HSBC BANK BERMUDA LIMITED
Consolidated Financial Statements

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HSBC BANK BERMUDA LIMITED

Consolidated Financial Statements

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Independent Auditor's Report

To the Board of Directors and Shareholder of HSBC Bank Bermuda Limited

Our opinion

In our opinion, the consolidated financial statements present fairly, in all material respects, the consolidated financial position of HSBC Bank Bermuda Limited (the Company) and its subsidiaries (together 'the Group') as at 31 December 2017, and their consolidated financial performance and their consolidated cash flows for the year then ended in accordance with International Financial Reporting Standards.

What we have audited

The Group's consolidated financial statements comprise:

- the consolidated income statement for the year ended 31 December 2017;
- the consolidated statement of comprehensive income for the year ended 31 December 2017;
- the consolidated balance sheet as at 31 December 2017;
- the consolidated statement of cash flows for the year ended 31 December 2017;
- the consolidated statement of changes in equity for the year ended 31 December 2017; and
- the notes to the consolidated financial statements, which include a summary of significant accounting policies.

Basis for opinion

We conducted our audit in accordance with International Standards on Auditing (ISAs). Our responsibilities under those standards are further described in the *Auditor's responsibilities for the audit of the consolidated financial statements* section of our report.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Independence

We are independent of the Group in accordance with the International Ethics Standards Board for Accountants' Code of Ethics for Professional Accountants (IESBA Code) and the ethical requirements of the Chartered Professional Accountants of Bermuda Rules of Professional Conduct (CPA Bermuda Rules) that are relevant to our audit of the consolidated financial statements in Bermuda. We have fulfilled our other ethical responsibilities in accordance with the IESBA Code and the ethical requirements of the CPA Bermuda Rules.

Responsibilities of Management and Those Charged with Governance for the Consolidated Financial Statements

Management is responsible for the preparation and fair presentation of the consolidated financial statements in accordance with International Financial Reporting Standards, and for such internal control as management determines is necessary to enable the preparation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the consolidated financial statements, management is responsible for assessing the Group's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless management either intends to liquidate the Group or to cease operations, or has no realistic alternative but to do so.

Those charged with governance are responsible for overseeing the Group's financial reporting process.

Auditor's responsibilities for the audit of the consolidated financial statements

Our objectives are to obtain reasonable assurance about whether the consolidated financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISAs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these consolidated financial statements.

As part of an audit in accordance with ISAs, we exercise professional judgment and maintain professional scepticism throughout the audit. We also:

- Identify and assess the risks of material misstatement of the consolidated financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.

- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Group's internal control.
- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.
- Conclude on the appropriateness of management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Group's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the consolidated financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the Group to cease to continue as a going concern.
- Evaluate the overall presentation, structure and content of the consolidated financial statements, including the disclosures, and whether the consolidated financial statements represent the underlying transactions and events in a manner that achieves fair presentation.
- Obtain sufficient appropriate audit evidence regarding the financial information of the entities or business activities within the Group to express an opinion on the consolidated financial statements. We are responsible for the direction, supervision and performance of the Group audit. We remain solely responsible for our audit opinion.

We communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

PricewaterhouseCoopers Ltd.

Chartered Professional Accountants

16 Church Street
Hamilton, Bermuda

1 March 2018

Consolidated Income Statement
for the year ended 31 December 2017

	Notes	2017 US$000	2016 US$000
Interest income		198,671	192,822
Interest expense		(4,298)	(3,456)
Net interest income	3	194,373	189,366
Fee income		74,904	79,910
Fee expense		(24,236)	(23,347)
Net fee income	3	50,668	56,563
Dealing profits		28,140	25,768
Gains less losses from financial investments	10	28,027	8,564
Dividend income		676	650
Total operating income before loan impairment charges		301,884	280,911
Loan impairment charges	9	(639)	(19,314)
Net operating income		301,245	261,597
Employee compensation and benefits	4,5	(33,104)	(88,782)
General and administrative expenses		(98,819)	(45,352)
Depreciation and impairment of property and equipment	12	(7,041)	(31,403)
Total operating expenses		(138,964)	(165,537)
Operating profit		162,281	96,060
Profit on restructuring and disposal of subsidiary investments	15	-	20,342
Share of profit in associates	13	35	118
Profit before tax		162,316	116,520
Tax expense	6	-	-
Profit for the year		162,316	116,520
Deduct Profit from discontinued operations (net of income tax)	15	-	22,837
Profit for the year from continuing operations		162,316	93,683

The accompanying notes are an integral part of the Consolidated Financial Statements

Consolidated Statement of Comprehensive Income
for the year ended 31 December 2017

	Notes	**2017** **US$000**	2016 US$000
Profit for the year		162,316	116,520
Other comprehensive income			
Items that will be reclassified subsequently to profit or loss when specific conditions are met:			
Available-for-sale investments		(23,600)	(9,426)
-fair value gains (losses)		4,427	(2,597)
-amounts reclassified to the income statement on disposal		(28,027)	(6,829)
Other movements		437	(156)
Items that will not be reclassified subsequently to profit or loss:			
Actuarial losses on defined benefit and healthcare plans	*4*	(6,753)	(3,370)
Other comprehensive loss for the year		(29,916)	(12,952)
Total comprehensive income for the year		132,400	103,568

The accompanying notes are an integral part of the Consolidated Financial Statements

Consolidated Balance Sheet
as at 31 December 2017

	Notes	**2017 US$000**	2016 US$000
ASSETS			
Cash and balances at central banks		32,691	29,651
Items in the course of collection from other banks		76	73
Derivatives	*7,11*	15,286	34,965
Loans and advances to banks	*8*	2,607,554	2,614,251
Loans and advances to customers	*9*	2,280,706	2,290,425
Financial investments	*10,11*	3,907,409	4,585,868
Prepayments and accrued income		47,252	43,636
Other assets		10,817	29,482
Interest in associate	*13*	1,631	1,596
Property and equipment	*12*	123,730	127,372
Total assets		9,027,152	9,757,319
LIABILITIES AND EQUITY			
Liabilities			
Deposits by banks		45,757	783,250
Customer accounts		8,085,001	7,988,166
Items in the course of transmission to other banks		2,055	2,380
Derivatives	*7,11*	8,981	21,828
Accruals and deferred income		25,976	28,084
Provisions	*16*	63,145	10,296
Other liabilities		24,992	33,371
Retirement benefit liabilities	*4*	14,742	62,430
Total liabilities		8,270,649	8,929,805
Equity			
Called up share capital	*25*	30,027	30,027
Share premium	*25*	388,652	388,652
Other reserves		(12,655)	11,606
Retained earnings		350,479	397,229
Total equity		756,503	827,514
Total liabilities and equity		9,027,152	9,757,319

The accompanying notes are an integral part of the Consolidated Financial Statements

Anthony Joaquin
Director

Mark Watkinson
Director

Consolidated Statement of Cash Flows
for the year ended 31 December 2017

	2017 US$000	2016 US$000
Cash flows from operating activities		
Profit for the year	162,316	116,520
Adjustments for:		
Net interest income	(194,373)	(189,366)
Dividend income	(676)	(650)
Non-cash items in profit for the year	(130,355)	50,036
Change in loans and advances to banks greater than 3 months	45,000	5,000
Change in loans and advances to customers	9,080	138,816
Change in other operating assets	33,931	30,782
Change in deposits by banks	(737,493)	692,080
Change in customer accounts	96,835	(1,154,950)
Change in other operating liabilities	30,057	(1,608,750)
Net gain from investing activities	(28,027)	(8,564)
Interest received	198,007	203,926
Interest paid	(3,379)	(2,841)
Net cash flows used in operating activities	(519,077)	(1,727,961)
Cash flows from investing activities		
Dividends received	676	650
Purchase of financial investments	(2,784,166)	(3,915,792)
Proceeds from the sale and maturity of financial investments	2,830,105	6,368,805
Purchase of property and equipment	(3,399)	(1,549)
Proceeds from the disposal of subsidiary investments	-	21,627
Net cash flows from investing activities	43,216	2,473,741
Cash flows from financing activities		
Dividends paid	(202,750)	(280,165)
Net cash flows used in financing activities	(202,750)	(280,165)
Net (decrease) increase in cash and cash equivalents	(678,611)	465,615
Cash and cash equivalents at the beginning of the year	2,506,519	2,040,272
Effect of exchange rate changes on cash and cash equivalents	20,358	632
Cash and cash equivalents at the end of the year	1,848,266	2,506,519
Cash and cash equivalents comprise		
Cash and balances at central banks	32,691	29,651
Items in the course of collection from other banks	76	73
Loans and advances to banks less than 3 months	1,817,554	1,779,251
Treasury bills, other bills and certificates of deposit less than 3 months	-	699,924
Items in the course of transmission to other banks	(2,055)	(2,380)
Total cash and cash equivalents	1,848,266	2,506,519

The accompanying notes are an integral part of the Consolidated Financial Statements

Consolidated Statement of Changes in Equity

for the year ended 31 December 2017

(In US dollar thousands)

	Called up share capital	Share premium	Other reserves: Available-for-sale fair value reserve	Other reserves: Share-based payment reserve	Retained earnings	Total equity
At 1 January 2016	**30,027**	**388,652**	**17,166**	**3,703**	**564,400**	**1,003,948**
Total Comprehensive income for the year						
Profit for the year	-	-	-	-	116,520	116,520
Available-for-sale valuation movement	-	-	(9,426)	-	-	(9,426)
Actuarial losses on defined benefit and healthcare plans	-	-	-	-	(3,370)	(3,370)
Other movements	-	-	-	-	(156)	(156)
Total comprehensive income for the year	-	-	(9,426)	-	112,994	103,568
Transactions with the shareholder recorded directly in equity						
Dividends	-	-	-	-	(280,165)	(280,165)
Share-based plan movements	-	-	-	163	-	163
Total transactions with the shareholder recorded directly in equity	-	-	-	163	(280,165)	(280,002)
At 31 December 2016	**30,027**	**388,652**	**7,740**	**3,866**	**397,229**	**827,514**
Total Comprehensive income for the year						
Profit for the year	-	-	-	-	162,316	162,316
Available-for-sale valuation movement	-	-	(23,600)	-	-	(23,600)
Actuarial losses on defined benefit and healthcare plans	-	-	-	-	(6,753)	(6,753)
Other movements	-	-	-	-	437	437
Total comprehensive income for the year	-	-	(23,600)	-	156,000	132,400
Transactions with the shareholder recorded directly in equity						
Dividends	-	-	-	-	(202,750)	(202,750)
Share-based plan movements	-	-	-	(661)	-	(661)
Total transactions with the shareholder recorded directly in equity	-	-	-	(661)	(202,750)	(203,411)
At 31 December 2017	**30,027**	**388,652**	**(15,860)**	**3,205**	**350,479**	**756,503**

The accompanying notes are an integral part of the Consolidated Financial Statements

1 Basis of preparation

(a) General

HSBC Bank Bermuda Limited (the 'Bank') was established in 1889 and incorporated in 1891. The address of its registered office is 37 Front Street, Hamilton HM11, Bermuda. The consolidated financial statements of the Bank for the year ended 31 December 2017 comprise the Bank and its subsidiaries (together referred to as the 'group') and the group's interests in associates. The Bank is domiciled in Bermuda and provides personal and corporate banking, investment, trust, custody and fund administration services to international and local clients. The immediate parent company of the Bank is HSBC Asia Holdings BV. The ultimate parent company is HSBC Holdings plc ('HSBC'). Copies of the financial statements of HSBC may be obtained from its registered office at 8 Canada Square, London, England, E14 5HQ, or from the HSBC website, www.hsbc.com.

These consolidated financial statements were authorised for issue by the Board of Directors on 1 March 2018.

The consolidated financial statements are presented in US dollars, which is the presentational currency of HSBC. The functional currency of the group is primarily Bermuda dollars. Bermuda dollars are translated into US dollars at par. All amounts and figures are rounded to the nearest thousand except where explicitly stated.

The consolidated financial statements have been prepared on a historical cost basis except for fair value measurement where stated.

The group has prepared its consolidated financial statements in accordance with International Financial Reporting Standards ('IFRSs'). IFRSs comprise accounting standards issued by the International Accounting Standards Board ('IASB'), as well as interpretations issued by the International Financial Reporting Interpretations Committee ('IFRIC').

Certain reclassifications have been made to the 2016 corresponding figures in order to conform to the current year presentation.

The consolidated financial statements are prepared on a going concern basis, as the Directors are satisfied that the group has 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, including projections of profitability, cash flows and capital resources.

Standards adopted during the year ended 31 December 2017

There were no new standards adopted during the year ended 31 December 2017.

(b) Basis of consolidation

The Bank 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 through its power over the entity. The Bank 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 Bank 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 Bank has the practical ability to exercise those rights.

The acquisition method of accounting is used when subsidiaries are acquired. 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 consolidated income statement in the period in which they are incurred. The acquired identifiable assets, liabilities and contingent liabilities are measured at their fair values at the date of acquisition. Goodwill is measured as the excess of the aggregation of the consideration transferred, the amount of non-controlling interest and the fair value of the acquirer's previously held equity interest, if any, over the net of the amounts of the identifiable assets acquired and the liabilities assumed. The amount of non-controlling interest is measured either at fair value or at the non-controlling interest's proportionate share of the acquiree's identifiable net assets. In a business combination achieved in stages, the previously held equity interest is remeasured at the acquisition date fair value with any resulting gain or loss recognised in the consolidated income statement or other comprehensive income as appropriate. In the event that the fair value of net assets acquired is in excess of the aggregation of the consideration transferred, the amount of non-controlling interest and the fair value of the previously held equity interest, the difference is recognised immediately in the consolidated income statement.

Entities that are controlled by the Bank are consolidated. Subsidiaries are consolidated from the date the group gains control, until the date that control ceases. The Bank performs a re-assessment of consolidation whenever there is a change in the facts and circumstances of determining the control of all entities.

All intra-group transactions are eliminated on consolidation.

The consolidated financial statements of the group include the attributable share of the results of any interests in associates, based on either financial statements made up to 31 December or pro-rated amounts adjusted for any material transactions or events occurring between the date of financial statements available and 31 December.

(c) Critical accounting estimates and judgements

The preparation of financial information requires the use of estimates and assumptions about future conditions. In view of the inherent uncertainties and the high level of subjectivity involved in the recognition or measurement of items listed below, 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 conclusions from those reached by management for the purposes of the 2017 consolidated financial statements. Management's selection of accounting policies which contain critical estimates and judgements are those which relate to; the impairment of loans and advances, the valuation of healthcare benefits, fair value of assets held for sale, the valuation of financial instruments, the impairment of available-for-sale financial assets and provisions for liabilities.

Further information about key assumptions concerning the future, and other key sources of estimation uncertainty, are set out in these notes on the consolidated financial statements.

(d) Future accounting developments

The IASB has published a number of minor amendments to IFRSs in the 'Annual Improvements to IFRSs '2014-2016' and in a series of stand-alone amendments which are effective from 1 January 2018. These amendments will have an insignificant effect when adopted.

Standard and amendments issued by the IASB

(i) IFRS 9 'Financial Instruments'

In July 2014, the IASB issued IFRS 9 'Financial Instruments', which is the comprehensive standard to replace IAS 39 'Financial Instruments: Recognition and Measurement', and includes requirements for classification and measurement of financial assets and liabilities, impairment of financial assets and hedge accounting.

Classification and measurement

The classification and measurement of financial assets depend on how they are managed (the entity's business model) and their contractual cash flow characteristics. These factors determine whether the financial assets are measured at amortised cost, fair value through other comprehensive income ('FVOCI') or fair value through profit or loss ('FVPL').

Impairment

The impairment requirements apply to financial assets measured at amortised cost and FVOCI, lease receivables and certain loan commitments and financial guarantee contracts. At initial recognition, an impairment allowance (or provision in the case of commitments and guarantees) is required for expected credit losses ('ECL') resulting from default events that are possible within the next 12 months ('12-month ECL'). In the event of a significant increase in credit risk, an allowance (or provision) is required for ECL resulting from all possible default events over the expected life of the financial instrument ('lifetime ECL'). Financial assets where 12-month ECL is recognised are considered to be 'stage 1'; financial assets which are considered to have experienced a significant increase in credit risk are in 'stage 2'; and financial assets for which there is objective evidence of impairment are considered to be in default or otherwise credit impaired are in 'stage 3'.

The assessment of credit risk and the estimation of ECL are required to be unbiased and probability-weighted, and should incorporate all available information which is relevant to the assessment including information about past events, current conditions and reasonable and supportable forecasts of economic conditions at the reporting date. In addition, the estimation of ECL should take into account the time value of money. As a result, the recognition and measurement of impairment is intended to be more forward-looking than under IAS 39 and the resulting impairment charge will tend to be more volatile. It will also tend to result in an increase in the total level of impairment allowances, since all financial assets will be assessed for at least 12-month ECL and the population of financial assets to which lifetime ECL applies is likely to be larger than the population for which there is objective evidence of impairment in accordance with IAS 39.

Hedge accounting

The general hedge accounting requirements aim to simplify hedge accounting, creating a stronger link with risk management strategy and permitting hedge accounting to be applied to a greater variety of hedging instruments and risks, but do not explicitly address macro hedge accounting strategies, which are particularly important for banks. As a result, IFRS 9 includes an accounting policy choice to continue IAS 39 hedge accounting, which HSBC has exercised, although it will implement the revised hedge accounting disclosures required by the related amendments to IFRS 7 'Financial Instruments: Disclosures'.

Expected impact of IFRS 9

The classification and measurement and impairment requirements are applied retrospectively by adjusting the opening balance at the date of initial adoption, with no requirement to restate corresponding periods. HSBC does not intend to restate corresponding periods. The combined effect of the adoption of the business model and the contractual cash flow characteristics tests resulted in a reclassification of equity investments from available for sale to FVPL of $3,437 and a reclassification of other reserves to retained earnings of $3,324. Impairment allowances will decrease by $5,728 and increase net assets at 1 January 2018 by $5,728. As a consequence, Tier 1 Capital will increase by $9,052 with no material impact on total capital.

(ii) IFRS 15 'Revenue from Contracts with Customers'

In May 2014, the IASB issued IFRS 15 'Revenue from Contracts with Customers' which was adopted for annual periods beginning on or after 1 January 2018. IFRS 15 provides a principles-based approach for revenue recognition, and introduces the concept of recognising revenue for performance obligations as they are satisfied. HSBC has adopted the standard on its mandatory effective date, and the standard will be applied on a modified retrospective basis, recognising the cumulative effective, if any, of initially applying the standard as an adjustment to the opening balance of retained earnings. HSBC has assessed the impact of IFRS 15 and when adopted will have no significant effect on the consolidated financial statements.

