as hedging instruments, and if the latter, the nature of the risks being hedged. All gains and losses from changes in the fair value of derivatives held for trading are recognised in the income statement. When derivatives are designated as hedges, the group classifies them as either: (i) hedges of the change in fair value of recognised assets or liabilities or firm commitments ('fair value hedges'); (ii) hedges of the variability in highly probable future cash flows attributable to a recognised asset or liability, or a forecast transaction ('cash flow hedges'); or (iii) a hedge of a net investment 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 the 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.

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Cash flow hedge

The effective portion of changes in the fair value of derivatives that are designated and qualify as cash flow hedges is recognised in other comprehensive income within “Cash flow hedges – fair value gains/(losses)”. Any gain or loss in fair value relating to an ineffective portion is recognised immediately in the income statement.

The accumulated gains and losses recognised in other comprehensive income are reclassified to the income statement in the periods in which the hedged item will affect profit or loss. However, when the forecast transaction that is hedged results in the recognition of a non-financial asset or a non-financial liability, the gains and losses previously recognised in other comprehensive income are removed from equity and included in the initial measurement of the cost of the asset or liability.

When a hedging instrument expires or is sold, or when a hedge no longer meets the criteria for hedge accounting, any cumulative gain or loss recognised in other comprehensive income 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 other comprehensive income is immediately reclassified to the income statement.

Net investment hedge

Hedges of net investments in foreign operations are accounted for in a similar way to cash flow hedges. A gain or loss on the effective portion of the hedging instrument is recognised in other comprehensive income; a gain or loss on the ineffective portion is recognised immediately in the income statement. Gains and losses previously recognised in other comprehensive income are reclassified to the income statement on the disposal, or part disposal, of the foreign operation.

Hedge effectiveness testing

To qualify for hedge accounting, the group requires that at the inception of the hedge and throughout its life, each hedge must be expected to be highly effective (prospective effectiveness) and demonstrate actual effectiveness (retrospective effectiveness) on an ongoing basis.

The documentation of each hedging relationship sets out how the effectiveness of the hedge is assessed. The method a group entity adopts for assessing hedge effectiveness will depend on its risk management strategy.

For prospective effectiveness the hedging instrument must be expected to be highly effective in offsetting changes in fair value or cash flows attributable to the hedged risk during the period for which the hedge is designated. For actual effectiveness to be achieved, the changes in fair value or cash flows must offset each other in the range of 80 per cent to 125 per cent.

Hedge ineffectiveness is recognised in the income statement in ‘Net trading income’.

Derivatives that do not qualify for hedge accounting

All gains and losses from changes in the fair values of derivatives that do not qualify for hedge accounting are recognised immediately in the income statement. These gains and losses are reported in ‘Net trading income’, except where derivatives are managed in conjunction with financial instruments designated at fair value (other than derivatives managed in conjunction with debt securities issued by the group), in which case gains and losses are reported in ‘Net income from financial instruments designated at fair value’. The interest on derivatives managed in conjunction with debt securities issued by the group which are designated at fair value is recognised in ‘Interest expense’. All other gains and losses on these derivatives are reported in ‘Net income from financial instruments designated at fair value’.

Derivatives that do not qualify for hedge accounting include non-qualifying hedges entered into as part of documented interest rate management strategies for which hedge accounting was not, or could not, be applied. The size and direction of changes in fair value of non-qualifying hedges can be volatile from year to year, but do not alter the cash flows expected as part of the documented management strategies for both the non-qualifying hedge instruments and the assets and liabilities to which the documented interest rate strategies relate. Non-qualifying hedges therefore operate as economic hedges of the related assets and liabilities.

(l) 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:

Notes on the Financial Statements (continued)

- 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.

(m) Offsetting financial assets and financial liabilities

Financial assets and financial liabilities are offset and the net amount is reported in the balance sheet when there is a legally enforceable right to offset the recognised amounts and there is an intention to settle on a net basis, or realise the asset and settle the liability simultaneously.

(n) Subsidiaries, associates and joint ventures

The group classifies investments in entities which it controls as subsidiaries. Investments in which the group, together with one or more parties, has joint control of an arrangement set up to undertake an economic activity are classified as joint ventures. The group classifies investments in entities over which it has significant influence, and that are neither subsidiaries nor joint ventures, as associates.

The bank's investments in subsidiaries are stated at cost less any impairment losses. Impairment losses recognised in prior periods are reversed through the income statement if, and only if, there has been a change in the estimates used to determine the investment in subsidiary's recoverable amount since the last impairment loss was recognised.

Investments in associates and interests in joint ventures are recognised using the equity method. Under this method, such investments are initially stated at cost, including attributable goodwill, and are adjusted thereafter for the post-acquisition change in the group's share of net assets.

Profits on transactions between the group and its associates and joint ventures are eliminated to the extent of the group's interest in the respective associates or joint ventures. Losses are also eliminated to the extent of the group's interest in the associates or joint ventures unless the transaction provides evidence of an impairment of the asset transferred.

A structured entity is an entity that has been designed so that voting or similar rights are not the dominant factor in deciding who controls the entity, for example when any voting rights relate to administrative tasks only, and key activities are directed by contractual agreement. Structured entities often have restricted activities and a narrow and well defined objective. Examples of structured entities include investment funds, securitisation vehicles and asset backed financings. Involvement with consolidated and unconsolidated structured entities is disclosed in Note 41.

For the purposes of disclosure, the group would be considered to sponsor another entity if it has a key role in establishing that entity or in bringing together the relevant counterparties so that the transaction, which is the purpose of the entity, can occur. This may include instances where the group initially sets up an entity for a structured transaction, and acts as an underwriter or lead manager. The group would not be considered a sponsor once our initial involvement in setting up the structured entity had ceased even if we were subsequently involved with an entity to the extent of providing arm's length services in the normal course of business, for example through the provision of senior lending.

(o) Goodwill and intangible assets

- Goodwill arises on the acquisition of subsidiaries, when the aggregate of the fair value of the consideration transferred, the amount of any non-controlling interest and the fair value of any previously held equity interests in the acquiree exceed the amounts of the identifiable assets and liabilities acquired. If they do not exceed the amounts of the identifiable assets and liabilities of an acquired business, the difference is recognised immediately in the income statement. Goodwill arises on the acquisition of interests in joint ventures and associates when the cost of investment exceeds the group's share of the net fair value of the associate's or joint venture's identifiable assets and liabilities.

Intangible assets are recognised separately from goodwill when they are separable or arise from contractual or other legal rights, and their fair value can be measured reliably.

Goodwill is allocated to cash-generating units for the purpose of impairment testing, which is undertaken at the lowest level at which goodwill is monitored for internal management purposes. Impairment testing is

Notes on the Financial Statements (continued)

performed at least annually, and whenever there is an indication that the cash-generating unit may be impaired, by comparing the recoverable amount from a cash-generating unit with the carrying amount of its net assets, including attributable goodwill. The recoverable amount of an asset is the higher of its fair value less cost to sell and its value in use. Value in use is the present value of the expected future cash flows from a cash-generating unit. If the recoverable amount is less than the carrying value, an impairment loss is charged to the income statement. Goodwill is stated at cost less accumulated impairment losses.

Goodwill on acquisitions of interests in joint ventures and associates is included in 'Interests in associates and joint ventures' and is not tested separately for impairment.

At the date of disposal of a business, attributable goodwill is included in the group's share of net assets in the calculation of the gain or loss on disposal.

Goodwill is included on a disposal group held for sale if the group is a cash-generating unit ('CGU') to which goodwill has been allocated or it is an operation within such a CGU. The goodwill associated with the operation disposed of is measured on the basis of the relative values of the operation disposed of and the portion of the CGU retained.

- (ii) Intangible assets include the present value of in-force long-term insurance business, computer software, trade names, mortgage service rights, customer lists, core deposit relationships, credit card customer relationships and merchant or other loan relationships. Computer software includes both purchased and internally generated software. The cost of internally generated software comprises all directly attributable costs necessary to create, produce and prepare the software to be capable of operating in the manner intended by management. Costs incurred in the ongoing maintenance of software are expensed immediately as incurred. Intangible assets are subject to impairment review if there are events or changes in circumstances that indicate that the carrying amount may not be recoverable. Where:
- intangible assets that have an indefinite useful life, or are not yet ready for use, are tested for impairment annually. This impairment test may be performed at any time during the year, provided it is performed at the same time every year. An intangible asset recognised during the current period is tested before the end of the current year; and
 - intangible assets that have a finite useful life, except for the present value of in-force long-term insurance business, are stated at cost less amortisation and accumulated impairment losses and are amortised over their estimated useful lives. Estimated useful life is the lower of legal duration and expected useful life. The amortisation of mortgage servicing rights is included within 'Net fee income'.

For the accounting policy governing the present value of in-force long-term insurance businesses, see Note 2(x).

- (iii) Intangible assets with finite useful lives are amortised, generally on a straight-line basis, over their useful lives as follows:

| | |
|---------------------------------------|----------------------------------|
| Trade names | 10 years |
| Mortgage service rights..... | generally between 5 and 12 years |
| Internally generated software | between 3 and 5 years |
| Purchased software | between 3 and 5 years |
| Customer/merchant relationships | between 3 and 10 years |
| Other | generally 10 years |

(p) Property, plant and equipment

Land and buildings are stated at historical cost, or fair value at the date of transition to IFRSs ('deemed costs'), less any impairment losses and depreciation calculated to write off the assets over their estimated useful lives as follows:

- freehold land is not depreciated;
- freehold buildings are depreciated at the greater of 2% per annum on a straight-line basis or over their remaining useful lives; and
- leasehold buildings are depreciated over the shorter of their unexpired terms of the leases or over their remaining useful lives.

Equipment, fixtures and fittings (including equipment on operating leases where the group is the lessor) are stated at cost less any impairment losses and depreciation calculated on a straight-line basis to write off the

Notes on the Financial Statements (continued)

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.

(q) 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.

(r) Income tax

Income tax comprises current tax and deferred tax. Income tax is recognised in the income statement except to the extent that it relates to items recognised in other comprehensive income or directly in equity, in which case it is recognised in the same statement in which the related item appears.

Current tax is the tax expected to be payable on the taxable profit for the year, calculated using tax rates enacted or substantively enacted by the balance sheet date, and any adjustment to tax payable in respect of previous years. Current tax assets and liabilities are offset when the group intends to settle on a net basis and the legal right to offset exists.

Deferred tax is recognised on temporary differences between the carrying amounts of assets and liabilities in the balance sheet and the amounts attributed to such assets and liabilities for tax purposes. Deferred tax liabilities are generally recognised for all taxable temporary differences and deferred tax assets are recognised to the extent that it is probable that future taxable profits will be available against which deductible temporary differences can be utilised.

Deferred tax is calculated using the tax rates expected to apply in the periods in which the assets will be realised or the liabilities settled based on tax rates and laws enacted, or substantively enacted, by the balance sheet date. Deferred tax assets and liabilities are offset when they arise in the same tax reporting group and relate to income taxes levied by the same taxation authority, and when the group has a legal right to offset.

Deferred tax relating to actuarial gains and losses on post-employment benefits is recognised in other comprehensive income. Deferred tax relating to share-based payment transactions is recognised directly in equity to the extent that the amount of the estimated future tax deduction exceeds the amount of the related cumulative remuneration expense. Deferred tax relating to fair value remeasurements of available-for-sale investments and cash flow hedging instruments which are charged or credited directly to other comprehensive income, is also credited or charged directly to other comprehensive income and is subsequently recognised in the income statement when the deferred fair value gain or loss is recognised in the income statement.

Notes on the Financial Statements (continued)

(s) Pension and other post-employment benefits

The group operates a number of pension and other post-employment benefit plans. These plans include both defined benefit and defined contribution plans and various other post-employment benefits such as post-employment healthcare.

Payments to defined contribution plans and state-managed retirement benefit plans, where the group's obligations under the plans are equivalent to a defined contribution plan, are charged as an expense as they fall due.

The defined benefit pension costs and the present value of defined benefit obligations are calculated at the reporting date by the scheme's actuaries using the Projected Unit Credit Method. The net charge to the income statement mainly comprises the service cost and the net interest on the net defined benefit asset or liability and is presented in operating expenses.

The past service costs which are charged immediately to the income statement is the change in the present value of the defined benefit obligation for service in prior periods, resulting from a plan amendment or curtailment.

Actuarial gains and losses comprise experience adjustments (the effects of differences between the previous actuarial assumptions and what has actually occurred), as well as the effects of changes in actuarial assumptions. Actuarial gains and losses are recognised in other comprehensive income in the period in which they arise.

The defined benefit liability recognised in the balance sheet represents the present value of defined benefit obligations adjusted for unrecognised past service costs and reduced by the fair value of plan assets. Any net defined benefit surplus is limited to unrecognised past service costs plus the present value of available refunds and reductions in future contributions to the plan.

The costs of obligations arising from other defined post-employment benefits plans, such as defined benefit health-care plans, are accounted for on the same basis as defined benefit pension plans.

(t) Share-based payments

The cost of share-based payment arrangements with employees is measured by reference to the fair value of equity instruments on the date they are granted, and recognised as an expense on a straight-line basis over the vesting period, with a corresponding credit to 'Retained Earnings'. The vesting period is the period during which all the specified vesting conditions of a share-based payment arrangement are to be satisfied. The fair value of equity instruments that are made available immediately, with no vesting period attached to the award, are expensed immediately.

Fair value is determined by using appropriate valuation models, taking into account the terms and conditions upon which the equity instruments were granted. Vesting conditions include service conditions and performance conditions. Market performance conditions are taken into account when estimating the fair value of equity instruments at the date of grant, so that an award is treated as vesting irrespective of whether the market performance condition or non-vesting condition is satisfied, provided all other conditions are satisfied.

Vesting conditions, other than market performance conditions, are not taken into account in the initial estimate of the fair value at the grant date. They are taken into account by adjusting the number of equity instruments included in the measurement of the transaction, so that the amount recognised for services received as consideration for the equity instruments granted shall be based on the number of equity instruments that eventually vest. On a cumulative basis, no expense is recognised for equity instruments that do not vest because of a failure to satisfy non-market performance or service conditions.

Where an award has been modified, as a minimum, the expense of the original award continues to be recognised as if it had not been modified. Where the effect of a modification is to increase the fair value of an award or increase the number of equity instruments, the incremental fair value of the award or incremental fair value of liabilities are measured at the higher of the initial fair value, less cumulative amortisation, and the best estimate of the expenditure required to settle the obligation.

A cancellation that occurs during the vesting period is treated as an acceleration of vesting and recognised immediately for the amount that would otherwise have been recognised for services over the vesting period.

HSBC Holdings is the grantor of its equity instrument for all share awards and share options across the group. The credit to 'Retained earnings' over the vesting period on expensing an award represents the effective capital contribution from HSBC Holdings. To the extent the group will be, or has been, required to fund a share-based

Notes on the Financial Statements (continued)

payment arrangement, this capital contribution is reduced and the fair value of shares expected to be released to employees is recorded within 'Other liabilities'.

(u) Foreign currencies

Items included in the financial statements of each of the group's entities are measured using the currency of the primary economic environment in which the entity operates ('the functional currency').

Transactions in foreign currencies are recorded in the functional currency at the rate of exchange prevailing on the date of the transaction. Monetary assets and liabilities denominated in foreign currencies are translated into the functional currency at the rate of exchange ruling at the balance sheet date. Any resulting exchange differences are included in the income statement. Non-monetary assets and liabilities that are measured at historical cost in a foreign currency are translated into the functional currency using the rate of exchange at the date of the initial transaction. Non-monetary assets and liabilities measured at fair value in a foreign currency are translated into the functional currency using the rate of exchange at the date the fair value was determined. Any exchange component of a gain or loss on a non-monetary item is recognised in other comprehensive income if the gain or loss on the non-monetary item is recognised in other comprehensive income. Any exchange component of a gain or loss on a non-monetary item is recognised in the income statement if the gain or loss on the non-monetary item is recognised in the income statement.

In the consolidated financial statements, the assets, including related goodwill where applicable, and liabilities of branches, subsidiaries, joint ventures and associates whose functional currency is not sterling, are translated into the group's presentational currency at the rate of exchange ruling at the balance sheet date. The results of branches, subsidiaries, joint ventures and associates whose functional currency is not sterling are translated into sterling at the average rates of exchange for the reporting period. Exchange differences arising from the retranslation of opening foreign currency net investments, and exchange differences arising from retranslation of the result for the reporting period from the average rate to the exchange rate prevailing at the period end, are recognised in other comprehensive income. Exchange differences on a monetary item that is part of a net investment in a foreign operation are recognised in the income statement of the separate financial statements. In consolidated financial statements these exchange differences are recognised in other comprehensive income. On disposal of a foreign operation, exchange differences relating thereto and previously recognised in other comprehensive income are recognised in the income statement.

(v) Provisions

Provisions are recognised when it is probable that an outflow of economic benefits will be required to settle a current legal or constructive obligation, which has arisen as a result of past events, and for which a reliable estimate can be made of the amount of the obligation.

Contingent liabilities, which include certain guarantees and letters of credit pledged as collateral security, are possible obligations that arise from past events whose existence will be confirmed only by the occurrence, or non-occurrence, of one or more uncertain future events not wholly within the control of the group; or are present obligations that have arisen from past events but are not recognised because it is not probable that settlement will require outflow of economic benefits, or because the amount of the obligations cannot be reliably measured. Contingent liabilities are not recognised in the financial statements but are disclosed unless the probability of settlement is remote.

(w) Financial guarantee contracts

Liabilities under financial guarantee contracts not classified as insurance contracts are recorded initially at their fair value, which is generally the fee received or receivable. Subsequently, the financial guarantee liabilities are measured at the higher of the initial fair value, less cumulative amortisation, and the best estimate of the expenditure required to settle the obligations.

The group has issued financial guarantees and similar contracts to other group entities. Where it has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting applicable to insurance contracts, the group may elect to account for guarantees as insurance contracts. This election is made on a contract by contract basis, but the election for each contract is irrevocable. Where these guarantees have been classified as insurance contracts, they are measured and recognised as insurance liabilities.

Where the group is the recipient of a guarantee, including from other HSBC Group companies, amounts receivable under a claim are recognised when their receipt is virtually certain. Any fees payable to the guarantor are expensed over the period of the guarantee contract.

Notes on the Financial Statements (continued)

(x) Insurance contracts

Through its insurance subsidiaries, the group issues contracts to customers that contain insurance risk, financial risk or a combination thereof. A contract under which the group accepts significant insurance risk from another party by agreeing to compensate that party on the occurrence of a specified uncertain future event is classified as an insurance contract. An insurance contract may also transfer financial risk, but is accounted for as an insurance contract if the insurance risk is significant.

While investment contracts with discretionary participation features are financial instruments, they continue to be treated as insurance contracts as permitted by IFRS 4.

Insurance contracts are accounted for as follows:

Insurance premiums

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

Gross insurance premiums for non-life insurance business are reported as income over the term of the insurance contract based on the proportion of risks borne during the accounting period. The unearned premium (the proportion of the business underwritten in the accounting year relating to the period of risk after the balance sheet date) is calculated on a daily or monthly pro rata basis.

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

Insurance claims and reinsurance recoveries

Gross insurance claims for life insurance contracts reflect the total cost of claims arising during the year, including claim handling costs and any policyholder bonuses allocated in anticipation of a bonus declaration. Claims arising during the year include maturities, surrenders and death claims.

Maturity claims are recognised when due for payment. Surrenders are recognised when paid or at an earlier date on which, following notification, the policy ceases to be included within the calculation of the related insurance liabilities. Death claims are recognised when notified.

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

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

Liabilities under insurance contracts

Liabilities under non-linked life insurance contracts are calculated by each life insurance operation based on local actuarial principles. Liabilities under unit-linked life insurance contracts are at least equivalent to the surrender or transfer value which is calculated by reference to the value of the relevant underlying funds or indices.

Outstanding claims liabilities for non-life insurance contracts are based on the estimated ultimate cost of all claims incurred but not settled at the balance sheet date, whether reported or not, together with related claim-handling costs and a reduction for the expected value of salvage and other recoveries. Liabilities for claims incurred but not reported are made on an estimated basis, using appropriate statistical techniques.

A liability adequacy test is carried out on insurance liabilities to ensure that the carrying amount of the liabilities is sufficient in the light of current estimates of future cash flows. When performing the liability adequacy test, all contractual cash flows are discounted and compared with the carrying value of the liability. When a shortfall is identified it is charged immediately to the income statement.

Future profit participation on insurance contracts with discretionary participation features

Where contracts provide discretionary profit participation benefits to policyholders, liabilities for these contracts include provisions for the future discretionary benefits to policyholders. These provisions reflect actual performance of the investment portfolio to date and management expectation on the future performance in connection with the assets backing the contracts, as well as other experience factors such as mortality, lapses and operational efficiency, where appropriate. This benefit may arise from the contractual terms, regulation, or past distribution policy.

Notes on the Financial Statements (continued)

Investment contracts

Unit linked and non-unit linked

Customer liabilities under linked and certain non-linked investment contracts and the corresponding financial assets are designated at fair value. Movements in fair value are recognised in 'Net income from financial instruments designated at fair value'. Premiums receivable and amounts withdrawn are accounted for as increases or decreases in the liability recorded in respect of investment contracts.

Liabilities under linked investment contracts are at least equivalent to the surrender or transfer value which is calculated by reference to the value of the relevant underlying funds or indices.

Investment management fees receivable are recognised in the income statement over the period of the provision of the investment management services, in 'Net fee income'.

The incremental costs directly related to the acquisition of new investment contracts or renewing existing investment contracts are deferred and amortised over the period during which the investment management services are provided.

Investment contracts with discretionary participation features

While investment contracts with discretionary participation features are financial instruments, they continue to be treated as insurance contracts as permitted by IFRS 4. The group therefore recognises the premiums for those contracts as revenue and recognises as an expense the resulting increase in the carrying amount of the liability.

In the case of net unrealised investment gains on these contracts, whose discretionary benefits principally reflect the actual performance of the investment portfolio, the corresponding increase in the liabilities is recognised in either the income statement or other comprehensive income, following the treatment of the unrealised gains on the relevant assets. In the case of net unrealised losses, a deferred participating asset is recognised only to the extent that its recoverability is highly probable. Movements in the liabilities arising from realised gains and losses on relevant assets are recognised in the income statement.

Present value of in-force long-term insurance business

The value placed on insurance contracts that are classified as long-term insurance business or long term investment contracts with discretionary participating features ("DPF") and are in force at the balance sheet date is recognised as an asset. The asset represents the present value of the equity holders' interest in the issuing insurance companies' profits expected to emerge from these contracts written at the balance sheet date.

The present value of in-force long-term insurance business and long term investment contracts with DPF, referred to as 'PVIF', is determined by discounting the equity holders' interest in future profits expected to emerge from business currently in force using appropriate assumptions in assessing factors such as future mortality, lapse rates and levels of expenses and a risk discount rate that reflects the risk premium attributable to the respective contracts. The PVIF incorporates allowances for both non-market risk and the value of financial options and guarantees. The PVIF asset is presented gross of attributable tax in the balance sheet and movements in the PVIF asset are included in "Other operating income" on a gross of tax basis.

(y) 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 received, net of directly attributable transaction costs incurred, and the redemption amount over the expected life of the instrument.

(z) Share capital and other equity instruments

Shares are classified as equity when there is no contractual obligation to transfer cash or other financial assets. Incremental costs directly attributable to the issue of equity instruments are shown in equity as a deduction from the proceeds, net of tax.

Notes on the Financial Statements (continued)

(aa) Cash and cash equivalents

For the purpose of the cash flow statement, cash and cash equivalents include highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of change in value. Such investments are normally those with less than three months' maturity from the date of acquisition, and include cash and balances at central banks, treasury bills and other eligible bills, loans and advances to banks, items in the course of collection from or in transmission to other banks and certificates of deposit.

(bb) Discontinued operations

A discontinued operation is a component of the group's business, the operations and cash flows of which can be clearly distinguished from the rest of the group and which:

- Represents a separate major line of business or geographical area of operations;
- Is part of a single co-ordinated plan to dispose of a separate major line of business or geographical area of operations; or
- Is a subsidiary acquired exclusively with a view to re-sale.

Classification as a discontinued operation occurs on disposal or when the operation meets the criteria to be classified as held-for-sale, if earlier.

When an operation is classified as a discontinued operation, the comparative consolidated income statement is re-presented as if the operation had been discontinued from the start of the comparative year.

3 Critical accounting policies

The results of the group are sensitive to the accounting policies, assumptions and estimates that underlie the preparation of its consolidated financial statements. The accounting policies used in the preparation of the consolidated financial statements are described in detail in Note 2.

When preparing the financial statements, it is the Directors' responsibility under UK company law to select suitable accounting policies and to make judgements and estimates that are reasonable and prudent.

The accounting policies that are deemed critical to the group's results and financial position, in terms of the materiality of the items to which the policy is applied, or which involve a high degree of judgement including the use of assumptions and estimation, are disclosed below:

Impairment of loans and advances

The group's accounting policy for losses arising from the impairment of customer loans and advances is described in Note 2(f). Further information can be found in the Report of the Directors: Risk (Credit Risk). Loan impairment allowances represent management's best estimate of losses incurred in the loan portfolios at balance sheet date.

Management is required to exercise judgement in making assumptions and estimations when calculating loan impairment allowances on both individually and collectively assessed loans and advances. The most significant judgemental area is the calculation of collective impairment allowances.

The methods used to calculate collective impairment allowances on homogeneous groups of loans that are not considered individually significant are disclosed in Note 2(f). They are subject to estimation uncertainty, in part because it is not practicable to identify losses on an individual loan basis because of the large number of individually insignificant loans in the portfolio.

The methods involve the use of statistically assessed historical information which is supplemented with significant management judgement to assess whether current economic and credit conditions are such that the actual level of inherent losses is likely to be greater or less than that suggested by historical experience. In normal circumstances, historical experience provides the most objective and relevant information from which to assess inherent loss within each portfolio. In certain circumstances, historical loss experience provides less relevant information about the inherent loss in a given portfolio at the balance sheet date, for example, where there have been changes in economic, regulatory or behavioural conditions such that the most recent trends in the portfolio risk factors are not fully reflected in the statistical models. In these circumstances, such risk factors are taken into account when calculating the appropriate levels of impairment allowances, by adjusting the impairment allowances derived solely from historical loss experience.

Notes on the Financial Statements (continued)

Risk factors include loan portfolio growth, product mix, unemployment rates, bankruptcy trends, geographic concentrations, loan product features, economic conditions such as national and local trends in housing markets, the level of interest rates, portfolio seasoning, account management policies and practices, changes in laws and regulations, and other factors that can affect customer payment patterns. Different factors are applied in different regions and countries to reflect different economic conditions and laws and regulations. The methodology and the assumptions used in calculating impairment losses are reviewed regularly in the light of differences between loss estimates and actual loss experience. For example, roll rates, loss rates and the expected timing of future recoveries are regularly benchmarked against actual outcomes to ensure they remain appropriate.

However, the exercise of judgement requires the use of assumptions which are highly sensitive to the risk factors, in particular, to changes in economic and credit conditions across geographical areas. Many of the factors have a high degree of interdependency and there is no one single factor to which the group's loan impairment allowances as a whole are sensitive. It is possible that the outcomes within the next financial year could be different from the assumptions built into the models, resulting in a material adjustment to the carrying amount of loans and advances.

Goodwill impairment

The group's accounting policy for goodwill is described in Note 2(o). The review of goodwill impairment represents management's best estimate of the factors below:

- the future cash flows of the cash-generating units ('CGUs') are sensitive to the cash flows projected for the periods for which detailed forecasts are available, and to assumptions regarding the long-term pattern of sustainable cash flows thereafter. Forecasts are compared with actual performance and verifiable economic data, but they necessarily and appropriately reflect management's view of future business prospects at the time of the assessment; and
- the discount rate used to discount the future expected cash flows is based on the cost of capital assigned to an individual CGU, and can have a significant effect on their valuation. The cost of capital percentage is generally derived from a Capital Asset Pricing Model, which incorporates inputs reflecting a number of financial and economic variables, including the risk-free interest rate in the country concerned and a premium for the inherent risk of the business being evaluated. These variables are subject to fluctuations in external market rates and economic conditions beyond management's control and are therefore require the exercise of significant management judgment and are consequently subject to uncertainty.

A decline in a CGU's expected cash flows and/ or an increase in its cost of capital reduces the CGU'S estimated recoverable amount. If this is lower than the carrying value of the CGU, a charge for impairment of goodwill is recognised in the income statement for the year.

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

Management reviewed the current and expected performance of the CGUs as at 31 December 2013 and determined that there was no indicator of potential impairment of the goodwill allocated to the CGUs. However, in the event of further significant deterioration in the economic and credit conditions beyond the levels already reflected by management in the cash flow forecasts for the CGUs, a material adjustment to a CGU's recoverable amount may occur which may result in the recognition of an impairment charge in the income statement.

Note 21 includes details of the CGUs with significant balances of goodwill and states the key assumptions used to assess the goodwill in each CGU for impairment.

Valuation of financial instruments

The group's accounting policy for valuation of financial instruments is described in Note 2(d) on the Financial Statement. The best evidence of fair value is a quoted price in an actively traded market. In the event that the market for a financial instrument is not active, a valuation technique is used. The majority of valuation techniques employ only observable market data, and so the reliability of the fair value measurement is high. However, certain financial instruments are valued on the basis of valuation techniques that feature one or more significant market inputs that are unobservable. Valuation techniques that rely to a greater extent on unobservable inputs require a higher level of management judgement to calculate a fair value than those based wholly on observable inputs.

Valuation techniques used to calculate fair values are discussed in Note 31. The main assumptions and estimates which management considers when applying a model with valuation techniques are:

Notes on the Financial Statements (continued)

- the likelihood and expected timing of future cash flows on the instrument. These cash flows are estimated based on the terms of the instrument, although management judgment may be required when the ability of the counterparty to service the instrument in accordance with the contractual terms is in doubt. Future cash flows may be sensitive to changes in market rates;
- selecting an appropriate discount rate for the instrument. The determination of this rate is based on an assessment of what a market participant would regard as the appropriate spread of the rate for the instrument over the appropriate risk-free rate; and
- judgment to determine what model to use to calculate fair value in areas where the choice of valuation model is particularly subjective, for example, when valuing complex derivative products.

When applying a model with unobservable inputs, estimates are made to reflect uncertainties in fair values resulting from a lack of market data inputs, for example, as a result of illiquidity in the market. For these instruments, the fair value measurement is less reliable. Inputs into valuations based on unobservable data are inherently uncertain because there are little or no current market data available from which to determine the level at which an arm's length transaction would occur under normal business conditions. However, in most cases there are some market data available on which to base a determination of fair value, for example historical data, and the fair values of most financial instruments will be based on some market observable inputs even where the unobservable inputs are significant.

Disclosure of types and amounts of fair value adjustments made in determining the fair value of financial instruments measured at fair value using valuation techniques is provided in Note 31. In addition a sensitivity analysis of fair value for financial instruments with significant unobservable inputs to reasonably possibly alternative assumption and a range of assumption can be found in Note 31. Given the uncertainty and subjective nature of valuing financial instruments at fair value, it is possible that the outcomes within the next financial year could differ from the assumptions used, and this would result in a material adjustment to the carrying amount of financial instruments measured at fair value.

Pensions

The group's accounting policy for pension and other post-employment benefits is described in Note 2(s) on the Financial Statements.

The most significant judgments in measuring the present value of defined benefit obligations relate to the determination of actuarial and financial assumptions. These assumptions include the nominal discount rate, rate of inflation over the period of projected cash flows and member longevity. Management reviews these assumptions in conjunction with its actuarial advisors and benchmarks its conclusions against market practice.

Judgment is also required in selecting the expected rate of return on plan assets which determines the net expense recognised. The expected rate of return on plan assets represents the best estimate of long-term future asset returns, which takes into account historical market returns plus additional factors such as the current rate of inflation and interest rates. The expected rates of return are weighted on the basis of the fair value of the plan assets.

The key assumptions used, and the sensitivity to changes in these assumptions, are disclosed in Note 7 Employee compensation and benefits. It is reasonably possible that the actuarial and financial assumptions determined at the end of the next year, are significantly different to these assumptions. This could result in the group recording material actuarial gains or losses in the next financial year.

Provisions

The accounting policy for provisions is described in Note 2(v) on the Financial Statements. Note 29 on the Financial Statements discloses the major categories of provisions recognised.

Provisions are uncertain in timing or amount, and are recognised when there is a present obligation as a result of a past event and the outflow of economic benefit is probable and can be estimated reliably. Judgement is involved in determining whether an obligation exists, and in estimating the probability, timing and amount of any outflows. Professional expert advice is taken on litigation provisions, property provisions (including onerous contracts) and similar liabilities.

Provisions for legal proceedings and regulatory matters typically require a higher degree of judgement than other types of provisions. When cases are at an early stage, accounting judgements can be difficult because of the high degree of uncertainty associated with determining whether a present obligation exists as a result of a past event, estimating the probability of outflows and making estimates of the amount of any outflows that may arise. As matters progress through various stages of development, management and legal advisers evaluate on an ongoing basis

Notes on the Financial Statements (continued)

whether provisions should be recognised and their estimated amounts, revising previous judgements and estimates as appropriate. At more advanced stages, it is typically possible to make judgements and estimates around a better defined set of possible outcomes. However, such judgements can be very difficult and the amount of any provision can be very sensitive to the assumptions used. There could be a wide range of possible outcomes for any pending legal proceedings, investigations or inquiries. As a result, it is often not practicable to quantify a range of possible outcomes for individual matters. It is also not practicable to meaningfully quantify ranges of potential outcomes in aggregate for these types of provisions because of the diverse nature and circumstances of such matters and the wide range of uncertainties involved. For a detailed description of the nature of uncertainties and assumptions and the effect on the amount and timing of possible cash outflows on material matters, see Note 42 on the Financial Statements.

Provisions for customer remediation also require significant levels of estimation and judgement. The amounts of provisions recognised depend on a number of different assumptions, for example, the number of customer complaints expected to be received, the response rates from customers who are contacted as part of customer outreach activities, the uphold rate for complaints and the amounts payable in respect of compensation and costs of conducting reviews. These assumptions are revised as additional information becomes available.

In view of the inherent uncertainties and the high level of subjectivity involved in the recognition and measurement of provisions, it is possible that the outcomes in the next financial year could differ from those on which management's estimates are based, resulting in materially different amounts of provisions recognised and outflows of economic benefits from those estimated by management for the purposes of the 2013 Financial Statements.

Notes on the Financial Statements (continued)

4 Net earned insurance premiums

| | Non-linked insurance £m | Linked life insurance £m | Investment contracts with DPF features £m | Total £m |
|--|-------------------------------|--------------------------------|--|-------------|
| 2013 | | | | |
| Gross written premiums | 294 | 314 | 1,526 | 2,134 |
| Movement in unearned premiums | 16 | – | – | 16 |
| Gross earned premiums | 310 | 314 | 1,526 | 2,150 |
| Gross written premiums ceded to reinsurers | (109) | (4) | – | (113) |
| Reinsurers' share of movement in unearned premiums | (15) | – | – | (15) |
| Reinsurers' share of gross earned premiums | (124) | (4) | – | (128) |
| Net earned insurance premiums | 186 | 310 | 1,526 | 2,022 |
| 2012 | | | | |
| Gross written premiums | 321 | 380 | 1,705 | 2,406 |
| Movement in unearned premiums | 27 | – | – | 27 |
| Gross earned premiums | 348 | 380 | 1,705 | 2,433 |
| Gross written premiums ceded to reinsurers | (117) | (4) | – | (121) |
| Reinsurers' share of movement in unearned premiums | (26) | – | – | (26) |
| Reinsurers' share of gross earned premiums | (143) | (4) | – | (147) |
| Net earned insurance premiums | 205 | 376 | 1,705 | 2,286 |

5 Net insurance claims incurred and movement in liabilities to policyholders

| | Non-linked insurance £m | Linked life Insurance £m | Investment contracts with DPF features £m | Total £m |
|--|-------------------------------|--------------------------------|--|-------------|
| 2013 | | | | |
| Claims, benefits and surrenders paid..... | 141 | 197 | 1,473 | 1,811 |
| Movement in liabilities | 48 | 388 | 877 | 1,313 |
| Gross claims incurred and movement in liabilities..... | 189 | 585 | 2,350 | 3,124 |
| Reinsurers' share of claims, benefits and surrenders paid..... | (76) | (3) | – | (79) |
| Reinsurers' share of movement in liabilities | (7) | (10) | – | (17) |
| Reinsurers' share of claims incurred and movement in liabilities | (83) | (13) | – | (96) |
| Net insurance claims incurred and movement in liabilities to policyholders | 106 | 572 | 2,350 | 3,028 |
| 2012 | | | | |
| Claims, benefits and surrenders paid..... | 174 | 139 | 1,589 | 1,902 |
| Movement in liabilities | 107 | 393 | 713 | 1,213 |
| Gross claims incurred and movement in liabilities..... | 281 | 532 | 2,302 | 3,115 |
| Reinsurers' share of claims, benefits and surrenders paid..... | (91) | (4) | – | (95) |
| Reinsurers' share of movement in liabilities | (96) | (5) | – | (101) |
| Reinsurers' share of claims incurred and movement in liabilities | (187) | (9) | – | (196) |
| Net insurance claims incurred and movement in liabilities to policyholders | 94 | 523 | 2,302 | 2,919 |

Notes on the Financial Statements (continued)

6 Net operating income

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

| | 2013 £m | 2012 £m |
|--|--------------|----------------|
| Income | | |
| Interest recognised on impaired financial assets | 47 | 25 |
| 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 | 3,043 | 2,851 |
| Fees earned on trust and other fiduciary activities where the group holds or invests assets on behalf of its customers | 703 | 710 |
| Expense | | |
| Interest on financial instruments, excluding interest on financial liabilities held for trading or designated at fair value | 2,714 | 3,340 |
| 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 | 511 | 502 |
| Fees payable on trust and other fiduciary activities where the group holds or invests assets on behalf of its customers | 1 | 2 |
| Gains/(losses) | | |
| Gains/(losses) on disposal or settlement of loans and advances | 3 | (41) |
| (Losses)/gains on financial liabilities measured at amortised cost | (5) | 1 |
| Impairment of available-for-sale equity shares | (36) | (26) |
| (Losses) on disposal of property, plant and equipment, intangible assets and non-financial investments | (7) | (17) |
| Loan impairment charges and other credit risk provisions | | |
| Net impairment charge on loans and advances | (1,102) | (1,213) |
| Net impairment of available-for-sale debt securities | 136 | (29) |
| Net impairment in respect of other credit risk provisions | (5) | (3) |
| | (971) | (1,245) |

7 Employee compensation and benefits

Total employee compensation

| | 2013 £m | 2012 £m |
|--------------------------------|--------------|--------------|
| Wages and salaries | 3,358 | 3,943 |
| Social security costs | 475 | 512 |
| Post-employment benefits | 5 | 334 |
| Total ¹ | 3,838 | 4,789 |

¹ Includes £nil million in respect of discontinued operations (2012: £436 million).

Average number of persons employed by the group during the year

| | 2013 | 2012 ¹ |
|----------------------------------|---------------|-------------------|
| Retail banking wealth management | 30,991 | 32,403 |
| Commercial banking | 8,744 | 8,413 |
| Global Banking and Markets | 6,975 | 6,791 |
| Global Private Banking | 738 | 2,738 |
| Other | 22,376 | 23,845 |
| Total ¹ | 69,824 | 74,190 |

¹ The 2012 comparatives have been restated in accordance with the revised operating segments (Note 2 (c)). Global function employees are included within 'Other'.

Notes on the Financial Statements (continued)

Post-employment benefit plans

Income statement charge

| | 2013 £m | 2012 £m |
|--|------------|------------|
| Defined benefit pension plans | | |
| - HSBC Bank (UK) Pension Scheme | (198) | 106 |
| - Other plans | 21 | 35 |
| Defined contribution pension plans | 175 | 186 |
| | (2) | 327 |
| Defined benefit healthcare plans | 7 | 7 |
| | <u>5</u> | <u>334</u> |

Defined benefit post-employment benefit plans

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

| | 2013 £m | 2012 £m |
|--|------------|--------------|
| Defined benefit pension plans | 1,041 | 1,439 |
| - HSBC Bank (UK) Pension Scheme | 1,234 | 1,619 |
| Fair value of plan assets | 19,156 | 17,999 |
| Present value of defined benefit obligations | (17,922) | (16,380) |
| - Other plans | (193) | (180) |
| Fair value of plan assets | 354 | 298 |
| Present value of defined benefit obligations | (547) | (478) |
| Defined benefit healthcare plans | (125) | (139) |
| Present value of defined benefit obligations | (125) | (139) |
| Fair value of plan assets | 19,510 | 18,297 |
| Present value of defined benefit obligations | (18,594) | (16,997) |
| | <u>916</u> | <u>1,300</u> |
| Retirement benefit liabilities | (318) | (319) |
| Retirement benefit assets | 1,234 | 1,619 |

Cumulative actuarial gains/(losses) recognised in other comprehensive income

| | 2013 £m | 2012 £m |
|--|----------------|--------------|
| At 1 January | (408) | (505) |
| HSBC Bank (UK) Pension Scheme | (973) | 131 |
| Other plans | 2 | (55) |
| Healthcare plans | 14 | 21 |
| Total actuarial gains/(losses) recognised in other comprehensive income for the year | <u>(957)</u> | <u>97</u> |
| At 31 December | <u>(1,365)</u> | <u>(408)</u> |

Notes on the Financial Statements (continued)

Pension plans

The extant plans are funded defined benefit plans with assets held in trust or similar funds separate from the group. The plans are reviewed at least annually or in accordance with local practice and regulations by qualified actuaries. The actuarial assumptions used to calculate the defined benefit obligations and related current service costs vary according to the economic conditions of the countries in which the plans are situated.

Defined benefit pension arrangements for bank employees who are members of defined benefit pension plans, as well as certain other employees of the group and HSBC, are provided principally by the HSBC Bank (UK) Pension Scheme (the 'Scheme'), the assets of which are held in a separate trust fund. The Pension Scheme is administered by a corporate trustee, HSBC Bank Pension Trust (UK) Limited (the 'Trustee'), whose Board is comprised of 13 Directors, four of whom are elected by employees and two by pensioners. The Trustee Directors of the Pension Scheme are required to act in the best interest of the Scheme's beneficiaries.

Healthcare benefit plans

The group provides post-employment healthcare benefits under plans in the United Kingdom, which are unfunded. Post-employment healthcare benefit plans are accounted for in the same manner as pension plans. The plans are reviewed at least annually or in accordance with local practice and regulations by qualified actuaries. The actuarial assumptions used to calculate the defined benefit obligation and related current service cost vary according to the economic conditions of the countries in which they are situated. The group's total healthcare cost for the year was £7 million (2012: £7 million).

Post-employment defined benefit plans' principal actuarial assumptions

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

| | Discount rate % | Inflation rate % | Rate of increase for pensions in payment and deferred pensions % | Deferred revaluation % | Rate of pay Increase % | Healthcare cost trend rates % |
|------------|-----------------------|------------------------|--|------------------------------|------------------------------|--|
| 2013 | 4.45 | 3.60 | 3.30 | 2.80 | 4.10 | 7.10 |
| 2012 | 4.50 | 3.10 | 2.90 | 2.30 | 3.60 | 6.60 |

The group determines the discount rates to be applied to its obligations in consultation with the plans' local actuaries, on the basis of the current average yield of high quality (AA rated or equivalent) debt instruments, with maturities consistent with those of the defined benefit obligations.

The mortality tables used and implied average life expectancy at 65 in the UK at 31 December were as follows:

| | Mortality table | Life expectancy at age 65 for a male member currently: | | Life expectancy at age 65 for a female member currently: | |
|------------|----------------------|--|---------|--|---------|
| | | Aged 65 | Aged 45 | Aged 65 | Aged 45 |
| 2013 | SAPS S1 ¹ | 23.6 | 25.2 | 24.9 | 26.8 |
| 2012 | SAPS S1 ¹ | 23.9 | 25.6 | 25.2 | 27.1 |

¹ Adjusted SAPS S1 with CMI_2013 improvements (2012: CMI_2011 improvements) and a 1.25 per cent long-term annual improvement. Light table with 1.01 rating for male pensioners and 1.02 rating for female pensioners.

Notes on the Financial Statements (continued)

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 | |
|---|-------------------------------|------------|
| | 2013 £m | 2012 £m |
| Discount rate | | |
| Change in pension obligation at year end from a 25bps increase | (818) | (737) |
| Change in pension obligation at year end from a 25bps decrease | 877 | 789 |
| Change in following year pension cost from a 25bps increase | (49) | (48) |
| Change in following year pension cost from a 25bps decrease | 49 | 46 |
| Rate of inflation | | |
| Change in pension obligation at year end from a 25bps increase | 601 | 545 |
| Change in pension obligation at year end from a 25bps decrease | (688) | (521) |
| Change in following year pension cost from a 25bps increase | 33 | 29 |
| Change in following year pension cost from a 25bps decrease | (36) | (29) |
| Rate of increase for pensions in payment and deferred revaluation | | |
| Change in pension obligation at year end from a 25bps increase | 787 | 445 |
| Change in pension obligation at year end from a 25bps decrease | (741) | (428) |
| Change in following year pension cost from a 25bps increase | 41 | 21 |
| Change in following year pension cost from a 25bps decrease | (38) | (22) |
| Rate of pay increase | | |
| Change in pension obligation at year end from a 25bps increase | 128 | 108 |
| Change in pension obligation at year end from a 25bps decrease | (124) | (107) |
| Change in following year pension cost from a 25bps increase | 10 | 8 |
| Change in following year pension cost from a 25bps decrease | (9) | (9) |
| Mortality | | |
| Change in pension obligation from each additional year of longevity assumed | 431 | 410 |

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

| | Other Plans | |
|---|-------------|------------|
| | 2013 £m | 2012 £m |
| Change in pension obligation from each additional year of longevity assumed | 10 | 9 |

Notes on the Financial Statements (continued)

Defined benefit pension plans

Net asset/(liability) under defined benefit pension plans

| | Fair value of plan assets | | Present value of defined benefit obligations | | Net benefit asset/(liability) | |
|--|-------------------------------------|-------------------|--|-------------------|-------------------------------------|-------------------|
| | HSBC Bank (UK) Pension Scheme £m | Other plans £m | HSBC Bank (UK) Pension Scheme £m | Other plans £m | HSBC Bank (UK) Pension Scheme £m | Other plans £m |
| Net defined benefit liability | | | | | | |
| At 1 January 2013 | 17,999 | 298 | (16,380) | (478) | 1,619 | (180) |
| Current service cost | – | – | (167) | (13) | (167) | (13) |
| Past service cost and (gains)/ losses from settlements | – | – | 280 | (3) | 280 | (3) |
| plan amendments | – | – | 280 | – | 280 | – |
| past service costs and gains and losses from settlement occurring together | – | – | – | (3) | – | (3) |
| Service cost | – | – | 113 | (16) | 113 | (16) |
| Net interest (income)/cost on the net defined benefit liability | 806 | 8 | (721) | (13) | 85 | (5) |
| Remeasurement effects recognised in other comprehensive income | 524 | 5 | (1,497) | (3) | (973) | 2 |
| return on plan assets (excluding interest income) | 524 | 5 | – | – | 524 | 5 |
| actuarial losses/(gains) from changes in demographic assumptions | – | – | 34 | 1 | 34 | 1 |
| actuarial losses/(gains) from changes in financial assumptions | – | – | (1,569) | (5) | (1,569) | (5) |
| actuarial losses/(gains) from experience | – | – | 38 | 1 | 38 | 1 |
| Exchange differences | – | 38 | – | (45) | – | (7) |
| Contributions by the group | | | | | | |
| Normal | 207 | 6 | – | – | 207 | 6 |
| Special | 180 | – | – | – | 180 | – |
| Contributions by employees | 24 | – | (24) | (5) | – | (5) |
| Benefits paid | (584) | (1) | 587 | 13 | 3 | 12 |
| At 31 December 2013 | 19,156 | 354 | (17,922) | (547) | 1,234 | (193) |
| Retirement benefit liabilities recognised on the balance sheet | | | | | – | (193) |
| Retirement benefit assets recognised on the balance sheet | | | | | 1,234 | – |
| Present value of defined benefit obligation relating to : | | | | | | |
| actives | | | (5,381) | (355) | | |
| deferreds | | | (5,056) | (70) | | |
| pensioners | | | (7,485) | (122) | | |

Notes on the Financial Statements (continued)

| | Fair value of plan assets | | Present value of defined benefit obligations | | Net benefit asset/(liability) | |
|--|-------------------------------|-------------|--|-------------|-------------------------------|-------------|
| | HSBC Bank (UK) Pension Scheme | Other plans | HSBC Bank (UK) Pension Scheme | Other plans | HSBC Bank (UK) Pension Scheme | Other plans |
| | £m | £m | £m | £m | £m | £m |
| Net defined benefit liability | | | | | | |
| At 1 January 2012 | 17,183 | 728 | (15,739) | (968) | 1,444 | (240) |
| Current service cost | – | – | (149) | (37) | (149) | (37) |
| Past service cost and (gains)/ losses from settlements | – | – | – | (2) | – | (2) |
| plan amendments | – | – | – | (2) | – | (2) |
| Service cost | – | – | (149) | (39) | (149) | (39) |
| Net interest (income)/cost on the net defined benefit liability | 786 | 29 | (743) | (25) | 43 | 4 |
| Remeasurement effects recognised in other comprehensive income | 429 | 16 | (298) | (71) | 131 | (55) |
| return on plan assets (excluding interest income) | 429 | 16 | – | – | 429 | 16 |
| actuarial losses/(gains) from changes in demographic assumptions | – | – | (460) | – | (460) | – |
| actuarial losses/(gains) from changes in financial assumptions | – | – | (386) | (68) | (386) | (68) |
| actuarial losses/(gains) from experience | – | – | 548 | (3) | 548 | (3) |
| Exchange differences | – | (14) | – | 21 | – | 7 |
| Contributions by the group | | | | | | |
| Normal | 150 | 47 | – | – | 150 | 47 |
| Special | – | – | – | – | – | – |
| Contributions by employees | 23 | 9 | (23) | (9) | – | – |
| Benefits paid | (572) | (27) | 572 | 43 | – | 16 |
| Administrative costs and taxes paid by the plan | – | – | – | – | – | – |
| Disposal | – | (490) | – | 570 | – | 80 |
| At 31 December 2012 | 17,999 | 298 | (16,380) | (478) | 1,619 | (180) |
| Retirement benefit liabilities recognised on the balance sheet | | | | | – | (180) |
| Retirement benefit assets recognised on the balance sheet | | | | | 1,619 | – |
| Present value of defined benefit obligation relating to : | | | | | | |
| actives | | | (4,717) | (275) | | |
| deferreds | | | (4,389) | (46) | | |
| pensioners | | | (7,274) | (157) | | |

The group expects to make £215 million of contributions to the HSBC UK Pension Scheme during 2014. Benefits expected to be paid from plans to retirees over each of the next five years and in aggregate for the five years thereafter, are as follows:

| | 2014 | 2015 | 2016 | 2017 | 2018 | 2019–2023 |
|-------------------------------|------|------|------|------|------|-----------|
| | £m | £m | £m | £m | £m | £m |
| HSBC Bank (UK) Pension Scheme | 602 | 622 | 643 | 664 | 686 | 3,886 |
| Other plans | 18 | 13 | 14 | 16 | 16 | 86 |

Notes on the Financial Statements (continued)

Fair value of plan assets by asset classes

| | 2013 | | | | 2012 | | | |
|--------------------------------------|------------------|--|---|--------------------|------------------|--|---|--------------------|
| | Fair value £m | Quoted market price in active market £m | No quoted market price in active market £m | Thereof HSBC £m | Fair value £m | Quoted market price in active market £m | No quoted market price in active market £m | Thereof HSBC £m |
| HSBC Bank (UK) Pension Scheme | | | | | | | | |
| Fair value of plan assets | 19,156 | | | | 17,999 | | | |
| Equities | 2,815 | 2,218 | 597 | 6 | 2,412 | 2,412 | – | 10 |
| Bonds | 10,712 | 10,712 | – | – | 10,496 | 10,496 | – | – |
| Contractually linked instruments | 1,778 | 1,776 | 2 | – | – | – | – | – |
| Property | 805 | – | 805 | – | 980 | – | 980 | – |
| Derivatives | 1,710 | – | 1,710 | 1,710 | 3,233 | – | 3,233 | 3,233 |
| Other | 1,336 | 1,336 | – | – | 878 | 878 | – | – |
| Other plans | | | | | | | | |
| Fair value of plan assets | 354 | | | | 298 | | | |
| Equities | 60 | 50 | 10 | – | 43 | 43 | – | 3 |
| Bonds | 127 | 117 | 10 | 6 | 122 | 122 | – | 6 |
| Property | 5 | – | 5 | – | 10 | – | 10 | – |
| Derivatives | – | – | – | – | – | – | – | – |
| Other | 162 | 111 | 51 | 32 | 123 | 123 | – | 21 |

The principal plan has entered into derivative transactions with the bank to manage the risks arising from its portfolio. These derivatives comprise interest rate (London Interbank Offered Rate - 'LIBOR') swaps and inflation (UK Retail Prices Index - 'RPI') swaps. Under the terms of these swaps, the plan is committed to making LIBOR-related interest payments in exchange for cash flows paid into the Scheme based on a projection of the future benefit payments to the Scheme members. Further details of these swap arrangements are included in Note 43.

The actual return on plan assets for the year ended 31 December 2013 was a positive return £1,343 million (2012: positive return of £1,260 million). The group expects to make £249 million of normal contributions to defined benefit pension plans during 2014.

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

| | 2013 | | 2012 | |
|--|-------------------------------------|-------------------|-------------------------------------|-------------------|
| | HSBC Bank (UK) Pension Scheme £m | Other plans £m | HSBC Bank (UK) Pension Scheme £m | Other plans £m |
| Defined benefit pension plans | | | | |
| Current service cost | 167 | 13 | 149 | 37 |
| Net interest (income) on net defined benefit assets ¹ | (85) | 5 | (43) | (4) |
| Past service (credit)/cost | (280) | 3 | – | 2 |
| Total (gain)/ expense | (198) | 21 | 106 | 35 |

1 2012: Expected return on plan assets less interest cost

Triennial valuation

UK regulation requires pension schemes be valued formally every three years and a funding plan agreed between the trustee and scheme sponsor. The most recent triennial actuarial valuation of the UK Scheme performed by the Scheme Actuary on behalf of the Trustee has been carried out as at 31 December 2011. At that date, the market value of the Scheme's assets was £17.2 billion. The market value of the plan represented 100 per cent of the amount expected to be required, on the basis of the assumptions adopted, to provide the benefits accrued to members after allowing for expected future increases in earnings, and resulted in neither surplus nor deficit. The method adopted for this valuation was the projected unit method.

The expected cash flows from the plan were projected by reference to the UK Retail Prices Index ('RPI') swap break-even curve at 31 December 2011. Salary increases were assumed to be 0.5 per cent per annum above RPI and inflationary pension increases, subject to a minimum of 0 per cent per annum and a maximum of 5 per cent per annum (maximum of 3 per cent per annum in respect of service accrued since 1 July 2009) were assumed to be in

Notes on the Financial Statements (continued)

line with RPI. The projected cash flows were discounted at the LIBOR swap curve at 31 December 2011 plus a margin for the expected return on the investment strategy of 160 basis points per annum.

The mortality experience of the Scheme's pensioners over the three year period since the previous valuation was analysed and the mortality assumption set on the basis of the experience in the six years 2006-2011, using the SAPS S1 series of tables with adjustment for the specific mortality experience of the Scheme. Allowance for future improvements in longevity was made in line with the medium cohort effect with a long-run rate of improvements of 2.0 per cent for males and 1.5 per cent for females.

Ongoing contributions

Following the completion of the 2011 triennial valuation, the bank pays contributions at the rate of 43 per cent of pensionable salaries (less member contributions) from 1 April 2013. An additional employer contribution was paid in April 2013 equal to 9 per cent of pensionable salaries, in respect of the period 1 January 2012 to 31 March 2013.

Solvency position

As part of the 31 December 2011 valuation, calculations were also carried out as to the amount of assets that might be needed to meet the liabilities if the Scheme was discontinued and the members' benefits bought out with an insurance company (although in practice this may not be possible for a plan of this size) or the Trustee continued to run the plan without the support of the bank. The amount required under this approach was estimated to be £26.2 billion as at 31 December 2011. In estimating the solvency position for this purpose, a more prudent assumption about future mortality was made than for the assessment of the ongoing position and it was assumed that the Trustee would alter the investment strategy to be an appropriately matched portfolio of cash and interest and inflation swaps. An explicit allowance for expenses was also included.

Future accrual

In 2013, following consultation on various employee benefit proposals, the bank announced to employees in the UK that the future service accrual for active members of the Defined Benefit Section ('DBS') would cease with effect from 30 June 2015. As a result, defined benefit pensions based on service to 30 June 2015 will continue to be linked to final salary on retirement (underpinned by increases in CPI) but all active members of the DBS will become members of the Defined Contribution Section from 1 July 2015. As part of these amendments, the HSBC Bank (UK) Pension Scheme ('the Scheme') will cease to deliver ill-health benefits to active members of the DBS and these benefits will, instead, be covered via insurance policies from 1 January 2015, consistent with other UK employees. This resulted in a reduction in the defined benefit obligation of the Scheme and a corresponding gain of £280 million, recorded in 'Past service cost and (gains)/losses on settlements' in the table above.

Notes on the Financial Statements (continued)

Directors' emoluments

The aggregate emoluments of the Directors of the bank, computed in accordance with the Companies Act 2006 as amended by statutory instrument 2008 No.410, were:

| | 2013 £000 | 2012 £000 |
|---|--------------------|--------------------|
| Fees ¹ | 1,382 | 1,087 |
| Salaries and other emoluments..... | 1,438 | 2,266 |
| Bonuses | 3,334 ² | 5,294 ³ |
| | 6,154 | 8,647 |
| Vesting of Restricted Share Plan awards | – | 873 |

1 Fees included fees paid to non-executive directors.

2 Incentive awards made to executive directors are delivered in the form of cash and HSBC Holdings plc shares. The amount shown is comprised of £463,875 in cash, £695,813 in deferred cash, £463,875 in Restricted Shares and £695,813 in deferred Restricted Shares, issued under the HSBC Share Plan 2011, and £1,014,212 in shares awarded under the Group Performance Share Plan ('GPSP') which is the long-term incentive under the HSBC Share Plan 2011. The total vesting period of deferred awards is no less than three years, with 33% of the award vesting on each of the first and second anniversaries of the date of the award and the balance vesting on the third anniversary of the date of the award. Where the total vesting period is three years, the share awards will be subject to a six month retention period upon vesting. GPSP awards are subject to a five year vesting period and on the vesting date are subject to a retention requirement until cessation of employment.

3 The amount shown is comprised of £827,306 in cash, £1,146,459 in deferred cash, £764,306 in Restricted Shares and £1,146,459 in deferred Restricted Shares issued under the HSBC Share Plan 2011, and £1,409,627 in deferred Restricted Shares issued under the GPSP. The total vesting period of deferred awards is no less than three years, with 33% of the award vesting on each of the first and second anniversaries of the date of the award and the balance vesting on the third anniversary of the date of the award. Where the total vesting period is three years, the share awards will be subject to a six month retention period upon vesting. GPSP awards are subject to a five year vesting period and on the vesting date are subject to a retention requirement until cessation of employment.

One Director exercised share options over HSBC Holdings plc ordinary shares during the year.

Awards were made to four Directors under long-term incentive plans in respect of qualifying services rendered in 2013 (2012: five Directors). During 2013, no Directors received shares in respect of awards under long-term incentive plans that vested during the year (2012: three Directors).

Retirement benefits are accruing to one Director under a defined benefit scheme and are accruing to two Directors under money purchase schemes in respect of Directors' qualifying services. Contributions of £158,963 were made during the year to money purchase arrangements in respect of Directors' qualifying services (2012: £238,467).

In addition, there were payments under retirement benefit agreements with former Directors of £809,519 (2012: £783,293), including payments in respect of unfunded pension obligations to former Directors of £693,632 (2012: £664,825). The provision as at 31 December 2013 in respect of unfunded pension obligations to former Directors amounted to £11,664,633 (2012: £11,532,388).

Discretionary bonuses for Directors are based on a combination of individual and corporate performance and are determined by the Remuneration Committee of the bank's parent company, HSBC Holdings plc. The cost of any conditional awards under the HSBC Share Plan 2013 are recognised through an annual charge based on the fair value of the awards, apportioned over the period of service to which the award relates. Details of the Plans are contained within the Directors' Remuneration Report of HSBC Holdings plc.

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

| | 2013 £000 | 2012 £000 |
|-------------------------------------|--------------------|--------------------|
| Fees | – | – |
| Salaries and other emoluments | 501 | 666 |
| Bonuses | 1,645 ¹ | 2,741 ² |

1 Awards made to the highest paid Director are delivered in the form of cash and HSBC Holdings plc shares. The amount shown is comprised of £219,305 in cash, £328,958 in deferred cash, £219,305 in Restricted Shares and £328,958 in deferred Restricted Shares issued under the HSBC Share Plan 2011, and £548,180 in shares awarded under the Group Performance Share Plan ('GPSP') which is the long-term incentive under the HSBC Share Plan 2011. The total vesting period of deferred awards is no less than three years, with 33% of the award vesting on each of the first and second anniversaries of the date of the award and the balance vesting on the third anniversary of the date of the award. Where the total vesting period is three years, the share awards will be subject to a six

Notes on the Financial Statements (continued)

month retention period upon vesting. GPSP awards are subject to a five year vesting period and on the vesting date are subject to a retention requirement until cessation of employment.

- 2 Awards made to the highest paid Director in respect of 2012 performance comprise a mixture of cash and HSBC Holdings plc shares. The amount shown is comprised of £340,235 in cash, £510,351 in deferred cash, £340,235 in Restricted Shares and £510,353 in deferred Restricted Shares issued under the HSBC Share Plan 2011, and £1,040,000 in shares awarded under the Group Performance Share Plan ('GPSP') which is the long-term incentive under the HSBC Share Plan 2011. The total vesting period of deferred awards is no less than three years, with 33% of the award vesting on each of the first and second anniversaries of the date of the award and the balance vesting on the third anniversary of the date of the award. Where the total vesting period is three years, the share awards will be subject to a six month retention period upon vesting. GPSP awards are subject to a five year vesting period and on the vesting date are subject to a retention requirement until cessation of employment

The highest paid Director did not receive any shares as the result of awards under long-term incentive plans that vested during the year. The highest paid Director exercised no share options over HSBC Holdings plc ordinary shares during the year.

Pension contributions of £113,963 were made by the bank in respect of services by the highest paid Director during the year.

8 Auditors' remuneration

| | 2013 | 2012 |
|---|------------|------|
| | £m | £m |
| Audit fees payable to KPMG ¹ | 7.1 | 9.3 |
| Audit fees payable to non-KPMG entities | 0.5 | 0.6 |
| Total auditors remuneration | 7.6 | 9.9 |

1 Fees payable to KPMG for HSBC Bank plc's statutory audit and the audit of the bank's subsidiaries.

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

| | 2013 | 2012 |
|---|-------------|------|
| | £m | £m |
| Audit fees for HSBC Bank plc statutory audit ¹ : | 3.8 | 3.1 |
| – fees relating to current year | 3.4 | 2.8 |
| – fees relating to prior year | 0.4 | 0.3 |
| Fees for other services provided to the group | 8.9 | 12.0 |
| – audit of the group's subsidiaries, pursuant to legislation ² | 3.2 | 6.1 |
| – audit-related assurance services ³ | 4.4 | 4.6 |
| – audit of pension schemes associated with the group | 0.1 | 0.1 |
| Tax services | | |
| – taxation compliance services | 0.1 | 0.1 |
| – taxation advisory services | 0.2 | 0.3 |
| All other services | 0.9 | 0.8 |
| Total fees payable | 12.7 | 15.1 |

- 1 Fees payable to KPMG Audit Plc for the statutory audit of the consolidated financial statements of the group and the separate financial statements of the HSBC Bank plc. They exclude amounts payable for the statutory audit of the bank's subsidiaries which have been included in 'Fees payable to KPMG for other services provided to the group'.
- 2 Including fees payable to KPMG for the statutory audit of the bank's subsidiaries.
- 3 Including services for assurance and other services that relate to statutory and regulatory filings, including comfort letters and interim reviews.

Fees payable to KPMG for non-audit services for HSBC Bank plc are not disclosed separately because such fees are disclosed on a consolidated basis for the group.

Notes on the Financial Statements (continued)

9 Share-based payments

Income statement charge

| | 2013 £m | 2012 £m |
|--|------------|------------|
| Restricted and performance share awards ¹ | 127 | 244 |
| Savings-related and other share option plans | 20 | 27 |
| Equity-settled share-based payments ² | 147 | 271 |

¹ Restricted share awards include awards granted under the Group Performance Share Plan ('GPSP')

² This charge, which was computed from the fair values of the share-based payment transaction when contracted, arose under employee share awards made in accordance with HSBC's reward structures (discussed further below).

The share-based payment income statement charge is recognised in wages and salaries (Note 7).

Deferred share awards

Included in the income statement charge above is £112 million relating to deferred share awards (2012: £230 million). The following table identifies the years in which these awards were, or are expected to be, granted. It also shows the expected charge to be recognised in future years in respect of awards granted in current and prior years and awards expected to be granted in the future.

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

| | Charge recognised in 2013 in respect of performance year: | | | Charge expected to be recognised in 2014 or later in respect of performance year: | | |
|----------------------------------|--|----------------|-------------|--|----------------|-------------|
| | 2013 £m | Pre-2013 £m | Total £m | 2013 £m | Pre-2013 £m | Total £m |
| HSBC deferred share awards | 45 | 67 | 112 | 62 | 33 | 95 |

| | Charge recognised in 2012 in respect of performance year: | | | Charge expected to be recognised in 2013 or later in respect of performance year: | | |
|----------------------------------|--|----------------|-------------|--|----------------|-------------|
| | 2012 £m | Pre-2012 £m | Total £m | 2012 £m | Pre-2012 £m | Total £m |
| HSBC deferred share awards | 62 | 168 | 230 | 70 | 63 | 133 |

HSBC Share Awards

Restricted share awards

The policy with respect to these awards is:

- vesting of the awards is based on continued employment with HSBC of between one and five years from the date of award;
- shares are awarded without corporate performance conditions; and
- certain shares are awarded subject to a retention requirement.

The purpose of these awards is to reward employee performance and potential, to aid recruitment and retention, and to part-defer annual bonuses.

Performance Share awards

The policy with respect to these awards is:

- vesting of the awards is based on three independent performance measures (HSBC's relative Total Shareholder Return ('TSR') (40%), economic profit (40%) and growth in HSBC earnings per share ('EPS') (20%)) and an overriding 'sustained improvement' judgement by the Group Remuneration Committee;
- performance conditions are measured over a three year period and reviewed annually; and
- awards are forfeited to the extent the performance conditions have not been met.

The purpose of these awards is to align the interests of executives with the creation of shareholder value and recognise individual performance and potential, and to reflect HSBC's relative and absolute performance over the long-term, taking into account an external measure of value creation, a measure of the extent to which the return on

Notes on the Financial Statements (continued)

capital invested in HSBC is in excess of a benchmark return and a direct measure of the profits generated for shareholders.

Movement on HSBC share awards

| | Restricted share awards | | Performance share awards ¹ | |
|---|--------------------------|--------------------------|---------------------------------------|--------------------------|
| | 2013 Number (000s) | 2012 Number (000s) | 2013 Number (000s) | 2012 Number (000s) |
| Outstanding at 1 January | 87,430 | 111,330 | 355 | - |
| Additions during the year | 47,612 | 110,816 | 428 | 355 |
| Released in the year | (50,514) | (104,792) | (72) | - |
| Forfeited in the year | (1,165) | (5,931) | (10) | - |
| Transferred | 30,541 | (23,993) | 25 | - |
| Outstanding at 31 December | 113,904 | 87,430 | 726 | 355 |
| Weighted average fair value of awards granted (£) | 7.17 | 4.02 | 7.29 | 5.56 |

1 Additions during the year comprised reinvested dividend equivalents.

HSBC Share Option Plans

Savings-related share option plans

The policy with respect to these options is:

- the options are exercisable within three months following the first anniversary of the commencement of a one-year savings contract or within six months following either the third or fifth anniversaries of the commencement of three-year or five-year contracts, respectively; and
- the exercise price is set at a 20% (2012: 20%) discount to the market value immediately preceding the date of invitation.

The purpose of these awards is to enable eligible employees to save up to £250 per month (or its equivalent in euros), with the option to use the savings to acquire shares, and to align the interests of employees with the creation of shareholder value.

HSBC Holdings Group Share Option Plan

The policy with respect to these options is:

- vesting of the options is based on achievement of certain TSR targets; and
- the options are exercisable between the third and tenth anniversaries of the date of grant.

The purpose of these awards was to provide a long-term incentive plan between 2000 and 2005, when certain HSBC employees were awarded share options, and to align the interests of those higher performing employees with the creation of shareholder value.

The table on page 140 shows the movement on HSBC share option plans during the year.

Calculation of fair values

Fair values of share options/awards, measured at the date of grant of the option/award, are calculated using a Black-Scholes model. When modelling options/share awards with vesting dependent on HSBC's TSR over a period, the TSR performance targets are incorporated into the model using Monte-Carlo simulation. The fair values calculated are inherently subjective and uncertain due to the assumptions made and the limitations of the model used.

Notes on the Financial Statements (continued)

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

| | Savings-Related Share Option Plans | |
|--|------------------------------------|--------------|
| | 3-year plans | 5-year plans |
| 2013 | | |
| Risk-free interest rate ¹ (%) | 0.9 | 1.7 |
| Expected life ² (years) | 3 | 5 |
| Expected volatility ³ (%) | 20 | 20 |
| Share price at grant date (£) | 6.89 | 6.89 |

| | Savings-Related Share Option Plans | | |
|--|------------------------------------|--------------|--------------|
| | 1-year plan | 3-year plans | 5-year plans |
| 2012 | | | |
| Risk-free interest rate ¹ (%) | 0.4 | 0.6 | 1.2 |
| Expected life ² (years) | 1 | 3 | 5 |
| Expected volatility ³ (%) | 25 | 25 | 25 |
| Share price at grant date (£) | 5.46 | 5.46 | 5.46 |

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

2 The expected life of options depends on the behaviour of option holders, which is incorporated into the option model on the basis of historical observable data and is not a single input parameter but a function of various behavioural assumptions.

3 Expected volatility is estimated by considering both historic average share price volatility and implied volatility derived from traded options over HSBC shares of similar maturity to those of the employee options.

The expected US dollar denominated dividend yield was determined to be 4.5 per cent per annum in line with consensus analyst forecasts (2012: 4.5 per cent).

Movement on HSBC share option plans

| | Savings-related share option plans | | HSBC Holdings Group share option plan | |
|---|------------------------------------|-----------------------|---------------------------------------|-----------------------|
| | Number (000s) | WAEP ¹ (£) | Number (000s) | WAEP ¹ (£) |
| 2013 | | | | |
| Outstanding at 1 January | 56,119 | 4.22 | 40,257 | 6.87 |
| Granted during the year | 8,205 | 5.47 | - | - |
| Exercised during the year | (5,668) | 4.68 | (10,026) | 6.18 |
| Transferred during the year | (164) | 4.17 | (123) | 7.17 |
| Forfeited and expired during the year | (5,187) | 4.61 | (4,139) | 6.15 |
| Outstanding at 31 December | 53,305 | 4.21 | 25,969 | 7.23 |
| Weighted average fair value of options granted during the year (£) | | 1.19 | | - |
| Weighted average share price at the date the options were exercised (£) | | 6.95 | | 6.99 |

At 31 December 2013

| | | |
|---|--------|--------|
| Exercise price range (£): | | |
| 3.00 – 4.50 | 39,324 | - |
| 4.51 – 6.00 | 13,974 | - |
| 6.01 – 7.50 | 7 | 25,797 |
| 7.51 – 9.00 | - | 172 |
| Of which exercisable: | 319 | - |
| Weighted average remaining contractual life (years) | 1.52 | - |

Notes on the Financial Statements (continued)

| | Savings-related share option plans | HSBC Holdings Group share option plan | Number (000s) | WAEP ¹ £ |
|---|--|---|------------------|------------------------|
| | Number (000s) | WAEP ¹ £ | | |
| 2012 | | | | |
| Outstanding at 1 January | 71,526 | 3.82 | 41,836 | 6.86 |
| Granted during the year | 21,945 | 4.43 | – | 0.00 |
| Exercised during the year | (26,066) | 3.32 | (80) | 6.02 |
| Transferred during the year | (1,938) | 4.04 | (934) | 6.77 |
| Forfeited and expired during the year | (9,348) | 5.74 | (565) | 6.95 |
| Outstanding at 31 December | <u>56,119</u> | <u>4.22</u> | <u>40,257</u> | <u>6.87</u> |
| Weighted average fair value of options granted during the year (£) | | 1.22 | | – |
| Weighted average share price at the date the options were exercised (£) | | 5.55 | | 5.78 |

At 31 December 2012

| | | | |
|---|--------|--------|---|
| Exercise price range (£): | | | |
| 3.00 – 4.50 | 45,433 | – | – |
| 4.51 – 6.00 | 9,687 | – | – |
| 6.01 – 7.50 | 996 | 40,057 | – |
| 7.51 – 9.00 | 1 | 200 | – |
| 9.01 – 10.50 | 2 | – | – |
| Of which exercisable: | 2,300 | – | – |
| Weighted average remaining contractual life (years) | 2.01 | | |

1 Weighted Average Exercise Price.

Pre-IFRS 2 awards

Detailed below are the share-based payment awards made before the date of application of IFRS 2 on 7 November 2002 and therefore not accounted for within the balance sheet or income statement.