(iii) IFRS 16 'Leases'

In January 2016, the IASB issued IFRS 16 'Leases' with an effective date of annual periods beginning on or after 1 January 2019. IFRS 16 results in lessees accounting for most leases within the scope of the standard in a manner similar to the way in which finance leases are currently accounted for under IAS 17 'Leases'. Lessees will recognise a 'right of use' asset and a corresponding financial liability on the balance sheet. The asset will be amortised over the length of the lease and the financial liability measured at amortised cost. Lessor accounting remains substantially the same as in IAS 17. The group is currently assessing the impact of IFRS 16 and it is not practicable to quantify the effect as at the date of the publication of these consolidated financial statements. Existing operating lease commitments are set out in note 18.

(iv) IFRS 17 'Insurance Contracts'

In May 2017, the IASB issued IFRS 17 'Insurance Contracts' with an effective date of annual periods beginning on or after 1 January 2021. The group is currently considering its impact.

2 Significant accounting policies

(a) Interest income and expense

Interest income and expense for all financial instruments are recognised in 'Interest income' and 'Interest expense' in the consolidated income statement using the effective interest rate method. The effective interest rate 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 payments or receipts through the expected life of the financial asset or financial liability or, where appropriate, a shorter period, to the net carrying amount of the financial asset or financial liability. When calculating the effective interest rate, the group estimates cash flows considering all contractual terms of the financial instrument but not future credit losses. The calculation includes all amounts paid or received by the group that are an integral part of the effective interest rate, 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 and expense

(i) Fee 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 the 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 is recorded in 'Interest income' (Note 2a).

(ii) Dealing profits

Dealing profits comprise exchange differences on translation of monetary assets and liabilities denominated in foreign currencies and commissions earned on foreign exchange trading transactions. Dealing profits also include gains and losses from changes in the fair value of derivatives that do not qualify for hedge accounting.

(iii) Dividend income

Dividend income is recognised net of withholding taxes 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) Cash and cash equivalents

For the purpose of the consolidated statement of cash flows, 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.

(d) 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 as held for trading or designated at fair value. They are recognised when cash is advanced to a borrower and 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 rate method, less impairment allowance.

Loans and advances are reclassified to 'Assets held for sale' when they meet the criteria presented in Note 2(h), though their measurement remains in accordance with this policy.

When the group purchases a financial asset and simultaneously enters into an agreement to resell the asset (or a substantially similar asset) at a fixed price on a future date ('reverse repo' or 'stock borrowing'), the arrangement is accounted for as a loan or advance, and the underlying asset is not recognised in the group's consolidated financial statements.

(e) Impairment of loans and advances and available for sale financial assets

Losses for impaired loans are recognised when there is objective evidence that impairment of a loan or portfolio of loans has occurred. Impairment allowances are calculated on individual loans and on groups of loans assessed collectively. Impairment losses are recorded as charges to the consolidated income statement. The carrying amount of impaired loans on the consolidated balance sheet is reduced through the use of impairment allowance accounts. Losses expected from future events are not recognised.

(i) 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 and the importance of the individual loan relationship, and how this is managed. Loans that are determined to be individually significant will be individually assessed for impairment, except when volumes of defaults and losses are sufficient to justify a collective assessment.

Loans considered as individually significant are typically residential mortgages or loans to corporate and wholesale customers and are for larger amounts, which are managed on an individual relationship basis. Personal 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;
- contractual payments of either principal or interest being past due for more than 90 days;
- breach of loan covenants or conditions;
- the probability that the borrower will enter bankruptcy or other financial realisation;
- a concession granted to the borrower for economic or legal reasons relating to the borrower's financial difficulty that results in forgiveness or postponement of principal, interest or fees, where the concession is significant;
- there has been deterioration in the financial condition or outlook of the borrower such that its ability to repay is considered doubtful; 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 capability to trade successfully out of financial difficulties and generate sufficient cash flow to service 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 commitments to the group and the likelihood of other creditors continuing to support the customer;
- 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 including collateral) 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 for the debt.

The determination of the realisable value of security is based on the most recently updated market value at the time the impairment assessment is performed. The value is not adjusted for expected future changes in market prices, though 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 or an approximation thereof, 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. Individually assessed impairment allowances are only released when there is reasonable and objective evidence of a reduction in the established loss estimate.

(ii) Collectively assessed loans and advances

Impairment is assessed collectively to cover losses which have been incurred but have not yet been identified on loans subject to individual assessment or for homogeneous groups of loans that are not considered individually significant.

Incurred but not yet identified impairment

Individually assessed loans for which no evidence of impairment 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. These credit risk characteristics may include country of origination, type of business involved, type of products offered, security obtained or other relevant factors. This assessment captures impairment losses that the group has incurred as a result of events occurring before the balance sheet date that the group is not able to identify on an individual loan basis, and that can be reliably estimated. When information becomes available that identifies losses on individual loans within the group, those loans are removed from the group and assessed individually.

The collective impairment loss is determined after taking into account:

- historical loss experience in portfolios of similar credit risk characteristics (for example, by industry sector, loan grade or product);
- the estimated period between impairment occurring and the loss being identified and evidenced by the establishment of an appropriate allowance against the individual loan; and
- management's experienced judgement as to whether current economic and credit conditions are such that the actual level of inherent losses at the balance sheet date is likely to be greater or less than that suggested by historical experience.

The period between a loss occurring and its identification is estimated by local management for each identified portfolio based on economic and market conditions, customer behaviour, portfolio management information, credit management techniques and collection and recovery experiences in the market. The estimated period may vary over time as these factors change.

Homogeneous groups of loans and advances

Statistical methods are used to determine impairment losses for homogeneous groups of loans that are not considered individually significant. Losses in these groups of loans are recorded individually when individual loans are removed from the group and written off. The methods that are used to calculate collective allowances are:

- When appropriate empirical information is available, the group utilises roll rate methodology which employs statistical analyses of historical data and experience of delinquency and default to reliably estimate the amount of loans that will eventually be written off as a result of events occurring before the balance sheet date and which the group is not able to identify individually. Individual loans are grouped using ranges of past due days. Statistical analysis is then used to estimate the likelihood that loans in each range will progress through the various stages of delinquency, and become irrecoverable. Additionally, individual loans are segmented based on their credit characteristics as described above. In applying this methodology, adjustments are made to estimate the periods of time between a loss event occurring and its discovery, for example through a missed payment, (known as the emergence period) and the period of time between discovery and write-off (known as the outcome period). Current economic conditions are also evaluated when calculating the appropriate level of allowance required to cover inherent loss.

- 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 formulaic approach based on historical loss rate experience, or a discounted cash flow model. Where a basic formulaic approach is undertaken, management estimates that typically it takes twelve months between a loss occurring and its identification.

Historical loss experience and other historical data, including an evaluation of current economic conditions, are considered to calculate the appropriate level of allowance to cover inherent loss. Roll rates, loss rates and the expected timing of future recoveries are regularly benchmarked against actual outcomes to ensure they remain appropriate.

(iii) Write-off of loans and advances

Loans (and the related impairment allowances) 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.

(iv) 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 consolidated income statement.

(v) 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'. 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 provided in respect of assets held for sale. Impairments and reversal of previous impairments are recognised in the consolidated income statement, in 'Loan impairment charges', together with any realised gains or losses on disposal.

In cases where a non-financial asset held as collateral for a loan is repossessed, but substantially all the risks and rewards of ownership of that asset are not transferred to the group, then the collateral is used to reinforce the right to contractual cash flows on any outstanding loan balance and the group continues to recognise the impaired loan.

(vi) Renegotiated loans and forbearance

Where a loan is modified due to significant concerns about the borrower's ability to meet contractual payments when due, 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.

– Identifying renegotiated loans
  Loans are identified as renegotiated loans when the group modifies the contractual payment terms due to significant credit distress of the borrower. 'Forbearance' describes concessions made on the contractual terms of a loan in response to an obligor's financial difficulties. When considering modification terms, the borrower's continued ability to repay is assessed. Concessions on loans which do not affect the payment structure or basis of repayment, such as waivers of financial or security covenants, do not provide concessionary relief to customers in terms of their ability to service obligations as they fall due and are therefore not included in this classification.

  Loans that have been identified as renegotiated retain this designation until maturity or derecognition. A loan that is renegotiated is derecognised if the existing agreement is cancelled and a new agreement is 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. Any new loans that arise following derecognition events will continue to be disclosed as renegotiated loans.

– Credit quality of renegotiated loans
  On execution of the renegotiation, the loan will also be classified as impaired if it is not already so classified. In wholesale lending all of the facilities with a customer, including loans which have not been modified, are considered impaired following the granting of a renegotiated loan. If the loan is considered to be impaired it will be presented as impaired and assessed for impairment on an individual basis.

  Those that are considered impaired retain the impaired classification for a minimum of one year. Renegotiated loans will continue to be disclosed as impaired until there is sufficient evidence to demonstrate a significant reduction in the risk of non-payment of future cash flows (the evidence typically comprises a history of payment performance against the original or revised terms), and there are no other indicators of impairment.

– Renegotiated loans and recognition of impairment allowances
  For personal lending, renegotiated secured loans are initially assessed individually. Collectively assessed renegotiated loans are segregated from other parts of the loan portfolio to reflect the higher rates of losses often encountered in these segments.

  For wholesale lending, renegotiated loans are typically assessed individually. Credit risk ratings are intrinsic to the impairment assessment. The individual impairment assessment takes into account the higher risk of the non-payment of future cash flows inherent in renegotiated loans.

(vii) Impairment of available-for-sale financial assets

Available-for-sale financial assets are assessed at each balance sheet date for objective evidence of impairment. If such evidence exists 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 has an impact which can be reliably measured on the estimated future cash flows of the financial asset, an impairment loss is recognised.

If the available-for-sale financial asset is impaired, the difference between its acquisition cost (net of any principal repayments and amortisation) and its current fair value, less any previous impairment loss recognised in the consolidated income statement, is recognised in the consolidated income statement.

Impairment losses are recognised in the consolidated income statement within 'Loan impairment charges' for debt instruments and within 'Gains less losses from financial investments' for equities. The impairment methodologies for available-for-sale financial assets are set out as follows:

- **Available-for-sale debt securities**

  In assessing 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 the recovery of future cash flows. Financial difficulties of the issuer, as well as 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.

In addition, the performance of underlying collateral and the extent and depth of market price declines is relevant when assessing objective evidence of impairment of available-for-sale asset backed securities ('ABSs'). The primary indicators of potential impairment are considered to be adverse fair value movements and the disappearance of an active market for a security, while changes in credit ratings are of secondary importance.

- **Available-for-sale equity securities**

  Objective evidence of impairment 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 equity 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 continuous 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, the subsequent accounting treatment for changes in the fair value of that asset depends on the type of asset:

- For an available-for-sale debt security, a subsequent decline in the fair value of the instrument is recognised in the consolidated income statement when there is 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 a 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 consolidated income statement, or the instrument is no longer impaired, the impairment loss is reversed through the consolidated income statement.

- 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 in other comprehensive income. Impairment losses recognised on the equity security are not reversed through the consolidated income statement. Subsequent decreases in the fair value of the available-for-sale equity security are recognised in the consolidated income statement to the extent that further cumulative impairment losses have been incurred.

(f) Financial investments

Treasury bills, debt securities and equity securities intended to be held on a continuing basis are classified as 'available-for-sale' securities. They are recognised on the trade date when the group enters into contractual arrangements to purchase those securities, and are normally derecognised when either the securities are sold or redeemed.

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 consolidated income statement as 'Gains less losses from financial investments'.

Interest income is recognised on available-for-sale debt securities using the effective interest rate, calculated over the asset's expected life. Premiums and/or discounts arising on the purchase of investment securities are included in the calculation of their effective interest rates. Dividends from equity assets are recognised in the consolidated income statement when the right to receive payment is established.

(g) Valuation of financial instruments

For available-for-sale securities that are quoted in active markets, fair values are determined by reference to the current quoted bid prices. 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. Where independent prices are not available, fair values may be determined using valuation techniques with reference to observable market data. These include comparison to similar instruments where market observable prices exist, discounted cash flow analysis and other valuation techniques commonly used by market participants. Fair values of financial instruments may be determined in whole or in part using valuation techniques based on assumptions that are not supported by prices from current market transactions or observable market data, where current prices or observable market data are not available.

A three level fair value hierarchy, which reflects the significance of observable market inputs, is used when estimating fair values:

- Level 1 - valuation technique using 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 valuation techniques where one or more significant inputs are unobservable. '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.

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.

(h) Assets and liabilities held for sale

Assets and liabilities of disposal groups and non-current assets are classified as held for sale ('HFS') when their carrying amounts will be recovered principally through sale rather than through continuing use. HFS assets are generally measured at the lower of their carrying amount and fair value less cost to sell.

Immediately before the initial classification as held for sale, the carrying amounts of the relevant assets and liabilities are measured in accordance with applicable IFRSs. On subsequent remeasurement of a disposal group, fair value less costs to sell of the disposal group is determined after each HFS asset and liability is individually measured under applicable IFRSs.

Income earned and expenses incurred on assets held for sale and liabilities of disposal groups held for sale continue to be recognised in the appropriate line items in the consolidated income statement until the transaction is complete. Once classified as held for sale, movements arising from the initial measurement or subsequent remeasurement of the non-current assets (or disposal groups) are recognised in the consolidated income statement.

(i) Non trading reverse repurchase and repurchase agreements

When securities are sold subject to a commitment to repurchase them at a predetermined price ('repos'), they remain on the consolidated balance sheet and a liability is recorded in respect of the consideration received. Securities purchased under commitments to resell ('reverse repos') are not recognised on the consolidated balance sheet and the consideration paid is recorded in 'Loans and advances to banks' or 'Loans and advances to customers' as appropriate. The difference between the sale and repurchase price is treated as interest and recognised over the life of the agreement for loans and advances to banks and customers, and as dealing profits for trading assets.

Securities lending and borrowing transactions are generally secured against cash or non-cash collateral. Securities lent or borrowed do not normally result in derecognition or recognition on the consolidated balance sheet.

(j) Derivatives and hedge accounting

Derivatives

Derivatives are financial instruments that derive their value from the price of underlying items such as equities, bonds, interest rates, foreign exchange, credit spreads, commodities and equity and other indices.

Derivatives are recognised initially and are subsequently measured at fair value. Fair values of derivatives are obtained either from quoted market prices or by using valuation techniques.

Derivatives may be embedded in other financial instruments, for example, a convertible bond with an embedded conversion option. Embedded derivatives are bifurcated from the host contract when their economic characteristics and risks are not clearly and closely related to those of the host non-derivative contract, their contractual terms would otherwise meet the definition of a stand-alone derivative and the combined contract is not held for trading or designated at fair value. The bifurcated embedded derivatives are measured at fair value with changes therein recognised in the consolidated 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 only offset for accounting purposes 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.

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 ‘Dealing profits’ except, when applicable, for derivatives managed in conjunction with financial instruments designated at fair value, where gains and losses are reported in ‘Gains less losses from financial investments’ together with the gains and losses on the economically hedged items. 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

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 requires documented assessment, both at hedge inception and on an ongoing basis, of whether or not the hedging instruments are highly effective in offsetting the changes attributable to the hedged risks in the fair values of the hedged items. Interest on designated qualifying hedges is included in ‘Net interest income’.

When a hedging relationship is discontinued, any cumulative gain or loss recognised in other comprehensive income remains in equity until the forecast transaction is recognised in the consolidated income statement. When a forecast transaction is no longer expected to occur, the cumulative gain or loss previously recognised in other comprehensive income is immediately reclassified to the consolidated income statement.

Fair value hedge

Changes in the fair value of derivatives that are designated and qualify as fair value hedging instruments are recorded in the consolidated income statement, along with changes in the fair value of the hedged assets, liabilities or group attributable to the hedged risk. Fair value hedge accounting does not change the recording of gains and losses on derivatives and other hedging instruments but results in recognising change in the fair value of the hedged assets and liabilities attributable to the hedge risk that would not otherwise be recognised in the income statement.

If a hedging relationship no longer meets the criteria for hedge accounting, the hedge accounting is discontinued: the cumulative adjustment to the carrying amount of the hedged item is amortised to the consolidated income statement on a recalculated effective interest rate, unless the hedged item has been derecognised, in which case it is released to the consolidated income statement immediately.

Cash flow hedge

The effective portion of gains and losses on hedging instruments designated and qualifying as cash flow hedges is recognised in other comprehensive income and the ineffective portion of the change in fair value is recognised immediately in the consolidated income statement.

The accumulated gains and losses recognised in other comprehensive income are reclassified to the consolidated income statement in the same periods in which the hedged item affects profit or loss. In hedges of forecast transactions that result in recognition of a non-financial asset or liability, previous gains and losses recognised in other comprehensive income are included in the initial measurement of the asset or liability.

When a hedging relationship is discontinued, any cumulative gain or loss recognised in other comprehensive income remains in equity until the forecast transaction is recognised in the consolidated income statement. When a forecast transaction is no longer expected to occur, the cumulative gain or loss previously recognised in other comprehensive income is immediately reclassified to the consolidated income statement.

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 both prospectively and retrospectively on an ongoing basis.

The documentation of each hedging relationship sets out how the effectiveness of the hedge is assessed and the method adopted by an entity to assess 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 with the effectiveness range being defined as 90% to 110% at inception and between 80-125% on an ongoing basis.

Hedge ineffectiveness is recognised in the consolidated income statement in ‘Dealing profits’.

Derivatives that do not qualify for hedge accounting

Non-qualifying hedges are derivatives entered into as economic hedges of assets and liabilities for which hedge accounting was not applied.

All gains and losses from changes in the fair values of derivatives that do not qualify for hedge accounting are recognised immediately in the consolidated income statement. These gains and losses are reported in ‘Dealing profits’.

(k) Derecognition of financial assets and financial liabilities

Financial assets are derecognised when the contractual right to receive cash flows from the assets has expired; or when the group has transferred its contractual right to receive the cash flows of the financial assets, and either:

- substantially all the risks and rewards of ownership have been transferred; or
- the group has neither retained nor transferred substantially all the risks and rewards, but has not retained control.

Financial liabilities are derecognised when they are extinguished, that is when the obligation is discharged, is cancelled, or expires.

(l) Offsetting financial assets and financial liabilities

Financial assets and financial liabilities are offset and the net amount reported in the consolidated 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.