The HSBC Holdings Group Share Option Plan

| | 2013 | | 2012 | |
|---|-------------------|---|-------------------|---|
| | Number (000's) | Weighted average exercise price £ | Number (000's) | Weighted average exercise price £ |
| Outstanding at 1 January | 303 | 6.50 | 15,022 | 7.31 |
| Exercised | (303) | 6.50 | – | – |
| Transferred | – | – | (50) | 7.13 |
| Expired | – | – | (14,669) | 7.32 |
| Outstanding and exercisable at 31 December ^{1,2} | <u>–</u> | <u>–</u> | <u>303</u> | <u>6.50</u> |

1 The above includes the bank employee awards of 35,000 options outstanding at 1 January 2013 (2012: 7,692,481), and no options outstanding at 31 December 2013 (2012: 35,000).

2 The weighted average exercise price for bank employees was £6.50 at 1 January 2013 (2012: 1 January £7.32, 31 December £6.50).

Notes on the Financial Statements (continued)

10 Tax expense

| | 2013 £m | 2012 £m |
|---|------------|--------------|
| Current taxation | | |
| UK corporation tax charge – on current year profit | 176 | 172 |
| UK corporation tax charge – adjustments in respect of prior years | (112) | (312) |
| Overseas tax – on current year profit | 361 | 389 |
| Overseas tax – adjustment in respect of prior years | (1) | (3) |
| | <u>424</u> | <u>246</u> |
| Deferred taxation | | |
| Origination and reversal of temporary differences | 254 | (381) |
| Effect of changes in the tax rates | 47 | 30 |
| Adjustment in respect of prior years | 29 | (51) |
| | <u>330</u> | <u>(402)</u> |
| Total tax charged/(credited) to the income statement | <u>754</u> | <u>(156)</u> |

The UK corporation tax rate applying to HSBC Bank plc and its subsidiaries was 23.25 per cent (2012: 24.5 per cent). Other overseas subsidiaries and overseas branches provided for taxation at the appropriate rates in the countries in which they operate.

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

| | 2013 | | 2012 | |
|---|------------|---|--------------|---|
| | £m | Percentage of overall tax charge % | £m | Percentage of overall tax charge % |
| Taxation at UK corporation tax rate of 23.25% (2012: 24.5%) ... | 766 | 23.25 | 556 | 24.5 |
| Effect of taxing overseas profit at different rates | 84 | 2.6 | 59 | 2.6 |
| Non taxable income and gains subject to tax at a lower rate | (28) | (0.9) | (49) | (2.2) |
| Deferred tax temporary differences not provided..... | 49 | 1.5 | 6 | 0.3 |
| Permanent disallowables | 4 | 0.1 | 18 | 0.8 |
| Changes in tax rates | 49 | 1.5 | 30 | 1.3 |
| Local taxes and overseas withholding taxes | 33 | 1.0 | 70 | 3.1 |
| Other items | (120) | (3.6) | (63) | (2.8) |
| Tax loss received for no consideration..... | – | – | (98) | (4.3) |
| Adjustment in respect of prior years | (83) | (2.5) | (366) | (16.1) |
| Recycling of foreign exchange revaluation reserve on sale of HSBC Private Banking Holdings (Suisse) SA | – | – | (319) | (14.1) |
| Total tax charged/(credited) to the income statement | <u>754</u> | <u>22.9</u> | <u>(156)</u> | <u>(6.9)</u> |

The UK Government announced that the main rate of corporation tax for the year beginning 1 April 2013 would reduce from 24% to 23% to be followed by a further 2% reduction to 21% for the year beginning 1 April 2014 and a further 1% reduction to 20% for the year beginning 1 April 2015. The reduction in the corporation tax rate to 23% was enacted through the 2012 Finance Act and this results in a weighted average rate of 23.25% for 2013 (2012: 24.5%). The reductions to 21% and 20% that were announced in the 2012 Autumn Statement and 2013 Budget respectively became enacted through the 2013 Finance Act on 17 July 2013.

The effective tax rate for 2013 of 22.9% was marginally lower than the UK corporation tax rate of 23.25%. The tax rate reflected an adjustment to prior-year liabilities. This has been partly offset by the geographical distribution of the profit from overseas subsidiaries and branches and non-recognition of tax losses in the group's operations in Ireland. The effective tax rate in 2012 of (6.9%) was lower primarily due to a non-taxable intragroup disposal of HSBC Private Banking Holdings (Suisse) SA and losses claimed from HSBC Holdings plc for nil consideration.

Movement of net deferred tax assets/(liabilities) before offsetting balances within countries
The group

| | Retirement benefits £m | Loan impairment allowances £m | Unused tax losses £m | Property, plant and equipment £m | Available- for-sale investments £m | Cash flow hedges £m | Share-based payments £m | Assets leased to customers £m | Revaluation of property £m | Goodwill and intangibles £m | Other £m | Total £m |
|---|------------------------------|--|----------------------------|---|---|---------------------------|-------------------------------|-------------------------------------|----------------------------------|--------------------------------------|-------------|-------------|
| Assets..... | – | 80 | 294 | 108 | 35 | – | 76 | 33 | – | 20 | 10 | 656 |
| Liabilities..... | (243) | – | – | (1) | (61) | (82) | – | – | (13) | – | (81) | (481) |
| At 1 January 2013..... | (243) | 80 | 294 | 107 | (26) | (82) | 76 | 33 | (13) | 20 | (71) | 175 |
| Income statement..... | (220) | 8 | (284) | 71 | 7 | – | (18) | 78 | – | 51 | (23) | (330) |
| Other comprehensive income: | | | | | | | | | | | | |
| - available-for-sale investments..... | – | – | – | – | 11 | – | – | – | – | – | – | 11 |
| - cash flow hedges..... | – | – | – | – | – | 109 | – | – | – | – | – | 109 |
| - actuarial movements..... | 251 | – | – | – | – | – | – | – | – | – | – | 251 |
| Equity: | | | | | | | | | | | | |
| - share-based payments..... | – | – | – | – | – | – | (8) | – | – | – | – | (8) |
| Foreign exchange and other adjustments... | 26 | – | 4 | – | (84) | (2) | 1 | – | (7) | (14) | 66 | (10) |
| | 57 | 8 | (280) | 71 | (66) | 107 | (25) | 78 | (7) | 37 | 43 | 23 |
| Assets..... | – | 88 | 14 | 179 | – | 25 | 51 | 113 | – | 71 | – | 541 |
| Liabilities..... | (186) | – | – | (1) | (92) | – | – | (2) | (20) | (14) | (28) | (343) |
| At 31 December 2013..... | (186) | 88 | 14 | 178 | (92) | 25 | 51 | 111 | (20) | 57 | (28) | 198 |

Movement of net deferred tax assets/(liabilities) before offsetting balances within countries
The group

| | Retirement benefits £m | Loan impairment allowances £m | Unused tax losses £m | Property, plant and equipment £m | Available- for-sale investments £m | Cash flow hedges £m | Share-based payments £m | Assets leased to customers £m | Revaluation of property £m | Goodwill and intangibles £m | Other £m | Total £m |
|---|------------------------------|--|----------------------------|---|---|---------------------------|-------------------------------|-------------------------------------|----------------------------------|--------------------------------------|-------------|-------------|
| Assets..... | – | 58 | 7 | 103 | 61 | – | 90 | – | – | – | – | 319 |
| Liabilities..... | (87) | – | – | – | – | (77) | – | (159) | (23) | – | (99) | (445) |
| At 1 January 2012..... | (87) | 58 | 7 | 103 | 61 | (77) | 90 | (159) | (23) | – | (99) | (126) |
| Income statement..... | (122) | (3) | 304 | 5 | (2) | – | (31) | 191 | 2 | 42 | 16 | 402 |
| Other comprehensive income: | | | | | | | | | | | | |
| - available-for-sale investments..... | – | – | (20) | – | (103) | – | – | – | – | – | – | (123) |
| - cash flow hedges..... | – | – | – | – | – | (7) | – | – | – | – | – | (7) |
| - actuarial movements..... | (3) | – | – | – | – | – | – | – | – | – | – | (3) |
| Equity: | | | | | | | | | | | | |
| - share-based payments..... | – | – | – | – | – | – | 18 | – | – | – | – | 18 |
| Foreign exchange and other adjustments... | (31) | 25 | 3 | (1) | 18 | 2 | (1) | 1 | 8 | (22) | 12 | 14 |
| | (156) | 22 | 287 | 4 | (87) | (5) | (14) | 192 | 10 | 20 | 28 | 301 |
| Assets..... | – | 80 | 294 | 108 | 35 | – | 76 | 33 | – | 20 | 10 | 656 |
| Liabilities..... | (243) | – | – | (1) | (61) | (82) | – | – | (13) | – | (81) | (481) |
| At 31 December 2012..... | (243) | 80 | 294 | 107 | (26) | (82) | 76 | 33 | (13) | 20 | (71) | 175 |

Movement of net deferred tax assets/(liabilities) before offsetting balances within countries*The bank*

| | Retirement benefits £m | Loan impairment allowances £m | Unused tax losses £m | Property, plant and equipment £m | Available- for-sale investments £m | Cash flow hedges £m | Share-based payments £m | Goodwill and intangibles | Other £m | Total £m |
|--|------------------------------|--|----------------------------|---|---|---------------------------|-------------------------------|--------------------------------|-------------|--------------|
| Assets | – | 18 | 280 | 105 | 1 | – | 62 | 38 | 22 | 526 |
| Liabilities | (274) | – | – | – | – | (50) | – | – | – | (324) |
| At 1 January 2013 | (274) | 18 | 280 | 105 | 1 | (50) | 62 | 38 | 22 | 202 |
| Income statement | (220) | (7) | (285) | 71 | – | – | (11) | 48 | (7) | (411) |
| Other comprehensive income: | | | | | | | | | | |
| - available-for-sale investments | – | – | – | – | – | – | – | – | – | – |
| - cash flow hedges | – | – | – | – | – | 52 | – | – | – | 52 |
| - actuarial movements | 250 | – | – | – | – | – | – | – | – | 250 |
| Equity: | | | | | | | | | | |
| - share-based payments | – | – | – | – | – | – | (9) | – | – | (9) |
| Foreign exchange and other adjustments | (2) | – | 5 | – | (1) | (1) | – | 1 | – | 2 |
| | 28 | (7) | (280) | 71 | (1) | 51 | (20) | 49 | (7) | (116) |
| Assets | – | 11 | – | 176 | – | 1 | 42 | 87 | 16 | 333 |
| Liabilities | (246) | – | – | – | – | – | – | – | (1) | (247) |
| At 31 December 2013 | (246) | 11 | – | 176 | – | 1 | 42 | 87 | 15 | 86 |

Movement of net deferred tax assets/(liabilities) before offsetting balances within countries
The bank

| | Retirement benefits £m | Loan impairment allowances £m | Unused tax losses £m | Property, plant and equipment £m | Available- for-sale investments £m | Cash flow hedges £m | Share-based payments £m | Goodwill and intangibles | Other £m | Total £m |
|--|------------------------------|--|----------------------------|---|---|---------------------------|-------------------------------|--------------------------------|-------------|-------------|
| Assets | – | 26 | – | 101 | – | – | 76 | – | 35 | 238 |
| Liabilities | (138) | – | – | – | – | (47) | – | – | – | (185) |
| At 1 January 2012 | (138) | 26 | – | 101 | – | (47) | 76 | – | 35 | 53 |
| Income statement | (122) | (8) | 300 | 6 | – | – | (32) | 38 | (13) | 169 |
| Other comprehensive income: | | | | | | | | | | |
| - available-for-sale investments | – | – | (20) | – | 1 | – | – | – | – | (19) |
| - cash flow hedges | – | – | – | – | – | (4) | – | – | – | (4) |
| - actuarial movements | (16) | – | – | – | – | – | – | – | – | (16) |
| Equity: | | | | | | | | | | |
| - share-based payments | – | – | – | – | – | – | 18 | – | – | 18 |
| Foreign exchange and other adjustments | 2 | – | – | (2) | – | 1 | – | – | – | 1 |
| | (136) | (8) | 280 | 4 | 1 | (3) | (14) | 38 | (13) | 149 |
| Assets | – | 18 | 280 | 105 | 1 | – | 62 | 38 | 22 | 526 |
| Liabilities | (274) | – | – | – | – | (50) | – | – | – | (324) |
| At 31 December 2012 | (274) | 18 | 280 | 105 | 1 | (50) | 62 | 38 | 22 | 202 |

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 | |
|--------------------------------|------------|------------|------------|------------|
| | 2013 £m | 2012 £m | 2013 £m | 2012 £m |
| Deferred tax assets | 222 | 274 | 88 | 204 |
| Deferred tax liabilities | (24) | (99) | (2) | (2) |
| | 198 | 175 | 86 | 202 |

For the group, the amount of temporary differences for which no deferred tax asset is recognised in the balance sheet is £776 million (2012: £708 million). This amount is in respect of losses where the recoverability of potential benefits is not considered likely.

For the bank, the amount of temporary differences for which no deferred tax asset is recognised in the balance sheet is nil (2012: nil).

Deferred tax is not recognised in respect of the group's investments in subsidiaries and branches where remittance is not contemplated, and for associates and interests in joint ventures where it has been determined that no additional tax will arise. The aggregate amount of temporary differences associated with such investments is nil (2012: nil). Following the change in the UK tax treatment of dividends on 1 July 2009, no UK tax is expected to arise on distributions from group entities and no temporary difference exists except where withholding tax or other foreign tax could arise on the investments. No meaningful amount of temporary differences associated with such investments can be disclosed.

11 Dividends

HSBC Bank plc dividends to shareholders of the parent company were as follows:

| | 2013 | | 2012 | |
|--|-------------|--------------|-------------|--------------|
| | £ per share | £m | £ per share | £m |
| Dividends declared on ordinary shares | | | | |
| Second interim dividend in respect of the previous year | – | – | 0.25 | 200 |
| Third interim dividend in respect of the previous year | 1.76 | 1,400 | – | – |
| First interim dividend in respect of the current year | 0.71 | 570 | 0.72 | 575 |
| Second interim dividend in respect of the current year | – | – | 2.51 | 2,000 |
| | 2.47 | 1,970 | 3.48 | 2,775 |
| | | | | |
| | | | | |
| Dividends on preference shares classified as equity | | | | |
| Dividend on HSBC Bank plc non-cumulative third dollar preference shares | 1.16 | 41 | 1.17 | 41 |
| | 1.16 | 41 | 1.17 | 41 |

12 Discontinued Operations

Sale of HSBC Private Banking Holdings (Suisse) SA

In November 2012, the group sold HSBC Private Banking Holdings (Suisse) SA to HSBC Holdings plc. Prior to the sale, the bank had acquired HSBC Private Bank (UK) Limited from HSBC Private Banking Holdings (Suisse) SA in October 2012. HSBC Private Banking Holdings (Suisse) SA and its subsidiaries comprised the majority of the Private Banking segment.

The profit from discontinued operations, before gain on disposal, of £316 million was attributable entirely to the shareholders of the parent company.

Notes on the Financial Statements (continued)

| | 2013 £m | 2012 £m |
|--|------------|--------------|
| Cash flows from (used in) discontinued operations | | |
| Net cash used in operating activities | – | 14 |
| Net cash from investing activities | – | 2,323 |
| Net cash from financing activities | – | – |
| Net cash flows for the year | <u>–</u> | <u>2,337</u> |
| Effect of disposal on the financial position of the group | | |
| Net assets..... | – | (3,732) |
| Goodwill on consolidation | – | (2,796) |
| Consideration received | <u>–</u> | <u>6,535</u> |
| Profit on disposal | <u>–</u> | <u>7</u> |

13 Segment analysis

The factors used in identifying the group's reporting segments are discussed in Note 2(c) Operating Segments.

The types of products and services from which each reportable segment derives its revenue are discussed in the 'Report of the Directors: Operating and Financial Review – Products and Services'.

Profit/(loss) for the year

| | Year ended 31 December 2013 | | | | | | Total £m |
|---|-----------------------------|----------------|----------------|---------------|--------------|-------------------------|----------------|
| | RBWM £m | CMB £m | GB&M £m | GPB £m | Other £m | Inter- segment £m | |
| Net interest income | 3,569 | 2,144 | 1,101 | 224 | (73) | (4) | 6,961 |
| Net fee income | 1,502 | 1,143 | 588 | 100 | 3 | – | 3,336 |
| Net trading income | 147 | 23 | 2,192 | 10 | (22) | 23 | 2,373 |
| Other income | (147) | 60 | 400 | (4) | (65) | (74) | 170 |
| Net operating income before loan impairment charges and other credit risk provisions | 5,071 | 3,370 | 4,281 | 330 | (157) | (55) | 12,840 |
| Loan impairment charges and other credit risk provisions | (223) | (601) | (133) | (14) | – | – | (971) |
| Net operating income | 4,848 | 2,769 | 4,148 | 316 | (157) | (55) | 11,869 |
| Employee compensation and benefits | (1,066) | (554) | (1,067) | (82) | (1,069) | – | (3,838) |
| General and administrative expenses ¹ | (2,517) | (832) | (1,998) | (93) | 1,190 | 55 | (4,195) |
| Depreciation and impairment of property, plant and equipment | (7) | (10) | (3) | (1) | (310) | – | (331) |
| Amortisation and impairment of intangible assets | (83) | (41) | (54) | – | (33) | – | (211) |
| Total operating expenses | (3,673) | (1,437) | (3,122) | (176) | (222) | 55 | (8,575) |
| Operating profit | 1,175 | 1,332 | 1,026 | 140 | (379) | – | 3,294 |
| Share of profit in associates and joint ventures | 2 | 1 | (3) | – | – | – | – |
| Profit before tax | 1,177 | 1,333 | 1,023 | 140 | (379) | – | 3,294 |
| Cost efficiency ratio | 72.43% | 42.64% | 72.93% | 53.33% | | | 66.78% |

¹ The reallocation and recharging of employee and other expenses incurred directly in the 'Other' reporting segment is shown in 'General and administrative expenses'.

Notes on the Financial Statements (continued)

| | Year ended 31 December 2012 | | | | | | Total £m |
|---|-----------------------------|-----------|------------|------------------------|-------------|-------------------------|-------------|
| | RBWM £m | CMB £m | GB&M £m | GPB ² £m | Other £m | Inter- segment £m | |
| Net interest income | 3,394 | 2,037 | 876 | 597 | (43) | 43 | 6,904 |
| Net fee income | 1,532 | 1,047 | 616 | 583 | 3 | – | 3,781 |
| Net trading income | 32 | 26 | 1,554 | 254 | (9) | (23) | 1,834 |
| Other income | (52) | 70 | 973 | 8 | (937) | (93) | (31) |
| Net operating income before loan impairment charges and other credit risk provisions | 4,906 | 3,180 | 4,019 | 1,442 | (986) | (73) | 12,488 |
| Loan impairment charges and other credit risk provisions | (248) | (699) | (280) | (18) | – | – | (1,245) |
| Net operating income | 4,658 | 2,481 | 3,739 | 1,424 | (986) | (73) | 11,243 |
| Employee compensation and benefits | (1,118) | (496) | (1,157) | (557) | (1,461) | – | (4,789) |
| General and administrative expenses ¹ | (3,050) | (1,182) | (1,897) | (371) | 1,521 | 73 | (4,906) |
| Depreciation and impairment of property, plant and equipment | (6) | (8) | (5) | (14) | (333) | – | (366) |
| Amortisation and impairment of intangible assets | (74) | (29) | (34) | (1) | (37) | – | (175) |
| Total operating expenses | (4,248) | (1,715) | (3,093) | (943) | (310) | 73 | (10,236) |
| Operating profit | 410 | 766 | 646 | 481 | (1,296) | – | 1,007 |
| Share of profit in associates and joint ventures | 1 | – | (4) | (1) | 1 | – | (3) |
| Profit before tax | 411 | 766 | 642 | 480 | (1,295) | – | 1,004 |
| Cost efficiency ratio | 86.59% | 53.93% | 76.96% | 65.40% | | | 81.97% |

1 The reallocation and recharging of employee and other expenses incurred directly in the 'Other' reporting segment is shown in 'General and administrative expenses'.

2 In November 2012, the group sold HSBC Private Banking Holdings (Suisse) SA to HSBC Holdings plc. The ownership of HSBC Private Bank (UK) Limited remains within the group. Included within the Global Private Banking reporting segment profit before tax of £380 million relating to discontinued operations.

Other information about the profit/(loss) for the year

| | RBWM £m | CMB £m | GB&M £m | GPB £m | Other £m | Inter- segment £m | Total £m |
|------------------------------------|------------|-----------|------------|-----------|-------------|-------------------------|-------------|
| Year ended 31 December 2013 | | | | | | | |
| Net operating income: | 4,848 | 2,769 | 4,148 | 316 | (157) | (55) | 11,869 |
| External | 4,446 | 3,000 | 4,631 | 301 | (509) | – | 11,869 |
| Inter-segment | 402 | (231) | (483) | 15 | 352 | (55) | – |
| Year ended 31 December 2012 | | | | | | | |
| Net operating income: | 4,658 | 2,481 | 3,739 | 1,424 | (986) | (73) | 11,243 |
| External | 4,283 | 2,693 | 4,232 | 1,235 | (1,200) | – | 11,243 |
| Inter-segment | 375 | (212) | (493) | 189 | 214 | (73) | – |

Notes on the Financial Statements (continued)

Balance sheet information

| | RBWM £m | CMB £m | GB&M £m | GPB £m | Other £m | Inter- segment £m | Total £m |
|---|------------|-----------|------------|-----------|-------------|-------------------------|-------------|
| Year ended 31 December 2013 | | | | | | | |
| Loans and advances to customers (net)..... | 107,287 | 63,819 | 124,910 | 8,515 | 501 | – | 305,032 |
| Investment in associates and joint venture..... | 20 | 18 | 29 | – | – | – | 67 |
| Total assets..... | 148,065 | 81,509 | 631,114 | 16,174 | 22,335 | (87,503) | 811,695 |
| Customer accounts..... | 124,183 | 81,133 | 170,773 | 13,311 | 617 | – | 390,017 |
| Total liabilities..... | 152,599 | 108,662 | 555,911 | 16,108 | 15,308 | (69,812) | 778,776 |
| Year ended 31 December 2012 | | | | | | | |
| Loans and advances to customers (net)..... | 104,702 | 65,454 | 103,729 | 8,252 | 548 | – | 282,685 |
| Investment in associates and joint venture..... | 18 | 17 | 32 | – | – | – | 67 |
| Total assets..... | 151,301 | 90,825 | 641,318 | 12,101 | 23,688 | (103,752) | 815,481 |
| Customer accounts..... | 118,187 | 75,261 | 121,730 | 9,250 | 458 | – | 324,886 |
| Total liabilities..... | 149,006 | 76,813 | 632,331 | 12,033 | 18,437 | (105,339) | 783,281 |

Information by country

| | 31 December 2013 | | 31 December 2012 | |
|----------------------|--|--|--|--|
| | External net Operating income ^{1,3} £m | Non-current assets ² £m | External net Operating income ^{1,3} £m | Non-current assets ² £m |
| United Kingdom..... | 9,149 | 3,385 | 7,964 | 3,921 |
| France..... | 1,990 | 6,365 | 1,822 | 6,243 |
| Switzerland..... | 6 | – | 381 | – |
| Germany..... | 542 | 177 | 513 | 176 |
| Turkey..... | 701 | 75 | 696 | 91 |
| Other countries..... | 452 | 232 | 1,112 | 232 |
| Total..... | 12,840 | 10,234 | 12,488 | 10,663 |

1 Net operating income is attributed to countries on the basis of the customers' location.

2 Non current assets consist of property, plant and equipment, goodwill, other intangible assets and certain other assets expected to be recovered more than twelve months after the reporting period.

3 Net operating income before loan impairment charges and other credit risk provisions, also referred to as revenue. The table previously reported net operating income after loan impairment charges and other credit risk provisions.

14 Analysis of financial assets and liabilities by measurement basis

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

The group

At 31 December 2013

| | Held for trading £m | Designated at fair value £m | Held-to-maturity securities £m | Loans and receivables £m | Available-for-sale securities £m | Financial assets and liabilities at amortised cost £m | Derivatives designated as fair value hedging instruments £m | Derivatives designated as cash flow hedging instruments £m | Total £m |
|--|------------------------|--------------------------------|-----------------------------------|-----------------------------|-------------------------------------|--|--|---|----------------|
| Financial assets | | | | | | | | | |
| Cash and balances at central banks | - | - | - | - | - | 67,584 | - | - | 67,584 |
| Items in the course of collection from other banks | - | - | - | - | - | 1,948 | - | - | 1,948 |
| Trading assets | 134,097 | - | - | - | - | - | - | - | 134,097 |
| Financial assets designated at fair value | - | 16,661 | - | - | - | - | - | - | 16,661 |
| Derivatives | 135,997 | - | - | - | - | - | 456 | 786 | 137,239 |
| Loans and advances to banks | - | - | - | 53,228 | - | - | - | - | 53,228 |
| Loans and advances to customers | - | - | - | 305,032 | - | - | - | - | 305,032 |
| Financial investments | - | - | - | - | 75,030 | - | - | - | 75,030 |
| Other assets | - | - | - | - | - | 5,027 | - | - | 5,027 |
| Accrued income | - | - | - | - | - | 2,412 | - | - | 2,412 |
| Total financial assets | 270,094 | 16,661 | - | 358,260 | 75,030 | 76,971 | 456 | 786 | 798,258 |
| Total non-financial assets | | | | | | | | | 13,437 |
| Total assets | | | | | | | | | 811,695 |
| Financial liabilities | | | | | | | | | |
| Deposits by banks | - | - | - | - | - | 50,683 | - | - | 50,683 |
| Customer accounts | - | - | - | - | - | 390,017 | - | - | 390,017 |
| Items in the course of transmission to other banks | - | - | - | - | - | 960 | - | - | 960 |
| Trading liabilities | 91,842 | - | - | - | - | - | - | - | 91,842 |
| Financial liabilities designated at fair value | - | 34,036 | - | - | - | - | - | - | 34,036 |
| Derivatives | 135,384 | - | - | - | - | - | 1,250 | 718 | 137,352 |
| Debt securities in issue | - | - | - | - | - | 32,895 | - | - | 32,895 |
| Other liabilities | - | - | - | - | - | 5,411 | - | - | 5,411 |
| Accruals | - | - | - | - | - | 2,694 | - | - | 2,694 |
| Subordinated liabilities | - | - | - | - | - | 10,785 | - | - | 10,785 |
| Total financial liabilities | 227,226 | 34,036 | - | - | - | 493,445 | 1,250 | 718 | 756,675 |
| Total non-financial liabilities | | | | | | | | | 22,101 |
| | | | | | | | | | 778,776 |

The group

At 31 December 2012

| | Held for trading £m | Designated at fair value £m | Held-to-maturity securities £m | Loans and receivables £m | Available-for-sale securities £m | Financial assets and liabilities at amortised cost £m | Derivatives designated as fair value hedging instruments £m | Derivatives designated as cash flow hedging instruments £m | Total £m |
|--|------------------------|--------------------------------|-----------------------------------|-----------------------------|-------------------------------------|--|--|---|----------------|
| Financial assets | | | | | | | | | |
| Cash and balances at central banks | - | - | - | - | - | 51,613 | - | - | 51,613 |
| Items in the course of collection from other banks | - | - | - | - | - | 1,961 | - | - | 1,961 |
| Trading assets | 161,516 | - | - | - | - | - | - | - | 161,516 |
| Financial assets designated at fair value | - | 15,387 | - | - | - | - | - | - | 15,387 |
| Derivatives | 176,559 | - | - | - | - | - | 88 | 1,161 | 177,808 |
| Loans and advances to banks | - | - | - | 32,286 | - | - | - | - | 32,286 |
| Loans and advances to customers | - | - | - | 282,685 | - | - | - | - | 282,685 |
| Financial investments | - | - | - | - | 71,265 | - | - | - | 71,265 |
| Other assets | - | - | - | - | - | 4,269 | - | - | 4,269 |
| Accrued income | - | - | - | - | - | 2,435 | - | - | 2,435 |
| Total financial assets | 338,075 | 15,387 | - | 314,971 | 71,265 | 60,278 | 88 | 1,161 | 801,225 |
| Total non-financial assets | | | | | | | | | 14,256 |
| Total assets | | | | | | | | | 815,481 |
| Financial liabilities | | | | | | | | | |
| Deposits by banks | - | - | - | - | - | 39,571 | - | - | 39,571 |
| Customer accounts | - | - | - | - | - | 324,886 | - | - | 324,886 |
| Items in the course of transmission to other banks | - | - | - | - | - | 1,017 | - | - | 1,017 |
| Trading liabilities | 122,896 | - | - | - | - | - | - | - | 122,896 |
| Financial liabilities designated at fair value | - | 32,918 | - | - | - | - | - | - | 32,918 |
| Derivatives | 178,809 | - | - | - | - | - | 1,500 | 786 | 181,095 |
| Debt securities in issue | - | - | - | - | - | 40,358 | - | - | 40,358 |
| Other liabilities | - | - | - | - | - | 6,286 | - | - | 6,286 |
| Accruals | - | - | - | - | - | 2,961 | - | - | 2,961 |
| Subordinated liabilities | - | - | - | - | - | 10,350 | - | - | 10,350 |
| Total financial liabilities | 301,705 | 32,918 | - | - | - | 425,429 | 1,500 | 786 | 762,338 |
| Total non-financial liabilities | | | | | | | | | 20,943 |
| Total liabilities | | | | | | | | | 783,281 |

The bank

At 31 December 2013

| | Held for trading £m | Designated at fair value £m | Held-to-maturity securities £m | Loans and receivables £m | Available-for-sale securities £m | Financial assets and liabilities at amortised cost £m | Derivatives designated as fair value hedging instruments £m | Derivatives designated as cash flow hedging instruments £m | Total £m |
|--|------------------------|--------------------------------|-----------------------------------|-----------------------------|-------------------------------------|--|--|---|----------------|
| Financial assets | | | | | | | | | |
| Cash and balances at central banks | - | - | - | - | - | 60,996 | - | - | 60,996 |
| Items in the course of collection from other banks | - | - | - | - | - | 1,374 | - | - | 1,374 |
| Trading assets | 101,287 | - | - | - | - | - | - | - | 101,287 |
| Financial assets designated at fair value | - | 3,983 | - | - | - | - | - | - | 3,983 |
| Derivatives | 111,685 | - | - | - | - | - | 493 | 445 | 112,623 |
| Loans and advances to banks | - | - | - | 41,566 | - | - | - | - | 41,566 |
| Loans and advances to customers | - | - | - | 240,180 | - | - | - | - | 240,180 |
| Financial investments | - | - | - | - | 45,048 | - | - | - | 45,048 |
| Other assets | - | - | - | - | - | 3,657 | - | - | 3,657 |
| Accrued income | - | - | - | - | - | 1,065 | - | - | 1,065 |
| Total financial assets | 212,972 | 3,983 | - | 281,746 | 45,048 | 67,092 | 493 | 445 | 611,779 |
| Total non-financial assets | | | | | | | | | 16,150 |
| Total assets | | | | | | | | | 627,929 |
| Financial liabilities | | | | | | | | | |
| Deposits by banks | - | - | - | - | - | 52,514 | - | - | 52,514 |
| Customer accounts | - | - | - | - | - | 312,080 | - | - | 312,080 |
| Items in the course of transmission to other banks | - | - | - | - | - | 422 | - | - | 422 |
| Trading liabilities | 62,414 | - | - | - | - | - | - | - | 62,414 |
| Financial liabilities designated at fair value | - | 22,006 | - | - | - | - | - | - | 22,006 |
| Derivatives | 113,428 | - | - | - | - | - | 995 | 287 | 114,710 |
| Debt securities in issue | - | - | - | - | - | 19,576 | - | - | 19,576 |
| Other liabilities | - | - | - | - | - | 3,662 | - | - | 3,662 |
| Accruals | - | - | - | - | - | 1,573 | - | - | 1,573 |
| Subordinated liabilities | - | - | - | - | - | 9,903 | - | - | 9,903 |
| Total financial liabilities | 175,842 | 22,006 | - | - | - | 399,730 | 995 | 287 | 598,860 |
| Total non-financial liabilities | | | | | | | | | 1,875 |
| Total liabilities | | | | | | | | | 600,735 |

The bank

At 31 December 2012

| | Held for trading £m | Designated at fair value £m | Held-to-maturity securities £m | Loans and receivables £m | Available-for-sale securities £m | Financial assets and liabilities at amortised cost £m | Derivatives designated as fair value hedging instruments £m | Derivatives designated as cash flow hedging instruments £m | Total £m |
|--|------------------------|--------------------------------|-----------------------------------|-----------------------------|-------------------------------------|--|--|---|----------------|
| Financial assets | | | | | | | | | |
| Cash and balances at central banks | – | – | – | – | – | 45,262 | – | – | 45,262 |
| Items in the course of collection from other banks | – | – | – | – | – | 1,213 | – | – | 1,213 |
| Trading assets | 137,999 | – | – | – | – | – | – | – | 137,999 |
| Financial assets designated at fair value | – | 4,373 | – | – | – | – | – | – | 4,373 |
| Derivatives | 139,695 | – | – | – | – | – | 162 | 483 | 140,340 |
| Loans and advances to banks | – | – | – | 17,207 | – | – | – | – | 17,207 |
| Loans and advances to customers | – | – | – | 225,567 | – | – | – | – | 225,567 |
| Financial investments | – | – | – | – | 36,603 | – | – | – | 36,603 |
| Other assets | – | – | – | – | – | 3,205 | – | – | 3,205 |
| Accrued income | – | – | – | – | – | 1,075 | – | – | 1,075 |
| Total financial assets | 277,694 | 4,373 | – | 242,774 | 36,603 | 50,755 | 162 | 483 | 612,844 |
| Total non-financial assets | | | | | | | | | 16,786 |
| Total assets | | | | | | | | | 629,630 |
| Financial liabilities | | | | | | | | | |
| Deposits by banks | – | – | – | – | – | 30,129 | – | – | 30,129 |
| Customer accounts | – | – | – | – | – | 256,341 | – | – | 256,341 |
| Items in the course of transmission to other banks | – | – | – | – | – | 334 | – | – | 334 |
| Trading liabilities | 104,946 | – | – | – | – | – | – | – | 104,946 |
| Financial liabilities designated at fair value | – | 23,513 | – | – | – | – | – | – | 23,513 |
| Derivatives | 142,217 | – | – | – | – | – | 1,537 | 167 | 143,921 |
| Debt securities in issue | – | – | – | – | – | 24,970 | – | – | 24,970 |
| Other liabilities | – | – | – | – | – | 5,020 | – | – | 5,020 |
| Accruals | – | – | – | – | – | 1,587 | – | – | 1,587 |
| Subordinated liabilities | – | – | – | – | – | 9,968 | – | – | 9,968 |
| Total financial liabilities | 247,163 | 23,513 | – | – | – | 328,349 | 1,537 | 167 | 600,729 |
| Total non-financial liabilities | | | | | | | | | 1,834 |
| Total liabilities | | | | | | | | | 602,563 |

Notes on the Financial Statements (continued)

15 Trading assets

| | The group | | The bank | |
|---|----------------|------------|----------------|------------|
| | 2013 £m | 2012 £m | 2013 £m | 2012 £m |
| Trading assets: | | | | |
| – which may be repledged or resold by counterparties | 53,174 | 53,883 | 31,232 | 36,508 |
| – not subject to repledge or resale by counterparties | 80,923 | 107,633 | 70,055 | 101,491 |
| | 134,097 | 161,516 | 101,287 | 137,999 |
| Treasury and other eligible bills | 2,623 | 2,258 | 643 | 1,120 |
| Debt securities | 56,414 | 54,576 | 28,821 | 30,084 |
| Equity securities | 36,007 | 22,892 | 34,422 | 22,050 |
| Loans and advances to banks | 16,067 | 32,655 | 16,568 | 38,258 |
| Loans and advances to customers | 22,986 | 49,135 | 20,833 | 46,487 |
| | 134,097 | 161,516 | 101,287 | 137,999 |

Included within the above figures for the group are debt securities issued by banks and other financial institutions of £ 12,062 million (2012: £10,163 million), of which £ 2,382 million (2012: £2,078 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 £ 6,456 million (2012: £5,049 million), of which nil (2012: nil) are guaranteed by governments.

16 Financial assets designated at fair value through profit or loss

| | The group | | The bank | |
|--|---------------|------------|--------------|------------|
| | 2013 £m | 2012 £m | 2013 £m | 2012 £m |
| Financial assets designated at fair value: | | | | |
| –not subject to repledge or resale by counterparties | 16,661 | 15,387 | 3,983 | 4,373 |
| Debt securities..... | 6,903 | 7,122 | 3,983 | 4,373 |
| Equity securities..... | 9,714 | 8,236 | – | – |
| Securities designated at fair value | 16,617 | 15,358 | 3,983 | 4,373 |
| Loans and advances to banks | 44 | 29 | – | – |
| | 16,661 | 15,387 | 3,983 | 4,373 |

Notes on the Financial Statements (continued)

17 Derivatives

Fair values of derivatives by product contract type held

The group

| | At 31 December 2013 | | | | | |
|-------------------------------|---------------------|---------------|----------------|------------------|----------------|------------------|
| | Assets | | | Liabilities | | |
| | Trading £m | Hedging £m | Total £m | Trading £m | Hedging £m | Total £m |
| Foreign exchange | 32,851 | 245 | 33,096 | (33,644) | (159) | (33,803) |
| Interest rate | 244,392 | 997 | 245,389 | (240,448) | (1,809) | (242,257) |
| Equity | 10,296 | – | 10,296 | (13,001) | – | (13,001) |
| Credit | 3,713 | – | 3,713 | (3,582) | – | (3,582) |
| Commodity and other | 865 | – | 865 | (829) | – | (829) |
| Gross total fair values | <u>292,117</u> | <u>1,242</u> | <u>293,359</u> | <u>(291,504)</u> | <u>(1,968)</u> | <u>(293,472)</u> |
| Netting | | | (156,120) | | | 156,120 |
| Total | | | <u>137,239</u> | | | <u>(137,352)</u> |

| | At 31 December 2012 | | | | | |
|-------------------------------|---------------------|---------------|----------------|------------------|----------------|------------------|
| | Assets | | | Liabilities | | |
| | Trading £m | Hedging £m | Total £m | Trading £m | Hedging £m | Total £m |
| Foreign exchange | 28,212 | 2 | 28,214 | (30,962) | (25) | (30,987) |
| Interest rate | 352,380 | 1,247 | 353,627 | (349,088) | (2,261) | (351,349) |
| Equity | 8,523 | – | 8,523 | (11,074) | – | (11,074) |
| Credit | 4,787 | – | 4,787 | (5,123) | – | (5,123) |
| Commodity and other | 646 | – | 646 | (551) | – | (551) |
| Gross total fair values | <u>394,548</u> | <u>1,249</u> | <u>395,797</u> | <u>(396,798)</u> | <u>(2,286)</u> | <u>(399,084)</u> |
| Netting | | | (217,989) | | | 217,989 |
| Total | | | <u>177,808</u> | | | <u>(181,095)</u> |

The bank

| | At 31 December 2013 | | | | | |
|-------------------------------|---------------------|---------------|----------------|------------------|----------------|------------------|
| | Assets | | | Liabilities | | |
| | Trading £m | Hedging £m | Total £m | Trading £m | Hedging £m | Total £m |
| Foreign exchange | 33,260 | 192 | 33,452 | (33,965) | (159) | (34,124) |
| Interest rate | 163,636 | 746 | 164,382 | (162,402) | (1,123) | (163,525) |
| Equity | 10,137 | – | 10,137 | (12,578) | – | (12,578) |
| Credit | 3,713 | – | 3,713 | (3,579) | – | (3,579) |
| Commodity and other | 880 | – | 880 | (845) | – | (845) |
| Gross total fair values | <u>211,626</u> | <u>938</u> | <u>212,564</u> | <u>(213,369)</u> | <u>(1,282)</u> | <u>(214,651)</u> |
| Netting | | | (99,941) | | | 99,941 |
| Total | | | <u>112,623</u> | | | <u>(114,710)</u> |

| | At 31 December 2012 | | | | | |
|-------------------------------|---------------------|---------------|----------------|------------------|----------------|------------------|
| | Assets | | | Liabilities | | |
| | Trading £m | Hedging £m | Total £m | Trading £m | Hedging £m | Total £m |
| Foreign exchange | 28,329 | – | 28,329 | (30,905) | – | (30,905) |
| Interest rate | 238,711 | 645 | 239,356 | (236,121) | (1,704) | (237,825) |
| Equity | 8,450 | – | 8,450 | (10,746) | – | (10,746) |
| Credit | 4,787 | – | 4,787 | (5,121) | – | (5,121) |
| Commodity and other | 652 | – | 652 | (558) | – | (558) |
| Gross total fair values | <u>280,929</u> | <u>645</u> | <u>281,574</u> | <u>(283,451)</u> | <u>(1,704)</u> | <u>(285,155)</u> |
| Netting | | | (141,234) | | | 141,234 |
| Total | | | <u>140,340</u> | | | <u>(143,921)</u> |

Notes on the Financial Statements (continued)

Use of derivatives

The group transacts derivatives for three primary purposes: to create risk management solutions for clients, to manage the portfolio of risks arising from client business, and to manage and hedge the group's own risks. Derivatives (except for derivatives which are designated as effective hedging instruments as defined in IAS 39) are held for trading. The held for trading classification includes two types of derivatives: those used in sales and trading activities, and those used for risk management purposes but which for various reasons do not meet the qualifying criteria for hedge accounting. The second category includes derivatives managed in conjunction with financial instruments designated at fair value. These activities are described more fully below.

The group's derivative activities give rise to significant open positions in portfolios of derivatives. These positions are managed constantly to ensure that they remain within acceptable risk levels, with matching deals being used to achieve this where necessary. When entering into derivative transactions, the group employs the same credit risk management procedures to assess and approve potential credit exposures that are used for traditional lending.

Trading derivatives

Most of the group's derivative transactions relate to sales and trading activities. Sales activities include the structuring and marketing of derivative products to customers to enable them to take, transfer, modify or reduce current or expected risks. Trading activities in derivatives are entered into principally for the purpose of generating profits from short-term fluctuations in price or margin. Positions may be traded actively or be held over a period of time to benefit from expected changes in currency rates, interest rates, equity prices or other market parameters. Trading includes market-making, positioning and arbitrage activities. Market-making entails quoting bid and offer prices to other market participants for the purpose of generating revenues based on spread and volume; positioning means managing market risk positions in the expectation of benefiting from favourable movements in prices, rates or indices; arbitrage involves identifying and profiting from price differentials between markets and products.

As mentioned above, other derivatives classified as held-for-trading include non-qualifying hedging derivatives, ineffective hedging derivatives and the components of hedging derivatives that are excluded from assessing hedge effectiveness. Non-qualifying hedging derivatives are entered into for risk management purposes but do not meet the criteria for hedge accounting. These include derivatives managed in conjunction with financial instruments designated at fair value.

Gains and losses from changes in the fair value of derivatives, including the contractual interest, that do not qualify for hedge accounting are reported in 'Net trading income', except for derivatives managed in conjunction with financial instruments designated at fair value, where gains and losses are reported in 'Net income from financial instruments designated at fair value', together with the gains and losses on the hedged items. Where the derivatives are managed with debt securities in issue, the contractual interest is shown in 'Interest expense' together with the interest payable on the issued debt. Substantially all of the group's derivatives entered into with the group's undertakings are managed in conjunction with financial liabilities designated at fair value.

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

| | At 31 December | | | |
|-------------------------|-------------------|------------|-------------------|------------|
| | The group | | The bank | |
| | 2013 £m | 2012 £m | 2013 £m | 2012 £m |
| Foreign exchange | 2,343,902 | 1,752,454 | 2,375,578 | 1,787,854 |
| Interest rate | 13,612,533 | 10,694,278 | 9,581,060 | 7,465,092 |
| Equity | 336,980 | 285,442 | 330,845 | 279,793 |
| Credit | 263,524 | 339,538 | 263,531 | 339,543 |
| Commodity | 34,233 | 41,533 | 35,414 | 44,246 |
| Total derivatives | 16,591,172 | 13,113,245 | 12,586,428 | 9,916,528 |

The notional or contractual amounts of these instruments indicate the nominal value of transactions outstanding at the balance sheet date; they do not represent amounts at risk.

Derivatives valued using models with unobservable inputs

The difference between the fair value at initial recognition (the transaction price) and the value that would have been derived had valuation techniques used for subsequent measurement been applied at initial recognition, less subsequent releases, is as follows:

Notes on the Financial Statements (continued)

| | The group | | The bank | |
|---|------------|------------|------------|------------|
| | 2013 £m | 2012 £m | 2013 £m | 2012 £m |
| Unamortised balance at 1 January | 90 | 97 | 86 | 91 |
| Deferral on new transactions | 113 | 76 | 111 | 76 |
| Recognised in the income statement during the period: | | | | |
| – amortisation | (55) | (57) | (54) | (57) |
| – subsequent to unobservable inputs becoming observable ... | (25) | – | (25) | – |
| – maturity or termination, or offsetting derivative | (38) | (23) | (37) | (21) |
| Exchange differences | – | (3) | – | (3) |
| Unamortised balance at 31 December ¹ | 85 | 90 | 81 | 86 |

1 This amount is yet to be recognised in the income statement.

Hedging instruments

The group uses derivatives (principally interest rate swaps) for hedging purposes in the management of its own asset and liability portfolios and structural positions. This enables the group to optimise the overall cost to the group of accessing debt capital markets, and to mitigate the market risk which would otherwise arise from structural imbalances in the maturity and other profiles of its assets and liabilities.

The accounting treatment of hedge transactions varies according to the nature of the instrument hedged and the type of hedge transactions. Derivatives may qualify as hedges for accounting purposes if they are fair value hedges, cash flow hedges, or hedges in net investment of foreign operations. These are described under the relevant headings below.

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

The notional contract amounts of these instruments indicate the nominal value of transactions outstanding at the balance sheet date; they do not represent amounts at risk.

| | The group | | | |
|---------------------|--------------------------|---------------------------|--------------------------|---------------------------|
| | At 31 December 2013 | | At 31 December 2012 | |
| | Cash flow hedge £m | Fair value hedge £m | Cash flow hedge £m | Fair value hedge £m |
| Exchange rate | 7,491 | 137 | 738 | 69 |
| Interest rate | 94,586 | 30,122 | 72,553 | 19,574 |

| | The bank | | | |
|---------------------|--------------------------|---------------------------|--------------------------|---------------------------|
| | At 31 December 2013 | | At 31 December 2012 | |
| | Cash flow hedge £m | Fair value hedge £m | Cash flow hedge £m | Fair value hedge £m |
| Exchange rate | 7,071 | – | 179 | – |
| Interest rate | 45,070 | 23,031 | 32,744 | 16,576 |

Fair value hedges

The group's fair value hedges principally consist of interest rate swaps that are used to protect against changes in the fair value of fixed-rate long-term financial instruments due to movements in market interest rates. For qualifying fair value hedges, all changes in the fair value of the derivative and in the fair value of the item in relation to the risk being hedged are recognised in the income statement. If the hedge relationship is terminated, the fair value adjustment to the hedged item continues to be reported as part of the basis of the item and is amortised to the income statement as a yield adjustment over the remainder of the hedging period.

Notes on the Financial Statements (continued)

Fair value of derivatives designated as fair value hedges

The group

| | At 31 December 2013 | | At 31 December 2012 | |
|------------------------|---------------------|-------------------|---------------------|-------------------|
| | Assets £m | Liabilities £m | Assets £m | Liabilities £m |
| Foreign exchange | 3 | – | – | – |
| Interest rate | 453 | (1,250) | 88 | (1,500) |
| | 456 | (1,250) | 88 | (1,500) |

The bank

| | At 31 December 2013 | | At 31 December 2012 | |
|---------------------|---------------------|-------------------|---------------------|-------------------|
| | Assets £m | Liabilities £m | Assets £m | Liabilities £m |
| Interest rate | 493 | (995) | 162 | (1,537) |
| | 493 | (995) | 162 | (1,537) |

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

| | The group | | The bank | |
|---|------------|------------|------------|------------|
| | 2013 £m | 2012 £m | 2013 £m | 2012 £m |
| Gains/ (losses) | | | | |
| – on hedging instruments | 472 | (371) | 514 | (241) |
| – on hedged items attributable to the hedged risk | (439) | 360 | (480) | 233 |

The gains and losses on ineffective portions of fair value hedges are recognised immediately in 'Net trading income'.

Cash flow hedges

The group's cash flow hedges consist principally of interest rate and cross-currency swaps that are used to protect against exposures to variability in future interest cash flows on non-trading assets and liabilities which bear interest at variable rates or which are expected to be re-funded or reinvested in the future. The amounts and timing of future cash flows, representing both principal and interest flows, are projected for each portfolio of financial assets and liabilities on the basis of their contractual terms and other relevant factors, including estimates of prepayments and defaults. The aggregate principal balances and interest cash flows across all portfolios over time form the basis for identifying gains and losses on the effective portions of derivatives designated as cash flow hedges of forecast transactions. Gains and losses are initially recognised in other comprehensive income, in the cash flow hedging reserve, and are transferred to the income statement when the forecast cash flows affect the income statement.

Fair value of derivatives designated as cash flow hedges

The group

| | At 31 December 2013 | | At 31 December 2012 | |
|------------------------|---------------------|-------------------|---------------------|-------------------|
| | Assets £m | Liabilities £m | Assets £m | Liabilities £m |
| Foreign exchange | 242 | (159) | 2 | (25) |
| Interest rate | 544 | (559) | 1,159 | (761) |
| | 786 | (718) | 1,161 | (786) |

The bank

| | At 31 December 2013 | | At 31 December 2012 | |
|------------------------|---------------------|-------------------|---------------------|-------------------|
| | Assets £m | Liabilities £m | Assets £m | Liabilities £m |
| Foreign exchange | 192 | (159) | – | – |
| Interest rate | 253 | (128) | 483 | (167) |
| | 445 | (287) | 483 | (167) |

Notes on the Financial Statements (continued)

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

The group

| | At 31 December 2013 | | | |
|--|---------------------------|---|--|----------------------------|
| | 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 | 64,230 | 56,681 | 38,577 | 909 |
| Liabilities | (19,893) | (12,262) | (10,481) | (4,807) |
| Net cash inflow/(outflow) exposure | 44,337 | 44,419 | 28,096 | (3,898) |

| | At 31 December 2012 | | | |
|--|---------------------------|---|--|----------------------------|
| | 3 months or less £m | More than 3 months but less than 1 year £m | 5 years or less but more than 1 year £m | More than 5 years £m |
| Assets | 44,530 | 34,784 | 26,234 | 3,022 |
| Liabilities | (17,422) | (9,948) | (6,788) | (1,336) |
| Net cash inflow/(outflow) exposure | 27,108 | 24,836 | 19,446 | 1,686 |

The bank

| | At 31 December 2013 | | | |
|--|---------------------------|---|--|----------------------------|
| | 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 | 43,498 | 42,862 | 34,489 | – |
| Liabilities | (6,343) | (6,223) | (4,539) | (322) |
| Net cash inflow/(outflow) exposure | 37,155 | 36,639 | 29,950 | (322) |

| | At 31 December 2012 | | | |
|--|---------------------------|---|--|----------------------------|
| | 3 months or less £m | More than 3 months but less than 1 year £m | 5 years or less but more than 1 year £m | More than 5 years £m |
| Assets | 29,226 | 27,014 | 18,612 | 82 |
| Liabilities..... | (3,050) | (3,050) | (3,050) | (230) |
| Net cash inflow/(outflow) exposure | 26,176 | 23,964 | 15,562 | (148) |

The gains and losses on ineffective portions of such derivatives are recognised immediately in 'Net trading income'. During the year to 31 December 2013, a loss of £8 million (2012: gain of £7 million) was recognised due to hedge ineffectiveness.

Notes on the Financial Statements (continued)

18 Financial investments

| | The group | | The bank | |
|---|---------------|------------|---------------|------------|
| | 2013 £m | 2012 £m | 2013 £m | 2012 £m |
| Financial investments: | | | | |
| – which may be repledged or resold by counterparties | 11,435 | 7,979 | 8,583 | 4,920 |
| – not subject to repledge or resale by counterparties | 63,595 | 63,286 | 36,465 | 31,683 |
| | 75,030 | 71,265 | 45,048 | 36,603 |
| | | | | |
| | The group | | The bank | |
| | 2013 £m | 2012 £m | 2013 £m | 2012 £m |
| Treasury and other eligible bills..... | 2,196 | 5,203 | 1,927 | 4,922 |
| – available-for-sale..... | 2,196 | 5,203 | 1,927 | 4,922 |
| Debt securities | 71,828 | 65,034 | 42,667 | 31,194 |
| – available-for-sale..... | 71,828 | 65,034 | 42,667 | 31,194 |
| Equity securities | 1,006 | 1,028 | 454 | 487 |
| – available-for-sale..... | 1,006 | 1,028 | 454 | 487 |
| Total financial investments | 75,030 | 71,265 | 45,048 | 36,603 |

For the group, £2,936 million (2012: £1,953 million), and for the bank, £865 million (2012: £358 million), of the debt securities issued by banks and other financial institutions are guaranteed by various governments.

19 Transfer of financial assets

The group enters into transactions in the normal course of business by which it transfers recognised financial assets directly to third parties including SPEs. Depending on the circumstances these transfers may either result in these financial assets being derecognised or continuing to be recognised.

- Full derecognition occurs when the group transfers its contractual right to receive cash flows from the financial assets, or retains the right but assumes an obligation to pass on the cash flows from the asset, and transfers substantially all the risks and rewards of ownership. The risks include credit, interest rate, currency, prepayment and other price risks.
- Derecognition does not occur when the group transfers its contractual right to receive cash flows from the financial assets, or retains the right but assumes an obligation to pass on the cash flows from the asset, but either:
 - i) retains substantially all of the risks and rewards of ownership of the transferred asset; or
 - ii) neither retains nor transfers substantially all of the risks and rewards of ownership but has retained control. In this situation the financial assets are recognised on the balance sheet to the extent of the group's continuing involvement.

The majority of transferred financial assets that do not qualify for derecognition are (i) debt securities held by counterparties as collateral under repurchase agreements or (ii) equity securities lent under securities lending agreements.

As the substance of these transactions is secured borrowings the asset collateral continues to be recognised in full and the related liability reflecting the Group's obligation to repurchase the transferred assets for a fixed price at a future date is recognised in deposits from banks or customers as appropriate. As a result of these transactions, the Group is unable to use, sell or pledge the transferred assets for the duration of the transaction. The Group remains exposed to interest rate risk and credit risk on these pledged instruments. The counterparty's recourse is not limited to the transferred assets.

In a small number of securitisation transactions, the group has neither transferred nor retained substantially all the risks and rewards of ownership of the transferred assets, and has retained control of the transferred assets. Circumstances in which the group has continuing involvement in the transferred assets may include retention of

Notes on the Financial Statements (continued)

servicing rights over the transferred assets, entering into a derivative transaction with the securitisation vehicle or retaining an interest in the securitisation vehicle. Where the group has continuing involvement it continues to recognise the transferred assets to the extent of its continuing involvement and recognises an associated liability. The net carrying amount of the transferred assets and associated liabilities reflects the rights and obligations that the group has retained.

The following tables analyse the carrying amount of financial assets that did not qualify for derecognition and their associated financial liabilities, including those that are recognised to the extent of the group's continuing involvement and the associated liabilities.

Financial assets not qualifying for full derecognition and associated financial liabilities

The group

| | Carrying amount of transferred assets £m | Carrying amount of associated liabilities £m | Fair value of transferred assets £m | Fair value of associated liabilities £m | Net position £m |
|---|--|--|---|---|-----------------------|
| At 31 December 2013 | | | | | |
| Repurchase agreements | <u>60,288</u> | <u>60,657</u> | | | |
| Securities lending agreements | <u>4,989</u> | <u>4,945</u> | | | |
| Other sales (recourse to transferred asset only) .. | <u>581</u> | <u>674</u> | <u>624</u> | <u>624</u> | <u>–</u> |

| | Carrying amount of assets before transfer £m | Carrying amount of recognised assets £m | Carrying amount of associated liabilities £m | Fair value of recognised assets £m | Fair value of associated liabilities £m | Net position £m |
|---|---|---|--|--|---|-----------------------|
| At 31 December 2013 | | | | | | |
| Securitisations recognised to the extent of continuing involvement | <u>5,021</u> | <u>9</u> | <u>5</u> | <u>9</u> | <u>5</u> | <u>4</u> |

| | Carrying amount of transferred assets £m | Carrying amount of associated liabilities £m | Fair value of transferred assets £m | Fair value of associated liabilities £m | Net position £m |
|---|--|--|---|---|-----------------------|
| At 31 December 2012 | | | | | |
| Repurchase agreements | <u>58,893</u> | <u>58,617</u> | | | |
| Securities lending agreements | <u>3,452</u> | <u>3,416</u> | | | |
| Other sales (recourse to transferred asset only) .. | <u>665</u> | <u>665</u> | <u>673</u> | <u>673</u> | <u>–</u> |

| | Carrying amount of assets before transfer £m | Carrying amount of recognised assets £m | Carrying amount of associated liabilities £m | Fair value of recognised assets £m | Fair value of associated liabilities £m | Net position £m |
|---|---|---|--|--|---|-----------------------|
| At 31 December 2012 | | | | | | |
| Securitisations recognised to the extent of continuing involvement | <u>7,823</u> | <u>8</u> | <u>4</u> | <u>8</u> | <u>4</u> | <u>4</u> |

Notes on the Financial Statements (continued)

The bank

| | Carrying amount of transferred assets £m | Carrying amount of associated liabilities £m | Fair value of transferred assets £m | Fair value of associated liabilities £m | Net position £m |
|---|--|--|---|---|-----------------------|
| At 31 December 2013 | | | | | |
| Repurchase agreements | <u>34,869</u> | <u>35,676</u> | | | |
| Securities lending agreements | <u>4,945</u> | <u>4,945</u> | | | |
| Other sales (recourse to transferred asset only) .. | <u>581</u> | <u>674</u> | <u>624</u> | <u>624</u> | <u>–</u> |

| | Carrying amount of assets before transfer £m | Carrying amount of recognised assets £m | Carrying amount of associated liabilities £m | Fair value of recognised assets £m | Fair value of associated liabilities £m | Net position £m |
|---|---|---|--|--|---|-----------------------|
| At 31 December 2013 | | | | | | |
| Securitisations recognised to the extent of continuing involvement | <u>5,021</u> | <u>9</u> | <u>5</u> | <u>9</u> | <u>5</u> | <u>4</u> |

| | Carrying amount of transferred assets £m | Carrying amount of associated liabilities £m | Fair value of transferred assets £m | Fair value of associated liabilities £m | Net position £m |
|---|--|--|---|---|-----------------------|
| At 31 December 2012 | | | | | |
| Repurchase agreements | <u>38,012</u> | <u>38,028</u> | | | |
| Securities lending agreements | <u>3,416</u> | <u>3,416</u> | | | |
| Other sales (recourse to transferred asset only) .. | <u>665</u> | <u>665</u> | <u>673</u> | <u>673</u> | <u>–</u> |

| | Carrying amount of assets before transfer £m | Carrying amount of recognised assets £m | Carrying amount of associated liabilities £m | Fair value of recognised assets £m | Fair value of associated liabilities £m | Net position £m |
|---|---|---|--|--|---|-----------------------|
| At 31 December 2012 | | | | | | |
| Securitisations recognised to the extent of continuing involvement | <u>7,823</u> | <u>8</u> | <u>4</u> | <u>8</u> | <u>4</u> | <u>4</u> |

Notes on the Financial Statements (continued)

Continuing involvement in financial assets and associated financial liabilities qualifying for full derecognition

The group and the bank

| | At 31 December 2013 | | | | | 2013 | | |
|--------------------------------|--|-------------------|--------------------------------------|-------------------|--------------------------|--|---|--|
| | Carrying amount of continuing involvement in statement of financial position | | Fair value of continuing involvement | | Maximum exposure to loss | Gain or loss recognised at transfer date | Income/ (expenses) recognised in reporting period | Income/ (expenses) recognised cumulatively |
| | Assets £m | Liabilities £m | Assets £m | Liabilities £m | | | | |
| Type of continuing involvement | | | | | | | | |
| Interest in SPEs | 184 | - | 186 | - | 184 | 6 | 5 | 41 |

| | At 31 December 2012 | | | | | 2012 | | |
|--------------------------------|--|-------------------|--------------------------------------|-------------------|--------------------------|--|---|--|
| | Carrying amount of continuing involvement in statement of financial position | | Fair value of continuing involvement | | Maximum exposure to loss | Gain or loss recognised at transfer date | Income/ (expenses) recognised in reporting period | Income/ (expenses) recognised cumulatively |
| | Assets £m | Liabilities £m | Assets £m | Liabilities £m | | | | |
| Type of continuing involvement | | | | | | | | |
| Interest in SPEs | 243 | - | 219 | - | 243 | 5 | 5 | 36 |

The assets in the table above represent our continuing involvement in securitisations where HSBC has transferred assets to an unconsolidated SPE, but has retained some of the notes issued by the SPE. These notes are reported in loans and advances to customers. The maximum exposure to loss is the carrying amount of the notes.

20 Interests in associates and joint ventures

Principal associates of the group and the bank

VocaLink Holdings Ltd ('VocaLink') is a principal associate of the bank and the group. VocaLink is incorporated in England and its principal activity is that of providing electronic payments and transaction services.

At 31 December 2013, the group had a 15.91% interest in the £133 million issued equity capital of VocaLink (2012: 15.91%). The carrying amount of the group's interest of £59 million at 31 December 2013 (2012: £56 million) reflects the net asset value of the company at that date.

VocaLink is accounted for as an associate due to the group's involvement in the operational activities, policy-making decisions and representation on the board of directors.

Summarised financial information on associates

The group's share of:

| | 2013 £m | 2012 £m |
|------------------------|------------|------------|
| Assets | 100 | 113 |
| Liabilities | 52 | 65 |
| Revenue | 38 | 23 |
| Profit after tax | - | (3) |

Interests in significant joint ventures

Vaultex UK Limited is a significant joint venture of the bank and the group. Vaultex UK Limited is incorporated in England and its principal activity is that of cash management services. At 31 December 2013 and 31 December 2012, the group had a 50% interest in the £10 million issued equity capital.

Notes on the Financial Statements (continued)

Summarised financial information on joint ventures

The group's share of:

| | 2013 | 2012 |
|-------------------------------|------|------|
| | £m | £m |
| Current assets | 103 | 234 |
| Non current assets | 17 | 17 |
| Current liabilities | 103 | 234 |
| Non current liabilities | 10 | 10 |
| Income | 48 | 48 |
| Expense | (48) | (48) |

Details of all associates and joint ventures, as required under S.409 Companies Act 2006, will be annexed to the next Annual Return of the bank filed with the UK Registrar of Companies.

21 Goodwill and intangible assets

| | The group | | The bank | |
|--|--------------|--------------|------------|------------|
| | 2013 | 2012 | 2013 | 2012 |
| | £m | £m | £m | £m |
| Goodwill | 6,526 | 6,399 | 298 | 298 |
| Present value of in-force long-term assurance business ('PVIIF') | 700 | 705 | – | – |
| Other intangible assets | 708 | 722 | 593 | 581 |
| | 7,934 | 7,826 | 891 | 879 |

Goodwill

The group

| | 2013 | 2012 |
|---|--------------|--------------|
| | £m | £m |
| Gross amount and Carrying amount | | |
| At 1 January | 6,399 | 9,629 |
| Acquisitions/(disposals) | 14 | (3,000) |
| Exchange differences | 113 | (230) |
| At 31 December | 6,526 | 6,399 |

The bank

| | 2013 | 2012 |
|---|------------|------------|
| | £m | £m |
| At 1 January and 31 December | 298 | 298 |

During 2013, no goodwill impairment was recognised (2012: nil).

Impairment testing in respect of goodwill is performed at least annually by comparing the recoverable amount of cash-generating units ('CGUs') determined as at 1 July 2013 based on a value in use calculation.

The value in use calculation uses cash flow estimates based on management's cash flow projections, extrapolated in perpetuity using a nominal long-term growth rate based on current market assessments of GDP and inflation for the countries within which the CGU operates. Cash flows are extrapolated in perpetuity due to the long-term perspective within the group of the business units making up the CGUs. The discount rate used is based on the cost of capital the group allocates to investments in the countries within which the CGU operates.

The cost of capital assigned to an individual CGU and used to discount its future cash flows can have a significant effect on its valuation. The cost of capital percentage is generally derived from an appropriate capital asset pricing model, which itself depends on inputs reflecting a number of financial and economic variables including the risk-free rate in the country concerned and a premium or discount to reflect the inherent risk of the business being evaluated. These variables are established on the basis of management judgement and current market assessments of economic variables.

Notes on the Financial Statements (continued)

The review of goodwill impairment represents management's best estimates of the factors set out in Note 3. These values are sensitive to the cash flows projected for the periods for which detailed forecasts are available, and to assumptions regarding the long-term sustainable pattern of cash flows thereafter. While the acceptable range within which underlying assumptions can be applied is governed by the requirement for resulting forecasts to be compared with actual performance and verifiable economic data in future years, the cash flow forecasts necessarily and appropriately reflect management's view of future business prospects. The process of identifying and evaluating goodwill impairment is inherently uncertain because it requires significant management judgement in making a series of estimations, the results of which are highly sensitive to the assumptions used.

The following CGUs, include in their carrying value goodwill that is a significant proportion of total goodwill reported by the group at 31 December 2013. These CGUs do not carry on their balance sheet any intangible assets with indefinite useful lives, other than goodwill.

| | Goodwill at 1 July 2013 £m | Discount rate % | Nominal growth rate beyond initial cash flow projections % |
|---|----------------------------------|-----------------------|--|
| 2013 | | | |
| Global Banking and Markets | 4,682 | 10% | 3.9% |
| Retail Banking Wealth Management | 1,338 | 8% | 4.0% |
| Total goodwill in the CGUs listed above | <u>6,020</u> | | |
| 2012 | £m | % | % |
| Global Banking and Markets | 5,292 | 10% | 3.6% |
| Continental Europe Retail ¹ | 818 | 10% | 3.5% |
| Total goodwill in the CGUs listed above | <u>6,110</u> | | |

1 In 2012 the goodwill testing was based on the then extant operating segments (Note 2 (c))

Additionally, as at 1 July 2013, aggregate goodwill of £ 668 million (2012: £344 million) had been allocated to other CGUs that were not considered individually significant.

Nominal long-term growth rate: external data that reflects the market's assessment of GDP and inflation for the countries within which the CGU operates. The rates used for 2013 and 2012 do not exceed the long-term growth rate for the countries within which the CGU operates.

Discount rate: the after tax discount rate used to discount the cash flows is based on the cost of capital assigned to each CGU, which is derived using a Capital Asset Pricing Model ('CAPM'). The CAPM depends on inputs reflecting a number of financial and economic variables including the risk-free rate in the country concerned and a premium to reflect the inherent risk of the business being evaluated. These variables are based on the market's assessment of the economic variables and management's judgement. In addition, for the purposes of testing goodwill for impairment, management supplements this process by comparing the discount rates derived using the internally-generated CAPM with cost of capital rates produced by external sources. The group uses externally-sourced cost of capital rates where, in management's judgement, these rates reflect more accurately the current market and economic conditions. For 2013 and 2012, internal costs of capital rates were consistent with externally-sourced rates.

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

Movement in PVIF

The group

| | 2013 £m | 2012 £m |
|---|------------|------------|
| At 1 January | 705 | 708 |
| Addition from current year new business | 65 | 97 |
| Movement from in-force business (including investment return variances and changes in investment assumptions) | (76) | (86) |
| Exchange differences and other movements | 6 | (14) |
| At 31 December | <u>700</u> | <u>705</u> |

Notes on the Financial Statements (continued)

The group's life insurance business is accounted for using the embedded value approach which, inter alia, provides a comprehensive risk and valuation framework. The PVIF asset represents the present value of the shareholders' interest in the profits expected to emerge from the book of in-force policies.

PVIF-specific assumptions

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

| | 2013 | | 2012 | |
|--------------------------|--------|---------|--------|---------|
| | France | UK Life | France | UK Life |
| Risk free rate | 2.38% | 2.45% | 2.12% | 1.53% |
| Risk discount rate | 4.69% | 2.95% | 4.05% | 2.03% |
| Expenses inflation | 2.00% | 3.39% | 2.00% | 2.84% |

The calculation of the PVIF is based upon assumptions that take into account risk and uncertainty. To project these cash flows, a variety of assumptions regarding future experience is made by each insurance operation which reflects local market conditions and management's judgement of local future trends.

The following table shows the effect on the PVIF of reasonably possible changes in the main economic assumption, risk-free rates, across all insurance manufacturing subsidiaries.

Sensitivity of PVIF to changes in economic assumptions

| | PVIF at 31 December | |
|--|---------------------|------------|
| | 2013 £m | 2012 £m |
| + 100 basis points shift in risk-free rate | 2 | 1 |
| - 100 basis points shift in risk-free rate | (51) | (28) |

Due to certain characteristics of the contracts, the relationships may be non-linear and the results of the sensitivity-testing should not be extrapolated to higher levels of stress. In calculating the scenario, the shift in the risk-free rate results in changes to investment returns, risk discount rates and bonus rates which are incorporated. The sensitivities shown are before actions that could be taken by management to mitigate impacts and before resultant changes in policyholder behaviour.

Non-economic assumptions

The group determines the policyholder liabilities for non-life manufacturers by reference to non-economic assumptions including claims costs and expense rates.

Policyholder liabilities and PVIF for life manufacturers are determined by reference to non-economic assumptions including mortality and/or morbidity, lapse rates and expense rates. The table below shows the sensitivity of profit for 2013 and total equity at 31 December 2013 to reasonably possible changes in these non-economic assumptions at that date across all of the group's insurance manufacturing companies, with comparatives for 2012.

The cost of claims is a risk associated with non-life insurance business. An increase in claims costs would have a negative effect on profit.

Mortality and morbidity risk is typically associated with life insurance contracts. The effect on profit of an increase in mortality or morbidity depends on the type of business being written.

Sensitivity to lapse rates is dependent on the type of contracts being written. For insurance contracts, the cost of claims is funded by premiums received and income earned on the investment portfolio supporting the liabilities. For a portfolio of term assurance, an increase in lapse rates typically has a negative effect on profit due to the loss of future premium income on the lapsed policies.

Expense rate risk is the exposure to a change in expense rates. To the extent that increased expenses cannot be passed on to policyholders, an increase in expense rates will have a negative impact on profits.

Notes on the Financial Statements (continued)

Sensitivity to changes in non-economic assumptions

| | PVIF at 31 December | |
|--|------------------------|------------|
| | 2013 £m | 2012 £m |
| 10% increase in mortality and/or morbidity rates | (20) | (19) |
| 10% decrease in mortality and/or morbidity rates | 20 | 19 |
| 10% increase in lapse rates | (34) | (34) |
| 10% decrease in lapse rates | 38 | 37 |
| 10% increase in expense rates | (30) | (30) |
| 10% decrease in expense rates | 30 | 30 |

Other intangible assets

The analysis of the movement of other intangible assets was as follows:

The group

| | Trade Names £m | Internally generated software £m | Purchased Software £m | Customer/ merchant relationships £m | Other £m | Total £m |
|--|----------------------|---|-----------------------------|--|-------------|----------------|
| Cost | | | | | | |
| At 1 January 2013 | 14 | 1,298 | 161 | 220 | 3 | 1,696 |
| Additions ¹ | – | 184 | 14 | – | 1 | 199 |
| Disposals | – | (1) | (2) | (1) | – | (4) |
| Amounts written off | – | (13) | – | – | – | (13) |
| Exchange differences | (3) | 3 | 3 | – | – | 3 |
| Other changes | – | (104) | (6) | 1 | – | (109) |
| At 31 December 2013 | 11 | 1,367 | 170 | 220 | 4 | 1,772 |
| Accumulated amortisation and impairment | | | | | | |
| At 1 January 2013 | (14) | (697) | (124) | (139) | – | (974) |
| Amortisation charge for the year ² | – | (177) | (17) | (11) | – | (205) |
| Impairment charge for the year ² | – | (6) | – | – | – | (6) |
| Disposals | – | 1 | – | – | – | 1 |
| Amounts written off | – | 13 | – | – | – | 13 |
| Exchange differences | 3 | (3) | (2) | – | – | (2) |
| Other changes | – | 104 | 6 | (1) | – | 109 |
| At 31 December 2013 | (11) | (765) | (137) | (151) | – | (1,064) |
| Net carrying amount at 31 December 2013 | – | 602 | 33 | 69 | 4 | 708 |
| Cost | | | | | | |
| At 1 January 2012 | 13 | 1,466 | 156 | 208 | 3 | 1,846 |
| Additions ¹ | 1 | 201 | 9 | 18 | – | 229 |
| Disposals | – | (5) | (6) | – | – | (11) |
| Amounts written off | – | (365) | (1) | (2) | – | (368) |
| Exchange differences | – | (3) | (4) | – | – | (7) |
| Other changes | – | 4 | 7 | (4) | – | 7 |
| At 31 December 2012 | 14 | 1,298 | 161 | 220 | 3 | 1,696 |
| Accumulated amortisation and impairment | | | | | | |
| At 1 January 2012 | (12) | (932) | (112) | (131) | (1) | (1,188) |
| Amortisation charge for the year ² | (2) | (144) | (15) | (12) | – | (173) |
| Impairment charge for the year ² | – | (1) | (1) | – | – | (2) |
| Disposals | – | 4 | 2 | – | – | 6 |
| Amounts written off | – | 365 | 1 | 2 | – | 368 |
| Exchange differences | – | 3 | 3 | – | – | 6 |
| Other changes | – | 8 | (2) | 2 | 1 | 9 |
| At 31 December 2012 | (14) | (697) | (124) | (139) | – | (974) |
| Net carrying amount at 31 December 2012 | – | 601 | 37 | 81 | 3 | 722 |

1 At 31 December 2013, the group did not have any contractual commitments to acquire intangible assets (2012: nil).

2 The amortisation and impairment charges for the year are recognised within the income statement under 'Amortisation and impairment of intangible assets'.