(m) Subsidiaries and associates

The group classifies investments in entities which it controls as subsidiaries. The group classifies investments in entities over which it has significant influence, and that are neither subsidiaries nor joint ventures, as associates.

Interests in associates, are recognised using the equity method. Under this method, such investments are initially stated at cost, including attributable goodwill, and adjusted thereafter for the post-acquisition change in the group’s share of net assets.

Profits on transactions between the group and its associates are eliminated to the extent of the group’s interests in the respective associates. Losses are also eliminated to the extent of the group’s interests in the associates unless the transaction provides evidence of an impairment of the asset transferred.

(n) Property and equipment

Land and buildings are stated at historical cost, or fair value at the date of transition to IFRSs (‘deemed cost’), less impairment losses and depreciated, using the straight-line method, over their estimated useful lives as follows:

Freehold land	not depreciated
Buildings	lesser of 50 years or the remaining useful lives
Leasehold improvements	lesser of life of the lease or the remaining useful lives

Equipment, fixtures and fittings and software are stated at cost less impairment losses and depreciated, using the straight-line method, over their estimated useful lives, which is generally between 3 and 7 years.

Property and equipment is subject to an impairment review if the carrying amount may not be recoverable.

(o) Impairment of assets other than financial instruments

In assessing whether an asset is impaired, the recoverable amount of the asset is calculated as the greater of its value in use and its fair value less costs to sell. In assessing value in use, the estimated future cash flows are discounted to their present value using a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the asset. For impairment testing, assets are grouped together into the smallest group of assets that generates cash inflows from continuing use that are largely independent of the cash inflows of other assets.

Impairment losses are recognised in the consolidated income statement.

(p) 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. As a lessee under finance leases, the group presents the leased assets in 'Property and equipment' with the corresponding liability 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.

All other leases are classified as operating leases. As lessor, the group presents assets subject to operating leases in 'Property and equipment'. Impairment losses are recognised to the extent that carrying values are not fully recoverable and the carrying value of the assets are thereby impaired. As a lessee, leased assets are not recognised on the consolidated balance sheet. Rentals payable and receivable under operating leases are accounted for on a straight-line basis over the lease periods and are included in 'General and administrative expenses'.

(q) Income tax

When applicable, income tax on the profit or loss for the year comprises current tax and deferred tax. Income tax is recognised in the consolidated 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 also 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, 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 amount of assets and liabilities in the consolidated balance sheet and the amount 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. Deferred tax assets and liabilities are offset when they arise in the same tax reporting group, relate to income taxes levied by the same taxation authority and a legal right to offset exists in the group.

Current and deferred tax are calculated based on tax rates and laws enacted, or substantively enacted, by the balance sheet date.

(r) Pension and other post-employment benefits

The group operates defined contribution pension plans and defined benefit pension plans, as well as a post-employment healthcare benefits plan.

(i) Defined contribution pension plans

Payments to the defined contribution pension plans are charged as an expense as the employee renders service. The group has no legal or constructive obligations to pay further contributions if the plan does not hold sufficient assets to pay all employees the benefits relating to employee service in the current and prior periods.

(ii) Defined benefit pension plans

The defined benefit pension costs and the present value of defined benefit obligations are calculated at the reporting date by the schemes' actuaries using the Projected Unit Method. The net charge to the consolidated 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 under 'Employee compensation and benefits'.

The past service cost, which is charged immediately to the consolidated income statement, is the change in the present value of the defined benefit obligation for employee service in prior periods resulting from plan amendment (the introduction or withdrawal of, or changes to, a defined benefit plan) or curtailment (a significant reduction by the entity in the number of employees covered by the plan).

A settlement is a transaction that eliminates all further legal and constructive obligations for part or all of the benefits provided under a defined benefit plan, other than a payment of benefits to, or on behalf of, employees that is set out in the terms of the plan and included in the actuarial assumptions.

Re-measurements of the net defined benefit asset or liability, which comprise actuarial gains and losses and return on plan assets (excluding interest), are recognised immediately in other comprehensive income.

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.

The net defined benefit pension liability recognised in the consolidated balance sheet represents the present value of the defined benefit obligations reduced by the fair value of plan assets. Any net defined benefit surplus is limited to the present value of available refunds and reductions in future contributions to the plan.

(iii) Post-employment healthcare benefits plan

The costs of obligations arising from other post-employment benefits such as post-employment healthcare are accounted for on the same basis as defined benefit pension plans in accordance with IAS 19 'Employee Benefits'.

(s) Share-based payments

The group enters into both equity-settled and cash-settled share-based payment arrangements with its employees as compensation for services provided by employees.

Equity-settled share-based payment arrangements entitle employees to receive equity instruments of HSBC. 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 the 'Share-based payment reserve' in equity. The vesting period is the period during which all the specified vesting conditions of the 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.

For cash-settled share-based payment arrangements, the services acquired and liability incurred are measured at the fair value of the liability and recognised as the employees render service. Until settlement, the fair value of the liability is re-measured, with changes to the fair value recognised in the consolidated income statement.

Fair value is determined using appropriate valuation models. Vesting conditions include service conditions and performance conditions; any other features of the arrangement are non-vesting conditions. Market performance conditions and non-vesting conditions are taken into account when estimating the fair value of the award at the date of grant.

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. 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.

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.

(t) Foreign currencies

(i) Transactions and balances

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 consolidated 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 either in other comprehensive income or in the consolidated income statement depending where the gain or loss on the underlying non-monetary item is recognised.

(ii) Group entities

The results and financial positions of all group entities (none of which has the currency of a hyperinflationary economy) that have functional currencies different from the presentation currency are translated into the presentation currency as follows:

- assets and liabilities for each balance sheet presented are translated at the closing rate at the date of that balance sheet;
- income and expenses for each income statement are translated at average exchange rates (unless this average is not a reasonable approximation of the cumulative effect of the rates prevailing on the transaction dates, in which case income and expenses are translated using exchange rates at the dates of the transactions); and
- all resulting exchange differences are recognised as a separate component of other comprehensive income.

On consolidation applicable exchange differences arising from the translation of the net investment in foreign entities, and of borrowings and other currency instruments designated as hedges of such investments, are recognised in the 'Foreign exchange reserve' in other comprehensive income. When a foreign operation is sold, such exchange differences are recognised in the consolidated income statement as part of the gain or loss on sale.

(u) Deposits by banks and customer accounts

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.

(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. Judgement is involved in determining whether a present obligation exists and in estimating the probability, timing and amount of any outflows. Professional expert advice is taken on the assessment of litigation, property (including onerous contracts) and similar obligations.

(w) Fiduciary activities

The group commonly acts as trustee and in other fiduciary capacities resulting in the holding or placing of assets on behalf of individuals, trusts, post-employment benefit plans and other institutions. The assets and liabilities and income and expenditure arising from these assets and liabilities are excluded from the consolidated financial statements, as they are not assets of the group. The group earns a fee for acting in these capacities.

(x) Contingent liabilities, contractual commitments and financial guarantee contracts

Contingent liabilities, which include certain guarantees and letters of credit pledged as collateral security as well as contingent liabilities related to legal proceedings or regulatory matters, 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 the outflow of economic benefits, or because the amount of the obligations cannot be reliably measured. Contingent liabilities are not recognised in the consolidated financial statements but are disclosed unless the probability of settlement is remote.

Contractual commitments include loan commitments to provide credit under pre-specified terms and conditions.

Financial guarantee contracts are contracts that require the group to make specific payments to reimburse the holder for a loss incurred because a specific debtor fails to make payment when due. Liabilities under financial guarantee contracts which are not classified as insurance contracts are recorded initially at their fair value which is generally the fee received or receivable and are amortised over the lives of the contracts. Subsequently, 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. Financial guarantee contracts are included in 'Other liabilities'.

(y) Trading assets and liabilities

Treasury bills, debt securities, equity securities, 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 recognised in the consolidated income statement. Subsequently, the fair values are remeasured, and gains and losses from changes therein are recognised in the consolidated income statement in 'Dealing profits'.

(In US dollar thousands) 31 December 2017

3 Net interest income and net fee income

(a) Analysis of net interest income

	2017	2016
Interest income		
Financial investments	47,740	44,226
Loans and advances to banks	21,420	15,344
Loans and advances to customers	129,511	133,252
	198,671	192,822
Interest expense		
Customer accounts	(4,298)	(3,456)
	(4,298)	(3,456)
Net interest income	194,373	189,366

(b) Analysis of net fee income

	2017	2016
Fee Income		
Custody and fund administration	5,550	5,974
Trust	294	3,598
Banking	42,493	42,491
Management	18,223	18,753
Other	8,344	9,094
Fee income	74,904	79,910
Fee expense	(24,236)	(23,347)
Net fee income	50,668	56,563

(In US dollar thousands) 31 December 2017

4 Employee compensation and benefits

Post-employment benefit plans

Income statement

	2017	2016
Defined contribution pension plans	(3,627)	(3,946)
Defined benefit pension plans	(171)	(26)
Post-employment healthcare benefits plan	52,795	(4,076)
Total post-employment benefit income (expense)	48,997	(8,048)

Balance sheet

	2017	2016
Defined benefit pension plans	(2,194)	(3,060)
Post-employment healthcare benefits plan	(12,548)	(59,370)
Total post-employment benefit plan deficit	(14,742)	(62,430)

(a) Defined contribution pension plans

The group provides defined contribution pension plans to its employees in Bermuda and Cayman. Employees are able to make additional voluntary payments to the defined contribution pension plans.

The group's expense for the defined contribution pension plans in 2017 was $3,765 (2016: $3,946), of which $3,730 (2016: $3,904) relates to the Bermuda-based plan.

(b) Defined benefit pension plans

HSBC has a funded defined benefit pension plan, a closed plan with no active employees, known as the 'Sterling area' plan. This plan is divided into four regional subsets, namely Isle of Man, Guernsey, Jersey and a fourth subset covering international managers ('Plan B').

The group continues to assume responsibility for the entire Plan B and a plan comprising previous employees of the Bank of Bermuda (Isle of Man) Limited for a combined total of forty three individuals (2016: forty four).

The net deficit at 31 December 2017 and 31 December 2016 relates only to the components of the plan over which the group maintains current and future legal responsibility.

All the group's defined benefit plans are closed plans not subject to new membership from current employees.

These defined benefit plans expose the group to actuarial risks, such as longevity risk, and to currency risk, interest rate risk and market (investment) risk.

Summary

The net deficit amount recognised in the consolidated balance sheet in respect of the group's pension plan is as follows:

	2017	2016
Defined benefit obligations	(10,833)	(10,980)
Fair value of plan assets	8,639	7,920
Net deficit	(2,194)	(3,060)

(In US dollar thousands) 31 December 2017

The changes in the present value of the defined benefit obligation in respect of the group's pension plan are presented below:

	2017	2016
At 1 January	10,980	10,960
Interest cost	359	281
Actuarial (gains) losses	(601)	1,246
Benefits paid	(673)	(272)
Exchange and other movements	768	(1,235)
At 31 December	10,833	10,980

The changes in the fair value of the group's pension plan assets are presented below:

	2017	2016
At 1 January	7,920	9,172
Return on plan assets excluding interest income	381	161
Interest income	188	255
Actuarial gains	158	-
Benefits paid	(673)	(272)
Exchange and other movements	665	(1,396)
At 31 December	8,639	7,920

The fair value of the group's pension plan assets are comprised of:

	2017	2016
Equities	2,667	2,952
Bonds	3,184	2,738
Property and other	2,788	2,230
Fair value of plan assets	8,639	7,920

The total net expense recognised in the consolidated income statement in 'Employee compensation and benefits' in respect of the pension plans comprises:

	2017	2016
Current service cost	-	-
Interest cost	(171)	(26)
Administrative costs and other movements	-	-
Total net expense	(171)	(26)

Actuarial valuation of the assets and liabilities of the group's defined benefit pension plans are carried out annually to determine their financial position and to ensure that benefit obligations are adequately funded. The group's pension expense for the defined benefit pension plans was $171 (2016: $26).

An actuarial gain of $759 (2016: loss of $1,246) was included in the consolidated statement of comprehensive income for the defined benefit pension plans. The cumulative amount of actuarial losses recognised in the consolidated statement of comprehensive income is $4,797 (2016: $5,556).

The group determines the discount rate to be applied to its obligations in consultation with the plan's actuaries, on the basis of current average yields of high quality (AA-rated or equivalent) debt instruments with maturities consistent with those of the defined benefit obligations.

(In US dollar thousands) 31 December 2017

The weighted average key actuarial assumptions at 31 December are:

Year	Discount Rate	Inflation Rate	Pension payment Rate increase
	%	%	%
2017	2.7	3.8	3.7
2016	2.6	3.8	4.0

Effect of changes in key assumptions on the defined benefit obligation:

	Financial impact of increase		Financial impact of decrease	
	2017	2016	**2017**	2016
Discount rate-increase/decrease of 0.25%	(159)	(219)	175	239
Inflation rate-increase/decrease of 0.25%	144	172	(98)	(108)
Pension payments -increase/decrease of 0.25%	198	215	(185)	(198)

(c) Post-employment healthcare benefits plan

The group provides an unfunded post-employment healthcare benefits plan (the 'plan') for certain Bermuda-based retired employees. To qualify, employees must have a minimum of 15 or 20 years (depending on their hire date) of successive service at the date of retirement. Independent, qualified actuaries carry out an actuarial assessment of the liabilities of the plan on an annual basis using the PRH-2014 Total Data Set Mortality Table rolled back to 2006 and then projected fully generationally with the MP-2017 Mortality Improvement Scale. The liabilities are evaluated by discounting the expected future claims to a net present value.

During 2017 the terms of the plan were amended. The amendments included closing the post-employment healthcare benefits plan to new employees from September 2017 and shifting the retiree's cost of the premiums on a gradual basis each year to achieve a fully funded premium by retirees by 2022. The actuarial assessment of the plan amendments was a reduction in the plan liability of $55,208, this has been reflected in the consolidated income statement under 'Employee compensation and benefits'.

The latest actuarial assessment was carried out in December 2017 in accordance with IAS 19. At 31 December 2017, the estimated present value of the post-employment healthcare benefit obligation was $12,548 (2016: $59,370). The main financial assumptions used to estimate the obligation at 31 December 2017 are current and ultimate healthcare claims trend rate of 7.50% and 4.50% per annum respectively (2016: 6.50% and 4.75%) and a discount rate of 3.20% (2016: 4.20%) per annum.

The changes in the present value of the post-employment healthcare benefit obligations are as follows:

	2017	2016
At 1 January	59,370	55,198
Current service cost	909	1,657
Interest cost	1,504	2,419
Contributions by employees	1,771	1,714
Plan amendment	(55,208)	-
Actuarial losses	7,512	2,124
Benefits paid	(3,310)	(3,742)
At 31 December	12,548	59,370

(In US dollar thousands) 31 December 2017

The total net income (expense) recognised in the consolidated income statement within 'Employee compensation and benefits' in respect of the post-employment healthcare benefits plan is comprised of:

	2017	2016
Current service cost	(909)	(1,657)
Interest cost	(1,504)	(2,419)
Plan amendment	55,208	-
Total net income (expense)	52,795	(4,076)

Total net actuarial results recognised in the consolidated statement of comprehensive income in 2017 in respect of the post-employment healthcare benefits plan are a loss of $7,512 (2016: loss of $2,124). The total cumulative net actuarial loss to date, which has been recognised in the consolidated statement of comprehensive income, is $21,237 (2016: $13,725 loss).

The net deficits and the experience adjustments on plan liabilities expressed as an amount and as a percentage of the net deficit for the current and previous annual period are as follows:

	2017	2016
Net obligation	12,548	59,370
Experience adjustments on plan liabilities expressed as an amount	7,512	2,124
Experience adjustments on plan liabilities expressed as a percentage	60%	4%

The actuarial assumptions related to the healthcare cost trend rates may have a significant effect on the amounts recognised. A one-percentage point change in assumed healthcare cost trend rates would have the following effects on amounts recognised in 2017:

	2017	2016
	1% increase	1% increase
Effect on the aggregate of the current service cost and interest cost	439	1,149
Effect on present value of the benefit obligation	1,099	13,314
	1% decrease	1% decrease
Effect on the aggregate of the current service cost and interest cost	(334)	(837)
Effect on present value of the benefit obligation	(964)	(10,116)

5 Share-based payments

During 2017, $641 was charged to the consolidated income statement in respect of share-based payment transactions relating to deferred share awards (2016: $609). This expense, which was computed from the fair values of the share-based payments on transaction dates, arose under employee share awards made in accordance with the group's reward structures. All share plans are based on ordinary $0.50 par value shares in the ultimate parent company HSBC Holdings plc.

The HSBC share plan

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

Restricted share awards

Restricted shares are awarded to employees on the basis of their performance, potential and retention requirements, to aid retention or as a part-deferral of annual bonuses. Shares are awarded without corporate performance conditions and generally vest between one and three years from the date of award, providing the employees have remained continually employed by the group for this period.

International Employee Share Purchase Plan ('ShareMatch')

In 2015 the group joined the Sharematch Plan replacing the Savings relatred share option plan highlighted below. Shares are purschased in the market each month up to a maximum value of three hundred and twenty five dollars. Matching awards are added at a ratio of one free share for every three purchaed. Matching awards vest subject to conitnued employment and the retention of the pruchased shares for a maximum period of two years and nine months.

Savings-related share option plans

During 2013 the savings-related share option plans was suspended. Prior to 2013 eligible employees were invited to enter into savings contracts to save up to three hundred and fifty dollars per month, with the option to use the savings to acquire shares. The aim of the plans is to align the interests of all employees with the creation of shareholder value. The options are exercisable within three months following the first anniversary of the commencement of a one-year savings contract or within six months following either the third or fifth anniversaries of the commencement of three-year or five-year savings contracts, respectively. The exercise price is set at a 20% discount to the average market value immediately preceding the date of invitation.

6 Tax expense

Under current Bermuda law the group is not required to pay any corporate taxes in Bermuda on either income or capital gains. All overseas subsidiaries also operate in jurisdictions where no corporate taxes are levied on either income or capital gains, consequently there was no deferred tax in 2017 and 2016.

(In US dollar thousands) 31 December 2017

7 Derivatives

Fair values of derivatives by product type

	2017		2016	
	Fair value		Fair value	
	Assets	**Liabilities**	Assets	Liabilities
Foreign exchange	8,840	8,930	22,712	21,801
Interest rate	119	51	129	27
Trading derivatives	8,959	8,981	22,841	21,828
Fair value hedges – Interest rate	6,327	-	12,124	-
Total derivatives	15,286	8,981	34,965	21,828

The notional contract amounts of derivatives held for trading purposes indicate the nominal value of transactions outstanding at the balance sheet date; they do not represent amounts at risk.