Notes on the Financial Statements (continued)

The bank

| | Internally generated software £m | Other £m | Total £m |
|--|---|-------------|--------------|
| Cost | | | |
| At 1 January 2013 | 1,103 | 24 | 1,127 |
| Additions ¹ | 178 | 6 | 184 |
| Disposals | – | – | – |
| Amounts written off | (12) | – | (12) |
| Other changes | – | – | – |
| At 31 December 2013 | 1,269 | 30 | 1,299 |
| Accumulated amortisation and impairment | | | |
| At 1 January 2013 | (544) | (2) | (546) |
| Amortisation charge for the year ² | (162) | (4) | (166) |
| Impairment charge for the year ² | (6) | – | (6) |
| Amounts written off | 12 | – | 12 |
| Other changes | – | – | – |
| At 31 December 2013 | (700) | (6) | (706) |
| Net carrying amount at 31 December 2013 | 569 | 24 | 593 |
| | | | |
| Cost | | | |
| At 1 January 2012 | 1,274 | 5 | 1,279 |
| Additions ¹ | 184 | 17 | 201 |
| Disposals | – | (3) | (3) |
| Amounts written off | (365) | – | (365) |
| Other changes | 10 | 5 | 15 |
| At 31 December 2012 | 1,103 | 24 | 1,127 |
| At 1 January 2012 | (777) | (1) | (778) |
| Amortisation charge for the year ² | (133) | (1) | (134) |
| Impairment charge for the year ² | (1) | – | (1) |
| Amounts written off | 365 | – | 365 |
| Other changes | 2 | – | 2 |
| At 31 December 2012 | (544) | (2) | (546) |
| Net carrying amount at 31 December 2012 | 559 | 22 | 581 |

1 At 31 December 2013, the bank did not have any contractual commitments to acquire intangible assets (2012: nil).

2 The amortisation and impairment charges for the year are recognised within the income statement under 'Amortisation and impairment of intangible assets'.

Notes on the Financial Statements (continued)

22 Property, plant and equipment

The group

| | Freehold land and buildings ⁴ £m | Long leasehold land and buildings £m | Short leasehold land and buildings £m | Equipment, fixtures and fittings ¹ £m | Equipment on operating leases £m | Total ² £m |
|--|--|--|---|---|---|--------------------------|
| Cost or fair value | | | | | | |
| At 1 January 2013 | 934 | 99 | 352 | 3,253 | 69 | 4,707 |
| Additions at cost ³ | 17 | 15 | 24 | 257 | 9 | 322 |
| Fair value adjustments | 5 | – | – | – | – | 5 |
| Acquisition of subsidiaries | – | – | – | – | – | – |
| Disposals | (3) | (19) | (17) | (143) | (7) | (189) |
| Disposal of subsidiaries | – | – | – | – | – | – |
| Reclassified to held for sale | (3) | – | – | (2) | – | (5) |
| Transfers | – | – | – | – | – | – |
| Exchange and other differences | 9 | 22 | 1 | 65 | – | 97 |
| At 31 December 2013 | 959 | 117 | 360 | 3,430 | 71 | 4,937 |
| Accumulated depreciation and impairment | | | | | | |
| At 1 January 2013 | (150) | (13) | (183) | (2,321) | (16) | (2,683) |
| Depreciation charge for the year | (18) | (10) | (34) | (261) | (8) | (331) |
| Disposals | 3 | 19 | 17 | 132 | 1 | 172 |
| Disposal of subsidiaries | – | – | – | – | – | – |
| Reclassified to held for sale | 1 | – | – | 1 | – | 2 |
| Transfers | – | – | – | – | – | – |
| Impairment losses (recognised)/reversed | – | – | – | – | – | – |
| Exchange and other differences | (1) | (20) | (3) | (69) | – | (93) |
| At 31 December 2013 | (165) | (24) | (203) | (2,518) | (23) | (2,933) |
| Net carrying amount at 31 December 2013 | 794 | 93 | 157 | 912 | 48 | 2,004 |

The group

| | Freehold land and buildings ⁴ £m | Long leasehold land and buildings £m | Short leasehold land and buildings £m | Equipment, fixtures and fittings ¹ £m | Equipment on operating leases £m | Total ² £m |
|---|--|--|---|---|---|--------------------------|
| Cost or fair value | | | | | | |
| At 1 January 2012 | 984 | 58 | 448 | 3,443 | 46 | 4,979 |
| Additions at cost ³ | 23 | 40 | 27 | 226 | 31 | 347 |
| Fair value adjustments | (1) | – | – | – | – | (1) |
| Disposals | (3) | – | (17) | (274) | (9) | (303) |
| Disposal of subsidiaries | (61) | – | (103) | (101) | – | (265) |
| Reclassified to held for sale | (5) | – | – | (3) | – | (8) |
| Exchange and other differences | (3) | 1 | (3) | (38) | 1 | (42) |
| At 31 December 2012 | 934 | 99 | 352 | 3,253 | 69 | 4,707 |
| Accumulated depreciation and impairment | | | | | | |
| At 1 January 2012 | (144) | (8) | (207) | (2,398) | (18) | (2,775) |
| Depreciation charge for the year | (17) | (6) | (40) | (266) | (8) | (337) |
| Reclassified to held for sale | 2 | 2 | 10 | 254 | 8 | 276 |
| Disposals | 11 | – | 50 | 98 | – | 159 |
| Reclassified to held for sale | 1 | – | – | 2 | – | 3 |
| Impairment losses recognised | 3 | – | – | (32) | – | (29) |
| Exchange and other differences | (6) | (1) | 4 | 21 | 2 | 20 |
| At 31 December 2012 | (150) | (13) | (183) | (2,321) | (16) | (2,683) |
| Net carrying amount at 31 December 2012 .. | 784 | 86 | 169 | 932 | 53 | 2,024 |

1 Including assets held on finance leases with a carrying amount of £29 million (2012: £22 million).

2 Including assets with a carrying amount of £nil million (2012: £11 million) pledged as security for liabilities.

3 At 31 December 2013, the group had £9 million (2012: £3 million) of contractual commitments to acquire property, plant and equipment.

4 Including the investment properties on page 172.

Notes on the Financial Statements (continued)

The bank

| | Freehold land and buildings £m | Long leasehold land and buildings £m | Short leasehold land and buildings £m | Equipment, fixtures and fittings £m | Total £m |
|--|---|--|---|--|-------------|
| Cost or fair value | | | | | |
| At 1 January 2013 | 462 | 101 | 340 | 2,460 | 3,363 |
| Additions at cost ¹ | 11 | 15 | 24 | 177 | 227 |
| Reclassified to held for sale | (3) | – | – | (2) | (5) |
| Disposals | (3) | (19) | (15) | (124) | (161) |
| Transfers | – | – | – | – | – |
| Exchange and other differences | – | 22 | 1 | 5 | 28 |
| At 31 December 2013 | 467 | 119 | 350 | 2,516 | 3,452 |
| Accumulated depreciation and impairment | | | | | |
| At 1 January 2013 | (117) | (12) | (175) | (1,818) | (2,122) |
| Depreciation charge for the year | (15) | (10) | (33) | (176) | (234) |
| Reclassified to held for sale | 1 | – | – | 1 | 2 |
| Disposals | 3 | 19 | 15 | 115 | 152 |
| Transfers | – | – | – | – | – |
| Exchange and other differences | – | (21) | (3) | (2) | (26) |
| At 31 December 2013 | (128) | (24) | (196) | (1,880) | (2,228) |
| Net carrying amount at 31 December 2013 | 339 | 95 | 154 | 636 | 1,224 |

The bank

| | Freehold land and buildings £m | Long leasehold land and buildings £m | Short leasehold land and buildings £m | Equipment, fixtures and fittings £m | Total £m |
|--|---|--|---|--|-------------|
| Cost or fair value | | | | | |
| At 1 January 2012 | 451 | 60 | 340 | 2,600 | 3,451 |
| Additions at cost ¹ | 12 | 43 | 15 | 105 | 175 |
| Reclassified to held for sale | (4) | (1) | – | (3) | (8) |
| Disposals | – | (1) | (15) | (241) | (257) |
| Exchange and other differences | 3 | – | – | (1) | 2 |
| At 31 December 2012 | 462 | 101 | 340 | 2,460 | 3,363 |
| Accumulated depreciation and impairment | | | | | |
| At 1 January 2012 | (107) | (8) | (151) | (1,838) | (2,104) |
| Depreciation charge for the year | (13) | (6) | (33) | (183) | (235) |
| Reclassified to held for sale | 1 | – | – | 2 | 3 |
| Disposals | 1 | 1 | 10 | 233 | 245 |
| Impairment losses recognised | – | – | – | (33) | (33) |
| Exchange and other differences | 1 | 1 | (1) | 1 | 2 |
| At 31 December 2012 | (117) | (12) | (175) | (1,818) | (2,122) |
| Net carrying amount at 31 December 2012 | 345 | 89 | 165 | 642 | 1,241 |

¹ At 31 December 2013, the bank had £7 million (2012: £2 million) of contractual commitments to acquire property, plant and equipment.

Notes on the Financial Statements (continued)

Investment properties

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

The group

| | Freehold land and buildings ¹ £m |
|----------------------------------|---|
| Fair value | |
| At 1 January 2013 | 261 |
| Fair value adjustments | 5 |
| Exchange and other changes | 5 |
| | <hr/> |
| At 31 December 2013 | 271 |
| Fair value | |
| At 1 January 2012 | 259 |
| Additions at cost | 6 |
| Fair value adjustments | (1) |
| Exchange and other changes | (3) |
| | <hr/> |
| At 31 December 2012 | 261 |

1 Included in 'Property, plant and equipment' on page 170.

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 £8 million (2012: £11 million) earned by the group on its investment properties. Direct operating expenses of £nil (2012: nil) incurred in respect of the investment properties during the year were recognised in 'General and administrative expenses'. Direct operating expenses arising in respect of investment properties that did not generate rental income during the year amounted to £nil (2012: nil). Net exchange differences on translation of investment properties were £5 million (2012: £6 million).

The bank

The bank had no investment properties at 31 December 2013 or 2012.

23 Investments in subsidiaries

Principal subsidiary undertakings of HSBC Bank plc

| | Country of incorporation or registration | HSBC Bank plc's interest in equity capital % | Share class |
|--|--|---|--------------------------------|
| HSBC France..... | France | 99.99 | Ordinary €5 |
| HSBC Asset Finance (UK) Limited..... | England | 100.00 | Ordinary £1 |
| HSBC Bank A.S. | Turkey | 100.00 | A-Common TRL1 B-Common TRL1 |
| HSBC Bank International Limited..... | Jersey | 100.00 | Ordinary £1 |
| HSBC Bank Malta p.l.c. | Malta | 70.03 | Ordinary €0.30 |
| HSBC Invoice Finance (UK) Limited..... | England | 100.00 | Ordinary £1 |
| HSBC Life (UK) Limited | England | 100.00 | Ordinary £1 |
| HSBC Private Bank (UK) Limited | England | 100.00 | Ordinary £10 |
| HSBC Private Bank (C.I.) Limited | Guernsey | 100.00 | Ordinary US\$1 |
| HSBC Trinkaus & Burkhardt AG..... | Germany | 80.62 | Shares of no par value |
| HSBC Trust Company (UK) Limited | England | 100.00 | Ordinary £5 |
| Marks and Spencer Retail Financial Services Holdings Limited | England | 100.00 | Ordinary £1 |

Notes on the Financial Statements (continued)

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

| | Carrying value of total consolidated assets £bn | Nature of SPE |
|--|---|-------------------------------|
| Barion Funding Limited..... | 2.3 | Securities investment conduit |
| Malachite Funding Limited..... | 1.8 | Securities investment conduit |
| Mazarin Funding Limited..... | 4.5 | Securities investment conduit |
| Regency Assets Limited..... | 8.1 | Conduit |
| Solitaire Funding Limited..... | 6.2 | Securities investment conduit |
| Performance Trust..... | 0.4 | Securitisation vehicle |
| Turquoise Receivables Trustee Limited..... | 0.9 | Securitisation vehicle |

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

Details of all subsidiaries, as required under S.409 Companies Act 2006, will be annexed to the next Annual Return of the bank filed with the UK Registrar of Companies.

Acquisitions

In November 2013, the group acquired HSBC Private Bank (C.I.) Limited, by way of an inter-group transfer from HSBC Private Banking Holdings (Suisse) SA, for £402 million. The acquisition was completed on 29 November 2013.

Disposals

In April 2013, the group sold HSBC (Hellas) AEDAK to the management team for circa £0.1 million. The sale was completed on 5 April 2013.

In May 2013, the group sold HSBC Assurances IARD to AIG Europe Limited for £8 million. The sale was completed on 17 May 2013.

In November 2013, the group sold Legend Estates Limited, by way of an inter-group transfer to HSBC Investment Bank Holdings plc, for £4 million. The sale was completed on 29 November 2013.

24 Other assets

| | The group | | The bank | |
|---|--------------|--------------|--------------|--------------|
| | 2013 £m | 2012 £m | 2013 £m | 2012 £m |
| Bullion..... | 928 | 1,452 | 880 | 1,385 |
| Assets held for sale..... | 33 | 109 | 20 | 98 |
| Reinsurers' share of liabilities under insurance contracts..... | 492 | 496 | – | – |
| Endorsements and acceptances..... | 703 | 779 | 343 | 525 |
| Other accounts..... | 4,465 | 3,530 | 3,315 | 2,680 |
| | 6,621 | 6,366 | 4,558 | 4,688 |

Assets held for sale

| | The group | | The bank | |
|---|------------|------------|------------|------------|
| | 2013 £m | 2012 £m | 2013 £m | 2012 £m |
| Non-current assets held for sale: | | | | |
| - property, plant and equipment..... | 32 | 42 | 20 | 31 |
| - other..... | 1 | 67 | – | 67 |
| Total assets classified as held for sale..... | 33 | 109 | 20 | 98 |

Also included within property plant and equipment classified as held for sale is repossessed property that had been pledged as collateral by customers. These repossessed assets are expected to be disposed of within 12 months of acquisition.

Notes on the Financial Statements (continued)

25 Trading liabilities

| | The group | | The bank | |
|---|---------------|----------------|---------------|----------------|
| | 2013 £m | 2012 £m | 2013 £m | 2012 £m |
| Deposits by banks | 29,006 | 38,796 | 24,795 | 42,643 |
| Customer accounts | 17,361 | 45,063 | 12,971 | 40,398 |
| Other debt securities in issue | 13,540 | 13,875 | 10,818 | 11,475 |
| Other liabilities – net short positions | 31,935 | 25,162 | 13,830 | 10,430 |
| | 91,842 | 122,896 | 62,414 | 104,946 |

26 Financial liabilities designated at fair value

| | The group | | The bank | |
|---|---------------|---------------|---------------|---------------|
| | 2013 £m | 2012 £m | 2013 £m | 2012 £m |
| Deposits by banks and customer accounts | 4,145 | 4,548 | 3,972 | 4,373 |
| Liabilities to customers under investment contracts | 5,300 | 4,817 | – | – |
| Debt securities in issue | 21,823 | 20,749 | 15,253 | 16,325 |
| Subordinated liabilities | 2,445 | 2,507 | 2,781 | 2,815 |
| Preference shares | 323 | 297 | – | – |
| | 34,036 | 32,918 | 22,006 | 23,513 |

The group

The carrying amount at 31 December 2013 of financial liabilities designated at fair value was £823 million higher (2012: £1,812 million higher) than the contractual amount at maturity. At 31 December 2013, the accumulated amount of change in fair value attributable to changes in credit risk was a loss of £276 million (2012: £110 million loss).

The bank

The carrying amount at 31 December 2013 of financial liabilities designated at fair value was £699 million higher (2012: £1,524 million higher) than the contractual amount at maturity. At 31 December 2013, the accumulated amount of change in fair value attributable to changes in credit risk was a loss of £223 million (2012: £62 million loss).

27 Other liabilities

| | The group | | The bank | |
|--|--------------|--------------|--------------|--------------|
| | 2013 £m | 2012 £m | 2013 £m | 2012 £m |
| Amounts due to investors in funds consolidated by the group | 550 | 227 | – | – |
| Obligations under finance leases | 88 | 91 | – | – |
| Endorsements and acceptances | 697 | 779 | 343 | 524 |
| Share-based payment liability to HSBC Holdings | 217 | 332 | 164 | 227 |
| Other liabilities | 4,298 | 5,417 | 3,320 | 4,497 |
| | 5,850 | 6,846 | 3,827 | 5,248 |

Notes on the Financial Statements (continued)

28 Liabilities under insurance contracts

| | 2013 | | |
|---|-------------|----------------------------|-----------|
| | Gross £m | Reinsurers' Share £m | Net £m |
| Non-linked insurance contracts | | | |
| At 1 January | 825 | (462) | 363 |
| Benefits paid | (141) | 76 | (65) |
| Increase in liabilities to policyholders | 189 | (83) | 106 |
| Exchange differences and other movements | (37) | 21 | (16) |
| At 31 December | 836 | (448) | 388 |
| Investment contracts with discretionary participation features | | | |
| At 1 January | 15,078 | – | 15,078 |
| Benefits paid | (1,473) | – | (1,473) |
| Increase in liabilities to policyholders | 2,350 | – | 2,350 |
| Exchange differences and other movements ¹ | 32 | – | 32 |
| At 31 December | 15,987 | – | 15,987 |
| Linked life insurance contracts | | | |
| At 1 January | 2,010 | (34) | 1,976 |
| Benefits paid | (197) | 3 | (194) |
| Increase in liabilities to policyholders..... | 585 | (13) | 572 |
| Exchange differences and other movements ² | 7 | 1 | 8 |
| At 31 December | 2,405 | (43) | 2,362 |
| Total liabilities to policyholders | 19,228 | (491) | 18,737 |
| | 2012 | | |
| | Gross £m | Reinsurers' share £m | Net £m |
| Non-linked insurance contracts¹ | | | |
| At 1 January | 855 | (441) | 414 |
| Benefits paid | (174) | 91 | (83) |
| Increase in liabilities to policyholders | 281 | (188) | 93 |
| Exchange differences and other movements | (137) | 76 | (61) |
| At 31 December | 825 | (462) | 363 |
| Investment contracts with discretionary participation features | | | |
| At 1 January | 13,872 | – | 13,872 |
| Benefits paid | (1,589) | – | (1,589) |
| Increase in liabilities to policyholders | 2,302 | – | 2,302 |
| Exchange differences and other movements ² | 493 | – | 493 |
| At 31 December | 15,078 | – | 15,078 |
| Linked life insurance contracts | | | |
| At 1 January | 1,620 | (29) | 1,591 |
| Benefits paid | (139) | 4 | (135) |
| Increase in liabilities to policyholders..... | 532 | (9) | 523 |
| Exchange differences and other movements ³ | (3) | – | (3) |
| At 31 December | 2,010 | (34) | 1,976 |
| Total liabilities to policyholders | 17,913 | (496) | 17,417 |

1 Includes liabilities under non-life insurance contracts

2 Includes movement in liabilities relating to discretionary profit participation benefits due to policyholders arising from net unrealised investment gains recognised in other comprehensive income.

3 Includes amounts arising under reinsurance agreements.

The increase in liabilities to policyholders represents the aggregate of all events giving rise to additional liabilities to policyholders in the year. The key factors contributing to the movement in liabilities to policyholders include death claims, surrenders, lapses, liabilities to policyholders created at the initial inception of the policies, the declaration of bonuses and other amounts attributable to policyholders.

Notes on the Financial Statements (continued)

29 Provisions

| | The group | | The bank | |
|---|------------|------------|------------|------------|
| | 2013 £m | 2012 £m | 2013 £m | 2012 £m |
| At 1 January | 1,641 | 820 | 1,250 | 565 |
| Additional provisions/increase in provisions ¹ | 1,165 | 1,757 | 726 | 1,346 |
| Provisions utilised | (1,079) | (736) | (746) | (587) |
| Amounts reversed | (125) | (128) | (61) | (72) |
| Acquisition/disposal of subsidiaries/businesses | 104 | (72) | 99 | – |
| Exchange differences and other movements | 1 | – | 3 | (2) |
| At 31 December | 1,707 | 1,641 | 1,271 | 1,250 |

¹ Includes unwinding of discounts of £5 million (2012: £2 million) in relation to vacant space provisions.

Provisions include £1,310 million (2012: £1,227 million) in respect of customer redress programmes. The most significant of these provisions are as follows and relate to both the group and bank, except where stated.

- (i) £572 million (2012: £692 million) for the group relating to the estimated liability for redress in respect of the possible mis-selling of Payment Protection Insurance ('PPI') policies in previous years (the bank: £493 million; 2012: £588 million). An increase in provisions of £483 million was recognised during the year. Cumulative provisions made since the Judicial Review ruling in the first half of 2011 amount to £1,816 million of which £1,390 million has been paid.

Including the 1.8 million policies of HFC Bank Limited (whose outstanding obligation was transferred to the bank in 2013) approximately 5.4 million PPI policies have been sold by the group, which generated estimated revenue of £2.6 billion, and with gross written premiums of approximately £3.2 billion. At 31 December 2013, the estimated total complaints (by policy number) expected to be received was 1.5 million, representing 29% of total policies sold. It is estimated contact will be made with customers with 1.9 million, or 35%, of total policies sold. This estimated contact level includes inbound complaints as well as the group's outbound contact exercise on certain policies.

During 2013, the group increased the estimate of the total number of policies to be ultimately redressed, as the level of complaints received was higher in volume and for a longer period than previously assumed. This change in assumptions contributed approximately £0.2 billion to the increased provision for the year.

The estimated liability for redress is calculated based on the total premiums paid by the customer plus simple interest of 8% per annum (or the rate inherent in the related loan product where higher). Future estimated redress levels are based on historically observed redress per policy for different loan categories.

The following table details the cumulative number of policies at 31 December 2013 and the number of claims expected in the future:

| | Cumulative to 31 December 2013 | Future Expected |
|--|-----------------------------------|--------------------|
| Inbound complaints ¹ (000s of policies) | 1,022 | 240 |
| Outbound contact (000s of policies) | 375 | 234 |
| Response rate to outbound contact | 49% | 44% |
| Average uphold rate per claim ² | 79% | 72% |
| Average redress per claim | £1,589 | £1,454 |

¹ Excludes invalid claims where complainant has not held a PPI policy.

² Claims include inbound and responses to outbound contact.

The main assumptions in the provision calculation are the current volume of inbound complaints, the projected period of inbound complaints, the decay rate of complaints volumes, the population identified as systemically mis-sold and the number of policies per customer. The main assumptions are likely to evolve over time as root cause analysis continues, more experience is available regarding initiated complaint volumes received and the experience of responses to ongoing active contact exercise.

A 100,000 increase/decrease in overall total inbound complaints (by policy number) would increase/decrease the provision by approximately £130 million. Each 1% increase/decrease in the response rate to the group's outbound contact exercise increases/decreases the provision by £5 million.

Notes on the Financial Statements (continued)

In addition to these factors and assumptions, the extent of the required redress will also depend on the facts and circumstances of each individual customer's case. For these reasons, there remains a high degree of uncertainty as to the eventual costs of redress for this matter.

- (ii) A provision of £469 million (2012: £375 million) relating to the estimated liability for redress in respect of the possible mis-selling of interest rate derivatives in the UK. Of this provision, £274 million relates to the estimated redress payable to customers in respect of historical payments under derivative contracts, with the remainder covering the expected write-off by the bank of open derivative contracts balances, estimated project expenses and other costs.

Following an FCA review of the sale of interest rate derivatives, the group agreed to pay redress to customers where mis-selling of these products has occurred under the FCA's criteria. On 31 January 2013, the FCA announced the findings from their review of pilot cases completed by the banks. Following its review, the FCA clarified the eligibility criteria to ensure the programme is focused on those small businesses that were unlikely to understand the risks associated with those products. The group has also been working with the FCA and an independent 'skilled person' adviser to clarify the standards against which it should assess sales, and how redress should be calculated (for example, when it would be appropriate to assume a customer would have taken an alternative interest rate product).

The extent to which the group is ultimately required to pay redress depends on the responses of contacted and other customers during the review period and analysis of the facts and circumstances of each individual case, including consequential loss claims received.

For these reasons, there is currently a high degree of uncertainty as to the eventual costs of redress related to this programme.

- (iii) Provisions of £102 million (2012: £65 million) in respect of alleged failings in the sale of card and identity protection products.
- (iv) Provisions of £96 million (2012: nil) for the estimated cost of redress in relation to the provision for possible mis-selling of wealth management products. The programme to redress customers is in an early stage. The main uncertainty arises from the time to finish this project and the associated project costs.
- (v) Provisions of £55 million (2012: £85 million) for the estimated cost of redress in relation to the provision of services to a number of trusts by a subsidiary of the bank. The bank has undertaken to reimburse the subsidiary in respect of the initial estimated cost of redress. The total provision is based on a calculation extrapolated from a sample of cases. Uncertainties arise from factors affecting the timing of notifying and reimbursing those affected.

Also included in the above table, for the bank and group, are provisions for onerous property contracts of £75 million (2012: £86 million) and £79 million (2012: £97 million) respectively, relating to the discounted future costs associated with leasehold properties that have become vacant. The provisions cover rent voids while finding new tenants, shortfalls in expected rent receivable compared with rent payable, and the cost of refurbishing the buildings to attract tenants. Uncertainties arise from movements in market rents, delays in finding new tenants and the timing of rental reviews.

Notes on the Financial Statements (continued)

30 Subordinated liabilities

| | The group | | The bank | |
|----------------------------------|---------------|---------------|---------------|---------------|
| | 2013 £m | 2012 £m | 2013 £m | 2012 £m |
| Subordinated liabilities: | | | | |
| – At amortised cost | 10,785 | 10,350 | 9,903 | 9,968 |
| Subordinated liabilities | 8,502 | 8,100 | 9,903 | 9,968 |
| Preference shares | 2,283 | 2,250 | – | – |
| – Designated at fair value | 2,768 | 2,804 | 2,781 | 2,815 |
| Subordinated liabilities | 2,445 | 2,507 | 2,781 | 2,815 |
| Preference shares | 323 | 297 | – | – |
| | 13,553 | 13,154 | 12,684 | 12,783 |

Subordinated borrowings of the group

| | | Carrying amount | |
|------------|---|-----------------|---------------|
| | | 2013 £m | 2012 £m |
| €1,000m | Floating Rate Subordinated Loan 2017 | 833 | 816 |
| £500m | 4.75% Callable Subordinated Notes 2020 ¹ | 524 | 522 |
| £500m | Callable Subordinated Floating Rate Notes 2020 | 396 | 375 |
| US\$1,000m | Floating Rate Subordinated Loan 2020 | 605 | 619 |
| US\$1,450m | Floating Rate Subordinated Loan 2021 | 877 | 897 |
| US\$450m | Subordinated Floating Rate Notes 2021 | 272 | 278 |
| €250m | Floating Rate Subordinated Loan 2021 | 208 | 204 |
| US\$275m | Floating Rate Subordinated Loan 2021 | 166 | 170 |
| £350m | Floating Rate Subordinated Loan 2022 | 350 | 350 |
| £350m | 5% Callable Subordinated Notes 2023 ² | 384 | 390 |
| £300m | 6.5% Subordinated Notes 2023 | 299 | 299 |
| €650m | Floating Rate Subordinated Loan 2023 | 542 | – |
| US\$300m | 7.65% Subordinated Notes 2025 | 230 | 244 |
| £350m | 5.375% Callable Subordinated Step-up Notes 2030 ³ | 364 | 390 |
| £500m | 5.375% Subordinated Notes 2033 | 535 | 572 |
| £390m | 6.9% Subordinated Loan 2033 | 390 | 390 |
| US\$977m | Floating Rate Subordinated Loan 2040 | 591 | 605 |
| €900m | 7.75% Non-cumulative Subordinated Notes 2040 | 750 | 734 |
| £225m | 6.25% Subordinated Notes 2041 | 224 | 224 |
| £600m | 4.75% Subordinated Notes 2046 | 593 | 593 |
| £700m | 5.844% Non-cumulative Step-up Perpetual Preferred Securities ⁴ | 700 | 700 |
| £300m | 5.862% Non-cumulative Step-up Perpetual Preferred Securities ⁵ | 323 | 297 |
| US\$750m | Undated Floating Rate Primary Capital Notes | 454 | 464 |
| US\$500m | Undated Floating Rate Primary Capital Notes | 302 | 309 |
| US\$300m | Undated Floating Rate Primary Capital Notes (Series 3) | 181 | 186 |
| US\$2,862m | Floating Rate Perpetual Subordinated Debt | 1,732 | 1,772 |
| | Other subordinated liabilities less than £100m | 728 | 754 |
| | | 13,553 | 13,154 |

1 In September 2015 the interest rate changes to three month sterling LIBOR plus 0.82%.

2 In March 2018 the interest rate changes to become the rate per annum which is the sum of the gross redemption yield of the then prevailing five year UK gilt plus 1.80%.

3 In November 2025 the interest rate changes to three month sterling LIBOR plus 1.50%.

4 In November 2031 the distribution rate changes to six month sterling LIBOR plus 1.76%.

5 In April 2020 the distribution rate changes to six month sterling LIBOR plus 1.85%.

Footnotes 1 to 5 all relate to instruments that are redeemable at the option of the issuer on the date of the change in the interest or distribution rate, and on subsequent rate reset and payment dates in some cases, subject to prior notification to the Prudential Regulation Authority.

Notes on the Financial Statements (continued)

31 Fair value of financial instruments carried at fair value

The accounting policies which determine the classification of financial instruments and the use of assumptions and estimation in valuing them are described on pages 106 to 123 and pages 124 to 125. The fair value of financial instruments is generally measured on the basis of the individual financial instrument. However, in cases where the group manages a group of financial assets and financial liabilities on the basis of its net exposure to either market risks or credit risk, the group measures the fair value of the group of financial instruments on a net basis, but presents the underlying financial assets and liabilities separately in the financial statements, unless they satisfy the IFRS offsetting criteria as described on page 116.

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The following table sets out the financial instruments carried at fair value.

Financial instruments carried at fair value

The group

| | Valuation techniques | | | Total £m |
|---|---|--|--|-------------|
| | Level 1 quoted market price £m | Level 2 using observable inputs £m | Level 3 with significant un-observable inputs £m | |
| At 31 December 2013 | | | | |
| Assets | | | | |
| Trading assets | 83,241 | 49,294 | 1,562 | 134,097 |
| Financial assets designated at fair value | 10,818 | 5,843 | – | 16,661 |
| Derivatives | 323 | 135,844 | 1,072 | 137,239 |
| Financial investments: available-for-sale | 55,737 | 17,640 | 1,653 | 75,030 |
| Liabilities | | | | |
| Trading liabilities | 42,064 | 48,417 | 1,361 | 91,842 |
| Financial liabilities at fair value | 4,078 | 29,958 | – | 34,036 |
| Derivatives | 1,236 | 134,819 | 1,297 | 137,352 |
| | | | | |
| At 31 December 2012 | | | | |
| Assets | | | | |
| Trading assets | 86,373 | 73,768 | 1,375 | 161,516 |
| Financial assets designated at fair value | 9,501 | 5,886 | – | 15,387 |
| Derivatives | 193 | 176,455 | 1,160 | 177,808 |
| Financial investments: available-for-sale | 49,035 | 20,159 | 2,071 | 71,265 |
| Liabilities | | | | |
| Trading liabilities | 57,282 | 64,097 | 1,517 | 122,896 |
| Financial liabilities at fair value | 3,767 | 29,151 | – | 32,918 |
| Derivatives | 189 | 179,598 | 1,308 | 181,095 |

The bank

| | Valuation techniques | | | Total £m |
|---|---|--|--|-------------|
| | Level 1 quoted market price £m | Level 2 using observable inputs £m | Level 3 with significant un-observable inputs £m | |
| At 31 December 2013 | | | | |
| Assets | | | | |
| Trading assets | 47,843 | 51,881 | 1,563 | 101,287 |
| Financial assets designated at fair value | – | 3,983 | – | 3,983 |
| Derivatives | 283 | 111,257 | 1,083 | 112,623 |
| Financial investments: available-for-sale | 33,724 | 8,607 | 2,717 | 45,048 |
| Liabilities | | | | |
| Trading liabilities | 18,346 | 42,778 | 1,290 | 62,414 |
| Financial liabilities at fair value | – | 22,006 | – | 22,006 |
| Derivatives | 1,214 | 112,129 | 1,367 | 114,710 |

Notes on the Financial Statements (continued)

| | Valuation techniques | | | Total £m |
|---|---|--|--|-------------|
| | Level 1 quoted market price £m | Level 2 using observable inputs £m | Level 3 with significant un-observable inputs £m | |
| At 31 December 2012 | | | | |
| Assets | | | | |
| Trading assets | 52,468 | 84,161 | 1,370 | 137,999 |
| Financial assets designated at fair value | – | 4,373 | – | 4,373 |
| Derivatives | 158 | 138,949 | 1,233 | 140,340 |
| Financial investments: available-for-sale..... | 30,548 | 3,420 | 2,635 | 36,603 |
| Liabilities | | | | |
| Trading liabilities | 33,256 | 70,221 | 1,469 | 104,946 |
| Financial liabilities at fair value | – | 23,513 | – | 23,513 |
| Derivatives | 143 | 142,378 | 1,400 | 143,921 |

The table below shows transfers between Level 1 and Level 2 fair values.

| | Assets | | | | Liabilities | | | |
|-----------------------------------|-----------------------------|---------------------------|--|-------------------|---------------------------|--|-------------------|--|
| | Available for sale £m | Held for trading £m | Designated at fair value through profit or loss £m | Derivatives £m | Held for trading £m | Designated at fair value through profit or loss £m | Derivatives £m | |
| At 31 December 2013 | | | | | | | | |
| Transfers from Level 1 to Level 2 | 46 | 14,151 | - | 1 | 21,848 | - | - | |
| Transfers from Level 2 to Level 1 | 548 | 368 | - | - | - | - | - | |

Control framework

Fair values are subject to a control framework designed to ensure that they are either determined, or validated, by a function independent of the risk-taker.

For all financial instruments where fair values are determined by reference to externally quoted prices or observable pricing inputs to models, independent price determination or validation is utilised. In inactive markets, direct observation of a traded price may not be possible. In these circumstances, the group will source alternative market information to validate the financial instrument's fair value, with greater weight given to information that is considered to be more relevant and reliable. The factors that are considered in this regard are, *inter alia*:

- the extent to which prices may be expected to represent genuine traded or tradable prices;
- the degree of similarity between financial instruments;
- the degree of consistency between different sources;
- the process followed by the pricing provider to derive the data;
- the elapsed time between the date to which the market data relates and the balance sheet date; and
- the manner in which the data was sourced.

For fair values determined using a valuation model, the control framework may include, as applicable, development or validation by independent support functions of (i) the logic within valuation models; (ii) the inputs to those models; (iii) any adjustments required outside the valuation models; and, where possible, (iv) model outputs. Valuation models are subject to a process of due diligence and calibration before becoming operational and are calibrated against external market data on an ongoing basis.