Notional contract amounts of derivatives by product type

	2017	2016
Foreign exchange	1,627,396	1,736,368
Interest rate	9,608	13,988
Trading derivatives	1,637,004	1,750,356
Fair value hedges – Interest rate	332,500	569,000
Total derivatives	1,969,504	2,319,356

Derivatives are financial instruments that derive their value from the price of an underlying item such as equities, bonds, interest rates, foreign exchange rates, credit spreads, commodities and equity or other indices. Derivatives enable users to increase, reduce or alter exposure to credit or market risks. The group makes markets in derivatives for its customers and uses derivatives to manage its exposure to market risks (Note 22).

Derivatives are carried at fair value and shown in the consolidated balance sheet gross. Asset values represent the cost to the group of replacing all transactions with a fair value in the group's favour assuming that the entire group's relevant counterparties default at the same time, and that transactions can be replaced instantaneously. Liability values represent the cost to the group's counterparties of replacing all their transactions with the group with a fair value in their favour if the group were to default. Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

Use of derivatives

The group uses derivatives for two primary purposes: to create risk management solutions for clients and to manage and hedge the group's own risks. For accounting purposes, derivative instruments are classified as held either for trading or hedging. Derivatives that are held as hedging instruments are formally designated as hedges as defined in IAS 39. All other derivative instruments are classified as held for trading. The held for trading classification includes two types of derivative instruments: those used in sales and trading activities; and those instruments that are used for risk management purposes but which for various reasons do not meet the qualifying criteria for hedge accounting.

The group's derivative activities give rise to significant open positions in portfolios of derivatives. These positions are managed frequently to ensure that they remain within acceptable risk levels, with matching deals being utilised 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 as are used for traditional lending.

With respect to derivative contracts, 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.

(In US dollar thousands) 31 December 2017

a) Trading derivatives

The derivative transactions of the group relate to foreign exchange and interest rate sales 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.

As mentioned above, other derivatives classified as held for trading may 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.

Gains and losses from changes in the fair value of derivatives that do not qualify for hedge accounting are reported in 'Dealing profits'.

A three level fair value hierarchy, which reflects the availability of observable market inputs, is used when estimating fair values. All derivatives are considered Level 2 as they are based upon observable market inputs. Total exposure to HSBC Group counterparties at 31 December 2017 amounted to an unrealised loss of $2,313 (2016: $14,370) and cash collateral was $9,750 (2016: $10,130). Where the group receives collateral from customers related to outstanding derivative contracts, these comprise cash and cash equivalents, securities and mortgage interests over property. Credit concentrations with large counterparties are controlled though counterparty limits. Credit exposures, incorporating derivative exposures, to single names are capped and monitored by senior management as detailed in Note 22.

b) Hedging accounting derivatives

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 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.

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 consolidated 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 consolidated income statement as a yield adjustment over the remainder of the hedging period.

Gains or (losses) arising from fair value hedges

	2017	2016
Gains (losses)		
- on hedging instruments	(5,833)	10,696
- on hedged items attributable to the hedged risk	5,589	(10,291)
Net (loss) gain	(244)	405

(In US dollar thousands) 31 December 2017

Offsetting of financial assets and financial liabilities

The following table presents the recognised financial instruments that are subject to enforceable master netting arrangements.

	Amounts subject to enforceable netting arrangements not set-off in Balance Sheet					Amounts not subject to enforceable netting arrangements	Balance sheet total
	Gross amounts	Amounts offset in the balance sheet	Amounts reported in the balance sheet	Cash collateral	Net amount		
At 31 December 2017							
Derivatives assets	13,763	-	13,763	9,750	4,013	1,523	15,286
Derivatives liabilities	5,979	-	5,979	-	5,979	3,002	8,981
At 31 December 2016							
Derivatives assets	30,255	-	30,255	18,290	11,965	4,710	34,965
Derivatives liabilities	19,171	-	19,171	13,680	5,491	2,657	21,828

For the financial assets and liabilities subject to enforceable master netting arrangements above, the agreement between the group and the counterparty allows for automatic net settlement of the relevant financial assets and financial liabilities when each party's obligation would otherwise be payable in the same currency in respect of the same transactions. In addition, the parties may elect in respect of two or more transactions, that a net amount will be determined in respect of all amounts payable on the same date in the same currency.

8 Loans and advances to banks

Maturity analysis

	2017		2016	
	Amortised cost	**Fair value**	Amortised cost	Fair value
One year or less	2,407,554	2,407,554	2,274,251	2,274,251
More than one year	200,000	200,000	340,000	340,000
	2,607,554	2,607,554	2,614,251	2,614,251

There are no past due loans (2016: $NIL) or impairment losses included in loans and advances to banks (2016: $NIL) and there are no netting agreements or collateral held in respect of loans and advances to banks (2016: $NIL).

Fair value of all loans and advances are calculated using observable market inputs and therefore are classified as Level 2 in the fair value hierarchy.

(In US dollar thousands) 31 December 2017

Loans and advances to banks by country and credit rating

	2017						
Country	**AAA**	**AA+ AA AA-**	**A+ A A-**	**BBB+ BBB BBB-**	**BB+ BB BB-**	**Not rated**	**Total**
Argentina	-	-	-	-	100,010	-	100,010
Australia	-	-	164	-	-	-	164
Belgium	-	4,353	-	-	-	-	4,353
Bermuda	5,420	-	-	11,742	-	-	17,162
Canada	-	153,693	145,000	-	-	-	298,693
Cayman Islands	-	-	-	-	-	5,734	5,734
Chile	-	-	70,000	-	-	-	70,000
China	-	1,920	-	-	-	-	1,920
Czech Republic	-	-	13	-	-	-	13
Denmark	-	-	890	-	-	-	890
Germany	-	-	68,258	-	-	-	68,258
Hong Kong	-	-	-	-	-	-	-
Hungary	-	-	1	-	-	-	1
Israel	-	-	9	-	-	-	9
Japan	-	31,418	160,000	-	-	-	191,418
Mexico	-	-	-	128	-	-	128
Netherlands	-	-	-	-	-	-	-
New Zealand	-	1,198	-	-	-	-	1,198
Norway	-	-	2,983	-	-	-	2,983
Poland	-	-	156	-	-	-	156
Qatar	-	-	75,000	-	-	-	75,000
Republic of Ireland	-	-	-	-	-	-	-
Singapore	-	5,961	-	-	-	-	5,961
South Africa	-	-	-	-	37	-	37
Sweden	-	-	548	-	-	-	548
Switzerland	-	-	45,747	-	-	-	45,747
Turkey	-	-	-	-	200,526	-	200,526
United Arab Emirates	-	446,096	-	-	-	-	446,096
United Kingdom	-	493,699	-	-	-	-	493,699
United States	-	395,443	181,407	-	-	-	576,850
	5,420	1,533,781	750,176	11,870	300,573	5,734	2,607,554

(In US dollar thousands) 31 December 2017

Loans and advances to banks by country and credit rating

	2016						
Country	**AAA**	**AA+ AA AA-**	**A+ A A-**	**BBB+ BBB BBB-**	**BB+ BB BB-**	**Not rated**	**Total**
Argentina	-	-	-	-	-	-	-
Australia	-	-	3,767	-	-	-	3,767
Belgium	-	2,550	-	-	-	-	2,550
Bermuda	12,009	-	-	5,721	-	293	18,023
Canada	-	189,359	-	-	-	-	189,359
Cayman Islands	-	-	-	-	-	11,373	11,373
Chile	-	-	70,000	-	-	-	70,000
China	-	-	-	-	-	-	-
Czech Republic	-	-	13	-	-	-	13
Denmark	-	-	750	-	-	-	750
Germany	-	-	-	104,686	-	-	104,686
Hong Kong	-	12,727	-	-	-	-	12,727
Hungary	-	1	-	-	-	-	1
Israel	-	-	17	-	-	-	17
Japan	-	17,046	370,000	-	-	-	387,046
Mexico	-	-	-	105	-	-	105
Netherlands	-	8,002	-	-	-	-	8,002
New Zealand	-	1,853	-	-	-	-	1,853
Norway	-	-	5,554	-	-	-	5,554
Poland	-	-	129	-	-	-	129
Qatar	-	-	75,000	-	-	-	75,000
Republic of Ireland	-	18,838	-	-	-	-	18,838
Singapore	-	18,726	-	-	-	-	18,726
South Africa	-	-	-	584	-	-	584
Sweden	-	-	293	-	-	-	293
Switzerland	-	-	4,873	-	-	-	4,873
Turkey	-	-	-	-	-	-	-
United Arab Emirates	-	441,313	-	-	-	-	441,313
United Kingdom	-	91,611	-	-	-	-	91,611
United States	-	920,044	220,732	6,282	-	-	1,147,058
	12,009	1,722,070	751,128	117,378	-	11,666	2,614,251

Loans and advances to banks are rated using a hierarchy of rating agencies. The Standard & Poor's ('S&P') ratings are used where available, followed by Fitch then Moody's. If no rating is provided by S&P, Fitch or Moody's, the balance is classified as not rated. Loans and advances to banks are unsecured.

Collateral may be held for the group's securities lending activity, for which the bank normally accepts collateral in the form of cash, US government or federal agency securities, letters of credit or OECD debt instruments approved by the group.

(In US dollar thousands) 31 December 2017

9 Loans and advances to customers

The group has the following concentration of loans and advances to customers.

Where customers have both a borrowing and a deposit relationship with the group, loans and deposits are presented gross:

	2017	2016
Personal		
-Residential mortgages	1,276,085	1,322,688
-Other personal	217,418	213,980
Total personal	1,493,503	1,536,668
Wholesale		
Corporate and Commercial		
-Industrial and international trade	51,441	166,843
-Commercial real estate	397,566	275,368
-Government	192,578	150,000
-Other commercial	260,573	299,213
Total corporate and commercial	902,158	891,424
Financial		
-Non-bank financial institutions	39,861	32,701
Total wholesale	942,019	924,125
Gross loans and advances to customers	2,435,522	2,460,793
Allowance for losses on loans and advances	(154,816)	(170,368)
Loans and advances to customers	2,280,706	2,290,425

In the current year the group adopted a change in the application of the accounting policy so that secured loans and advances to customers are written off after the realization of collateral regardless of the period past due, unless there is no reasonable expectation of further recovery then write off may be earlier. Previously, secured loans were partially written off when a customer reached 180 days past due regardless of collateral. The change in application provides more reliable and relevant information for the following reasons:

- gross loans and advances to customers is more reflective of contractual loan values; and
- allowance for losses on loans and advances provides a more accurate reflection of collateral value exposure.

The change in application of the accounting policy has no impact on the timing of the recognition of loan impairment charges and the impact on the closing balance sheets are indicated in the table below. The corresponding period note disclosures were also updated for the impact of the change in the application of the accounting policy.

	2016	2015
Gross loans and advances to customers	97,926	89,131
Allowance for losses on loans and advances	(97,926)	(89,131)
Loans and advances to customers	-	-

Gross loans with variable rates are $2,407,717 (2016: $2,441,886) and fixed rates are $27,805 (2016: $18,907).

The following table provides an analysis of remaining contractual maturities and measurement bases of loans and advances to customers:

	2017		2016	
Maturity analysis	**Amortised cost**	**Fair value**	Amortised cost	Fair value
One year or less	268,831	268,548	328,212	327,901
More than one year	2,011,875	1,966,559	1,962,213	1,907,855
	2,280,706	2,235,107	2,290,425	2,235,756

(In US dollar thousands) 31 December 2017

The loan fair values disclosed above are based on weighted average estimated remaining maturities and are determined using a valuation technique supported by market interest rates and estimated future cash flows. As there is no secondary liquid market, they are classified as Level 3. Additional information about the interest rate risk exposure pertaining to loans and advances to customers is presented in Note 22.

The following tables provide further analyses of customer loans and collateral types at 31 December:

	2017	2016
Gross loans and advances to customers		
Neither past due nor impaired	2,035,906	1,969,683
Past due but not impaired:		
Past due less than 30 days	30,451	42,779
Past due between 30 and 60 days	9,984	10,393
Past due between 60 and 90 days	1,162	357
Impaired	358,019	437,581
Total	2,435,522	2,460,793

Gross loans and advances to customers by type of collateral	**2017**			2016		
	Mortgage interest	**Assets other than mortgage interest**	**Unsecured**	Mortgage interest	Assets other than mortgage interest	Unsecured
Neither past due nor impaired	1,227,795	194,473	613,638	1,287,384	94,771	587,528
Past due but not impaired:						
Past due less than 30 days	26,130	579	3,742	36,883	123	5,773
Past due between 30 and 60 days	8,976	29	979	9,254	62	1,077
Past due between 60 and 90 days	811	-	351	-	-	357
Impaired	351,862	724	5,433	383,438	49,113	5,030
Total	1,615,574	195,805	624,143	1,716,959	144,069	599,765

The group holds collateral against loans and advances to customers in the form of mortgage interests over property and pledges, other charges over real and financial assets, and guarantees. Estimates of fair value are based on the value of collateral assessed at the time of borrowing, and updated at a minimum of every three years for performing facilities but more frequently where the market is subject to significant changes in condition. In the case of performing personal mortgages the value of collateral is adjusted annually to reflect overall movements in the market. Where a loan is showing signs of potential impairment, or where the loan is individually assessed as impaired, collateral values are updated annually. Collateral held for impaired loans amounts to $383,263 (2016: $483,181).

The group adheres to HSBC policy and monitors credit concentration risk in accordance with local regulatory requirements. A substantial portion of the loans and advances to customers is due from residents of Bermuda and is secured by residential or commercial property in Bermuda. The only exposures of significance to customers with principle operations outside of Bermuda are $166,667 (2016: $200,000) in Qatar, $131,500 (2016: $140,500) in Brazil, $50,000 (2016: $50,000) in Mexico and $54,844 (2016: $3,656) in UAE.

The group regularly reviews loans and advances to customers and allocates a risk rating against each loan or advance based on performance criteria. The breakdown of loans and advances to customers by risk category at 31 December 2017 is 84.3% (2016: 80.8%) performing, 1.0% (2016: 1.4%) sub-standard and 14.7% (2016: 17.8%) impaired.

‘Performing’ exposures demonstrate a strong to fair capacity to meet financial commitments, with low to moderate probability of default. Personal accounts meet commitments as agreed or show only short periods of delinquency. (‘Performing’ encompasses the ‘Strong,’ ‘Good’ and ‘Satisfactory’ categories outlined in Note 22). ‘Sub-standard’ exposures require varying degrees of special attention and default risk is of greater concern. Personal portfolio segments show longer delinquency periods, of up to 90 days past due. ‘Impaired’ exposures have been assessed as impaired. These include wholesale exposures where the group considers that either the customer is unlikely to pay its credit obligations in full, without recourse by the group to actions such as realizing security if held, or the customer is past due more than 90 days on any material credit obligation.

(In US dollar thousands) 31 December 2017

The breakdown of impaired exposures by customer category is as follows: Personal $297,296 (2016: $307,473), Wholesale $60,723 (2016: $130,108).

Interest receivable on non-performing facilities at 31 December 2017 amounted to $12,329 (2016: $14,270).

At 31 December 2017, the group held repossessed collateral relating to impaired loans with carrying value of $13,011 (2016: $7,942).

The following table provides an analysis of the movements in allowance for impairment losses on loans and advances to customers during the year:

	Individually assessed loans	Collectively assessed loans	Total
Opening balance at 1 January 2016	180,846	28,543	209,389
Uncollectible amounts written off during the year[1]	(57,476)	(1,977)	(59,453)
Recoveries	-	1,118	1,118
Impairment charges during the year	18,283	1,031	19,314
Balance at 31 December 2016	141,653	28,715	170,368
Uncollectible amounts written off during the year	(15,223)	(2,434)	(17,657)
Recoveries	415	1,051	1,466
Impairment charges during the year	8,288	(7,649)	639
Balance at 31 December 2017	135,133	19,683	154,816

Impairment charges during 2017 are split between Personal $2,368 (2016: $11,767) and Wholesale $1,729 release (2016: $7,547).

Allowances for impairment losses are split between Personal $111,545 (2016: $121,007) and Wholesale $43,271 (2016: $49,361).

Renegotiated loans and advances to customers are shown in the table below:

	2017			
	Neither past due nor impaired	**Past due but not impaired**	**Impaired**	**Total**
Personal				
-Residential mortgages	42,783	3,385	207,837	254,005
-Other personal	739	74	8,338	9,151
Total personal	43,522	3,459	216,175	263,156
Wholesale				
Corporate and Commercial				
-Industrial and international trade	518	9	10,465	10,992
-Commercial real estate	66,825	340	29,834	96,999
-Other commercial	250	47	584	881
Total corporate and commercial	67,593	396	40,883	108,872
Financial				
-Non-bank financial institutions	-	-	1,604	1,604
Total wholesale	67,593	396	42,487	110,476
Total renegotiated loans and advances to customers	111,115	3,855	258,662	373,632

[1] As a result of the change in the application of an accounting policy, the uncollectible amounts written off for individually assessed loans during 2016 has decreased by $8,795.

(In US dollar thousands) 31 December 2017

	2016			
	Neither past due nor impaired	Past due but not impaired	Impaired	Total
Personal				
-Residential mortgages	34,156	5,290	203,143	242,589
-Other personal	956	59	8,608	9,623
Total personal	35,112	5,349	211,751	252,212
Wholesale				
Corporate and Commercial				
-Industrial and international trade	549	-	36,921	37,470
-Commercial real estate	64,830	-	63,720	128,550
-Other commercial	501	-	1,240	1,741
Total corporate and commercial	65,880	-	101,881	167,761
Financial				
-Non-bank financial institutions	-	-	3,934	3,934
Total wholesale	65,880	-	105,815	171,695
Total renegotiated loans and advances to customers	100,992	5,349	317,566	423,907

Of the total renegotiated loans and advances $NIL (2016: $NIL) relates to loans that were derecognised for accounting purposes and a new asset recognised following renegotiation. On derecognition, an impairment charge of the difference between the previous carrying value of the derecognised loan and the new loan recorded at fair value would be recognised.

Renegotiated loans

The group proactively work with financially distressed clients, to manage customer relationships, improve collection opportunities and, where possible, to avoid repossession. The vast majority of loans renegotiated with customers are on amortising terms. Renegotiated loans are designated as impaired until the customer has demonstrated long term ability to repay the loan.