Determination of fair value

Fair values are determined according to the following hierarchy:

- Level 1 – quoted market price*: financial instruments with quoted prices for identical instruments in active markets.
- Level 2 – valuation technique using observable inputs*: financial instruments with quoted prices for similar instruments in active markets or quoted prices for identical or similar instruments in inactive markets and financial instruments valued using models where all significant inputs are observable.
- Level 3 – valuation technique with significant unobservable inputs*: financial instruments valued using models where one or more significant inputs are unobservable.

Notes on the Financial Statements (continued)

The best evidence of fair value is a quoted price in an actively traded market. The fair values of financial instruments that are quoted in active markets are based on bid prices for assets held and offer prices for liabilities issued. Where a financial instrument has a quoted price in an active market, the fair value of the total holding of the financial instrument is calculated as the product of the number of units and quoted price. In the event that the market for a financial instrument is not active, a valuation technique is used.

The judgement as to whether a market is active may include, but is not restricted to, the consideration of factors such as the magnitude and frequency of trading activity, the availability of prices and the size of bid/offer spreads. The bid/offer spread represents the difference in prices at which a market participant would be willing to buy compared with the price at which they would be willing to sell. In inactive markets, obtaining assurance that the transaction price provides evidence of fair value or determining the adjustments to transaction prices that are necessary to measure the fair value of the instrument requires additional work during the valuation process.

Valuation techniques

Valuation techniques incorporate assumptions about factors that other market participants would use in their valuations. A range of valuation techniques is employed, dependent on the instrument type and available market data. Most valuation techniques are based upon discounted cash flow analyses, in which expected future cash flows are calculated and discounted to present value using a discounting curve. Prior to considering credit risk, the expected future cash flows may be known, as would be the case for the fixed leg of an interest rate swap, or may be uncertain and require projection, as would be the case for the floating leg of an interest rate swap. 'Projection' utilises market forward curves, if available. In option models, the probability of different potential future outcomes must be considered. In addition, the value of some products are dependent on more than one market factor, and in these cases it will typically be necessary to consider how movements in one market factor may affect the other market factors. The model inputs necessary to perform such calculations include interest rate yield curves, exchange rates, volatilities, correlations, prepayment and default rates. For interest rate derivatives with collateralised counterparties and in significant currencies, HSBC uses a discounting curve that reflects the overnight interest rate ('OIS discounting').

The majority of valuation techniques employ only observable market data. However, certain financial instruments are valued on the basis of valuation techniques that feature one or more significant market inputs that are unobservable, and for them the derivation of fair value is more judgemental. An instrument in its entirety is classified as valued using significant unobservable inputs if, in the opinion of management, a significant proportion of the instrument's inception profit ('day 1 gain or loss') or greater than 5% of the instrument's carrying value is driven by unobservable inputs. 'Unobservable' in this context means that there is little or no current market data available from which to determine the price at which an arm's length transaction would be likely to occur. It generally does not mean that there is no data available at all upon which to base a determination of fair value (consensus pricing data may, for example, be used). All fair value adjustments are included within the levelling determination.

In certain circumstances, the group records its own debt in issue at fair value, based on quoted prices in an active market for the specific instrument concerned, where available. An example of this is where own debt in issue is hedged with interest rate derivatives. When quoted market prices are unavailable, the own debt in issue is valued using valuation techniques, the inputs for which are either based upon quoted prices in an inactive market for the instrument, or are estimated by comparison with quoted prices in an active market for similar instruments. In both cases, the fair value includes the effect of applying the credit spread which is appropriate to the group's liability. The change in fair value of issued debt securities attributable to the group's own credit spread is computed as follows: for each security at each reporting date, an externally verifiable price is obtained or a price is derived using credit spreads for similar securities for the same issuer. Then, using discounted cash flow, each security is valued using a LIBOR-based discount curve. The difference in the valuations is attributable to the group's own credit spread. This methodology is applied consistently across all securities.

Structured notes issued and certain other hybrid instrument liabilities are included within trading liabilities and are measured at fair value. The credit spread applied to these instruments is derived from the spreads at which the group issues structured notes.

Gains and losses arising from changes in the credit spread of liabilities issued by the group reverse over the contractual life of the debt, provided that the debt is not repaid at a premium or a discount.

Changes in fair value are generally subject to a profit and loss analysis process. This process disaggregates changes in fair value into three high level categories; (i) portfolio changes, such as new transactions or maturing transactions, (ii) market movements, such as changes in foreign exchange rates or equity prices, and (iii) other, such as changes in fair value adjustments, discussed below.

Notes on the Financial Statements (continued)

Fair value adjustments

Fair value adjustments are adopted when HSBC considers that there are additional factors that would be considered by a market participant which are not incorporated within the valuation model. HSBC classifies fair value adjustments as either 'risk-related' or 'model-related'. The majority of these adjustments relate to GB&M.

Movements in the level of fair value adjustments do not necessarily result in the recognition of profits or losses within the income statement. For example, as models are enhanced, fair value adjustments may no longer be required. Similarly, fair value adjustments will decrease when the related positions are unwound, but this may not result in profit or loss.

Risk-related adjustments

Bid-offer

IFRS 13 requires use of the price within the bid-offer spread that is most representative of fair value. Valuation models will typically generate mid-market values. The bid-offer adjustment reflects the extent to which bid-offer cost would be incurred if substantially all residual net portfolio market risks were closed using available hedging instruments or by disposing of or unwinding the position.

Uncertainty

Certain model inputs may be less readily determinable from market data, and/or the choice of model itself may be more subjective. In these circumstances, there exists a range of possible values that the financial instrument or market parameter may assume and an adjustment may be necessary to reflect the likelihood that in estimating the fair value of the financial instrument, market participants would adopt more conservative values for uncertain parameters and/or model assumptions than those used in the valuation model.

Credit valuation adjustment

The credit valuation adjustment is an adjustment to the valuation of OTC derivative contracts to reflect within fair value the possibility that the counterparty may default and that the group may not receive the full market value of the transactions (see below).

Debit valuation adjustment

The debit valuation adjustment is an adjustment to the valuation of OTC derivative contracts to reflect within fair value the possibility that the group may default, and that the group may not pay full market value of the transactions (see below).

Model-related adjustments

Model limitation

Models used for portfolio valuation purposes may be based upon a simplifying set of assumptions that do not capture all material market characteristics. Additionally, markets evolve, and models that were adequate in the past may require development to capture all material market characteristics in current market conditions. In these circumstances, model limitation adjustments are adopted. As model development progresses, model limitations are addressed within the valuation models and a model limitation adjustment is no longer needed.

Inception profit (Day 1 P&L reserves)

Inception profit adjustments are adopted when the fair value estimated by a valuation model is based on one or more significant unobservable inputs. The accounting for inception profit adjustments is discussed in Note 2 (d).

Credit valuation adjustment methodology

The group calculates a separate credit valuation adjustment ('CVA') and debit valuation adjustment ('DVA') for each group legal entity, and within each entity for each counterparty to which the entity has exposure.

The group calculates the CVA by applying the probability of default ('PD') of the counterparty, conditional on the non-default of the group, to the group's expected positive exposure to the counterparty and multiplying the result by the loss expected in the event of default. Conversely, the group calculates the DVA by applying the PD of the group, conditional on the non-default of the counterparty, to the expected positive exposure of the counterparty to the group.

Notes on the Financial Statements (continued)

and multiplying by the loss expected in the event of default. Both calculations are performed over the life of the potential exposure.

The derivation of a proxy has regard to the range of market practice, and considers relevant data in this context, including CDS index and rating transition data.

For most products, the group uses a simulation methodology to calculate the expected positive exposure to a counterparty. This incorporates the range of potential exposures across the portfolio of transactions with the counterparty over the life of the portfolio. The simulation methodology includes credit mitigants such as counterparty netting agreements and collateral agreements with the counterparty. A standard loss given default assumption of 60% is generally adopted for developed market exposures, and 75% for emerging market exposures. Alternative loss given default assumptions may be adopted where both the nature of the exposure and the available data support this.

For certain types of exotic derivatives where the products are not currently supported by the simulation, or for derivative exposures in smaller trading locations where the simulation tool is not yet available, the group adopts alternative methodologies. These may involve mapping to the results for similar products from the simulation tool or where such a mapping approach is not appropriate, a simplified methodology is used, generally following the same principles as the simulation methodology. The calculation is applied at a trade level, with more limited recognition of credit mitigants such as netting or collateral agreements than used in the simulation methodology.

The methodologies do not, in general, account for 'wrong-way risk'. Wrong-way risk arises where the underlying value of the derivative prior to any CVA is positively correlated to the probability of default of the counterparty. When there is significant wrong-way risk, a trade-specific approach is applied to reflect the wrong-way risk within the valuation.

With the exception of certain central clearing parties, the group includes all third party counterparties in the CVA and DVA calculations and does not net these calculations across group entities. During the year, the group refined the methodologies used to calculate the CVA and DVA to more accurately reflect the impact of ratings downgrade triggers on credit mitigation. The group reviews and refines the CVA and DVA methodologies on an ongoing basis.

Valuation of uncollateralised derivatives

The group values uncollateralised derivatives by discounting expected future cash flows at a benchmark interest rate, typically Libor or its equivalent. This approach has historically been adopted across the industry, and has therefore been an appropriate basis for fair value. The group and other industry participants are currently considering whether this approach appropriately reflects the manner in which the derivatives are funded, which may occur at rates other than interbank offer rates. No consensus has yet emerged on how such funding should be reflected in the fair value measurement for uncollateralised derivatives. In the future, and possibly in 2014, the group may adopt a 'funding fair value adjustment' to reflect funding of uncollateralised derivatives at rates other than interbank offered rates.

Notes on the Financial Statements (continued)

Financial instruments measured at fair value using a valuation technique with significant unobservable inputs – Level 3

The group

| | Assets | | | | Liabilities | | | |
|----------------------------------|--------------------------|------------------------|---|-------------------|------------------------|---|-------------------|--------------|
| | Available-for-sale £m | Held for trading £m | Designated at fair value through profit or loss £m | Derivatives £m | Held for trading £m | Designated at fair value through profit or loss £m | Derivatives £m | |
| At 31 December 2013 | | | | | | | | |
| Private equity investments | 642 | 56 | – | – | – | – | – | – |
| Asset-backed securities | 1,011 | 264 | – | – | – | – | – | – |
| Structured notes | – | – | – | – | 1,361 | – | – | – |
| Derivatives | – | – | – | 1,072 | – | – | – | 1,297 |
| Other portfolios | – | 1,242 | – | – | – | – | – | – |
| | 1,653 | 1,562 | – | 1,072 | 1,361 | – | – | 1,297 |
| At 31 December 2012 | | | | | | | | |
| Private equity investments | 452 | 51 | – | – | – | – | – | – |
| Asset-backed securities | 1,409 | 137 | – | – | – | – | – | – |
| Leverage finance | – | – | – | – | – | – | – | 7 |
| Structured notes | – | 5 | – | – | 1,515 | – | – | – |
| Derivatives | – | – | – | 1,160 | 2 | – | – | 1,301 |
| Other portfolios | 210 | 1,182 | – | – | – | – | – | – |
| | 2,071 | 1,375 | – | 1,160 | 1,517 | – | – | 1,308 |

The bank

| | Assets | | | | Liabilities | | | |
|----------------------------------|--------------------------|------------------------|---|-------------------|------------------------|---|-------------------|--------------|
| | Available-for-sale £m | Held for trading £m | Designated at fair value through profit or loss £m | Derivatives £m | Held for trading £m | Designated at fair value through profit or loss £m | Derivatives £m | |
| At 31 December 2013 | | | | | | | | |
| Private equity investments | 457 | 56 | – | – | – | – | – | – |
| Asset-backed securities | 2,260 | 265 | – | – | – | – | – | – |
| Structured notes | – | – | – | – | 1,290 | – | – | – |
| Derivatives | – | – | – | 1,083 | – | – | – | 1,367 |
| Other portfolios | – | 1,242 | – | – | – | – | – | – |
| | 2,717 | 1,563 | – | 1,083 | 1,290 | – | – | 1,367 |
| At 31 December 2012 | | | | | | | | |
| Private equity investments | 264 | 51 | – | – | – | – | – | – |
| Asset-backed securities | 2,164 | 137 | – | – | – | – | – | – |
| Leverage finance | – | – | – | – | – | – | – | 7 |
| Structured notes | – | – | – | – | 1,467 | – | – | – |
| Derivatives | – | – | – | 1,233 | 2 | – | – | 1,393 |
| Other portfolios | 207 | 1,182 | – | – | – | – | – | – |
| | 2,635 | 1,370 | – | 1,233 | 1,469 | – | – | 1,400 |

Private equity

The group's private equity positions are generally classified as available-for-sale and are not traded in active markets. In the absence of an active market, an investment's fair value is estimated on the basis of an analysis of the investee's financial position and results, risk profile, prospects and other factors, as well as by reference to market valuations for similar entities quoted in an active market, or the price at which similar companies have changed ownership.

Asset-backed securities (ABSs)

While quoted market prices are generally used to determine the fair value of these securities, valuation models are used to substantiate the reliability of the limited market data available and to identify whether any adjustments to quoted market prices are required. For ABSs including residential MBSs, the valuation uses an industry standard model and the assumptions relating to prepayment speeds, default rates and loss severity based on collateral type and

Notes on the Financial Statements (continued)

performance, as appropriate. The valuations output is benchmarked for consistency against observable data for securities of a similar nature.

Loans including leveraged finance and loans held for securitisation

Loans held at fair value are valued from broker quotes and/or market data consensus providers when available. In the absence of an observable market, the fair value is determined using valuation techniques. These techniques include discounted cash flow models, which incorporate assumptions regarding an appropriate credit spread for the loan, derived from other market instruments issued by the same or comparable entities.

Structured notes

The fair value of structured notes valued using a valuation technique is derived from the fair value of the underlying debt security, and the fair value of the embedded derivative is determined as described in the paragraph below on derivatives.

Trading liabilities valued using a valuation technique with significant unobservable inputs principally comprised equity-linked structured notes, which are issued by the group and provide the counterparty with a return that is linked to the performance of certain equity securities, and other portfolios. The notes are classified as level 3 due to the unobservability of parameters such as long-dated equity volatilities and correlations between equity prices, between equity prices and interest rates and between interest rates and foreign exchange rates.

Derivatives

OTC (i.e. non-exchange traded) derivatives are valued using valuation models. Valuation models calculate the present value of expected future cash flows, based upon 'no-arbitrage' principles. For many vanilla derivative products, such as interest rate swaps and European options, the modelling approaches used are standard across the industry. For more complex derivative products, there may be some differences in market practice. Inputs to valuation models are determined from observable market data wherever possible, including prices available from exchanges, dealers, brokers or providers of consensus pricing. Certain inputs may not be observable in the market directly, but can be determined from observable prices via model calibration procedures or estimated from historical data or other sources. Examples of inputs that may be unobservable include volatility surfaces, in whole or in part, for less commonly traded option products, and correlations between market factors such as foreign exchange rates, interest rates and equity prices.

Derivative products valued using valuation techniques with significant unobservable inputs included certain types of correlation products, such as foreign exchange basket options, equity basket options, foreign exchange interest rate hybrid transactions and long-dated option transactions. Examples of the latter are equity options, interest rate and foreign exchange options and certain credit derivatives. Credit derivatives include certain tranching CDS transactions.

Notes on the Financial Statements (continued)

Reconciliation of fair value measurements in Level 3 of the fair value hierarchy

The group

| | Assets | | | | Liabilities | | | |
|--|--------------------------|------------------------|---|-------------------|------------------------|---|-------------------|--|
| | Available-for-sale £m | Held for trading £m | Designated at fair value through profit or loss £m | Derivatives £m | Held for trading £m | Designated at fair value through profit or loss £m | Derivatives £m | |
| At 1 January 2013 | 2,071 | 1,375 | – | 1,160 | 1,517 | – | 1,308 | |
| Total gains or losses recognised in profit or loss | (39) | 259 | – | (209) | (220) | – | (88) | |
| - trading income excluding net interest income | – | 259 | – | (209) | (220) | – | (88) | |
| - gains less losses from financial investments | (39) | – | – | – | – | – | – | |
| Total gains or losses recognised in other comprehensive income | 107 | – | – | – | – | – | – | |
| - available-for-sale investments: fair value gains/(losses) | 107 | – | – | – | – | – | – | |
| Purchases | 294 | 89 | – | – | – | – | – | |
| Issues | – | – | – | – | 683 | – | – | |
| Sales | (91) | (110) | – | – | (9) | – | – | |
| Settlements | (251) | (48) | – | 87 | (603) | – | 84 | |
| Transfer out | (638) | (43) | – | (14) | (8) | – | (61) | |
| Transfer in | 175 | 105 | – | 48 | – | – | 41 | |
| Exchange differences | 25 | (65) | – | – | 1 | – | 13 | |
| At 31 December 2013 | 1,653 | 1,562 | – | 1,072 | 1,361 | – | 1,297 | |
| Unrealised gains/(losses) recognised in profit or loss relating to and liabilities held at 31 December | (93) | 139 | – | 5 | (264) | – | 68 | |
| - trading income excluding net interest income | – | 139 | – | 5 | (264) | – | 68 | |
| - gains less losses from financial investments | (93) | – | – | – | – | – | – | |

| | Assets | | | | Liabilities | | | |
|---|--------------------------|------------------------|---|-------------------|------------------------|---|-------------------|--|
| | Available-for-sale £m | Held for trading £m | Designated at fair value through profit or loss £m | Derivatives £m | Held for trading £m | Designated at fair value through profit or loss £m | Derivatives £m | |
| At 1 January 2012 | 2,349 | 1,831 | – | 1,555 | 1,704 | – | 1,703 | |
| Total gains or losses recognised in profit or loss | (81) | 51 | – | (274) | 59 | – | (394) | |
| Total gains or losses recognised in other comprehensive income | 194 | – | – | – | – | – | – | |
| Purchases | 176 | 9 | – | – | (232) | – | – | |
| Issues | – | – | – | – | 565 | – | – | |
| Sales | (136) | (131) | – | – | 248 | – | – | |
| Settlements | (143) | (314) | – | (52) | (611) | – | 124 | |
| Transfer out | (1,204) | (165) | – | (115) | (221) | – | (148) | |
| Transfer in | 950 | 139 | – | 45 | 6 | – | 17 | |
| Exchange differences | (34) | (45) | – | 1 | (1) | – | 6 | |
| At 31 December 2012 | 2,071 | 1,375 | – | 1,160 | 1,517 | – | 1,308 | |
| Total gains or losses recognised in profit or loss relating to assets and liabilities held at 31 December | (62) | 41 | – | (36) | 18 | – | (85) | |

Notes on the Financial Statements (continued)

The bank

| | Assets | | | | Liabilities | | |
|--|--------------------------|------------------------|---|-------------------|------------------------|---|-------------------|
| | Available-for-sale £m | Held for trading £m | Designated at fair value through profit or loss £m | Derivatives £m | Held for trading £m | Designated at fair value through profit or loss £m | Derivatives £m |
| At 1 January 2013 | 2,635 | 1,370 | – | 1,233 | 1,469 | – | 1,400 |
| Total gains or losses recognised in profit or loss | 129 | 260 | – | (230) | (230) | – | (41) |
| - trading income excluding net interest income | – | 260 | – | (230) | (230) | – | (41) |
| - gains less losses from financial investments | 129 | – | – | – | – | – | – |
| Total gains or losses recognised in other comprehensive income | 32 | – | – | – | – | – | – |
| - available-for-sale investments: fair value gains/(losses) | 32 | – | – | – | – | – | – |
| Purchases | 37 | 89 | – | – | – | – | – |
| Issues | – | – | – | – | 631 | – | – |
| Sales | (82) | (110) | – | – | – | – | – |
| Settlements | (25) | (41) | – | 71 | (573) | – | 47 |
| Transfer out | (3) | (43) | – | (17) | (8) | – | (68) |
| Transfer in | – | 76 | – | 27 | – | – | 21 |
| Exchange differences | (6) | (38) | – | (1) | 1 | – | 8 |
| At 31 December 2013 | 2,717 | 1,563 | – | 1,083 | 1,290 | – | 1,367 |
| Unrealised gains/(losses) recognised in profit or loss relating to and liabilities held at 31 December | 132 | 140 | – | (76) | (264) | – | 21 |
| - trading income excluding net interest income | – | 140 | – | (76) | (264) | – | 21 |
| - gains less losses from financial investments | 132 | – | – | – | – | – | – |

| | Assets | | | | Liabilities | | |
|---|--------------------------|------------------------|---|-------------------|------------------------|---|-------------------|
| | Available-for-sale £m | Held for trading £m | Designated at fair value through profit or loss £m | Derivatives £m | Held for trading £m | Designated at fair value through profit or loss £m | Derivatives £m |
| At 1 January 2012 | 3,123 | 1,814 | – | 1,667 | 1,651 | – | 1,831 |
| Total gains or losses recognised in profit or loss | (69) | 50 | – | (256) | 59 | – | (338) |
| Total gains or losses recognised in other comprehensive income | (240) | – | – | – | – | – | – |
| Purchases | 73 | 9 | – | – | (231) | – | – |
| Issues | – | – | – | – | 563 | – | – |
| Sales | (104) | (131) | – | – | 248 | – | – |
| Settlements | (80) | (301) | – | (114) | (603) | – | 16 |
| Transfer out | (126) | (164) | – | (119) | (218) | – | (152) |
| Transfer in | 43 | 139 | – | 54 | – | – | 34 |
| Exchange differences | 15 | (46) | – | 1 | – | – | 9 |
| At 31 December 2012 | 2,635 | 1,370 | – | 1,233 | 1,469 | – | 1,400 |
| Total gains or losses recognised in profit or loss relating to those assets and liabilities held at 31 December | (69) | 38 | – | (37) | 23 | – | (25) |

Effects of changes in significant unobservable assumptions to reasonably possible alternatives

As discussed above, the fair value of financial instruments are, in certain circumstances, measured using valuation techniques that incorporate assumptions that are not evidenced by prices from observable current market transactions in the same instrument and are not based on observable market data. The following table shows the sensitivity of Level 3 fair values to reasonably possible alternative assumptions:

Notes on the Financial Statements (continued)

The group

| | Reflected in profit or loss | | Reflected in other comprehensive income | |
|---|-----------------------------|----------------------|---|----------------------|
| | Favourable changes | Unfavourable changes | Favourable changes | Unfavourable changes |
| | £m | £m | £m | £m |
| At 31 December 2013 | | | | |
| Derivatives/trading assets/trading liabilities ¹ | 180 | (133) | – | – |
| Financial investments: available-for-sale | – | – | 89 | (133) |
| At 31 December 2012 | | | | |
| Derivatives/trading assets/trading liabilities ¹ | 204 | (133) | – | – |
| Financial investments: available-for-sale | – | – | 152 | (150) |

The bank

| | Reflected in profit or loss | | Reflected in other comprehensive income | |
|---|-----------------------------|----------------------|---|----------------------|
| | Favourable changes | Unfavourable changes | Favourable changes | Unfavourable changes |
| | £m | £m | £m | £m |
| At 31 December 2013 | | | | |
| Derivatives/trading assets/trading liabilities ¹ | 209 | (146) | – | – |
| Financial investments: available-for-sale | – | – | 238 | (276) |
| At 31 December 2012 | | | | |
| Derivatives/trading assets/trading liabilities ¹ | 283 | (155) | – | – |
| Financial investments: available-for-sale | – | – | 296 | (295) |

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

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

| | Reflected in profit or loss | | Reflected in other comprehensive income | |
|----------------------------------|-----------------------------|----------------------|---|----------------------|
| | Favourable changes | Unfavourable changes | Favourable changes | Unfavourable changes |
| | £m | £m | £m | £m |
| At 31 December 2013 | | | | |
| Private equity investments | – | (7) | 24 | (74) |
| Asset-backed securities | 28 | (8) | 65 | (59) |
| Structured notes | 6 | (6) | – | – |
| Derivatives | 129 | (93) | – | – |
| Other portfolios | 17 | (19) | – | – |
| At 31 December 2012 | | | | |
| Private equity investments | 14 | (14) | 43 | (43) |
| Asset-backed securities | 23 | (13) | 88 | (86) |
| Structured notes | 3 | (3) | – | – |
| Derivatives | 163 | (102) | – | – |
| Other portfolios | 1 | (1) | 21 | (21) |

Favourable and unfavourable changes are determined on the basis of changes in the value of the instrument as a result of varying the levels of the unobservable parameters using statistical techniques. When parameters are not amenable to statistical analysis, quantification of uncertainty is judgemental.

When the fair value of a financial instrument is affected by more than one unobservable assumption, the above table reflects the most favourable or most unfavourable change from varying the assumptions individually.

Notes on the Financial Statements (continued)

Quantitative information about significant unobservable inputs in level 3 valuations

| | Fair value | | Valuation technique | Key unobservable inputs | Full range of inputs | | Core range of inputs | |
|--|--------------|-------------------|--------------------------|-------------------------|----------------------|--------|----------------------|--------|
| | Assets £m | Liabilities £m | | | Lower | Higher | Lower | Higher |
| At 31 December 2013 | | | | | | | | |
| Private equity including strategic investments | 698 | - | See notes below | See notes below... | n/a | n/a | n/a | n/a |
| Asset-backed securities | 1,275 | - | | | | | | |
| CLO/CDO ¹ | 601 | - | Market proxy | Bid quotes | - | 102 | 46 | 95 |
| Other ABSs | 674 | - | | | - | 99 | 30 | 82 |
| Structured notes | - | 1,361 | | | | | | |
| Equity-linked notes | - | 649 | Model – Option model | Equity volatility... | 7% | 67% | 13% | 39% |
| Fund-linked notes | - | 311 | Model – Option model | Equity correlation | 0.54 | 0.54 | 0.54 | 0.54 |
| FX-linked notes | - | 229 | Model – Option model | Fund volatility | 18% | 22% | 19% | 21% |
| Other | - | 172 | Model – Option model | FX volatility | 0% | 28% | 0% | 28% |
| Derivatives | 1,072 | 1,297 | | | | | | |
| Interest rate derivatives: | | | | | | | | |
| – securitisation swaps | 166 | 681 | Model – DCF ² | Prepayment rate... | 0% | 22% | 2% | 20% |
| – long-dated swaptions | 384 | 111 | Model – Option model | IR volatility | 4% | 78% | 13% | 40% |
| – other | 99 | 77 | | | | | | |
| Foreign exchange derivatives: | | | | | | | | |
| – Foreign exchange options | 89 | 109 | Model – Option model | FX volatility | 0% | 28% | 5% | 13% |
| Equity derivatives: | | | | | | | | |
| – long-dated single stock options | 226 | 228 | Model – Option model | Equity volatility... | 7% | 67% | 13% | 39% |
| – other | 14 | 50 | | | | | | |
| Credit derivatives: | | | | | | | | |
| – other | 94 | 41 | | | | | | |
| Other portfolios | 1,242 | - | | | | | | |
| | 4,287 | 2,658 | | | | | | |

1 Collateralised loan obligation/collateralised debt obligation

2 Discounted cash flow

Key unobservable inputs to Level 3 financial instruments

The table above lists key unobservable inputs to level 3 financial instruments, and provides the range of those inputs as at 31 December 2013. A further description of the categories of key unobservable inputs is given below.

Private equity including strategic investments

HSBC's private equity and strategic investments 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. Given the bespoke nature of the analysis in respect of each holding, it is not practical to quote a range of key unobservable inputs.

Prepayment rates

Prepayment rates are a measure of the anticipated future speed at which a loan portfolio will be repaid in advance of the due date. Prepayment rates are an important input into modelled values of asset-backed securities. A modelled price may be used where insufficient observable market prices exist to enable a market price to be determined directly. Prepayment rates are also an important input into the valuation of derivatives linked to securitisations. For example, so-called securitisation swaps have a notional value that is linked to the size of the outstanding loan portfolio in a securitisation, which may fall as prepayments occur. Prepayment rates vary according to the nature of the loan portfolio, and expectations of future market conditions. For example, prepayment rates will generally be anticipated to increase as interest rates rise. Prepayment rates may be estimated using a variety of evidence, such as prepayment rates implied from proxy observable security prices, current or historic prepayment rates, macro-economic modelling.

Notes on the Financial Statements (continued)

Market proxy

Market proxy pricing may be used for an instrument for which specific market pricing is not available, but evidence is available in respect of instruments that have some characteristics in common. In some cases it might be possible to identify a specific proxy, but more generally evidence across a wider range of instruments will be used to understand the factors that influence current market pricing and the manner of that influence. For example, in the collateralised loan obligation market it may be possible to establish that A-rated securities exhibit prices in a range, and to isolate key factors that influence position within the range. Application of this to a specific A-rated security within HSBC's portfolio allows assignment of a price.

The range of prices used as inputs into a market proxy pricing methodology may therefore be wide. This range is not indicative of the uncertainty associated with the price derived for an individual security.

Volatility

Volatility is a measure of the anticipated future variability of a market price. Volatility tends to increase in stressed market conditions, and decrease in calmer market conditions. Volatility is an important input in the pricing of options. In general, the higher the volatility, the more expensive the option will be. This reflects both the higher probability of an increased return from the option, and the potentially higher costs that HSBC may incur in hedging the risks associated with the option. If option prices become more expensive, this will increase the value of HSBC's long option positions (i.e. the positions in which HSBC has purchased options), while HSBC's short option positions (i.e. the positions in which HSBC has sold options) will suffer losses.

Volatility varies by underlying reference market price, and by strike and maturity of the option. Volatility also varies over time. As a result, it is difficult to make general statements regarding volatility levels. For example, while it is generally the case that foreign exchange volatilities are lower than equity volatilities, there may be examples in particular currency pairs or for particular equities where this is not the case.

Certain volatilities, typically those of a longer-dated nature, are unobservable. The unobservable volatility is then estimated from observable data. For example, longer-dated volatilities may be extrapolated from shorter-dated volatilities.

The range of unobservable volatilities quoted in the table reflects the wide variation in volatility inputs by reference market price. For example, FX volatilities for a pegged currency may be very low, whereas for non-managed currencies the FX volatility may be higher. As a further example, volatilities for deep-in-the-money or deep-out-of-the-money equity options may be significantly higher than at-the-money options as a result of 'volatility skew'. For any single unobservable volatility, the uncertainty in the volatility determination is significantly less than the range quoted above.

Correlation

Correlation is a measure of the inter-relationship between two market prices. Correlation is a number between minus one and one. A positive correlation implies that the two market prices tend to move in the same direction, with a correlation of one implying that they always move in the same direction. A negative correlation implies that the two market prices tend to move in opposite directions, with a correlation of minus one implying that the two market prices always move in opposite directions.

Correlation is used to value more complex instruments where the payout is dependent upon more than one market price. For example, an equity basket option has a payout that is dependent upon the performance of a basket of single stocks, and the correlation between the price movements of those stocks will be an input to the valuation. This is referred to as equity-equity correlation. There are a wide range of instruments for which correlation is an input, and consequently a wide range of both same-asset correlations (e.g. equity-equity correlation) and cross-asset correlations (e.g. foreign exchange rate-interest rate correlation) used. In general, the range of same-asset correlations will be narrower than the range of cross-asset correlations.

Correlation may be unobservable. Unobservable correlations may be estimated based upon a range of evidence, including consensus pricing services, HSBC trade prices, proxy correlations and examination of historical price relationships.

The range of unobservable correlations quoted in the table reflects the wide variation in correlation inputs by market price pair. For any single unobservable correlation, the uncertainty in the correlation determination is likely to be less than the range quoted above.

Notes on the Financial Statements (continued)

Credit spread

Credit spread is the premium over a benchmark interest rate required by the market to accept a lower credit quality. In a discounted cash flow model, the credit spread increases the discount factors applied to future cash flows, thereby reducing the value of an asset. Credit spreads may be implied from market prices. Credit spreads may not be observable in more illiquid markets.

Inter-relationships between key unobservable inputs

Key unobservable inputs to level 3 financial instruments may not be independent of each other. As described above, market variables may be correlated. This correlation typically reflects the manner in which different markets tend to react to macro-economic or other events. For example, improving economic conditions may lead to a 'risk on' market, in which prices of risky assets such as equities and high yield bonds will rise, while 'safe haven' assets such as gold and US Treasuries decline. Furthermore, the impact of changing market variables upon the HSBC portfolio will depend upon HSBC's net risk position in respect of each variable. For example, increasing high-yield bond prices will benefit long high-yield bond positions, but the value of any credit derivative protection held against those bonds will fall.

In respect of private equity investments, in many of the methodologies, the principal assumption is the valuation multiple to be applied to the main financial indicators. This may be determined with reference to multiples for comparable listed companies and includes discounts for marketability.

For ABSs, the principal assumptions in the models are based on benchmark information about prepayment speeds, default rates, loss severities and the historical performance of the underlying assets.

For leveraged finance and loans held for securitisation the principal assumption concerns the appropriate value to be attributed to the counterparty credit risk. This requires estimation of exposure at default, probability of default and recovery in the event of default. For loan transactions, assessment of exposure at default is straightforward. For derivative transactions, a future exposure profile is generated on the basis of current market data. Probabilities of default and recovery levels are estimated using market evidence, which may include financial information, historical experience, CDS spreads and consensus recovery levels.

For structured notes and other derivatives, principal assumptions concern the value to be attributed to future volatility of asset values and the future correlation between asset values. These principal assumptions include credit volatilities and correlations used in the valuation of structured credit derivatives (including leveraged credit derivatives). For such unobservable assumptions, estimates are based on available market data, which may include the use of a proxy method to derive volatility or a correlation from comparable assets for which market data is more readily available, and/or an examination of historical levels.

32 Fair values of financial instruments not carried at fair value

The accounting policies which determine the classification of financial instruments and the use of assumptions and estimation in valuing them are described in Notes 2 and 3 respectively.

Fair values are, however, provided for information and are calculated as described below.

The group

| | At 31 December 2013 | | | | | At 31 December 2012 | |
|---|-----------------------|--------------------------------------|--|---|---------|-----------------------|------------------|
| | Fair values | | | | | Carrying amount £m | Fair value £m |
| | Valuation techniques | | | | | | |
| | Carrying amount £m | Quoted market price Level 1 £m | Using observable inputs Level 2 £m | With significant unobservable inputs Level 3 £m | | | |
| Total £m | | | | Carrying amount £m | | | |
| Assets and liabilities not held for sale | | | | | | | |
| Assets | | | | | | | |
| Loans and advances to banks | 53,228 | – | 49,740 | 3,488 | 53,228 | 32,286 | 32,285 |
| Loans and advances to customers | 305,032 | – | 33,695 | 269,777 | 303,472 | 282,685 | 276,397 |
| Liabilities | | | | | | | |
| Deposits by banks ¹ | 50,683 | – | 50,683 | – | 50,683 | 39,571 | 39,571 |
| Customer accounts | 390,017 | – | 390,057 | – | 390,057 | 324,886 | 325,029 |
| Debt securities in issue | 32,895 | – | 32,499 | 430 | 32,929 | 40,358 | 40,401 |
| Subordinated liabilities | 10,785 | – | 10,487 | – | 10,487 | 10,350 | 10,013 |

Notes on the Financial Statements (continued)

The bank

| | At 31 December 2013 | | | | | At 31 December 2012 | | |
|---|--------------------------|--|--|--|---------------|---------------------|--------------------------|---------------------|
| | Fair values | | | | | Total £m | Carrying amount £m | Fair value £m |
| | Valuation techniques | | | | | | | |
| | Carrying amount £m | Quoted market price Level 1 £m | Using observable inputs Level 2 £m | With significant unobserv- able inputs Level 3 £m | Fair values | | | |
| Level 1 £m | | | | | Level 2 £m | Level 3 £m | Level 3 £m | |
| Assets and liabilities not held for sale | | | | | | | | |
| Assets | | | | | | | | |
| Loans and advances to banks | 41,566 | – | 40,431 | 1,135 | 41,566 | 17,207 | 17,207 | |
| Loans and advances to customers | 240,180 | – | 24,345 | 214,439 | 238,784 | 225,567 | 219,416 | |
| Liabilities | | | | | | | | |
| Deposits by banks | 52,514 | – | 52,514 | – | 52,514 | 30,129 | 30,129 | |
| Customer accounts | 312,080 | – | 312,080 | – | 312,080 | 256,341 | 256,341 | |
| Debt securities in issue | 19,576 | – | 19,576 | – | 19,576 | 24,970 | 24,970 | |
| Subordinated liabilities | 9,903 | – | 9,575 | – | 9,575 | 9,968 | 9,581 | |

Fair values are determined according to the hierarchy set out in Note 31.

The following is a list of 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:

Assets

Cash and balances at central banks
 Items in the course of collection from other banks
 Endorsements and acceptances
 Short-term receivables within 'Other assets'
 Accrued income

Liabilities

Items in the course of transmission to other banks
 Investment contracts with discretionary participation features within 'Liabilities under insurance contracts'
 Endorsements and acceptances
 Short-term payables within 'Other liabilities'
 Accruals

Valuation

The fair value measurement is the group's estimate of the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. It does not reflect the economic benefits and costs that the group expects to flow from the instruments' cash flows over their expected future lives. Other reporting entities may use different valuation methodologies and assumptions in determining fair values for which no observable market prices are available.