Renegotiated loans by delinquency:

	2017				
	Current	**1 – 30 days past due**	**31 – 60 days past due**	**> 90 days past due**	**Total**
Personal					
Impaired	121,127	13,540	15,062	66,446	216,175
Not impaired	43,522	1,772	1,687	-	46,981
Total personal	164,649	15,312	16,749	66,446	263,156
Wholesale					
Impaired	316	1,032	131	41,008	42,487
Not impaired	67,593	9	340	47	67,989
Total wholesale	67,909	1,041	471	41,055	110,476
Total renegotiated loans and advances to customers	232,558	16,353	17,220	107,501	373,632

(In US dollar thousands) 31 December 2017

	2016				
	Current	1 – 30 days past due	31 – 60 days past due	> 90 days past due	Total
Personal					
Impaired	132,133	19,797	12,854	46,966	211,750
Not impaired	35,112	4,501	849	-	40,462
Total personal	167,245	24,298	13,703	46,966	252,212
Wholesale					
Impaired	55,546	1,143	646	48,480	105,815
Not impaired	65,880	-	-	-	65,880
Total wholesale	121,426	1,143	646	48,480	171,695
Total renegotiated loans and advances to customers	288,671	25,441	14,349	95,446	423,907

10 Financial investments

The following tables provide an analysis of the group's financial investments, all classified as available-for-sale securities with the exception of $12,311 (2016: $36,369) classified as trading assets related to structured certificates of deposit.

	2017		2016	
	Amortised cost	**Fair value**	Amortised cost	Fair value
Treasury and other eligible bills	453,101	453,104	938,279	938,270
Debt securities – fixed rate	2,966,831	2,943,708	3,223,376	3,199,120
Debt securities – floating rate	506,290	507,160	425,955	425,134
Total debt securities	3,926,222	3,903,972	4,587,610	4,562,524
Equity securities	113	3,437	138	23,344
Total financial investments	3,926,335	3,907,409	4,587,748	4,585,868

Maturity analysis of debt securities	**2017**	2016
One year or less	984,660	1,241,714
More than one year	2,919,312	3,320,810
	3,903,972	4,562,524

Credit rating analysis of debt securities	**2017**	2016
AAA	1,870,271	1,816,686
AA+	592,594	1,579,785
AA	115,961	184,987
AA-	286,942	299,298
A+	991,498	681,768
A	46,706	-
	3,903,972	4,562,524

Total gains or losses included in profit and loss for the period are presented in the consolidated income statement in 'Gains less losses from financial investments'.

Debt securities are rated using a hierarchy of rating agencies. The Standard & Poor's ('S&P') ratings are used where available, followed by Fitch then Moody's. All securities guaranteed by the U.S. Government are assigned the U.S. Government's sovereign rating. The structured certificates of deposit have been assigned the issuer's rating.

(In US dollar thousands) 31 December 2017

Financial investments by country and sector

	2017				
Country	**Sovereign**	**Bank**	**Asset backed**	**Equities**	**Total**
Belgium	-	-	-	47	47
Bermuda	25,111	-	-	79	25,190
Canada	24,681	770,123	-	-	794,804
Cayman Islands	-	-	-	3,311	3,311
Finland	-	44,253	-	-	44,253
France	-	66,121	-	-	66,121
Germany	-	413,990	-	-	413,990
Japan	453,104	58,847	-	-	511,951
Netherlands	-	143,710	-	-	143,710
Norway	-	16,106	-	-	16,106
Supranational	-	1,313,821	-	-	1,313,821
Sweden	-	47,750	-	-	47,750
United Kingdom	-	49,840	-	-	49,840
United States	464,204	12,311	-	-	476,515
	967,100	2,936,872	-	3,437	3,907,409

Financial investments by country and sector

	2016				
Country	**Sovereign**	**Bank**	**Asset backed**	**Equities**	**Total**
Belgium	-	-	-	34	34
Bermuda	23,560	-	-	239	23,799
Canada	49,947	826,129	-	-	876,076
Cayman Islands	-	-	-	4,173	4,173
Finland	-	44,191	-	-	44,191
France	-	66,223	-	-	66,223
Germany	-	330,900	-	-	330,900
Japan	238,314	-	-	-	238,314
Netherlands	-	144,238	-	-	144,238
Norway	-	-	-	-	-
Supranational	-	1,165,166	-	-	1,165,166
Sweden	-	47,894	-	-	47,894
United Kingdom	-	66,562	-	18,898	85,460
United States	1,451,692	86,113	21,595	-	1,559,400
	1,763,513	2,777,416	21,595	23,344	4,585,868

Supranational entities, reflected in the above tables, are formed by two or more central governments to promote economic development for the member countries.

No debt securities (2016: $NIL) have been pledged to third parties as collateral in the normal course of business and debt securities amounting to $482,576 (2016: $378,702) have been transferred to third parties under securities lending agreements. The group is unable to use, sell or pledge the transferred assets for the duration of the transaction, and remains exposed to interest rate risk and credit risk on these pledged assets.

The group is carrying all financial investments at fair value. During the year the group received proceeds of $3,540,151 (2016: $8,218,798) from the sale or maturity of financial investments, including $700,000 (2016: $1,850,000) from financial investments classified as cash and cash equivalents and realised a net gain of $28,027 (2016: $8,564). The group monitors interest rate sensitivity under varying interest rate scenarios as summarised in Note 22.

(In US dollar thousands) 31 December 2017

11 Fair values of financial investments carried at fair value

The fair value of financial instruments is generally measured on the basis of the individual financial instrument. A three level fair value hierarchy, which reflects the significance of observable market inputs, is used when estimating fair values and is summarised below:

Financial Investments fair value hierarchy summary by sector	**2017** Quoted market price Level 1	Using observable inputs Level 2	With significant unobservable inputs Level 3	Total
Sovereign	464,204	502,896	-	967,100
Bank	-	2,924,561	12,311	2,936,872
Asset backed	-	-	-	-
Equities	-	-	3,437	3,437
Total Financial Investments	464,204	3,427,457	15,748	3,907,409
Derivatives				
Assets	-	15,286	-	15,286
Liabilities	-	8,981	-	8,981

Financial Investments fair value hierarchy summary by sector	2016 Quoted market price Level 1	Using observable inputs Level 2	With significant unobservable inputs Level 3	Total
Sovereign	1,451,692	311,821	-	1,763,513
Bank	-	2,758,944	18,472	2,777,416
Asset backed	-	21,595	-	21,595
Equities	-	-	23,344	23,344
Total Financial Investments	1,451,692	3,092,360	41,816	4,585,868
Derivatives				
Assets	-	34,965	-	34,965
Liabilities	-	21,828	-	21,828

For Levels 1 and 2 the fair values of these securities have been measured using quoted market prices for identical or similar instruments in active markets.

There have been no transfers between the Levels. The following table shows the reconciliation from the beginning balance to the ending balance for fair value measurements in Level 3 of the fair value hierarchy:

	2017			2016		
	Debt Securities	**Equities**	**Total**	Debt Securities	Equities	Total
At 1 January	18,472	23,344	41,816	88,619	26,289	114,908
Purchases	-	-	-	-	-	-
Sales	(7,181)	(22,257)	(29,438)	(72,259)	-	(72,259)
Total gains or losses:						
in profit or loss[1]	1,020	25,384	26,404	2,112	(1,710)	402
in other comprehensive income	-	(23,034)	(23,034)	-	(1,235)	(1,235)
At 31 December	12,311	3,437	15,748	18,472	23,344	41,816

[1] *Included in 'Gains less losses from financial investments' in the consolidated income statement'.*

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Level 3 securities comprise (i) AFS equities and (ii) equity and equity-linked securities ('structured CDs'). In the absence of an active market, an investment's fair value is estimated on the basis of an analysis of the investee's financial position and results, risk profile, prospects and other factors, as well as by reference to market valuations for similar entities quoted in an active market, or the price at which similar companies have changed ownership. The fair value of structured CDs valued using a valuation technique with significant unobservable inputs is derived from the fair value of the underlying debt security, and the fair value of the embedded derivative. Level 3 structured CDs principally comprise equity-linked notes which are issued by HSBC and provide the counterparty with a return that is linked to the performance of certain equity securities which are capped. The structured CDs are classified as Level 3 due to the unobservability of parameters such as long-dated equity volatilities and correlations between equity prices. As the performance of the equity securities are capped, a range cannot be placed on it. Included in customers deposits are structured certificates of deposit liabilities ('CD liabilities') in the amount of $12,311 (2016: $36,369) including Level 3 securities of $12,311 (2016: $18,472). The movement in Level 3 CD liabilities mirrors the movement in the structured CDs as shown in the above table.

12 Property and equipment

	Land and buildings	**Equipment, fixtures and fittings and software**	**Total**
Cost			
Cost at 1 January 2017	186,654	100,415	287,069
Additions at cost	84	3,315	3,399
Disposals and write-offs	-	-	-
Cost at 31 December 2017	186,738	103,730	290,468
Accumulated depreciation			
Accumulated depreciation at 1 January 2017	69,183	90,514	159,697
Depreciation charge for the year	2,137	4,904	7,041
Impairment losses	-	-	-
Disposals and write-offs	-	-	-
Accumulated depreciation at 31 December 2017	71,320	95,418	166,738
Net book value at 31 December 2017	115,418	8,312	123,730

	Land and buildings	Equipment, fixtures and fittings and software	Total
Cost			
Cost at 1 January 2016	186,654	99,030	285,684
Additions at cost	-	1,549	1,549
Disposals and write-offs	-	(164)	(164)
Cost at 31 December 2016	186,654	100,415	287,069
Accumulated depreciation			
Accumulated depreciation at 1 January 2016	44,518	83,940	128,458
Depreciation charge for the year	3,388	6,738	10,126
Impairment losses	21,277	-	21,277
Disposals and write-offs	-	(164)	(164)
Accumulated depreciation at 31 December 2016	69,183	90,514	159,697
Net book value at 31 December 2016	117,471	9,901	127,372

During 2017 there was recognition of an impairment loss where book value exceed fair market value on the portfolio of land and buildings in the amount of $NIL (2016: $21,277). The impairment has been included in the consolidated income statement as part of 'Depreciation and impairment of property and equipment '.

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13 Group entities

(a) Principal subsidiaries

The Bank has a 100% interest in the legal entities listed below:

Legal Entity	Country of incorporation or registration	Activity
HSBC Global Asset Management (Bermuda) Limited	Bermuda	Investment management
HSBC Institutional Trust Services (Bermuda) Limited	Bermuda	Custodial and other fiduciary services
HSBC Securities Services (Bermuda) Limited	Bermuda	Fund administration
HSBC Cayman Services Limited	Cayman	Fund and Trust administration

All of the above entities prepare their financial statements up to 31 December. Please refer to Note 14 for details of acquisitions and disposals during 2017 and 2016.

During the year ended December 31, 2016 Bermuda Trust Company Limited was sold to The Bank of N.T. Butterfield & Son Limited (Note 14) and Bermuda International Securities Limited was placed into liquidation (Note 14).

(b) Principal associate

Movement in investment in associate

	2017	2016
At 1 January	1,596	1,478
Share of profit	35	118
At 31 December	1,631	1,596

Summarised aggregate financial information on associate at 31 December

	2017	2016
Assets	3,917	3,901
Liabilities	609	677
Operating income	4,436	4,930
Profit for the year	70	236

The associate investment is accounted for using the equity method.

14 Investments

(a) Acquisitions

The group did not purchase any subsidiary undertakings in 2017 or 2016.

(b) Disposals

The group did not dispose of any subsidiary undertakings in 2017.

During the year ended 31 December 2016 the Bank completed the disposal and sale of the Private Banking investment management operations in Bermuda and a wholly owned subsidiary, Bermuda Trust Company Limited to The Bank of N.T. Butterfield & Son Limited. The disposal and sale was per an agreement entered into in 2015 with The Bank of N.T. Butterfield & Son Limited. The attributable gain of $20,342 has been included in ‘Gains (losses) on restructuring and disposal of subsidiary investments’. Note 15 presents further details on the discontinued operations of the Private Banking operations and the subsidiary.

(In US dollar thousands) 31 December 2017

Also during 2016, a strategic review was performed to streamline the number of subsidiary undertakings. As a result Bermuda International Securities Limited was placed into liquidation and all businesses transferred to the main banking entity.

15 Discontinued operations

During the year ended 31 December 2017 there were no discontinued operations

During the year ended 31 December 2016

In 2015, following a strategic review, the group entered into an agreement to sell the Private Banking business and a wholly owned subsidiary, Bermuda Trust Company Limited, to The Bank of N.T. Butterfield & Son Limited. The sale of the Private Banking business and a wholly owned subsidiary, Bermuda Trust Company Limited, to The Bank of N.T.Butterfield & Son Limited closed on 29 April 2016 with customer balances transferring from that date. The net proceeds paid by The Bank of N.T.Butterfield & Son Limited were $21,627.

The consolidated income statement has been presented to show the discontinued operations separately from continuing operations. The results and impact of the discontinued operations are summarised below:

	2016
Results from discontinued operations	
Net operating income	8,979
Loan impairment charges	39
Total operating expenses	(6,523)
Operating profit	2,495
Profit on restructuring and disposal of subsidiary investments	20,342
Profit before tax	22,837
Tax expense	-
Profit from discontinued operations	22,837

	2016
Cash flows used in discontinued operations	
Net cash flows used in operating activities	(1,555,532)
Net cash flows from investing activities	21,627
Net cash flows from financing activities	-
Net decrease in cash and cash equivalents	(1,533,905)

16 Provisions

	Restructuring	Legal	Total
At 1 January 2016	14,866	-	14,866
Increase in provisions	2,548	-	2,548
Provisions utilised	(7,118)	-	(7,118)
Amounts reversed	-	-	-
At 31 December 2016	10,296	-	10,296
At 1 January 2017	10,296	-	10,296
Increase in provisions	640	55,000	55,640
Provisions utilised	(2,503)	-	(2,503)
Amounts reversed	(288)	-	(288)
At 31 December 2017	8,145	55,000	63,145

Restructuring provisions relate to an onerous contract, debt collection and redundancy costs associated with discontinued operations. Legal provisions relate to ongoing legal proceedings, which are undertaken in the normal course of business.

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17 Contingent liabilities, contractual commitments and guarantees

Contingent liabilities and commitments are credit-related instruments, which include letters of credit, guarantees and commitments to extend credit. The contractual amounts represent the amounts at risk should the contract be fully drawn upon and the client defaults. Since a significant portion of guarantees and commitments are expected to expire without being drawn upon, the total of the contractual amounts is not indicative of future liquidity requirements.

The following table gives the nominal principal amounts of off-balance sheet transactions.

	2017	2016
Guarantees and contingent liabilities		
Guarantees in the form of irrevocable letters of credit	92,025	143,040
Financial and other guarantees	27,500	27,500
At 31 December	119,525	170,540
Commitments		
Documentary credits and short-term trade-related transactions	119	200
Standby facilities, credit lines and other commitments to lend		
– remaining contractual maturity one year or less	323,817	334,246
– remaining contractual maturity more than one year	143,591	253,402
At 31 December	467,527	587,848
Total guarantees, contingent liabilities and commitments	587,052	758,388

At 31 December 2017 approximately 68% (2016: 73%) of the above guarantees have an original contractual term of less than one year. Guarantees with a term of more than one year are subject to the group's annual credit review process. When the group has given a guarantee on behalf of a customer, it will have the right to recover from that customer any amounts paid under the guarantee. At 31 December 2017, the group holds collateral amounting to $66,100 (2016: $119,990), which could be used to recover amounts paid under the above guarantees.

18 Lease commitments

At 31 December 2017, 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 as follows:

	2017		2016	
Future minimum lease payments under non-cancellable operating leases	**Land and buildings**	**Equipment**	Land and buildings	Equipment
No later than one year	820	170	1,639	179
Later than one year and not later than five years	-	170	7,471	509
Later than five years	-	-	2,851	-
	820	340	11,961	688

During the year $1,809 (2016: $1,826) was recognised in respect of lease agreements of which $170 (2016: $179) was recognized within 'General and administrative expenses'.

The group has chosen to exercise an option to reduce the lease term of its primary residence in the Cayman Islands. The option was exercised by providing written notice 12 months prior to 30 June 2018 and by agreeing to pay a sum of $6,000 which represents the cost of the break option under the terms of the lease. The group accounts for the onerous contract as a provision in the consolidated balance sheet.

(In US dollar thousands) 31 December 2017

19 Maturity analysis of financial assets and financial liabilities

The following is an analysis of financial assets and financial liabilities by remaining contractual maturities at the date of the consolidated balance sheet:

31 December 2017	Due not more than 1 month	Due over 1 month but not more than 3 months	Due over 3 months but not more than 6 months	Due over 6 months but not more than 9 months	Due over 9 months but not more than 1 year	Due over 1 year but not more than 2 years	Due over 2 years but not more than 5 years	Due over 5 years	Total
Cash and balances at central banks	32,691	-	-	-	-	-	-	-	32,691
Items in the course of collection from other banks	76	-	-	-	-	-	-	-	76
Derivatives	5,054	2,028	703	144	913	-	6,444	-	15,286
Loans and advances to banks	1,817,554	325,000	225,000	-	40,000	200,000	-	-	2,607,554
Loans and advances to customers	154,011	19,926	32,720	30,160	32,014	313,147	613,353	1,085,375	2,280,706
Of which:									
- Personal	60,389	13,751	20,454	20,204	20,097	85,591	227,785	933,059	1,381,330
- Corporate and commercial	87,892	5,778	11,738	9,423	11,378	205,260	382,420	148,798	862,687
- Financial and other	5,730	397	528	533	539	22,296	3,148	3,518	36,689
Financial investments	-	515,458	213,328	94,768	161,106	844,260	2,049,940	28,549	3,907,409
Total financial assets	2,009,386	862,412	471,751	125,072	234,033	1,357,407	2,669,737	1,113,924	8,843,722
Other assets	58,069	-	-	-	-	-	-	125,361	183,430
Total assets	2,067,455	862,412	471,751	125,072	234,033	1,357,407	2,669,737	1,239,285	9,027,152
Deposits by banks [1]	45,757	-	-	-	-	-	-	-	45,757
Customer accounts[1]	7,711,940	148,748	76,284	72,465	36,686	15,575	23,303	-	8,085,001
Of which:									
- Personal	2,170,217	93,154	61,454	46,299	34,967	12,438	23,278	-	2,441,807
- Corporate and commercial	1,253,099	31,532	1,783	25,396	1,719	2,028	25	-	1,315,582
- Financial and other	4,288,624	24,062	13,047	770	-	1,109	-	-	4,327,612
Items in course of transmission to other banks	2,055	-	-	-	-	-	-	-	2,055
Derivatives	5,632	1,592	699	144	863	-	51	-	8,981
Total financial liabilities	7,765,384	150,340	76,983	72,609	37,549	15,575	23,354	-	8,141,794
Other liabilities	41,850	55,085	140	6,552	1,859	1,343	2,630	19,396	128,855
Total liabilities	7,807,234	205,425	77,123	79,161	39,408	16,918	25,984	19,396	8,270,649
Off balance sheet commitments given									
Loans and other credit-related commitments	174,004	153,302	26,844	73,307	12,929	52,926	83,830	9,910	587,052
Of which:									
- Personal	143,248	3,308	1	-	-	30	363	9,875	156,825
- Corporate and commercial	24,243	17,092	1,575	1,874	275	52,665	33,317	-	131,041
- Financial and other	6,513	132,902	25,268	71,433	12,654	231	50,150	35	299,186

'Other assets' comprise 'Prepayments and accrued income' classified within 'Due not more than 1 month' and 'Interest in associate', 'Property and equipment ' classified as 'Due over 5 years'.