Fair values of the assets and liabilities set out below are estimated for the purpose of disclosure as follows:

Loans and advances to banks and customers

The fair value of loans and advances is based on observable market transactions, where available. In the absence of observable market transactions, fair value is estimated using valuation models that incorporate a range of input assumptions. These assumptions may include value estimates from third party brokers which reflect over-the-counter trading activity; forward looking discounted cash flow models using assumptions which HSBC believes are consistent with those which would be used by market participants in valuing such loans; and trading inputs from other market participants which includes observed primary and secondary trades.

Loans are grouped, as far as possible, into homogeneous groups and stratified by loans with similar characteristics to improve the accuracy of estimated valuation outputs. The stratification of a loan book considers all material factors, including vintage, origination period, estimates of future interest rates, prepayment speeds, delinquency rates, loan-to-value ratios, the quality of collateral, default probability, and internal credit risk ratings.

Notes on the Financial Statements (continued)

Valuation techniques are calibrated on a regular basis and tested for validity using prices from observable current market transactions in the same instrument, without modification or repackaging, or are based on any available observable market data.

The fair value of a loan reflects both loan impairments at the balance sheet date and estimates of market participants' expectations of credit losses over the life of the loans, and the fair value impact of repricing between origination and the balance sheet date. For impaired loans, fair value is estimated by discounting the future cash flows over the time period they are expected to be recovered.

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.

Deposits by banks and customer accounts

For the purpose of estimating fair value, deposits by banks and customer accounts are grouped by remaining contractual 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 approximated by its carrying value.

Debt securities in issue and subordinated liabilities

Fair values are determined using quoted market prices at the balance sheet date where available, or by reference to quoted market prices for similar instruments.

The fair values in this note are stated at a specific date and may be significantly different from the amounts which will actually be paid on the maturity or settlement dates of the instruments. In many cases, it would not be possible to realise immediately the estimated fair values given the size of the portfolios measured. Accordingly, these fair values do not represent the value of these financial instruments to the group as a going concern.

33 Maturity analysis of assets and liabilities

The balance in the table below will not agree directly with those in the consolidated balance sheet as the table incorporates, on an undiscounted basis, all cash flows relating to principal and future coupon payments (except for trading liabilities and trading derivatives). In addition, loan and other credit-related commitments and financial guarantees and similar contracts are generally not recognised on the balance sheet. Trading liabilities and trading derivatives are included in the 'On demand' time bucket, and not by contractual maturity, because trading liabilities are typically held for short periods of time. The group classifies the undiscounted cash flows payable under hedging derivative liabilities according to their contractual maturities. The undiscounted cash flows potentially payable under financial guarantees and similar contracts are classified on the basis of the earliest date they can be called.

Cash flows payable in respect of customer accounts are primarily contractually repayable on demand or at short notice. However, in practice, short-term deposit balances remain stable as inflows and outflows broadly match and a significant portion of loan commitments expire without being drawn upon. The group therefore manages its balance sheet on both contractual and behaviouralised bases. Each operating entity determines the behaviouralisation of its products within the guidelines set out in the group's liquidity framework and as approved by its Asset and Liability Committee.

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

Notes on the Financial Statements (continued)

Cash flows payable under financial liabilities by remaining contractual maturities

The group

| | On demand £m | Due within 3 months £m | Due between 3 and 12 months £m | Due between 1 and 5 years £m | Due after 5 years £m | Total £m |
|--|-----------------|------------------------------|--|--|----------------------------|----------------|
| At 31 December 2013 | | | | | | |
| Deposits by banks | 23,831 | 23,798 | 2,316 | 512 | 277 | 50,734 |
| Customer accounts | 311,089 | 57,132 | 17,932 | 4,059 | 85 | 390,297 |
| Trading liabilities | 91,842 | – | – | – | – | 91,842 |
| Financial liabilities designated at fair value | 6,825 | 493 | 1,477 | 15,692 | 14,063 | 38,550 |
| Derivatives | 135,490 | 204 | 912 | 2,529 | 571 | 139,706 |
| Debt securities in issue | 2,364 | 13,682 | 12,392 | 5,695 | 714 | 34,847 |
| Subordinated liabilities | 33 | 62 | 144 | 783 | 12,734 | 13,756 |
| Other financial liabilities | 1,730 | 5,494 | 922 | 194 | 680 | 9,020 |
| | 573,204 | 100,865 | 36,095 | 29,464 | 29,124 | 768,752 |
| Loan commitments | 121,324 | 792 | 408 | 459 | 34 | 123,017 |
| Financial guarantee contracts | 3,328 | 1,066 | 3,591 | 1,842 | 2,019 | 11,846 |
| | 697,856 | 102,723 | 40,094 | 31,765 | 31,177 | 903,615 |
| At 31 December 2012 | | | | | | |
| Deposits by banks | 13,882 | 19,935 | 1,925 | 7,120 | 493 | 43,355 |
| Customer accounts | 261,108 | 56,211 | 11,098 | 4,761 | 298 | 333,476 |
| Trading liabilities | 122,896 | – | – | – | – | 122,896 |
| Financial liabilities designated at fair value | 4,802 | 409 | 2,935 | 16,054 | 13,461 | 37,661 |
| Derivatives | 181,095 | 78 | 477 | 2,440 | 292 | 184,382 |
| Debt securities in issue | 40 | 18,158 | 13,836 | 8,623 | 343 | 41,000 |
| Subordinated liabilities | 4 | 72 | 71 | 642 | 12,114 | 12,903 |
| Other financial liabilities | 981 | 6,460 | 1,104 | 615 | 416 | 9,576 |
| | 584,808 | 101,323 | 31,446 | 40,255 | 27,417 | 785,249 |
| Loan commitments | 113,654 | 1,342 | 580 | 128 | 21 | 115,725 |
| Financial guarantee contracts | 3,047 | 1,005 | 3,776 | 1,709 | 2,123 | 11,660 |
| | 701,509 | 103,670 | 35,802 | 42,092 | 29,561 | 912,634 |

The bank

| | On demand £m | Due within 3 months £m | Due between 3 and 12 months £m | Due between 1 and 5 years £m | Due after 5 years £m | Total £m |
|--|-----------------|------------------------------|--|--|----------------------------|----------------|
| At 31 December 2013 | | | | | | |
| Deposits by banks | 20,506 | 25,048 | 2,020 | 544 | 4,449 | 52,567 |
| Customer accounts | 260,565 | 42,205 | 5,850 | 4,332 | 1 | 312,953 |
| Trading liabilities | 62,414 | – | – | – | – | 62,414 |
| Financial liabilities designated at fair value | – | 493 | 1,460 | 12,761 | 10,100 | 24,814 |
| Derivatives | 113,683 | 203 | 912 | 1,717 | 571 | 117,086 |
| Debt securities in issue | – | 4,391 | 10,543 | 4,244 | 713 | 19,891 |
| Subordinated liabilities | – | 44 | 23 | 1,108 | 9,668 | 10,843 |
| Other financial liabilities | 827 | 4,149 | 148 | – | – | 5,124 |
| | 457,995 | 76,533 | 20,956 | 24,706 | 25,502 | 605,692 |
| Loan commitments | 79,605 | 111 | 259 | 409 | 33 | 80,417 |
| Financial guarantee contracts | 462 | 1,637 | 3,307 | 1,907 | 2,053 | 9,366 |
| | 538,062 | 78,281 | 24,522 | 27,022 | 27,588 | 695,475 |

Notes on the Financial Statements (continued)

| | On demand £m | Due within 3 months £m | Due between 3 and 12 months £m | Due between 1 and 5 years £m | Due after 5 years £m | Total £m |
|--|-----------------|------------------------------|--|--|----------------------------|-------------|
| At 31 December 2012 | | | | | | |
| Deposits by banks | 19,373 | 7,419 | 2,101 | 941 | 227 | 30,061 |
| Customer accounts | 219,227 | 24,790 | 7,674 | 4,052 | – | 255,743 |
| Trading liabilities | 104,946 | – | – | – | – | 104,946 |
| Financial liabilities designated at fair value | – | 403 | 1,281 | 12,670 | 12,287 | 26,641 |
| Derivatives | 143,921 | 78 | 477 | 1,496 | 292 | 146,264 |
| Debt securities in issue | 40 | 6,690 | 12,058 | 5,795 | 641 | 25,224 |
| Subordinated liabilities | – | 44 | 23 | 1,095 | 9,781 | 10,943 |
| Other financial liabilities | 47 | 5,240 | 460 | 115 | 153 | 6,015 |
| | 487,554 | 44,664 | 24,074 | 26,164 | 23,381 | 605,837 |
| Loan commitments | 76,654 | 472 | 399 | 95 | 20 | 77,640 |
| Financial guarantee contracts | 31 | 1,627 | 3,865 | 1,731 | 2,064 | 9,318 |
| | 564,239 | 46,763 | 28,338 | 27,990 | 25,465 | 692,795 |

Maturity analysis of assets and liabilities

The group

| | At 31 December 2013 | | |
|--|------------------------------|--|-------------|
| | Due within one year £m | Due after more than one year £m | Total £m |
| Assets | | | |
| Financial assets designated at fair value | 734 | 15,927 | 16,661 |
| Loans and advances to banks | 49,032 | 4,196 | 53,228 |
| Loans and advances to customers | 147,710 | 157,322 | 305,032 |
| Financial investments | 10,484 | 64,546 | 75,030 |
| Other financial assets | 4,899 | 128 | 5,027 |
| | 212,859 | 242,119 | 454,978 |
| Liabilities | | | |
| Deposits by banks | 49,912 | 771 | 50,683 |
| Customer accounts | 385,976 | 4,041 | 390,017 |
| Financial liabilities designated at fair value | 4,045 | 29,991 | 34,036 |
| Debt securities in issue | 26,394 | 6,501 | 32,895 |
| Other financial liabilities | 4,629 | 782 | 5,411 |
| Subordinated liabilities | 80 | 10,705 | 10,785 |
| | 471,036 | 52,791 | 523,827 |
| | At 31 December 2012 | | |
| | Due within one year £m | Due after more than one year £m | Total £m |
| Assets | | | |
| Financial assets designated at fair value | 282 | 15,105 | 15,387 |
| Loans and advances to banks | 29,511 | 2,775 | 32,286 |
| Loans and advances to customers | 128,877 | 153,808 | 282,685 |
| Financial investments | 13,636 | 57,629 | 71,265 |
| Other financial assets | 4,469 | 2,103 | 6,572 |
| | 176,775 | 231,420 | 408,195 |
| Liabilities | | | |
| Deposits by banks | 33,482 | 6,089 | 39,571 |
| Customer accounts | 320,786 | 4,100 | 324,886 |
| Financial liabilities designated at fair value | 2,495 | 30,423 | 32,918 |
| Debt securities in issue | 31,536 | 8,822 | 40,358 |
| Other financial liabilities | 7,878 | 1,297 | 9,175 |
| Subordinated liabilities | 34 | 10,316 | 10,350 |
| | 396,211 | 61,047 | 457,258 |

Notes on the Financial Statements (continued)

The bank

| | At 31 December 2013 | | |
|--|------------------------------|--|----------------|
| | Due within one year £m | Due after more than one year £m | Total £m |
| Assets | | | |
| Financial assets designated at fair value | 2 | 3,981 | 3,983 |
| Loans and advances to banks | 39,735 | 1,831 | 41,566 |
| Loans and advances to customers | 120,603 | 119,577 | 240,180 |
| Financial investments | 6,571 | 38,477 | 45,048 |
| Other financial assets | 3,637 | 20 | 3,657 |
| | 170,548 | 163,886 | 334,434 |
| Liabilities | | | |
| Deposits by banks | 47,537 | 4,977 | 52,514 |
| Customer accounts | 307,823 | 4,257 | 312,080 |
| Financial liabilities designated at fair value | 1,858 | 20,148 | 22,006 |
| Debt securities in issue | 14,885 | 4,691 | 19,576 |
| Other financial liabilities | 3,587 | 75 | 3,662 |
| Subordinated liabilities | – | 9,903 | 9,903 |
| | 375,690 | 44,051 | 419,741 |
| | | | |
| | At 31 December 2012 | | |
| | Due within one year £m | Due after more than one year £m | Total £m |
| Assets | | | |
| Financial assets designated at fair value | – | 4,373 | 4,373 |
| Loans and advances to banks | 15,854 | 1,353 | 17,207 |
| Loans and advances to customers | 107,183 | 118,384 | 225,567 |
| Financial investments | 9,471 | 27,132 | 36,603 |
| Other financial assets | 3,404 | 906 | 4,310 |
| | 135,912 | 152,148 | 288,060 |
| Liabilities | | | |
| Deposits by banks | 25,602 | 4,527 | 30,129 |
| Customer accounts | 252,409 | 3,932 | 256,341 |
| Financial liabilities designated at fair value | 1,112 | 22,401 | 23,513 |
| Debt securities in issue | 18,654 | 6,316 | 24,970 |
| Other financial liabilities | 6,628 | 370 | 6,998 |
| Subordinated liabilities | – | 9,968 | 9,968 |
| | 304,405 | 47,514 | 351,919 |

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

Notes on the Financial Statements (continued)

34 Offsetting of financial assets and financial liabilities

Financial assets subject to offsetting, enforceable master netting arrangements and similar agreements

| | Gross amounts of recognised financial assets £m | Gross amounts offset in the balance sheet £m | Amounts presented in the balance sheet £m | Amounts not offset in the balance sheet | | Net amount £m |
|--|--|---|--|--|--------------------------------------|---------------------|
| | | | | Financial instruments £m | Cash collateral received £m | |
| At 31 December 2013 | | | | | | |
| Derivatives | 293,359 | (156,120) | 137,239 | 96,018 | 16,913 | 24,308 |
| Reverse repurchase, securities borrowing and similar agreements Classified as: | | | | | | |
| – trading assets | 23,082 | (11,234) | 11,848 | 11,848 | – | – |
| – loans and advances to banks at amortised cost | 39,074 | (9,051) | 30,023 | 30,001 | 22 | – |
| – loans and advances to customers at amortised cost ... | 50,694 | (21,603) | 29,091 | 29,077 | 11 | 3 |
| Loans and advances excluding reverse repos | | | | | | |
| – to banks | – | – | – | – | – | – |
| – to customers | 111,695 | (54,236) | 57,459 | 54,076 | – | 3,383 |
| | 517,904 | (252,244) | 265,660 | 221,020 | 16,946 | 27,694 |

At 31 December 2012

| | | | | | | |
|--|----------------|------------------|----------------|----------------|---------------|---------------|
| Derivatives | 395,797 | (217,989) | 177,808 | 122,169 | 18,992 | 36,647 |
| Reverse repurchase, securities borrowing and similar agreements Classified as: | | | | | | |
| – trading assets | 69,223 | (26,409) | 42,814 | 42,814 | – | – |
| – loans and advances to banks at amortised cost | 17,949 | (4,151) | 13,798 | 13,693 | 105 | – |
| – loans and advances to customers at amortised cost ... | 28,607 | (11,717) | 16,890 | 16,862 | 27 | 1 |
| Loans and advances excluding reverse repos | | | | | | |
| – to banks | – | – | – | – | – | – |
| – to customers | 105,227 | (53,797) | 51,430 | 48,009 | – | 3,421 |
| | 616,803 | (314,063) | 302,740 | 243,547 | 19,124 | 40,069 |

Financial liabilities subject to offsetting, enforceable master netting arrangements and similar agreements

| | Gross amounts of recognised financial liabilities £m | Gross amounts offset in the balance sheet £m | Amounts presented in the balance sheet £m | Amounts not offset in the balance sheet | | Net amount £m |
|--|---|---|--|--|-------------------------------------|---------------------|
| | | | | Financial instruments £m | Cash collateral pledged £m | |
| At 31 December 2013 | | | | | | |
| Derivatives | 293,472 | (156,120) | 137,352 | 96,462 | 14,610 | 26,280 |
| Repurchase, securities lending and similar agreements Classified as: | | | | | | |
| – trading liabilities | 27,596 | (11,234) | 16,362 | 16,362 | – | – |
| – deposits by banks | 29,914 | (9,051) | 20,863 | 20,821 | 42 | – |
| – customer accounts | 59,642 | (21,603) | 38,039 | 38,032 | 7 | – |
| Deposits by banks excluding repos ... | – | – | – | – | – | – |
| Customer accounts excluding repos ... | 115,739 | (54,236) | 61,503 | 54,076 | – | 7,427 |
| | 526,363 | (252,244) | 274,119 | 225,753 | 14,659 | 33,707 |

Notes on the Financial Statements (continued)

| | Gross amounts of recognised financial liabilities £m | Gross amounts offset in the balance sheet £m | Amounts presented in the balance sheet £m | Amounts not offset in the balance sheet | | Net amount £m |
|--|---|---|--|--|-------------------------------------|---------------------|
| | | | | Financial instruments £m | Cash collateral pledged £m | |
| At 31 December 2012 | | | | | | |
| Derivatives | 399,084 | (217,989) | 181,095 | 122,499 | 22,984 | 35,612 |
| Repurchase, securities lending and similar agreements | | | | | | |
| Classified as: | | | | | | |
| – trading liabilities | 71,142 | (26,409) | 44,733 | 44,733 | – | – |
| – deposits by banks | 10,508 | (4,151) | 6,357 | 6,300 | 57 | – |
| – customer accounts | 23,924 | (11,717) | 12,207 | 12,205 | 1 | 1 |
| Deposits by banks excluding repos ... | 29 | – | 29 | – | – | 29 |
| Customer accounts excluding repos ... | 109,840 | (53,797) | 56,043 | 48,009 | – | 8,034 |
| | 614,527 | (314,063) | 300,464 | 233,746 | 23,042 | 43,676 |

35 Foreign exchange exposures

The group's structural foreign currency exposure is represented by the net asset value of its foreign currency equity and subordinated debt investments in subsidiary undertakings, branches, joint ventures and associates.

The group's management of structural foreign currency exposures is discussed in the risk section in the Report of Directors.

Net structural foreign currency exposures

Currency of structural exposure

| | 2013 £m | 2012 £m |
|---|---------------|---------------|
| Euro | 10,126 | 11,891 |
| US dollars | 442 | 1,994 |
| Swiss francs | 7 | 162 |
| Turkish lira | 927 | 1,106 |
| Russian rouble | 185 | 186 |
| Others, each less than £150 million | 419 | 269 |
| Total | 12,106 | 15,608 |

36 Assets charged as security for liabilities and collateral accepted as security for assets

Financial assets pledged to secure liabilities are as follows:

| | Group assets pledged at 31 December | | Bank assets pledged at 31 December | |
|--|--|----------------|---------------------------------------|---------------|
| | 2013 £m | 2012 £m | 2013 £m | 2012 £m |
| Treasury bills and other eligible securities | 1,331 | 483 | – | – |
| Loans and advances to banks | 8,309 | 12,780 | 5,244 | 7,708 |
| Loans and advances to customers | 44,293 | 39,833 | 19,022 | 21,429 |
| Debt securities | 90,675 | 97,612 | 51,181 | 59,855 |
| Equity shares | 5,070 | 3,488 | 4,945 | 3,416 |
| Other | 72 | 35 | – | – |
| | 149,750 | 154,231 | 80,392 | 92,408 |

The table above shows assets over which a legal charge has been granted to secure liabilities. The amount of such assets may be greater than the book value of assets utilised as collateral for funding purposes or to cover liabilities. This is the case for securitisations and covered bonds where the amount of liabilities issued, plus any mandatory over-collateralisation, is less than the book value of financial assets available for funding or collateral purposes in the relevant pool of assets. This is also the case where financial assets are placed with a custodian or settlement agent, which has a floating charge over all the financial assets placed to secure any liabilities under settlement accounts.

Notes on the Financial Statements (continued)

These transactions are conducted under terms that are usual and customary to collateralised transactions, including, where relevant, standard securities lending and repurchase agreements.

Collateral accepted as security for assets

The fair value of financial assets accepted as collateral that the group is permitted to sell or repledge in the absence of default is £108,471 million (2012: £122,502 million) (the bank: 2013 £63,862 million; 2012 £79,852 million). The fair value of any such collateral that has been sold or repledged is £79,844 million (2012: £80,072 million) (the bank: 2013 £36,445 million; 2012 £41,562 million). The group is obliged to return equivalent securities.

These transactions are conducted under terms that are usual and customary to standard securities borrowing and reverse repurchase agreements.

37 Called up share capital and other equity instruments

Issued capital

HSBC Bank plc £1.00 ordinary shares

| | Number | £m |
|---|--------------------|------------|
| At 1 January 2013 | 796,969,107 | 797 |
| Share issued | 1 | – |
| At 31 December 2013 | 796,969,108 | 797 |
| At 1 January and 31 December 2012 | 796,969,107 | 797 |

HSBC Bank plc £1.00 preferred ordinary shares

| | Number | £'000 |
|--|----------|----------|
| At 1 January and 31 December 2013 | 1 | – |
| At 1 January and 31 December 2012 | 1 | – |

The preferred ordinary share ranks pari passu in all respects with the ordinary shares and with all other shares expressed to rank pari passu therewith. It carries the same rights and is subject to the same limitations as the ordinary shares but in addition the preferred ordinary share confers:

- (i) on each and any distribution of profits by the bank on any class of share (other than the ordinary shares), the right to receive, in priority to any other share, the first £100 of any amount so distributed; and
- (ii) on any distribution on a winding-up of the bank (but not on any redemption, reduction or purchase of any share capital), the right to receive out of the assets of the bank available for distribution, in priority to any other share, a sum equal to the nominal amount of the preferred ordinary share and any premium paid on the issue thereof.

HSBC Bank plc US\$0.01 non-cumulative third dollar preference shares

| | Number | £'000 |
|--|-------------------|------------|
| At 1 January and 31 December 2013 | 35,000,000 | 172 |
| At 1 January and 31 December 2012 | 35,000,000 | 172 |

The bank has no obligation to redeem the preference shares but may redeem them in part or in whole at any time, subject to prior notification to the Prudential Regulation Authority. Dividends on the preference shares in issue are paid annually at the sole and absolute discretion of the Board of Directors. The Board of Directors will not declare a dividend on the preference shares in issue if payment of the dividend would cause the bank not to meet the capital adequacy requirements of the Prudential Regulation Authority or the profit of the bank, available for distribution as dividends, is not sufficient to enable the bank to pay in full both dividends on the preference shares in issue and dividends on any other shares that are scheduled to be paid on the same date and have an equal right to dividends or if payment of the dividend is prohibited by the rights attached to any class of shares in the capital of the bank, excluding ordinary shares. The preference shares in issue carry no rights to conversion into ordinary shares of the bank. Holders of the preference shares in issue will be able to attend any general meetings of shareholders of the bank and to vote on any resolution proposed to vary or abrogate any of the rights attaching to the preference shares or any resolution proposed to reduce the paid up capital of the preference shares. If the dividend payable on the preference shares in issue has not been paid in full for the most recent dividend period or any resolution is proposed for the winding-up of the bank or the sale of its entire business then, in such circumstances, holders of preference

Notes on the Financial Statements (continued)

shares will be entitled to vote on all matters put to general meetings. In the case of unpaid dividends the holders of preference shares in issue will be entitled to attend and vote at any general meetings until such time as dividends on the preference shares have been paid in full, or a sum set aside for such payment in full, in respect of one dividend period.

All shares in issue are fully paid.

38 Notes on the cash flow statement

Non-cash items included in profit before tax

| | The group | | The bank | |
|---|--------------|--------------|--------------|--------------|
| | 2013 £m | 2012 £m | 2013 £m | 2012 £m |
| Depreciation, amortisation and impairment | 542 | 541 | 410 | 403 |
| Share-based payment expense | 147 | 271 | 119 | 191 |
| Credit-related impairment losses..... | 971 | 1,245 | 800 | 965 |
| Provisions raised | 1,055 | 1,616 | 665 | 1,274 |
| Impairment of investments..... | 36 | 26 | 7 | 687 |
| Credit charge for defined benefit plans | (170) | 148 | (191) | 112 |
| Accretion of discounts and amortisation of premiums | 103 | 141 | 198 | 120 |
| | 2,684 | 3,988 | 2,008 | 3,752 |

Change in operating assets

| | The group | | The bank | |
|---|-----------------|-----------------|-----------------|-----------------|
| | 2013 £m | 2012 £m | 2013 £m | 2012 £m |
| Change in prepayments and accrued income | 23 | 208 | – | 75 |
| Change in net trading securities and net derivatives..... | (9,234) | (29,920) | (9,177) | (19,974) |
| Change in loans and advances to banks | (19,899) | 5,446 | (28,309) | 8,142 |
| Change in loans and advances to customers..... | (22,462) | (6,503) | (15,269) | (11,810) |
| Change in financial assets designated at fair value..... | (1,179) | (55) | 397 | 222 |
| Change in other assets..... | (255) | (3,205) | 136 | 3,322 |
| | (53,006) | (34,029) | (52,222) | (20,023) |

Change in operating liabilities

| | The group | | The bank | |
|--|---------------|---------------|---------------|---------------|
| | 2013 £m | 2012 £m | 2013 £m | 2012 £m |
| Change in accruals and deferred income..... | (288) | (11) | (51) | (11) |
| Change in deposits by banks..... | 10,815 | (3,908) | 22,167 | (2,195) |
| Change in customer accounts..... | 57,890 | 27,986 | 54,445 | 18,687 |
| Change in debt securities in issue | (7,670) | (4,081) | (5,394) | (735) |
| Change in financial liabilities designated at fair value | 1,118 | 1,274 | (1,507) | 1,002 |
| Change in other liabilities | (830) | 2,627 | (2,165) | 2,281 |
| | 61,035 | 23,887 | 67,495 | 19,029 |

Notes on the Financial Statements (continued)

Cash and cash equivalents

| | The group | | The bank | |
|--|----------------|---------------|---------------|---------------|
| | 2013 £m | 2012 £m | 2013 £m | 2012 £m |
| Cash and balances at central banks | 67,584 | 51,613 | 60,996 | 45,262 |
| Items in the course of collection from other banks | 1,948 | 1,961 | 1,374 | 1,213 |
| Loans and advances to banks of one month or less | 39,228 | 42,859 | 25,512 | 30,132 |
| Treasury bills, other bills and certificates of deposit less than three months | 969 | 2,742 | 557 | 2,388 |
| Less: items in the course of transmission to other banks..... | (960) | (1,017) | (422) | (334) |
| Total cash and cash equivalents¹ | 108,769 | 98,158 | 88,017 | 78,661 |

¹ Total cash and cash equivalents include the following amounts that are not available for use by the group: Nil held by foreign subsidiaries and subject to foreign exchange control restrictions (2012: nil); and £3,543 million subject to other restrictions (2012: £2,356 million).

Total interest paid by the group during the year was £3,900 million (2012: £3,282 million). Total interest received by the group during the year was £10,767 million (2012: £12,565 million). Total dividends received by the group during the year were £454 million (2012: £293 million).

39 Contingent liabilities, contractual commitments and guarantees

| | The group | | The bank | |
|--|----------------|----------------|---------------|---------------|
| | 2013 £m | 2012 £m | 2013 £m | 2012 £m |
| Guarantees and other contingent liabilities | | | | |
| Guarantees | 15,529 | 14,829 | 11,606 | 11,066 |
| Other contingent liabilities | 40 | 55 | 39 | 54 |
| | 15,569 | 14,884 | 11,645 | 11,120 |
| Commitments¹ | | | | |
| Documentary credits and short-term trade-related transactions .. | 2,814 | 2,729 | 1,475 | 1,172 |
| Forward asset purchases and forward deposits placed | 18 | 19 | - | - |
| Undrawn formal standby facilities, credit lines and other commitments to lend ² | 120,185 | 112,977 | 78,942 | 76,468 |
| | 123,017 | 115,725 | 80,417 | 77,640 |

¹ Excluding capital commitments, which are separately disclosed below.

² Based on original contractual maturity.

The table above discloses the nominal principal amounts of commitments, guarantees and other contingent liabilities. They are mainly credit-related instruments which include both financial and non-financial guarantees and commitments to extend credit. Nominal principal amounts represent the amounts at risk should contracts be fully drawn upon and clients default. As a significant portion of guarantees and commitments is expected to expire without being drawn upon, the total of these nominal principal amounts is not representative of future liquidity requirements.

Contingent liabilities arising from litigation against the group are disclosed in Note 42.

Financial Services Compensation Scheme

The Financial Services Compensation Scheme ('FSCS') has provided compensation to consumers following the collapse of a number of deposit takers. The compensation paid out to consumers is currently funded through loans from the Bank of England and HM Treasury which at 31 December 2013 stood at approximately £17 billion.

In order to repay the loan principal which is not expected to be recovered, the FSCS confirmed in February 2013 that it would levy approximately £363 million in Scheme Year 2013/2014 and in the following two Scheme Years on participating financial institutions. In January 2014, the FSCS announced that the expected levy on participating financial institutions for Scheme Year 2014/2015 would be £399 million.

Notes on the Financial Statements (continued)

The bank could be liable to pay a further proportion of the outstanding borrowings that the FSCS has borrowed from HM Treasury.

The ultimate FSCS levy to the industry as a result of the collapses cannot currently be estimated reliably as it is dependent on various uncertain factors including the potential recoveries of assets by the FSCS and changes in the level of protected deposits and the population of FSCS members at the time.

Guarantees

The group provides guarantees and similar undertakings on behalf of both third party customers and other entities within the group. These guarantees are generally provided in the normal course of the group's banking business. The principal types of guarantees provided, and the maximum potential amount of future payments which the group could be required to make at 31 December, were as follows:

The group

| Guarantee type | At 31 December 2013 | | At 31 December 2012 | |
|--|---------------------------------------|---|---------------------------------------|---|
| | Guarantees in favour of third parties | Guarantees by the group in favour of other Group entities | Guarantees in favour of third parties | Guarantees by the group in favour of other Group entities |
| | £m | £m | £m | £m |
| Financial guarantee contracts ¹ | 7,944 | 875 | 7,549 | 1,032 |
| Credit-related substitutes ² | 2,929 | 98 | 2,850 | 229 |
| Other guarantees | 3,427 | 296 | 3,106 | 118 |
| Total | 14,300 | 1,269 | 13,505 | 1,379 |

The bank

| Guarantee type | At 31 December 2013 | | At 31 December 2012 | |
|--|---------------------------------------|---|---------------------------------------|---|
| | Guarantees in favour of third parties | Guarantees by the group in favour of other Group entities | Guarantees in favour of third parties | Guarantees by the group in favour of other Group entities |
| | £m | £m | £m | £m |
| Financial guarantee contracts ¹ | 6,231 | 1,804 | 5,776 | 1,975 |
| Credit-related substitutes ² | 1,139 | 192 | 1,077 | 490 |
| Other guarantees | 1,912 | 367 | 1,636 | 166 |
| Total | 9,282 | 2,363 | 8,489 | 2,631 |

¹ Financial guarantee contracts are contracts that require the issuer to make specified payments to reimburse the holder for a loss incurred because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument. The amounts in the above table are nominal principal amounts.

² Credit related guarantees are contracts that have similar features to financial guarantee contracts but fail to meet the strict definition of a financial guarantee contract under IAS 39.

The amounts disclosed in the above table reflect the group's maximum exposure under a large number of individual guarantee undertakings. The risks and exposures arising from guarantees are captured and managed in accordance with the group's overall credit risk management policies and procedures. Guarantees with terms of more than one year are subject to the group's annual credit review process.

Other commitments

In addition to the commitments disclosed above, at 31 December 2013 the group had capital commitments to purchase, within one year, land and buildings and other fixed assets from a number of suppliers for a value of £14 million (2012: £3 million).

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

Notes on the Financial Statements (continued)

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.

| | 2013 | | | 2012 | | |
|--|-------------------------------------|---------------------|------------------|-------------------------------------|---------------------|------------------|
| | Total future minimum payments | Interest charges | Present value | Total future Minimum payments | Interest charges | Present value |
| | £m | £m | £m | £m | £m | £m |
| No later than one year | 8 | (8) | – | 7 | (7) | – |
| Later than one year and no later than five years | 39 | (39) | – | 39 | (38) | 1 |
| Later than five years | 97 | (9) | 88 | 105 | (15) | 90 |
| Total | 144 | (56) | 88 | 151 | (60) | 91 |

At 31 December 2013 future minimum sublease payments of £144 million (2012: £151 million) were expected to be received under non-cancellable subleases at the balance sheet date.

Operating lease commitments

At 31 December 2013, 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 | |
|--|--------------------|-------|
| | 2013 | 2012 |
| | £m | £m |
| Future minimum lease payments under non-cancellable operating leases expiring | | |
| No later than one year | 164 | 158 |
| Later than one year and no later than five years | 588 | 537 |
| Later than five years | 892 | 927 |
| Total | 1,644 | 1,622 |

In 2013, £186 million (2012: £180 million) was charged to 'General and administrative expenses' in respect of lease and sublease agreements, all of which related to minimum lease payments.

Finance lease receivables

HSBC leases a variety of assets to third parties under finance leases, including transport assets (such as aircraft), property and general plant and machinery. At the end of lease terms, assets may be sold to third parties or leased for further terms. Lessees may participate in any sales proceeds achieved. Lease rentals arising during the lease terms will either be fixed in quantum or be varied to reflect changes in, for example, tax or interest rates. Rentals are calculated to recover the cost of assets less their residual value, and earn finance income.

| | 2013 | | | 2012 | | |
|--|-------------------------------------|---------------------|------------------|-------------------------------------|---------------------|------------------|
| | Total future minimum payments | Interest charges | Present value | Total future Minimum payments | Interest charges | Present value |
| | £m | £m | £m | £m | £m | £m |
| Lease receivables | | | | | | |
| No later than one year | 1,147 | (117) | 1,030 | 1,203 | (92) | 1,111 |
| Later than one year and no later than five years | 2,883 | (366) | 2,517 | 3,037 | (417) | 2,620 |
| Later than five years | 1,641 | (342) | 1,299 | 1,822 | (433) | 1,389 |
| Total | 5,671 | (825) | 4,846 | 6,062 | (942) | 5,120 |

At 31 December 2013, unguaranteed residual values of £124 million (2012: £106 million) had been accrued, and the accumulated allowance for uncollectible minimum lease payments receivable amounted to £7 million (2012: £12 million).

In 2013, £26 million (2012: £30 million) was received as contingent rents and recognised in the income statement.

Notes on the Financial Statements (continued)

Operating lease receivables

The group leases a variety of different assets to third parties under operating lease arrangements, including property, aircraft and general plant and machinery.

| | Equipment | |
|--|-----------|-----------|
| | 2013 | 2012 |
| | £m | £m |
| Future minimum lease payments under non-cancellable operating leases expiring | | |
| No later than one year | 12 | 14 |
| Later than one year and no later than five years | 25 | 40 |
| | 37 | 54 |

41 Structured entities

The group is involved with structured entities, mainly through securitisation of financial assets, conduits and investment funds.

The group also uses structured entities to mitigate the capital absorbed by some of the customer loans and advances it has originated, using synthetic securitisations by which the structured entity writes credit default swap protection to the group. The structured entity is funded by the issuance of notes with the cash held as collateral against the credit default protection. From a UK regulatory perspective, the credit protection issued by the structured entity in respect of the customer loans allows the risk weight of the loans to be replaced by the risk weight of the collateral in the structured entity and as a result mitigates the capital absorbed by the customer loans.

Group arrangements that involve structured entities are authorised centrally when they are established to ensure appropriate purpose and governance. The activities of structured entities administered by the group are closely monitored by senior management. The group has involvement with both consolidated and unconsolidated structured entities, which may be established by the group or by a third party, detailed below.

Consolidated structured entities

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

Total assets of the group's consolidated structured entities, split by entity type

| | Conduits £m | Securitisations £m | Group managed funds £m | Other £m | Total £m |
|---------------------------|----------------|-----------------------|---------------------------------|-------------|-------------|
| At 31 December 2013 | 23,324 | 1,253 | - | 5,826 | 30,403 |
| At 31 December 2012 | 23,248 | 979 | 1,218 | 4,616 | 30,061 |

Conduits

The group has established and manages two types of conduits: securities investment conduits ('SIC's) and multi-seller conduits. These entities have been designed so that voting or similar rights are not the dominant factor in deciding who has control; in such cases, the relevant activities are directed by means of contractual arrangement. The conduits are consolidated where the group is exposed or has the right to variable returns from its involvement with the entity and has the ability to affect its returns through its power over the entity.