'Other liabilities' comprise 'Accruals' and 'Provisions' classified within 'Due not more than 1 month'; 'Retirement benefit liabilities' within 'Due over 5 years' and 'Deferred income' which is reflected across all periods.

[1] Deposits by banks are predominantly Bermuda (41%), US (35%), Other (24 %). Customer accounts are predominantly Bermuda (88%), Other (12%). Both Deposit by banks and Customer deposits are included in Level 2 of the fair value levelling hierarchy and the carrying amounts equal the fair value as these are typically short term in nature.

(In US dollar thousands) 31 December 2017

31 December 2016	Due not more than 1 month	Due over 1 month but not more than 3 months	Due over 3 months but not more than 6 months	Due over 6 months but not more than 9 months	Due over 9 months but not more than 1 year	Due over 1 year but not more than 2 years	Due over 2 years but not more than 5 years	Due over 5 years	Total
Cash and balances at central banks	29,651	-	-	-	-	-	-	-	29,651
Items in the course of collection from other banks	73	-	-	-	-	-	-	-	73
Derivatives	10,084	12,269	417	71	40	-	12,084	-	34,965
Loans and advances to banks	1,779,251	-	195,000	-	300,000	340,000	-	-	2,614,251
Loans and advances to customers	159,297	40,193	36,965	58,989	32,768	163,127	741,759	1,057,327	2,290,425
Of which:									
- Personal	61,075	18,559	23,297	23,024	22,945	100,035	268,694	903,351	1,420,980
- Corporate and commercial	87,664	20,717	12,226	32,851	8,851	60,071	468,859	151,127	842,366
- Financial and other	10,558	917	1,442	3,114	972	3,021	4,206	2,849	27,079
Financial investments	699,956	335,784	58,894	34,413	112,667	747,977	2,527,678	68,499	4,585,868
Total financial assets	2,678,312	388,246	291,276	93,473	445,475	1,251,104	3,281,521	1,125,826	9,555,233
Other assets	73,118	-	-	-	-	-	-	128,968	202,086
Total assets	2,751,430	388,246	291,276	93,473	445,475	1,251,104	3,281,521	1,254,794	9,757,319
Deposits by banks [1]	783,250	-	-	-	-	-	-	-	783,250
Customer accounts [1]	7,673,893	93,756	77,373	84,075	24,314	19,568	15,187	-	7,988,166
Of which:									
- Personal	1,871,517	64,018	47,996	43,914	23,333	10,420	11,588	-	2,072,786
- Corporate and commercial	1,734,258	10,361	2,180	22,312	230	-	163	-	1,769,504
- Financial and other	4,068,118	19,377	27,197	17,849	751	9,148	3,436	-	4,145,876
Items in course of transmission to other banks	2,380	-	-	-	-	-	-	-	2,380
Derivatives	9,238	12,103	386	74	-	8	19	-	21,828
Total financial liabilities	8,468,761	105,859	77,759	84,149	24,314	19,576	15,206	-	8,795,624
Other liabilities	61,586	193	176	281	156	778	3,538	67,473	134,181
Total liabilities	8,530,347	106,052	77,935	84,430	24,470	20,354	18,744	67,473	8,929,805
Off balance sheet commitments given									
Loans and other credit-related commitments	319,203	27,500	43,755	67,256	9,758	107,795	176,674	6,447	758,388
Of which:									
- Personal	202,906	7	1	8	-	297	426	6,374	210,019
- Corporate and commercial	32,386	1,714	1,575	48,772	275	450	126,782	35	211,989
- Financial and other	83,911	25,779	42,179	18,476	9,483	107,048	49,466	38	336,380

'Other assets' comprise 'Prepayments and accrued income' classified within 'Due not more than 1 month' and 'Interest in associate', 'Property and equipment ' classified as 'Due over 5 years'.

'Other liabilities' comprise 'Accruals' and 'Provisions' classified within 'Due not more than 1 month'; 'Retirement benefit liabilities' within 'Due over 5 years' and 'Deferred income' which is reflected across all periods.

[1] Deposits by banks are predominantly US (67%), UK (16%), Bermuda (3%), Other (14 %). Customer accounts are predominantly Bermuda (87%), Other (13%). Both Deposit by banks and Customer deposits are included in Level 2 of the fair value levelling hierarchy and the carrying amounts equal the fair value as these are typically short term in nature.

(In US dollar thousands) 31 December 2017

20 Interest rate analysis of financial instruments

The table below discloses the mismatch of the dates on which interest on financial assets and financial liabilities are next reset to market rate on a contractual basis, or if earlier, the dates on which the instruments mature. Contractual terms may not be representative of the behaviour of financial assets and liabilities and the group therefore manages interest rate risk based on the behavioural characteristics of the relevant financial assets and liabilities.

31 December 2017	Up to 3 months	From 3 months to 6 months	From 6 months to 1 year	From 1 year to 5 years	From 5 years to 10 years	Non-interest bearing	Total	Range of weighted average effective interest rates
Financial assets								
Cash and balances at central banks	-	-	-	-	-	32,691	32,691	
Items in the course of collection from other banks	-	-	-	-	-	76	76	
Derivatives	-	-	-	-	-	15,286	15,286	
Loans and advances to banks	2,607,554	-	-	-	-	-	2,607,554	0.43-1.76%
Loans and advances to customers	2,255,159	-	2,174	23,373	-	-	2,280,706	4.99-5.34%
Financial investments	1,364,263	157,468	189,267	2,167,863	25,111	3,437	3,907,409	1.17-1.34%
Total at 31 December 2017	6,226,976	157,468	191,441	2,191,236	25,111	51,490	8,843,722	
Financial liabilities								
Deposits by banks	45,509	-	-	-	-	248	45,757	0.00-0.11%
Customer accounts	7,872,999	67,426	109,151	35,425	-	-	8,085,001	0.05-0.09%
Items in course of transmission to other banks	-	-	-	-	-	2,055	2,055	
Derivatives	-	-	-	-	-	8,981	8,981	
Total at 31 December 2017	7,918,508	67,426	109,151	35,425	-	11,284	8,141,794	
Interest rate sensitivity gap	(1,691,532)	90,042	82,290	2,155,811	25,111			
Cumulative interest rate sensitivity gap	(1,691,532)	(1,601,490)	(1,519,200)	636,611	661,722			

Financial instruments included within ‘Prepayments and accrued income’, ‘Other assets’, ‘Accruals and deferred income’, ‘Provisions’, ‘Other liabilities’ and ‘Retirement benefit liabilities’ have not been included in the analysis above and are all considered non-interest bearing. The interest rate sensitivity gap on non-interest bearing assets and liabilities is considered to be $NIL.

(In US dollar thousands) 31 December 2017

31 December 2016	Up to 3 months	From 3 months to 6 months	From 6 months to 1 year	From 1 year to 5 years	From 5 years to 10 years	Non-interest bearing	Total	Range of weighted average effective interest rates
Financial assets								
Cash and balances at central banks	-	-	-	-	-	29,651	29,651	
Items in the course of collection from other banks	-	-	-	-	-	73	73	
Derivatives	-	-	-	-	-	34,965	34,965	
Loans and advances to banks	2,614,251	-	-	-	-	-	2,614,251	0.40-0.77%
Loans and advances to customers	2,272,814	-	-	17,611	-	-	2,290,425	4.72-5.40%
Financial investments	1,990,745	41,161	85,271	2,421,787	23,560	23,344	4,585,868	0.85-1.22%
Total at 31 December 2016	6,877,810	41,161	85,271	2,439,398	23,560	88,033	9,555,233	
Financial liabilities								
Deposits by banks	777,604	-	-	-	-	5,646	783,250	0.00-0.15%
Customer accounts	7,804,184	59,476	101,985	22,521	-	-	7,988,166	0.04-0.05%
Items in course of transmission to other banks	-	-	-	-	-	2,380	2,380	
Derivatives	-	-	-	-	-	21,828	21,828	
Total at 31 December 2016	8,581,788	59,476	101,985	22,521	-	29,854	8,795,624	
Interest rate sensitivity gap	(1,703,978)	(18,315)	(16,714)	2,416,877	23,560			
Cumulative interest rate sensitivity gap	(1,703,978)	(1,722,293)	(1,739,007)	677,870	701,430			

Financial instruments included within ‘Prepayments and accrued income’, ‘Other assets’, ‘Accruals and deferred income’, ‘Provisions’, ‘Other liabilities’ and ‘Retirement benefit liabilities’ have not been included in the analysis above and are all considered non-interest bearing. The interest rate sensitivity gap on non-interest bearing assets and liabilities is considered to be $NIL.

(In US dollar thousands) 31 December 2017

21 Foreign currency exposures

(a) Balance sheet denominated in foreign currency

The group recognises that changes in foreign exchange rates can result in changes to profit and loss and other comprehensive income. In order to mitigate this risk, the group matches assets and liabilities by currency to the greatest extent possible including using forward foreign exchange contracts to reduce potential mismatches. The table below shows the extent of foreign currency mismatch including the impact of the forward foreign exchange contracts.

31 December 2017	**Assets**	**Liabilities and Equity**	**Net foreign exchange exposure**
Euro	535,829	539,556	(3,727)
Pound sterling	357,522	369,364	(11,842)
Japanese yen	256,668	262,279	(5,611)
Canadian dollars	153,458	158,748	(5,290)
Australian dollars	158,611	162,647	(4,036)
New Zealand dollars	47,271	48,886	(1,615)
Swiss franc	48,117	48,063	54
Other currencies	69,756	65,743	4,013
Total foreign currency	1,627,232	1,655,286	(28,054)
US and Bermuda dollars	7,399,920	7,371,866	28,054
Total	9,027,152	9,027,152	-

31 December 2016	Assets	Liabilities and Equity	Net foreign exchange exposure
Euro	437,489	435,339	2,150
Pound sterling	381,408	378,932	2,476
Japanese yen	245,988	246,597	(609)
Canadian dollars	318,681	319,511	(830)
Australian dollars	155,896	160,764	(4,868)
New Zealand dollars	47,026	46,955	71
Swiss franc	118,578	117,740	838
Other currencies	50,457	50,421	36
Total foreign currency	1,755,523	1,756,259	(736)
US and Bermuda dollars	8,001,796	8,001,060	736
Total	9,757,319	9,757,319	-

Considering the foreign exchange exposures as at 31 December 2017 and 31 December 2016, shareholder's equity, which is in Bermuda dollars (2017: $811,503; 2016: $827,514), would decrease by US$1,323 (2016: US$159) if Pound sterling, Euro, Japanese yen and Canadian dollar foreign currency exchange rates all weakened by 5% relative to the US dollar. The group therefore considers that the overall risk of changes in foreign exchange rates to profit and loss and equity is not significant.

(b) Structural currency exposures

The group's structural foreign currency exposure is represented by the net asset value of its foreign currency equity in subsidiary undertakings and associates. Gains or losses arising from structural foreign currency exposures are recognised in other comprehensive income. The group's management of structural foreign currency exposures is discussed in the 'Market risk management' section in Note 22.

22 Risk management

The most important types of risk categories that the group are exposed to are market risk (including interest rate, equity price, foreign exchange and credit spread risk), liquidity and funding risk, operational risks (including financial crime and compliance risks), credit risk (including cross-border risk) and reputational risk. This note presents information about the group's risk management framework, objectives, policies and processes for measuring and managing risk, the group's exposure to each of the material risks, and the group's management of capital.

Managing risk
The group maintains a conservative and consistent approach to risk, ensuring we protect customers' funds, lend responsibly and support economies. By carefully aligning our risk appetite to our strategy, we are able to deliver long-term shareholder returns. All employees are responsible for the management of risk, with the ultimate accountability residing with the Board. We have a strong risk culture, which is embedded through clear and consistent communication and appropriate training for all employees.

A comprehensive risk management framework is applied throughout the group, with effective governance and corresponding risk management tools. Our dedicated HSBC Global Risk function supported by the Bermuda Risk function oversees the framework, and is led by the HSBC Group Chief Risk Officer supported by the group Chief Risk Officer. It is independent from our sales and trading functions to help provide challenge, appropriate oversight, and balance in risk/ reward decisions. The group's risk appetite defines its desired forward-looking risk profile, and informs the strategic and financial planning process.

The following principles guide the group's overarching risk appetite and determine how its businesses and risks are managed.

Financial position
- Strong capital position, defined by regulatory and internal capital ratios.
- Liquidity and funding management for each operating entity, on a stand-alone basis.

Operating model
- Returns generated in line with risk taken.
- Sustainable and diversified earnings mix, delivering consistent returns for shareholders.

Business practice
- Zero tolerance for knowingly engaging in any business, activity or association where foreseeable reputational risk or damage has not been considered and/or mitigated.
- No appetite for deliberately or knowingly causing detriment to consumers arising from our products and services or incurring a breach of the letter or spirit of regulatory requirements.
- No appetite for inappropriate market conduct by a member of staff or by any group business.
- Robust risk governance and accountability is embedded into our risk management framework.

Our risk management framework
Our enterprise-wide risk management framework is underpinned by a strong risk culture and reinforced by the HSBC Values and our Global Standards. These are instrumental in aligning the behaviours of individuals with the group's attitude to assuming and managing risk and ensuring that our risk profile remains in line with our risk appetite.

The risk management framework promotes continuous monitoring of the risk environment, and an integrated evaluation of risks and their interactions. It also ensures a consistent approach to monitoring, managing and mitigating the risks we accept and incur in our activities.

The key aspects of the framework include (i) our risk culture; (ii) governance and structure; (iii) our responsibilities; and (iv) risk management policies and risk appetite.

(i) Our risk culture
The group has long recognised the importance of a strong risk culture, the fostering of which is a key responsibility of senior executives. We use clear and consistent employee communication on risk to convey strategic messages and set the tone from senior management. We also deploy mandatory training on risk and compliance topics to embed skills and understanding in order to strengthen our risk culture and reinforce the attitude to risk in the behaviour expected of employees, as described in our risk policies. Mandatory training materials are updated regularly, describing technical, cultural and ethical aspects of the various risks assumed by the group and how they should be managed effectively. A whistleblowing policy is in place to allow people to raise concerns confidentially. Our risk culture is also reinforced by our approach to remuneration. Individual awards, including those for senior executives, are based on compliance with HSBC Values and the achievement of financial and non-financial objectives, which are aligned to our risk appetite and global strategy.

(ii) Governance and structure

Robust risk governance and accountability are embedded throughout the group through an established framework that ensures appropriate oversight of and accountability for the effective management of risk. The Board has ultimate responsibility for the effective management of risk and approves the group's risk appetite. The Board is advised on risk-related matters primarily by the Risk Management Meeting ('RMM').

Our strong risk governance reflects the importance placed by the Board and the RMM on shaping the group's risk strategy and managing risks effectively. It is supported by a clear policy framework of risk ownership, a risk appetite process through which the types and levels of risk that we are prepared to accept in executing our strategy are articulated and monitored, performance scorecards cascaded that align business and risk objectives, and the accountability of all staff for identifying, assessing and managing risks within the scope of their assigned responsibilities. This personal accountability, reinforced by the governance structure, mandatory learning and our approach to remuneration, helps to foster a disciplined and constructive culture of risk management and control.

Primary responsibility for managing risk at the group's operating entity levels lies with the relevant Chief Executive Officer, as custodian of the relevant balance sheets. In turn, the Chief Risk Officer has functional responsibility for the primary financial risk types, namely: credit, market, operational and security / fraud risks. Operational Risk Function co-ordinates the development of the risk appetite statement. Finance (including asset and liability management) is primarily responsible for the economic capital and stress-testing frameworks.

(iii) Our responsibilities

All employees are responsible for identifying and managing risk within the scope of their role as part of the three lines of defence model. We use an activity-based three lines of defence model to delineate management accountabilities and responsibilities for risk management and the control environment. This creates a robust control environment in which to manage residual risks. The model underpins our approach to risk management by clarifying responsibility, encouraging collaboration, and enabling efficient coordination of risk and control activities.

The three lines of defence are summarised below:

First line of defence	**Owns the risk and is responsible for identifying, recording, reporting, managing risks and ensuring that the right controls and assessments are in place to mitigate these risks.**
Second line of defence	**Sets the policy and guidelines for managing the risks and provides advice, guidance and challenge to the First Line of Defence on effective risk management.**
Third line of defence	**The third line of defence is the Internal Audit function, which provides independent and objective assurance of the adequacy of the design and operational effectiveness of the group's risk management framework and control governance process.**

(iv) Risk management policies and risk appetite

The group's risk appetite defines its desired forward-looking risk profile, and informs the strategic and financial planning process. The group's approach to risk appetite reinforces the integration of risk considerations into key business goals and planning processes. Preserving the strong capital position remains a key priority for the group, and the level of integration of risk and capital management helps to optimise response to business demand for regulatory and economic capital.

As risk is not static, the group's risk profile continually alters as a result of change in the scope and impact of a wide range of factors, from geopolitical to transactional. The risk environment requires continual monitoring and holistic assessment in order to understand and manage its complex interactions across the group.

The group's risk management policies, encapsulated in the HSBC Group Standards Manual ('GSM') are cascaded in a hierarchy of policy manuals throughout the group and are designed to communicate standards, instructions and guidance to employees. They support the formation of risk appetite and establish procedures for monitoring and controlling risks, with timely and reliable reporting to management. Risk management policies, systems and methodologies are regularly reviewed and updated to reflect changes in law, regulation, markets, products and emerging best practice. Functional Instruction Manuals ('FIM') are the vehicles by which policies on risk and capital governance are articulated. All senior managers are required to have read and adhere to GSM and all relevant FIMs.

Each business area is responsible for creating and maintaining its own business-specific procedures. Staff are trained using the procedures which are reviewed on a regular basis. The Operational Risk Function performs independent oversight and highlights any control gaps. In addition, HSBC Group Audit conducts periodic audits of functions and businesses.

The group's Risk Appetite Statement ('RAS') is the written articulation of the aggregated level and types of risk that we are willing to accept in our business activities in order to achieve our business objectives. It is central to an integrated approach to risk, capital and business management. The RAS is a key component in our management of risk and is reviewed on an ongoing basis, with formal annual approval from the Board on recommendation from the RMM.

The formulation of risk appetite considers the group's risk capacity, its financial position, the strength of its core earnings and the resilience of its reputation and brand. It is expressed both qualitatively, describing which risks are taken and why, and quantitatively. Quantitative and qualitative metrics are assigned to nine key categories: earnings, capital and leverage, liquidity and funding, risk categories such as credit risk, financial crime compliance, regulatory compliance, pension risk and traded risk.

Senior management attach quantitative metrics within the risk appetite framework in order that (i) underlying business activity may be guided and controlled so it continues to align with risk appetite; (ii) key assumptions underpinning the risk appetite can be monitored and, as necessary, adjusted through subsequent business plan iterations; and (iii) anticipated mitigating business decisions are flagged and acted upon promptly.

The risk appetite framework covers both the beneficial and adverse aspects of risk. It is used as the basis for risk evaluation, capital ratio monitoring and performance measurement for the group and across customer groups. Risk appetite is executed through the operational limits that control the levels of risk run by the group and customer groups and is measured using risk-adjusted performance metrics.

(a) Market risk management

Market risk is the risk that movements in market factors, such as foreign exchange rates, interest rates, credit spreads, equity prices and commodity prices, will reduce our income or the value of our portfolios.

The group has been in compliance with the Volcker Rule since its introduction on 21 July 2016. The Volcker Rule prohibits "banking entities from (i) engaging in short-term proprietary trading of securities, derivatives, commodity futures and options on these instruments for their own account and (ii) owning, sponsoring, or having certain relationships with hedge funds or private equity funds, referred to as covered funds."

Certain activities are excluded from the scope of the rule, including transactions in spot foreign exchange, spot commodities and loans and deposits. The rules require banking entities to establish an internal compliance program in order to monitor compliance with the rules. The group does not engage in proprietary trading however implementation of the rule requires an extensive compliance programme and includes additional reporting and record keeping requirements. Mandatory training has been completed by all group personnel whose roles have been identified as being affected by the Volcker rule compliance programme.

Exposure to market risk relating to the non-trading portfolios comprises positions that primarily arise from the interest rate management of personal and wholesale banking assets and liabilities, financial investments designated as available for sale and fair value hedges and these activities are considered out of scope for Volcker reporting. The group's trading portfolio related to balance sheet risk hedging activity is considered exempt through the 'Risk Mitigating Hedging Exemption'. In addition, the foreign exchange client sales activity is exempt through the 'Market Making Exemption'.

The group is not required to report under market risk methodologies as its trading book does not exceed the De Minimis threshold, resulting in an exemption as defined in the Bermuda Monetary Authority ('BMA') Framework. Further details are noted below in the capital management section explanations regarding Basel III Pillar 1 regulatory reporting requirements.

Market Risk is:

- **measured** in terms of value at risk ('VaR'), which measures the potential losses on risk positions over a specified time horizon for a given level of confidence, and assessed using stress testing and sensitivity analysis;
- **monitored** using VaR, stress testing and other measures including the sensitivity of net interest income and the sensitivity of structural foreign exchange; and
- **managed** using approved risk limits applied to our businesses.

The objectives of the group's market risk management strategy are to manage and control market risk exposures in order to optimise return within the group's risk appetite.

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The management of market risk is undertaken mainly in Global Markets using risk limits approved by the HSBC Group Management Board ('GMB'). Limits are set for portfolios, products and risk types with market liquidity being a primary factor in determining the level of limits set. Final approval of limits resides with local entity Boards.

Global Risk is responsible for our market risk management policies and measurement techniques. The group has an independent market risk management and control function which is responsible for measuring market risk exposures in accordance with the policies defined by Global Risk, and for monitoring and reporting exposures against the prescribed limits on a daily basis in accordance with our risk appetite. Interest rate risk in the banking book ('IRRBB') is defined as the exposure of our non-trading products to interest rates. This risk arises in such portfolios principally from mismatches between the future yield on assets and their funding costs, as a result of interest rate changes. Analysis of this risk is complicated by behavioural assumptions regarding the economic duration of liabilities which are contractually repayable on demand such as current accounts.

The group assesses the structural interest rate risks which arise in the businesses and transfers these risks to the group's balance sheet management ('BSM') team. Our aim is to ensure that all market risks are consolidated within operations that have the necessary skills, tools, management and governance to manage them. When the behavioural characteristics of a product differ from its contractual characteristics, the behavioural characteristics are assessed to determine the appropriate underlying interest rate risk. The Asset and Liability Management Committee ('ALCO') regularly monitors all such behavioural assumptions and interest rate risk positions to ensure they comply with established interest rate risk limits.

In executing the management of the liquidity risk on behalf of ALCO, and managing the non-trading interest rate positions transferred to it, BSM invests in highly-rated liquid assets in line with the group's liquid asset policy. The majority of the liquidity is invested in central bank deposits and government, supranational and agency securities with most of the remainder held in short-term interbank and central bank loans. BSM is permitted to use derivatives as part of its mandate to manage interest rate risk. Derivative activity is predominantly through the use of interest rate swaps which are part of cash flow hedging and fair value hedging relationships.

In the course of managing interest rate risk, quantitative techniques and simulation models are used where appropriate to identify the potential net interest income and market value effects of these interest rate positions under different scenarios. We use a range of tools to monitor and limit market risk exposures including sensitivity analysis, value at risk and stress testing. The primary objective of such interest rate risk management is to limit potential adverse effects of interest rate movements on net interest income whilst balancing the effect on the current net operating income stream and unrealised mark-to-market positions.

A principal part of the group's management of market risk is to monitor 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 by utilising interest rate hedges, while balancing the cost of such hedging activities on the current net operating income stream. The table below sets out the effect on our accounting net interest income projections of a series of four quarterly parallel shocks of 25 basis points to the current actual interest rates by product beginning each quarter from 1 January 2018. The sensitivities shown represent the change in the expected base case net interest income that would be expected under two rate scenarios assuming that all other non-interest rates risk variables remain constant and current management policies are applied. The models measure the effect on net interest income due to parallel and ramp movements of plus or minus 100 basis points in all yield curves. The results represent the effect of the pro-forma movements in net interest income.

Change in 2017 projected net interest income arising from 100 basis points movement in yield curves	**At 31 December 2017 increase (decrease)**	**At 31 December 2016 increase (decrease)**
+100 basis points parallel	29,304	31,361
+100 basis points ramp	17,802	20,335
-100 basis points parallel	(29,089)	(29,493)
-100 basis points ramp	(15,670)	(18,563)

The scenarios are calculated by first establishing a base case projection for the following financial year using the current consolidated balance sheet. In deriving our base case net interest income projections, the re-pricing rates of assets and liabilities used are derived from current yield curves, thereby reflecting current market expectations of the future path of interest rates. The scenarios therefore represent interest rate shocks which occur to the current market implied path of rates. The interest rate sensitivities are indicative and based on simplified scenarios for product groups. The base case assumes no change in volumes or margins across all currencies. The parallel scenario is calculated by impacting all interest margins by 100 basis points immediately while the ramp scenario simulates a margin impact of 25 basis points every 3 months. The prospective annual differences in net interest income, between the base case and the parallel and ramp cases respectively, are set out in the table above. The model is further simplified in the assumption that all currency yield curves rise and fall at the same time and all current management policies are applied consistently. The model does not incorporate the proactive management of the interest rate risk profile undertaken by the group's ALCO and global markets division in order to minimise losses and optimise net income.

The group's foreign exchange exposure comprises trading exposures and structural foreign currency translation exposure. Structural currency risk exists for the group in holding subsidiary company investments whose functional currencies are not the US dollar or Bermuda dollar.

(b) Liquidity and funding risk management

Liquidity and funding risk is the risk that the Bank, at an entity level, does not have sufficient financial resources to meet its obligations as they fall due or will have to do so at excessive cost. Liquidity risk arises from mismatches in the timing of cash flows. Funding risk arises where the liquidity needed to fund illiquid asset positions cannot be obtained at the expected terms and when required.

Liquidity and funding risk is:

- **measured** using a range of different metrics including liquidity coverage ratio and net stable funding ratio;
- **monitored** against the Group's liquidity and funding risk framework; and
- **managed** on a stand-alone basis with no reliance on any HSBC Group entity (unless pre-committed) or central bank or government body unless this represents routine established business as usual market practice.

The objective of the Group's internal liquidity and funding framework ('LFRF') is to allow it to withstand very severe liquidity stresses. It is designed to be adaptable to changing business models, markets and regulations. All operating entities are required to managed liquidity and funding risk in accordance with the LFRF.

On 1 January 2016, the Group implemented a new LFRF. It uses the liquidity coverage ratio ('LCR') and net stable funding ratio ('NSFR') regulatory framework as a foundation, but adds extra metrics, limits and overlays to address the risks that we consider are not adequately reflected by the regulatory framework.

The LFRF is delivered using the following key aspects:

- Stand-alone management of liquidity and funding by operating entity;
- Operating entity classification by inherent liquidity risk ('ILR') categorisation;
- Minimum LCR requirement dependant on ILR categorisation (European Commission Delegated Regulation 2015/16 basis);
- Minimum NSFR requirement dependant on ILR categorisation (HSBC's interpretation of Basel Committee on Banking Supervision's publication 295 basis);
- Legal entity depositor concentration limit;
- Three month and twelve month cumulative rolling term contractual maturity limits covering deposits from banks, deposits from non-bank financials and securities issued;
- Annual Individual Liquidity Adequacy Assessment ('ILAA') by operating entity.
- Minimum LCR requirement by currency;
- Intra-day liquidity; and
- Forward looking funding assessments.

The LCR metric is designed to promote the short-term resilience of a bank's liquidity profile. It aims to ensure that a bank has sufficient unencumbered high-quality liquid assets ('HQLA') to meet its liquidity needs in a 30-calendar day liquidity stress scenario. HQLA consist of cash or assets that can be converted into cash at little or no loss of value in markets.

The NSFR requires institutions to maintain sufficient stable funding relative to required stable funding, and reflects a bank's long-term funding profile (funding with a term of more than a year). It is designed to complement the LCR.

The LCR and NSFR metrics assume a stressed outflow based on a portfolio of depositors within each deposit segment. The validity of these assumptions is challenged if the underlying depositors do not represent a large enough portfolio so that a depositor concentration exists. Operating entities are exposed to term re-financing concentration risk if the current maturity profile results in future maturities being overly concentrated in any defined period. Therefore additional risk tolerance levels have been established for deposit concentration and term funding maturity concentration.

The ILAA process aims to identify risks that are not reflected in the LFRF, and, where required, to assess additional limits required locally, and to validate the risk tolerance at the operating entity level.

The primary responsibility for managing liquidity and funding within the group's framework and risk appetite resides with the Asset Liability and Management Committee ('ALCO'). ALCO is responsible for ensuring prudent management of liquidity and funding risk and is also responsible for evaluating and communicating the impact of new liquidity regulatory requirements. These actions ensure the group adheres to HSBC liquidity and funding policies and maintains sufficient liquidity to meet day-to-day needs and local regulatory requirements. As at 31 December 2017, the Group was within the risk tolerance levels applicable under the LFRF.

On 31 December 2014 the group's lead regulator, the Bermuda Monetary Authority, ('the Authority' or 'the BMA') published the 'Basel III for Bermuda Banks – Final Rule' which became effective on 1 January 2015. The Basel III rules issued by the BMA address the areas of Leverage and Liquidity. The Authority has adopted a 5% leverage ratio calculated as the ratio of Tier 1 ('T1') Capital to Total Exposure. The group is currently in excess of this requirement. The Authority has adopted a Liquidity Coverage Ratio ('LCR') with an implementation timetable consistent with that published by the Basel Committee. The minimum requirement is 60% starting on 1 January 2015 rising in equal annual incremental steps of 10% to reach 100% on 1 January 2019. The LCR is designed to ensure that banks have a sufficient stock of unencumbered high-quality liquid assets ('HQLA') to survive a significant liquidity stress scenario lasting 30 days. The LCR is calculated as HQLA divided by total net cash outflows over the period of the next 30 days. Total net cash outflows are calculated in accordance with rules prescribed by the regulator. The group is compliant with LCR requirements and is well positioned to continue to be compliant during the ramp up to a 100% ratio.

(c) Operational risk management

Operational risk is the risk to achieving our strategy or objectives or the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events including legal risks. Operational risk is relevant to every aspect of our business and covers a wide spectrum of issues including in particular legal, compliance, security and fraud. Losses 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.

Regulatory compliance risk is the risk that we fail to observe the letter and spirit of all relevant laws, codes, rules, regulations and standards of good market practice, and incur fines and penalties and suffer damage to our business as a consequence. Regulatory compliance risk is part of operational risk, and arises from the risks associated with breaching our duty to clients and other counterparties, inappropriate market conduct and breaching other regulatory requirements.

Financial crime risk is the risk that we knowingly or unknowingly help parties to commit or to further potentially financial crime activity through HSBC. Financial crime risk is part of operational risk and arises from day to day banking operations.

Operational risk is:

- **measured** using the risk and control assessment ('RCA') process, which assesses the level of risk and effectiveness of controls in place against them;
  - regulatory compliance risk, more specifically, is measured by reference to identified metrics, incident assessments, regulatory feedback and the judgement and assessment of our Regulatory Compliance teams;
  - financial crime compliance risk, more specifically, is measured by reference to identified metrics, incident assessments, regulatory feedback and the judgement and assessment of our Financial Crime Compliance Risk management teams.
- **monitored** using key indicators and other internal control activities;
  - regulatory compliance risk is monitored against our regulatory compliance risk assessments and metrics, the results of the monitoring and control activities of the second line of defence functions, and the results of internal and external audits and regulatory inspections;
  - financial crime compliance risk is monitored against our financial crime compliance risk appetite statement and metrics, the results of the monitoring and control activities of the second line of defence functions, and the results of internal and external audits and regulatory inspections.
- **managed** primarily by global business and functional managers that identify and assess risks, implement controls to manage them and monitor the effectiveness of these controls utilising the operational risk management framework;
  - regulatory compliance risk is managed by establishing and communicating appropriate policies and procedures, training employees in them, and monitoring activity to assure their observance. Proactive risk control and/or remediation work is undertaken where required;
  - financial crime compliance risk is managed by establishing and communicating appropriate policies and procedures, training employees in them, and monitoring activity to assure their observance. Proactive risk control and/or remediation work is undertaken where required.

Responsibility for minimising operational risk lies with all of the group's staff. All staff are required to manage the operational risks of the business and operational activities for which they are responsible. The objective of our operational risk management is to manage and control operational risk in a cost effective manner within targeted levels consistent with our risk appetite.

Operational Risk is organised as a specific risk discipline within Risk, and a formal governance structure provides oversight over its management. The Operational Risk function supports the Chief Risk Officer and is responsible for oversight of the operational risk management framework ('ORMF'), monitoring the level of operational losses and the effectiveness of the control environment. It is also responsible for operational risk reporting, including the preparation of reports for consideration by the Risk Management Meeting.

The ORMF is our overarching approach for managing operational risk with a purpose to

- identify and manage our operational risks in an effective manner;
- remain within the Group's operational risk appetite, which helps the organisation understand the level of risk it is willing to accept; and
- drive forward-looking risk awareness and assist management focus.

Activity to strengthen our risk culture and better embed the use of the ORMF was further implemented in 2017. The ORMF defines our standards and processes, and the governance structure for the management of operational risk and internal control in our businesses and functions. The ORMF has been codified in a high-level standards manual, supplemented with detailed policies, which describes our approach to identifying, assessing, monitoring and controlling operational risk and gives guidance on mitigating action to be taken when weaknesses are identified.

Business managers throughout the group are responsible for maintaining an acceptable level of internal control commensurate with the scale and nature of operations, and for identifying and assessing risks, designing controls and monitoring the effectiveness of these controls. The ORMF helps managers to fulfil these responsibilities by defining a standard risk assessment methodology and providing a tool for the systematic reporting of operational loss data.

A centralised database is used to record the results of the operational risk management process. Operational risk and control assessments (see below) are input and maintained by business units. Business and Functional management and business risk and control managers monitor the progress of documented action plans to address shortcomings. To ensure that operational risk losses are consistently reported and monitored, reporting is required for all individual losses when the net loss is expected to exceed $10,000, and to aggregate all other operational risk losses under $10,000. Losses are entered into the operational risk database and are reported to the Risk Management Meeting on a monthly basis.

RCAs' are a key component of the Operational Risk Management Framework which provides senior management with a point in time view of operational risk and helps them to determine whether their key operational risks are controlled within acceptable levels. RCAs are dynamically updated to remain representative of the risks faced by the HBBM.

RCAs' are performed by individual business units and functions. The RCA process is designed to provide business areas and functions with a forward looking view of operational risks and an assessment of the effectiveness of controls, and a tracking mechanism for action plans so that they can proactively manage operational risks within acceptable levels. RCAs are reviewed and updated at least annually.

For regulatory reporting, the group has adopted the Standardised approach to determine its operational risk capital which is a method of calculating the operational capital requirement by the application of a Bermuda Monetary Authority (BMA) defined percentage charge to the gross income of eight specified business lines. It continues to enhance its ORMF including the use of the RCA process.

Local management is responsible for implementation of HSBC standards on operational risk throughout their operations and where deficiencies are evident these are required to be rectified within a reasonable timeframe.

Regulatory Compliance

The Regulatory Compliance sub-function ('RC') provides independent, objective oversight and challenge and promotes a compliance-orientated culture, supporting the business in delivering fair outcomes for customers, maintaining the integrity of financial markets and achieving the group's strategic objectives. Global policies and procedures require the prompt identification and escalation of any actual or potential regulatory breach to RC.