Securities investment conduits

Solitaire, the group's principal SIC, purchases highly rated asset-backed securities ('ABS's) to facilitate tailored investment opportunities. At 31 December 2013, Solitaire held £5.4 billion of ABSs (2012: £6.0 billion). These are included within the disclosures of ABS 'held through consolidated structured entities' on pages 52 and 53. The group's other SICs, Mazarin, Barion and Malachite, evolved from the restructuring of group's established structured investment vehicles ('SIV's) in 2008.

Notes on the Financial Statements (continued)

- *Solitaire* – Solitaire is currently funded entirely by Commercial Paper ('CP') issued to the group. Although the group continues to provide a liquidity facility, Solitaire has no need to draw on it so long as the group purchases the CP issued, which it intends to do for the foreseeable future. At 31 December 2013 HSBC held £6.7 billion of CP (2012: £7.9 billion).

- *Mazarin* – the group is exposed to the par value of Mazarin's assets through the provision of a liquidity facility equal to the lesser of the amortised cost of issued senior debt and the amortised cost of non-defaulted assets. At 31 December 2013, this amounted to £4.5 billion (2012: £5.1 billion). First loss protection is provided through the capital notes issued by Mazarin, which are substantially all held by third parties.

At 31 December 2013, the group held 1.3% of Mazarin's capital notes (2012: 1.3%) which have a par value of £10 million (2012: £10 million) and a carrying amount of £0.2 million (2012: nil).

- *Barion and Malachite* – the group's primary exposure to these SICs is represented by the amortised cost of the debt required to support the non-cash assets of the vehicles. At 31 December 2013 this amounted to £3.8 billion (2012: £4.5 billion). First loss protection is provided through the capital notes issued by these vehicles, which are substantially all held by third parties.

At 31 December 2013, the group held 3.8% of the capital notes (2012: 3.8%) issued by these vehicles which have a par value of £22 million (2012: £22 million) and a carrying amount of £2 million (2012: £2 million).

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.

The group bears risk equal to the transaction-specific liquidity facilities offered to the multi-seller conduits. First loss protection is provided by the originator of the assets, and not by the group, through transaction-specific credit enhancements. A layer of secondary loss protection is provided by the group in the form of programme-wide enhancement facilities.

Securitisations

The group uses structured entities to securitise customer loans and advances that it has originated in order to diversify its sources of funding for asset origination and for capital efficiency purposes. The loans and advances are transferred by the group to the structured entities for cash, and the structured entities issue debt securities to investors to fund the cash purchases.

Group managed funds

The group has established a number of money market, and non-money market funds. Where the group is deemed to be acting as principal rather than agent in its role as investment manager, the group will control and hence consolidate these funds.

Other

The group also enters into a number of transactions in the normal course of business, including asset and structured finance transactions where it has control of the structured entity.

Unconsolidated structured entities

The term 'unconsolidated structured entities' refers to all structured entities that are not controlled by the group. It includes interests in structured entities that are not consolidated. The group enters into transactions with unconsolidated structured entities in the normal course of business to facilitate customer transactions and for specific investment opportunities.

The table below shows the total assets of unconsolidated structured entities in which the group has an interest at the reporting date, as well as the group's maximum exposure to loss in relation to those interests.

The total asset values for unconsolidated structured entities have been provided in the table below as an indication of their size.

The maximum exposure to loss from the group's interests in unconsolidated structured entities represents the maximum loss that the group could be required to report as a result of its involvement with unconsolidated structured entities regardless of the probability of the loss being incurred. They are contingent in nature, and may arise as a result of the provision of liquidity facilities and any other funding commitments provided by the group to unconsolidated structured entities.

Notes on the Financial Statements (continued)

- For commitments and guarantees, and written credit default swaps, the maximum exposure to loss is the notional amount of potential future losses.
- For retained and purchased investments in and loans to unconsolidated structured entities, the maximum exposure to loss is the carrying value of these interests at the balance sheet reporting date.

The maximum exposure to loss is stated gross of the effects of hedging and collateral arrangements entered into to mitigate the group's exposure to loss.

Nature and risks associated with the group's interests in unconsolidated structured entities

| | Group managed funds £m | Non-group managed funds £m | Other £m | Total £m |
|---|---------------------------------|-------------------------------------|--------------|---------------|
| At 31 December 2013 | | | | |
| Total assets | 13,674 | 1,005,343 | 10,036 | 1,029,053 |
| Group interest – assets | | | | |
| Cash | | | | |
| Trading assets | 44 | 149 | 985 | 1,178 |
| Financial assets designated at fair value | 1,151 | 3,055 | 3,972 | 8,178 |
| Derivatives | - | 23 | 714 | 737 |
| Loans and advances to customers | 60 | - | 253 | 313 |
| Financial investments | 74 | 302 | 80 | 456 |
| Other assets | 54 | 25 | - | 79 |
| Total assets in relation to the group's interests in the unconsolidated structured entities | <u>1,383</u> | <u>3,554</u> | <u>6,004</u> | <u>10,941</u> |
| Group interest – liabilities | | | | |
| Customer accounts | 78 | - | - | 78 |
| Total liabilities in relation to the group's interests in the unconsolidated structured entities | <u>78</u> | <u>-</u> | <u>-</u> | <u>78</u> |
| The group's maximum exposure | <u>1,383</u> | <u>3,554</u> | <u>6,004</u> | <u>10,941</u> |
| Total income from the group interests ¹ | 2 | 14 | 358 | 374 |

¹ Income includes recurring and non-recurring fees, interest, dividends, gains or loss on the remeasurement or derecognition of interests in structured entities, any mark-to-market gains/losses on a net basis and gains or losses from the transfer of assets and liabilities to the structured entity.

Group managed funds

The group has established and manages money market funds and non-money market investment funds to provide customers with investment opportunities. The group, as fund manager, may be entitled to receive a management and performance fee based on the assets under management.

Non-group managed funds

The group purchases and holds units of third party managed funds in order to facilitate both business and customer needs.

Other

The group has established structured entities in the normal course of business for example, structured credit transactions for customers, to provide finance to public and private sector infrastructure projects, and for asset and structured finance transactions.

Group sponsored structured entities

The definition of a sponsor is given in Note 2(n). In some cases, the group does not have an interest in these entities at the reporting date. The amount of assets transferred to and income received from such sponsored entities during 2013 is not significant.

Notes on the Financial Statements (continued)

42 Legal proceedings and regulatory matters

The group is party to legal proceedings and regulatory matters in a number of jurisdictions arising out of its normal business operations. The recognition of provisions is determined in accordance with the accounting policies set out in Note 2(v). Apart from the matters described below, the group considers that none of these matters are material, either individually or in the aggregate. Where an individual provision is material, the fact that a provision has been made is stated and quantified. Any provision recognised does not constitute an admission of wrongdoing or legal liability. While the outcome of these matters is inherently uncertain, management believes that, based on the information available to it, appropriate provisions have been made in respect of legal proceedings as at 31 December 2013 (See Note 29). It is not practicable to provide an aggregate estimate of potential liability for our legal proceedings and regulatory matters as a class of contingent liabilities.

Bernard L. Madoff Investment Securities LLC

In December 2008, Bernard L. Madoff ('Madoff') was arrested for running a Ponzi scheme and a trustee was appointed for the liquidation of his firm, Bernard L. Madoff Investment Securities LLC ('Madoff Securities'), an SEC-registered broker-dealer and investment adviser. Madoff was sentenced in 2009.

Various non-US HSBC companies provided custodial, administration and similar services to a number of funds incorporated outside the US whose assets were invested with Madoff Securities. Based on information provided by Madoff Securities, as at 30 November 2008, the purported aggregate value of these funds was US\$8.4 billion, an amount that includes fictitious profits reported by Madoff. Based on information available to HSBC to date, the Group estimate that the funds' actual transfers to Madoff Securities minus their actual withdrawals from Madoff Securities during the time that HSBC serviced the funds totalled approximately US\$4 billion.

Plaintiffs (including funds, fund investors, and the Madoff Securities trustee) have commenced Madoff-related proceedings against numerous defendants in a multitude of jurisdictions. Various HSBC companies have been named as defendants in suits in the US, Ireland, Luxembourg, and other jurisdictions. Certain suits (which include US putative class actions) allege that the HSBC defendants knew or should have known of Madoff's fraud and breached various duties to the funds and fund investors.

In December 2011, claims against HSBC and other defendants by fund investors in three related putative class actions pending in the US District Court for the Southern District of New York were dismissed on grounds of *forum non conveniens*. In September 2013, the US Court of Appeals for the Second Circuit affirmed the dismissal of the claims. The plaintiffs have requested a rehearing of their appeal, and that request remains pending.

In July and December 2013, settlements were reached in respect of the claim by Thema International Fund plc and AA (Alternative Advantage) Plc respectively against HSBC Institutional Trust Services (Ireland) Limited in the Irish High Court.

The Madoff Securities Trustee has commenced suits against various HSBC companies in the US Bankruptcy Court and in the English High Court. The US action (which also names certain funds, investment managers, and other entities and individuals) sought US\$9 billion in damages and additional recoveries from HSBC and the various co-defendants and alleged that HSBC aided and abetted Madoff's fraud and breach of fiduciary duty. In July 2011, the US District Court for the Southern District of New York dismissed the trustee's various common law claims on the grounds that the trustee lacks standing to assert them and that dismissal was affirmed in a decision issued by the Second Circuit in June 2013. On 9 October 2013, the Trustee filed a petition for *writ of certiorari* to review the Second Circuit's decision with the US Supreme Court. The HSBC defendants filed their response to the petition for writ of certiorari on 16 December 2013. The Supreme Court has issued an order inviting the US Solicitor General to file a brief in the case expressing the views of the US government on the petition. The Trustee's remaining US claims seek, pursuant to US bankruptcy law, recovery of unspecified amounts received by HSBC from funds invested with Madoff, including amounts that HSBC received when it redeemed units HSBC held in the various funds in connection with financing transactions HSBC had entered into with various clients, as well as fees earned by HSBC for providing custodial, administration and similar services to the funds. These claims remain pending.

The trustee's English action seeks recovery of unspecified transfers of money from Madoff Securities to or through HSBC, on the ground that the HSBC defendants actually or constructively knew of Madoff's fraud. HSBC has not been served with the trustee's English action.

Between October 2009 and April 2012, Fairfield Sentry Limited, Fairfield Sigma Limited, and Fairfield Lambda Limited ('Fairfield'), funds whose assets were directly or indirectly invested with Madoff Securities, commenced multiple suits in the British Virgin Islands ('BVI') and the US against numerous fund shareholders, including various

Notes on the Financial Statements (continued)

HSBC companies that acted as nominees for clients of HSBC's private banking business and other clients who invested in the Fairfield funds. The Fairfield actions seek restitution of amounts paid to the defendants in connection with share redemptions, on the ground that such payments were made by mistake, based on inflated values resulting from Madoff's fraud, and some actions also seek recovery of the share redemptions under BVI insolvency law. The actions in the US are currently stayed in the Bankruptcy Court pending developments in related appellate litigation in the BVI.

There are many factors which may affect the range of possible outcomes, and the resulting financial impact, of the various Madoff-related proceedings, including but not limited to the circumstances of the fraud, the multiple jurisdictions in which the proceedings have been brought and the number of different plaintiffs and defendants in such proceedings. For these reasons, among others, it is not practicable at this time for HSBC to estimate reliably the aggregate liabilities, or ranges of liabilities, that might arise as a result of all such claims but they could be significant. In any event, HSBC considers that it has good defences to the claims made against it and will continue to defend them vigorously.

Anti-money laundering and sanctions-related investigations

In December 2012, HSBC Holdings plc ('HSBC Holdings'), the bank's ultimate parent company, HSBC Bank USA, N.A. ('HBUS'), and HSBC North America Holdings ('HNAH') entered into agreements with US and UK government agencies regarding past inadequate compliance with anti-money laundering ('AML'), US Bank Secrecy Act ('BSA') and sanctions laws. Among those agreements, HSBC Holdings and HBUS entered into a five-year Deferred Prosecution Agreement (the 'US DPA') with the US Department of Justice ('DOJ'), HSBC Holdings entered into a two-year Deferred Prosecution Agreement with the New York County District Attorney ('DANY'), and HSBC Holdings consented to a cease and desist order with the Federal Reserve Board ('FRB'). HSBC Holdings also entered into an Undertaking with the UK Financial Services Authority (now a Financial Conduct Authority ('FCA') Direction) to comply with certain forward-looking obligations with respect to anti-money laundering and sanctions requirements over a five-year term.

In addition, HBUS entered into a monetary penalty consent order with the US Department of the Treasury's Financial Crimes Enforcement Network ('FinCEN') and a separate monetary penalty order with the Office of the Comptroller of the Currency ('OCC'). HBUS also entered into a separate consent order with the OCC requiring it to correct the circumstances and conditions as noted in the OCC's then most recent report of examination, imposing certain restrictions on HBUS directly or indirectly acquiring control of, or holding an interest in, any new financial subsidiary, or commencing a new activity in its existing financial subsidiary, unless it receives prior approval from the OCC. HBUS entered into a separate consent order with the OCC requiring it to adopt an enterprise-wide compliance program.

Under these agreements, HSBC Holdings and HBUS will continue to cooperate fully with US and UK regulatory and law enforcement authorities and take further action to strengthen their compliance policies and procedures. Under the agreements with the DOJ, the FCA, and the FRB, an independent corporate compliance monitor will evaluate the HSBC Group's progress in implementing its obligations under the relevant agreements. Michael Cherkasky began work as the independent monitor on 1 July 2013.

If HSBC Holdings and HSBC Bank USA fulfil all of the requirements imposed by the US DPA, the DOJ's charges against those entities will be dismissed at the end of the five-year period of that agreement. Similarly, if HSBC Holdings fulfils all of the requirements imposed by the DANY DPA, DANY's charges against it will be dismissed at the end of the two-year period of that agreement. The DOJ may prosecute HSBC Holdings or HSBC Bank USA in relation to the matters which are the subject of the US DPA if HSBC Holdings or HSBC Bank USA breaches the terms of the US DPA, and DANY may prosecute HSBC Holdings in relation to the matters which are subject of the DANY DPA if HSBC Holdings violates the terms of the DANY DPA.

Under these agreements, HSBC Holdings has certain obligations to ensure that entities in the HSBC Group, including the bank and its subsidiaries, comply with certain requirements. Steps continue to be taken to implement ongoing obligations under the US DPA, FCA direction, and other settlement agreements. The settlement with US and UK authorities does not preclude private litigation relating to, among other things, the HSBC Group's compliance with applicable AML/BSA and sanctions laws or other regulatory or law enforcement actions for AML/BSA or sanctions matters not covered by the various agreements.

Notes on the Financial Statements (continued)

London interbank offered rates, European interbank offered rates and other benchmark interest and foreign exchange rate investigations and litigation

Various regulators and competition and enforcement authorities around the world including in the UK, the US, the EU, Switzerland, Hong Kong, Thailand, South Korea and elsewhere, are conducting investigations and reviews related to certain past submissions made by panel banks and the processes for making submissions in connection with the setting of London interbank offered rates ('Libor'), European interbank offered rates ('Euribor') and other benchmark interest and foreign exchange rates. As certain HSBC companies are members of such panels, HSBC and/or its subsidiaries have been the subject of regulatory demands for information and are cooperating with those investigations and reviews.

On 4 December 2013, the European Commission ('Commission') announced that it had imposed fines on eight financial institutions under its cartel settlement procedure for their participation in illegal activity related to Euro interest rate derivatives and/or Yen interest rate derivatives. Although HSBC was not one of the financial institutions fined, the Commission announced that it had opened proceedings against HSBC in connection with its Euribor-related investigation of Euro interest rate derivatives only. This investigation will continue under the standard Commission cartel procedure.

On 3 January 2014, the Canadian Competition Bureau ('CCB') notified HSBC that it was discontinuing its investigation into alleged collusive conduct in the setting of Japanese Yen Libor on the basis that the evidence collected was insufficient to justify prosecution under applicable law.

As for on-going regulatory investigations, reviews and proceedings, based on the facts currently known in respect of each of these, there is a high degree of uncertainty as to the terms on which the on-going investigations, reviews or proceedings will be resolved and the timing of such resolutions, including the amounts of fines and/or penalties. As matters progress, it is possible that fines and penalties could be significant.

The Financial Conduct Authority is also conducting investigations alongside several other law enforcement agencies and regulatory agencies in various countries into a number of firms, including HSBC, related to trading on the foreign exchange market. We are cooperating with the investigations which are ongoing. It is not practicable at this stage for HSBC to estimate reliably any possible liability that might arise.

In addition, HSBC and other panel banks have been named as defendants in a number of private lawsuits filed in the US with respect to the setting of US dollar Libor. These lawsuits include individual and putative class actions, most of which have been transferred and/or consolidated for pre-trial purposes before the US District Court for the Southern District of New York. The complaints in those actions assert claims against HSBC and other US dollar Libor panel banks under various US laws including US antitrust and racketeering laws, the US Commodity Exchange Act ('CEA'), and state law.

In March 2013, the US District Court Judge overseeing the consolidated proceeding that encompasses a number of pending actions related to US dollar Libor issued an opinion and order in the six oldest actions, dismissing the plaintiffs' federal and state antitrust claims, racketeering claims and unjust enrichment claims in their entirety, but allowing certain of their CEA claims that were not barred by the applicable statute of limitations to proceed. Some of those plaintiffs have appealed the dismissal opinion and order to the US Court of Appeals for the Second Circuit. The Court of Appeals has dismissed those appeals on the grounds that they are premature and plaintiffs' subsequent motion for reconsideration was denied. Other plaintiffs have filed amended complaints in the District Court to assert additional allegations, and the defendants have filed motions to dismiss the amended complaints. The District Court held oral argument on the motions to dismiss in February 2014, and it has stayed proceedings with respect to all other actions in the consolidated proceeding pending its decision on the motions to dismiss.

Separately, HSBC and other panel banks have also been named as defendants in a putative class action filed in the US on behalf of persons and entities who transacted in euroyen futures and options contracts related to the euroyen Tokyo interbank offered rate ('Tibor'). The complaint alleges, amongst other things, misconduct related to euroyen Tibor, although HSBC is not a member of the Japanese Bankers Association's Euroyen TIBOR panel, as well as Japanese Yen Libor, in violation of US antitrust laws, the US CEA, and state law. In April 2013, the plaintiff filed a second amended complaint, which the defendants moved to dismiss in June 2013. Oral argument on the motion to dismiss is scheduled for March 2014.

In November 2013, HSBC and other panel banks were also named as defendants in a putative class action filed in the US on behalf of persons who transacted in futures contracts and other financial instruments related to Euribor. The complaint alleges, amongst other things, misconduct related to Euribor in violation of US antitrust laws, the US CEA, and state law. HSBC has not yet responded to the complaint and an amended complaint is expected by the end of March 2014. HSBC expects to file a motion to dismiss thereafter.

Notes on the Financial Statements (continued)

In late 2013 and early 2014, HSBC and a number of other banks were named as defendants in various putative class actions filed in the US on behalf of persons who executed foreign currency trades that settled on the basis of foreign exchange rates published by WM/Reuters or that otherwise occurred during the time periods when the WM/Reuters rates were being set. The complaints allege, amongst other things, that the defendants conspired to manipulate the WM/Reuters foreign exchange rates in violation of US antitrust laws. In February 2014, the US District Court Judge appointed interim lead class counsel and ordered the plaintiffs to file a consolidated amended complaint. HSBC has not yet responded, but intends to do so at the appropriate time set by the court.

Based on the facts currently known, it is not practicable at this time for HSBC to predict the resolution of these private lawsuits, including the timing and potential impact on HSBC.

Credit default swap regulatory investigation and litigation

In July 2013, HSBC received a Statement of Objections from the European Commission relating to its on-going investigation of alleged anti-competitive activity by a number of market participants in the credit derivative market between 2006 and 2009. The Statement of Objections sets out the European Commission's preliminary views and does not prejudice the final outcome of its investigation. HSBC has submitted a response to the European Commission. Based on the facts currently known, it is not practicable at this time for HSBC to predict the resolution of the European Commission's investigation, including the timing or impact on HSBC.

Various HSBC entities including HSBC Bank plc have been named as defendants, among others, in numerous putative class actions filed in federal courts located in New York and Chicago. These class actions allege that the defendants, which include ISDA, Markit and several financial institutions, conspired to restrain trade in violation of the federal anti-trust laws by, among other things, restricting access to credit default swap pricing exchanges and blocking new entrants into the exchange market, with the purpose and effect of artificially inflating the bid/ask spread paid to buy and sell credit default swaps in the United States. The plaintiffs in these suits purport to represent a class of all persons who purchased credit default swaps from or sold credit default swaps to defendants primarily in the United States. On 16 October 2013, the Judicial Panel on Multi-district Litigation ordered that all cases be consolidated in the Southern District of New York as *In re Credit Default Swaps Antitrust Litigation*, MDL No. 2476. On 5 December 2013, the District Court held its Initial Pretrial Conference, at which time it selected Lead Interim Class Counsel and set a schedule for the filing of an amended, consolidated complaint and motions to dismiss that complaint. The amended, consolidated complaint was filed on 31 January 2014. Based on the facts currently known, it is not practicable at this time for HSBC to predict the resolution of these lawsuits, including the timing and potential impact on HSBC.

43 Related party transactions

The ultimate parent company of the group is HSBC Holdings plc, which is incorporated in England.

Copies of the Group financial statements may be obtained from the following address:

HSBC Holdings plc
8 Canada Square
London
E14 5HQ

The group's related parties include the parent, fellow subsidiaries, associates, joint ventures, post-employment benefit plans for HSBC employees, Key Management Personnel, close family members of Key Management Personnel and entities which are controlled or jointly controlled or significantly influenced by Key Management Personnel or their close family members.

Notes on the Financial Statements (continued)

(a) Transactions with Directors and other Key Management Personnel

Key Management Personnel are defined as those persons having authority and responsibility for planning, directing and controlling the activities of HSBC Bank plc and the group and includes members of the Boards of Directors of HSBC Bank plc and HSBC Holdings plc and Group Managing Directors of HSBC Holdings plc.

Compensation of Key Management Personnel

The following represents the compensation paid to the Key Management Personnel of the bank in exchange for services rendered to the bank.

| | 2013 | 2012 |
|------------------------------------|--------------|--------------|
| | £000 | £000 |
| Short-term employee benefits | 3,284 | 4,181 |
| Post-employment benefits | 159 | 238 |
| Other long-term benefits | 341 | 727 |
| Share-based payments | 1,709 | 2,993 |
| | 5,493 | 8,139 |

Shareholdings and options of Directors and other Key Management Personnel

| | Balance at 31 December 2013 | Balance at 31 December 2012 |
|--|--------------------------------|--------------------------------|
| Number of options over HSBC Holdings plc ordinary shares held by Directors and other key management personnel under employee share plans | 224,916 | 357,509 |
| Number of HSBC Holdings plc shares held by Directors and other key management personnel beneficially | 14,999,933 | 14,875,312 |

Transactions, arrangements and agreements including Directors and other Key Management Personnel

The table below sets out transactions which fall to be disclosed under IAS 24 'Related Party Disclosures' between the group and Key Management Personnel.

| | 2013 | | 2012 | |
|---|---|--|---|--|
| | Highest balance during the year ¹ | Balance at 31 December ¹ | Highest balance during the year ¹ | Balance at 31 December ¹ |
| | £000 | £000 | £000 | £000 |
| Key Management Personnel² | | | | |
| Loans | 109,567 | 89,354 | 253,742 | 160,439 |
| Credit cards | 662 | 269 | 762 | 293 |
| Guarantees | 4,911 | – | 25,770 | 20,031 |

- ¹ The disclosure of the year-end balance and the highest balance during the year is considered the most meaningful information to represent transactions during the year.
- ² Includes the Key Management Personnel of both the bank and its parent company, HSBC Holdings plc, close family members of Key Management Personnel, and entities which are controlled or jointly controlled by Key Management Personnel or their close family members.

The above transactions were made in the ordinary course of business and on substantially the same terms, including interest rates and security, as for comparable transactions with persons of a similar standing or, where applicable, with other employees. The transactions did not involve more than the normal risk of repayment or present other unfavourable features.

Transactions with Directors: Advances, Credits and Guarantees (Companies Act 2006)

In addition to the requirements of IAS 24, particulars of advances (loans and quasi-loans), credits and guarantees entered into by HSBC Bank plc and its subsidiaries with Directors of HSBC Bank plc are required to be disclosed pursuant to section 413 of the Companies Act 2006. Under the Companies Act there is no requirement to disclose transactions with the Key Management Personnel of the bank's parent company, HSBC Holdings plc.

The table below sets out transactions which fall to be disclosed under section 413 of Companies Act 2006.

Notes on the Financial Statements (continued)

The group

| | Balance at 31 December 2013 | Balance at 31 December 2012 |
|--------------------|--------------------------------|--------------------------------|
| | £000 | £000 |
| Directors | | |
| Loans | 3,493 | 4,530 |
| Credit cards | 57 | 77 |

No guarantees were issued in favour of Directors during 2013 (2012: nil).

(b) Transactions with other related parties

Associates and joint ventures

The group

| | 2013 | | 2012 | |
|--|---|--|---|--|
| | Highest balance during the year ¹ | Balance at 31 December ¹ | Highest balance during the year ¹ | Balance at 31 December ¹ |
| | £m | £m | £m | £m |
| Amounts due from joint ventures – unsubordinated | 182 | 182 | 204 | 130 |
| Amounts due from associates – unsubordinated | – | – | 25 | – |
| Amounts due to joint ventures | 4 | 4 | 2 | – |
| Amounts due to associates | – | – | 1 | – |

¹ The disclosure of the year-end balance and the highest balance during the year is considered the most meaningful information to represent transactions during the year.

The bank

| | 2013 | | 2012 | |
|--|---|--|---|--|
| | Highest balance during the year ¹ | Balance at 31 December ¹ | Highest balance during the year ¹ | Balance at 31 December ¹ |
| | £m | £m | £m | £m |
| Amounts due from joint ventures – unsubordinated | 182 | 182 | 204 | 130 |
| Amounts due from associates – unsubordinated | – | – | 25 | – |
| Amounts due to joint ventures | 4 | 4 | 1 | – |
| Amounts due to associates | – | – | 1 | – |

¹ The disclosure of the year-end balance and the highest balance during the year is considered the most meaningful information to represent transactions during the year.

The above outstanding balances arose from the ordinary course of business and on substantially the same terms, including interest rates and security, as for comparable transactions with third party counterparties.

Transactions of the group with HSBC Holdings plc and fellow subsidiaries of HSBC Holdings plc

Transactions detailed below include amounts due to/from HSBC Holdings plc.

| | 2013 | | 2012 | |
|---|---|--|---|--|
| | Highest balance during the year ¹ | Balance at 31 December ¹ | Highest balance during the year ¹ | Balance at 31 December ¹ |
| | £m | £m | £m | £m |
| Assets | | | | |
| Trading assets | 1,982 | 1,574 | 1,884 | 1,884 |
| Financial assets designated at fair value | 23 | 22 | 30 | 21 |
| Loans and advances to customers | 4,580 | 3,582 | 5,014 | 4,580 |
| Financial investments | 103 | 100 | 33 | 33 |
| Liabilities | | | | |
| Trading liabilities | 2 | – | 16 | – |
| Deposits by banks | – | – | 1 | – |
| Customer accounts | 10,033 | 10,033 | 8,211 | 6,181 |
| Subordinated amounts due | 5,827 | 5,827 | 5,283 | 5,099 |
| Guarantees | – | – | – | – |

Notes on the Financial Statements (continued)

| | 2013 | 2012 |
|---|------|------|
| | £m | £m |
| Income Statement | | |
| Interest income | 71 | 13 |
| Interest expense | 177 | 177 |
| Fee income | 1 | 1 |
| Dividend income | 1 | 1 |
| Trading income | 10 | 19 |
| Other operating income | 20 | 14 |
| General and administrative expenses | 76 | 82 |

1 The disclosure of the year-end balance and the highest balance during the year is considered the most meaningful information to represent transactions during the year.

Transactions detailed below include amounts due to/from fellow subsidiaries of HSBC Holdings plc

| | 2013 | | 2012 | |
|--|---|--|---|--|
| | Highest balance during the year ¹ £m | Balance at 31 December ¹ £m | Highest balance during the year ¹ £m | Balance at 31 December ¹ £m |
| Assets | | | | |
| Trading assets | 9,765 | 1,801 | 11,199 | 6,065 |
| Derivatives | 21,175 | 15,698 | 23,522 | 19,912 |
| Financial assets designated at fair value | 62 | 18 | 15 | 12 |
| Loans and advances to banks | 10,542 | 9,301 | 8,851 | 5,312 |
| Loans and advances to customers | 4,161 | 3,969 | 2,398 | 1,506 |
| Financial investments | 270 | 114 | 7,253 | 150 |
| Liabilities | | | | |
| Trading liabilities | 20,165 | 7,163 | 16,720 | 12,696 |
| Financial liabilities designated at fair value | – | – | 32 | – |
| Deposits by banks | 15,225 | 9,230 | 13,429 | 11,997 |
| Customer accounts | 9,017 | 6,878 | 1,605 | 1,605 |
| Derivatives | 19,664 | 15,745 | 22,547 | 19,089 |
| Subordinated amount due..... | 2,220 | 1,826 | 2,099 | 2,099 |
| Guarantees | 2,016 | 889 | 1,134 | 1,033 |

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.

| | 2013 | 2012 |
|---|------|------|
| | £m | £m |
| Income Statement | | |
| Interest income | 24 | 128 |
| Interest expense | 137 | 131 |
| Fee income | 102 | 123 |
| Fee expense | 296 | 223 |
| Trading income | 82 | 64 |
| Other operating income | 70 | 93 |
| General and administrative expenses | 273 | 360 |

The above outstanding balances arose from the ordinary course of business and on substantially the same terms, including interest rates and security, as for comparable transactions with third party counterparties.

Notes on the Financial Statements (continued)

Transactions between HSBC Bank plc and its subsidiaries, HSBC Holdings plc and fellow subsidiaries of HSBC Holdings plc

Transactions detailed below include amounts due to/from HSBC Bank plc and its subsidiaries.

| | 2013 | | 2012 | |
|---|--|---|--|---|
| | Highest balance during the year ¹ £m | Balance at 31 December ¹ £m | Highest balance during the year ¹ £m | Balance at 31 December ¹ £m |
| Assets | | | | |
| Trading assets | 27,817 | 7,677 | 25,146 | 15,184 |
| Derivatives | 18,734 | 12,971 | 23,803 | 18,732 |
| Financial assets designated at fair value | – | – | – | – |
| Loans and advances to banks | 14,010 | 11,928 | 6,437 | 2,005 |
| Loans and advances to customers | 18,880 | 11,495 | 21,253 | 18,630 |
| Financial investments | 9,069 | 8,895 | 2,522 | 2,087 |
| Liabilities | | | | |
| Trading liabilities | 21,397 | 2,928 | 20,376 | 12,028 |
| Deposits by banks | 16,573 | 11,877 | 11,815 | 11,026 |
| Customer accounts | 3,573 | 3,573 | 6,887 | 3,002 |
| Derivatives | 16,476 | 12,415 | 19,944 | 15,783 |
| Subordinated amounts due | 2,928 | 2,283 | 3,088 | 2,781 |
| Guarantees | 1,795 | 957 | 1,271 | 1,191 |

¹ The disclosure of the year-end balance and the highest balance during the year is considered the most meaningful information to represent transactions during the year.

Transactions detailed below include amounts due to/from HSBC Bank plc and HSBC Holdings plc.

| | 2013 | | 2012 | |
|---------------------------------------|--|---|--|---|
| | Highest balance during the year ¹ £m | Balance at 31 December ¹ £m | Highest balance during the year ¹ £m | Balance at 31 December ¹ £m |
| Assets | | | | |
| Trading assets | 1,884 | 1,220 | 1,884 | 1,884 |
| Loans and advances to customers | 4,579 | 3,581 | 5,013 | 4,579 |
| Liabilities | | | | |
| Trading liabilities | 2 | – | 16 | – |
| Customer accounts | 10,011 | 10,011 | 7,654 | 6,167 |
| Subordinated amounts due | 5,567 | 5,567 | 5,011 | 4,835 |
| Guarantees | – | – | – | – |

¹ The disclosure of the year-end balance and the highest balance during the year is considered the most meaningful information to represent transactions during the year.

In December 2010, the bank received two guarantees from HSBC Holdings plc in respect of monies owing to the bank by its structured investment conduits ('SICs'). The first guarantee covers due but unpaid monies owed by the bank's principal SIC, Solitaire, up to a maximum amount of US\$16 billion, to the extent that unpaid liabilities exceed US\$1 billion. A second guarantee covers due but unpaid monies owed by the bank's other SICs, Mazarin, Barion and Malachite, up to a maximum amount of US\$22 billion, to the extent that unpaid liabilities exceed US\$200 million. In December 2012, the bank received a third guarantee from HSBC Holdings plc that covers due but unpaid monies owed to the bank by its multi-seller conduit, Regency, up to a maximum amount of US\$17 billion, to the extent that unpaid liabilities exceed US\$2 billion.

The bank pays no fee to its parent company for the provision of these guarantees.

Notes on the Financial Statements (continued)

Transactions detailed below include amounts due to/from HSBC Bank plc and fellow subsidiaries of HSBC

| | 2013 | | 2012 | |
|---------------------------------------|--|---|--|---|
| | Highest balance during the year ¹ £m | Balance at 31 December ¹ £m | Highest balance during the year ¹ £m | Balance at 31 December ¹ £m |
| Assets | | | | |
| Trading assets | 9,594 | 1,734 | 11,018 | 5,744 |
| Derivatives | 37,701 | 27,618 | 20,728 | 17,808 |
| Loans and advances to banks | 6,533 | 5,897 | 5,075 | 4,231 |
| Loans and advances to customers | 3,943 | 3,787 | 2,211 | 1,463 |
| Liabilities | | | | |
| Trading liabilities | 19,997 | 7,117 | 16,499 | 12,441 |
| Deposits by banks | 8,624 | 6,219 | 6,537 | 6,537 |
| Customer accounts | 8,893 | 6,755 | 1,547 | 1,547 |
| Derivatives | 36,465 | 30,027 | 25,330 | 16,236 |
| Subordinated amount due..... | 297 | – | 292 | 278 |
| Guarantees | 1,877 | 752 | 988 | 865 |

1 The disclosure of the year-end balance and the highest balance during the year is considered the most meaningful information to represent transactions during the year.

The above outstanding balances arose from the ordinary course of business and on substantially the same terms, including interest rates and security, as for comparable transactions with third party counterparties.

Pension funds

At 31 December 2013, fees of £9 million (2012: £8 million) were earned by group companies for management services related to the group's pension funds held under management. The group's pension funds had placed deposits of £347 million (2012: £148 million) with its banking subsidiaries.

The above outstanding balances arose from the ordinary course of business and on substantially the same terms, including interest rates and security, as for comparable transactions with third party counterparties.

The HSBC Bank (UK) Pension Scheme (the 'Scheme') entered into swap transactions with the bank to manage the inflation and interest rate sensitivity of the liabilities. At 31 December 2013, the gross notional value of the swaps was £26,144 million (2012: £18,998 million), the swaps had a negative fair value of £1,710 million to the bank (2012: negative fair value of £3,233 million) and the bank had delivered collateral of £2,348 million (2012: £4,423 million) to the Scheme in respect of these swaps. All swaps were executed at prevailing market rates and within standard market bid/offer spreads. Previously there were special collateral provisions for the swap transactions between the bank and the Scheme. Those provisions stipulated that the scheme never posted collateral to the bank, although the bank posted collateral to the scheme. From December 2013, the swap transactions between the bank and the Scheme are now on substantially the same terms as for comparable transactions with third party counterparties, including the two-way posting of collateral.

Acquisition of HSBC Private Bank (C.I.) Limited

In November 2013, the group acquired HSBC Private Bank (C.I.) Limited, by way of an inter-group transfer from HSBC Private Banking Holdings (Suisse) SA, for £402 million. The acquisition was completed on 29 November 2013.

Sale of Legend Estates Limited

In November 2013, the group sold Legend Estates Limited, by way of an inter-group transfer to HSBC Investment Bank Holdings plc, for £4 million. The sale was completed on 29 November 2013.

Sale of HSBC Private Banking Holdings (Suisse) SA

In November 2012, the group sold HSBC Private Banking Holdings (Suisse) SA, by way of an inter-group transfer to HSBC Holdings plc, for non-cash consideration of £6,535 million. The sale was completed on 16 November 2012. The ownership of HSBC Private Bank (UK) Limited remains with HSBC Bank plc.

44 Events after the balance sheet date

A second interim dividend for 2013 of £630 million to shareholders of the parent company was declared by the Directors after 31 December 2013.

HSBC Bank plc

Incorporated in England with limited liability. Registered in England: number 14259

REGISTERED OFFICE

8 Canada Square, London E14 5HQ, United Kingdom

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