The Conduct agenda remains a priority for HSBC, our customers, our regulators and the financial services industry. In 2017, the majority of our activities have been inward and focused on:

- Remediating our customer due diligence
- Enhancing our complaint handling processes
- Improving quality of sales documentation and ability to evidence suitability
- Addressing fees and pricing hotspots
- Enhancing our governance and policies

Financial Crime Compliance

Financial Crime Risk (FCR) is a global function that brings together all areas of financial crime risk management at HSBC and is dedicated to implementing the most effective global standards to combat financial crime. The function has been set up to enable us to build on our achievements in managing financial crime risk effectively across the bank and to continue to strengthen financial crime detection, anti-money laundering ('AML'), sanctions and anti-bribery and corruption ('AB&C') compliance. The Head of FCR, reports to the Chief Executive Officer.

Globally, the FCR function encompasses FCR Assurance, Financial Crime Compliance ('FCC'), Financial Crime Threat Mitigation (FCTM), the Monitor Liaison Office and FCR Chief Operating Officer ('COO'). The structure has been designed around the following key principles:

- FCR sets policy and standards, provides subject matter expertise and guidance, drives execution at country level via regions, and maintains line of business subject matter expertise in support of the global businesses.
- Country-level execution accountability is driven by a common set of global principles with material variations managed by exception.
- Sub-functions within FCR are leveraged across the global function, ensuring consistency and utilizing expertise and resourcing.

In Bermuda the FCC function is evolving into an intelligence–led risk management approach, using data, new technology and working in partnership with regulators and law enforcement, driving us towards the future of financial crime risk management. Key enhancements during 2017 included the deployment of our global customer due diligence system which is used by all our customer groups, enhancements to our transaction monitoring regime to adopt global standard AML scenarios and case management and improved customer and negative news screening technology, all of which are underpinned by standard operating models including support from Centres of Excellence. These, together with the enhanced financial crime risk training that we have delivered to our senior leaders and staff in high risk roles, will ensure our people have the guidance and tools required.

(d) Reputational risk management

Reputational risk is the risk of failure to meet stakeholder expectations as a result of any event, behaviour, action or inaction, either by the group itself, our employees or those with whom we are associated, that might cause stakeholders to form a negative view of the group. This may result in financial or non-financial impacts, loss of confidence, or other consequences. Primary reputational risks arise directly from an action or inaction by the group, its employees or associated parties that are not the consequence of another type of risk. Secondary reputational risks are those arising indirectly and are a result of a failure to control any other risks. There were no material changes to our policies and practices for the management of reputational risk in 2017.

Reputational risk is:

- **measured** by reference to our reputation as indicated by our dealings with all relevant stakeholders, including media, regulators, customers and employees;
- **monitored** through a reputational risk management framework that is integrated into the group's broader risk management framework; and
- **managed** by every member of staff and covered by a number of policies and guidelines. There is a clear structure of committees and individuals charged with mitigating reputational risk, including the Reputational Risk Committee.

Reputational risk relates to stakeholders' perceptions, whether fact-based or otherwise. Stakeholders' expectations change constantly and so reputational risk is dynamic and varies between geographical regions, groups and individuals. We have an unwavering commitment to operating at the high standards we have set for ourselves in every jurisdiction. Any lapse in standards of integrity, compliance, customer service or operating efficiency represents a potential reputational risk.

Our policies set out our risk appetite and operational procedures for all areas of reputational risk, including financial crime prevention, regulatory compliance, conduct-related concerns, environmental impacts, human rights matters and employee relations.

(e) Credit risk management

Credit risk is the risk of financial loss if a customer or counterparty fails to meet an obligation under a contract. Credit risk arises principally from direct lending, trade finance and also from certain other products such as guarantees and derivatives.

Credit risk is:

- **measured** as the amount that could be lost if a customer or counterparty fails to make repayments;
- **monitored** using various internal risk management measures and within limits, approved by individuals within a framework of delegated authorities. These limits represent the peak exposure or loss to which the group could be subjected should the customer or counterparty fail to perform its contractual obligations; and

- **managed** through a robust risk control framework which outlines clear and consistent policies, principles and guidance for risk managers.

The group has in place standards, policies and procedures for the control and monitoring of all such risks. There have been no material changes to policies and practices for the management of credit risk during 2017. Additional credit-related information and information to determine maximum exposure to credit risk is presented in Note 7 'Derivatives', Note 8 'Loans and advances to banks', Note 9 'Loans and advances to customers', Note 10 'Financial investments' and Note 17 'Contingent liabilities, contractual commitments and guarantees'.

The role of independent credit control unit is fulfilled by the Risk function. Credit approval authorities are delegated by the Board to the Chief Executive together with the authority to sub-delegate them. The Credit Risk sub-function in Risk is responsible for the key policies and processes for managing credit risk, which includes formulating group credit policies and risk rating frameworks, guiding group's appetite for credit risk exposures, undertaking independent reviews and objective assessment of credit risk, and monitoring performance and management of portfolios.

The principal objectives of our 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 our businesses in defining, implementing and continually re-evaluating our risk appetite under actual and scenario conditions; and
- to ensure there is independent, expert scrutiny of credit risks, their costs and their mitigation.

The group's credit risk limits to counterparties in the financial and government sectors are managed centrally to optimise the use of credit availability and to avoid excessive risk concentration. Cross-border risk is controlled through the imposition of country limits, which are determined by taking into account economic and political factors, and local business knowledge, with sub-limits by maturity and type of business. Transactions with counterparties in higher risk countries are considered on a case-by-case basis.

Within the overall framework of the HSBC policy, the group has an established risk management process encompassing credit approvals, the control of exposures (including those to borrowers in financial difficulty), credit policy direction to business units and the monitoring and reporting of exposures both on an individual and a portfolio basis. The group's management is responsible for the quality of its credit portfolios and follows a credit process involving delegated approval authorities and credit procedures, the objective of which is to build and maintain risk assets of high quality. Regular reviews are undertaken to assess and evaluate levels of risk concentration, including those to individual industry sectors and products. Special attention is paid to the management of problematic loans and a specialist unit has been established to provide intensive management and control to maximise recoveries of assets, which show early signs of potential impairment and to assist customers to avoid default wherever possible.

Under IFRSs, an entity is required to assess whether there is objective evidence that financial assets are impaired at the end of each reporting period. A loan is impaired and an impairment allowance is recognised when there is objective evidence of a loss event that has an effect on the cash flows of the loan which can be reliably estimated. For loans that are assessed for impairment on a collective basis, the evidence typically comprises a history of payment performance against the original or revised terms, as appropriate to the circumstances. For loans that are assessed for impairment on an individual basis, all available evidence is assessed on a case-by-case basis. For details of our impairment policies on loans and advances and financial investments, see Note 2(e) on the Financial Statements.

Concentration of 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. We use a number of controls and measures to minimise undue concentration of exposure in our portfolios across industries, countries and global businesses. These include portfolio and counterparty limits, approval and review controls, and stress testing.

Credit quality of financial instruments

The group is responsible for the formulation of high-level credit policies based on HSBC policies. The group also reviews the application of HSBC's universal credit risk rating system. Our 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 that are predominantly within our wholesale businesses, risk ratings are reviewed regularly and any amendments are implemented promptly. Within our personal lending businesses, risk is assessed and managed using a wide range of risk and pricing models to generate portfolio data.

Our risk rating system includes calculation of Probability of Default ('PD') and Expected Loss ('EL') and is specific to credit risk segments. The Customer Risk Rating ('CRR') 10-grade scale summarises a more granular underlying 23-grade scale of obligor PD. All group customers are rated using the 10- or 23-grade scale. Each CRR band is associated with an external rating grade by reference to long-run default rates for that grade, represented by the average of issuer-weighted historical default rates. This mapping between internal and external ratings is indicative and may vary over time. The EL 10-grade scale for personal lending business summarises a more granular underlying EL scale for this customer segment. 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 five quality classifications based upon the mapping of related CRR to external credit grade. The five credit quality classifications defined below, each encompass a range of granular internal credit rating grades assigned to wholesale and personal lending businesses and the external ratings attributed by external agencies to debt securities.

(In US dollar thousands) 31 December 2017

Credit quality classification definitions are highlighted below. Performing loans are sub-divided into the first three categories.

Strong	'Strong' exposures demonstrate a strong capacity to meet financial commitments, with negligible or low probability of default and/or low levels of expected loss.
Good	'Good' exposures require closer monitoring and demonstrate a good capacity to meet financial commitments, with low default risk.
Satisfactory	'Satisfactory' exposures require closer monitoring and demonstrate an average to fair capacity to meet financial commitments, with moderate default risk.
Sub-standard	'Sub-standard' exposures require varying degrees of special attention and default risk is of greater concern.
Impaired	Impaired' exposures have been assessed as impaired, as described in Note 2 (e). These also include personal accounts that are delinquent by more than 90 days, unless individually they have been assessed as not impaired; and renegotiated loans that have met the requirements to be disclosed as impaired and have not yet met the criteria to be returned to the unimpaired portfolio.

Renegotiated loans and forbearance

Where a loan is modified due to significant concerns about the borrower's ability to meet contractual payments when due, a range of forbearance strategies is employed in order to improve the management of customer relationships, maximise collection opportunities and, if possible, avoid default, foreclosure or repossession. Policies regarding renegotiated loans and forbearance are described in more detail in Note 2(e).

(f) Capital management

Regulatory Capital

The group's lead regulator, the BMA, sets and monitors capital requirements for the group as a whole under the Banks and Deposit Companies Act 1999. The group does not have any banking operations outside of Bermuda.

The Basel III capital framework issued by the BMA, which became effective on 1 January 2015, adopts the Common Equity Tier 1 Capital ('CET1') as the main form of regulatory capital. Minimum Basel III capital ratios will be CET1 at least 4.5% of Risk Weighted Assets ('RWAs'), Tier 1 Capital at least 6.0% of RWAs and Total Capital at least 8.0% of RWAs. Through Pillar 2 capital ratio add-ons, which form part of the Authority's Prudential Supervision, the Authority has prescribed a total minimum capital ratio in excess of the minimum Basel III requirements. The group has at all times maintained a capital ratio in excess of the minimum regulatory requirement and it is well placed to continue to exceed regulatory requirements in the future.

In addition to the minimum capital ratios and Pillar 2 related add-ons prescribed by the Authority the Basel III rules also provide for the following capital requirements:

- Capital Conservation Buffer ('CCB'): Ultimately set at 2.5% of RWAs and is composed of CET1 eligible capital. The CCB is subject to a 5-year phase in period from 1 January 2015 to 1 January 2019. As of 1 January 2017 the CCB was 1.25% (2016: 0.63%).

- Countercyclical Buffer: To be comprised of CET1 eligible capital. The Authority will assess the need for a buffer of up to 2.5% of RWAs during periods of excessive credit or periods exhibiting other macroeconomic pressures.

- Capital Surcharge for Domestic Systemically Important Banks ('D-SIB'): Can range from 0.5% to 3.0% and is related to factors such as size, interconnectedness, substitutability and complexity. The D-SIB buffer has been determined by the Authority in conjunction with the CARP process in 2016.

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The group is required to comply with the provisions of the Basel III framework in respect of regulatory capital. Basel III is structured around three 'pillars': Pillar 1, 'minimum capital requirements', Pillar 2, 'supervisory assessment process' and Pillar 3, 'market discipline'. The 'Revised Framework for Regulatory Capital Assessment' and 'Basel III for Bermuda Banks – Final Rule' are the means by which Basel III is implemented in Bermuda.

The group's total banking regulatory capital is analysed into two tiers: (i) Common Equity Tier 1 Capital: Called up share capital, share premium, retained earnings; and (ii) Tier 2 Capital: Allowable Loan Loss Provisions.

Various limits are applied to elements of the capital base. Total Tier 2 capital is limited to 100% of the Tier 1 capital. There are also restrictions on the level of collective impairment allowances that may be included in Tier 2 capital.

The group's policy is to maintain a strong capital base and our approach to managing group capital is designed to ensure that we exceed current regulatory requirements and are well placed to meet those expected in the future so as to maintain creditor and market confidence and to sustain future development of the business. We monitor capital adequacy by the use of capital ratios, which measure capital relative to a regulatory assessment of risks taken, and by the leverage ratio, which measures capital relative to exposure. The group has complied with all external imposed capital requirements throughout the period. There have been no material changes in the group's management of capital during the year.

The group's consolidated regulatory capital position under Basel III at 31 December was as follows:

Composition of regulatory capital

	Notes	**2017**	2016
Tier 1 capital			
Called up share capital	*25*	30,027	30,027
Share premium		388,652	388,652
Retained earnings		353,372	402,281
Total Tier 1 capital		772,051	820,960
Tier 2 capital			
Collective impairment allowances	*9*	19,683	28,715
Total regulatory capital		791,734	849,675

Pillar 1

Basel III applies three approaches of increasing sophistication to the calculation of Pillar 1 credit risk capital requirements. The most basic level, the standardised approach, requires banks to use external credit ratings to determine the risk weightings applied to rated counterparties. Other counterparties are grouped into broad categories and standardised risk weightings are applied to these categories. The next level, the internal ratings-based ('IRB') foundation approach, allows banks to calculate their credit risk capital requirements on the basis of their internal assessment of counterparty's probability of 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. For credit risk, the group has adopted the standardised approach for consolidated reporting.

Basel III includes capital requirements 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 the bank's own statistical analysis and modelling of operational risk data to determine capital requirements. The group has adopted the standardised approach in determining its consolidated operational risk capital requirement.

The group is not required to report under market risk methodologies as its trading book does not exceed the De Minimis threshold, resulting in an exemption as defined in the BMA Framework.

Pillar 2

The second pillar of Basel III, supervisory assessment process, involves both the group and the Authority to assess and agree the appropriate capital necessary to mitigate the impact of risks not fully captured by the credit risk measures ('Pillar 1'). The annual Supervisory Assessment Process ('SAP'), undertaken by the Authority, aims to assess the group's risk profile and self-assessment as documented in the Capital Assessment and Risk Profile ('CARP'). The completion of the SAP formed the basis for the final agreements on new statutory minimum capital requirements for the group going forward. The group has complied with all minimum capital requirements prescribed by the Authority in 2017 and 2016.

Pillar 3

The third pillar of Basel III, market discipline, complements the minimum capital requirements and the supervisory review process. Its aim is to develop disclosures by banks which allow market participants to assess the scope of application of Basel III, capital, particular risk exposures and risk assessment processes, and hence the capital adequacy of the institution. Under the Pillar 3 framework all material risks must be disclosed, enabling a comprehensive view of the institution's risk profile. Disclosures consist of both quantitative and qualitative information and are provided at the consolidated level. The most recent disclosure of the group, 'Capital and Risk Management Interim Pillar 3 Disclosures at 30 June 2017', is published on the group's internet website: www.about.hsbc.bm/hsbc-in-bermuda.

Capital allocation

Although maximisation of return on risk-adjusted capital is the principal basis used in determining how capital is allocated within the group to particular operations or activities, it is not the sole basis used for decision-making. Account is also taken of synergies, and the fit of the activity within the group's longer-term strategic objectives.

23 Litigation

In the ordinary course of business, the group is routinely defendant in, or party to, a number of pending and threatened legal actions and proceedings. Apart from the matters described below, the group considers that none of these matters is material, either individually or in the aggregate. While the outcome of these matters is inherently uncertain, management believes that, based on the information available to it, the actions and proceedings and losses, if any, resulting from the final outcome thereof will not be material in the aggregate to the group's financial position or results of operation.

Bernard L. Madoff Investment Securities LLC

Bernard L. Madoff ('Madoff') was arrested in December 2008 and later pleaded guilty to running a Ponzi scheme. His firm, Bernard L. Madoff Investment Securities LLC ('Madoff Securities'), is being liquidated in the US by a trustee (the 'Trustee').

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, at 30 November 2008 the purported aggregate value of these funds was $8.4bn, including fictitious profits reported by Madoff.

Based on information available to HSBC, the funds' actual transfers to Madoff Securities minus their actual withdrawals from Madoff Securities during the time HSBC serviced the funds are estimated to have totalled approximately $4bn. Various HSBC companies have been named as defendants in lawsuits arising out of Madoff Securities' fraud.

US/UK litigation: The Trustee has brought lawsuits against various HSBC companies in the US Bankruptcy Court and in the English High Court, seeking recovery of transfers from Madoff Securities to HSBC in an amount not yet pleaded or determined. HSBC and other parties to the action have moved to dismiss the Trustee's US actions. The US Bankruptcy Court granted HSBC's motion to dismiss with respect to certain of the Trustee's claims in November 2016. In September 2017, the US Court of Appeals for the Second Circuit (the 'Second Circuit Court of Appeals') agreed to hear the Trustee's appeal of the US Bankruptcy Court's decision, where this matter is pending.

The deadline by which the Trustee must serve HSBC with his English action has been extended to September 2018 for UK-based defendants and November 2018 for all other defendants.

Fairfield Sentry Limited, Fairfield Sigma Limited and Fairfield Lambda Limited (together, 'Fairfield') (in liquidation since July 2009) have brought lawsuits in the US and the British Virgin Islands ('BVI') against fund shareholders, including HSBC companies that acted as nominees for clients, seeking restitution of redemption payments. In October 2016, the liquidators for Fairfield (the 'Fairfield Liquidators') filed a motion seeking leave to amend their complaints in the US Bankruptcy Court. In January 2017, the defendants moved to dismiss and oppose the Fairfield Liquidators' motion. These motions are pending.

In December 2014, three additional actions were filed in the US. A purported class of direct investors in Madoff Securities asserted common law claims against various HSBC companies in the US District Court for the Southern District of New York (the 'New York District Court'). In September 2016, the New York District Court granted HSBC's motion to dismiss this action and the plaintiffs' failure to appeal renders the court's ruling final. Two investors in Hermes International Fund Limited ('Hermes') also asserted common law claims against various HSBC companies in the New York District Court. In March 2017, the court granted HSBC's motion to dismiss, which dismissal was upheld by the Second Circuit Court of Appeals in November 2017. In addition, SPV Optimal SUS Ltd ('SPV OSUS'), the purported assignee of the Madoff-invested company, Optimal Strategic US Equity Ltd ('Optimal'), filed a lawsuit in New York state court against various HSBC companies and others, seeking damages on various alleged grounds, including breach of fiduciary duty and breach of trust. This action has been stayed pending the issuance of a potentially dispositive decision in an action initiated by Optimal regarding the validity of the assignment of its claims to SPV OSUS.

Bermuda litigation: In January 2009, Kingate Global Fund Limited and Kingate Euro Fund Limited (together, 'Kingate') brought an action against HSBC Bank Bermuda Limited ('HBBM') for recovery of funds held in Kingate's accounts, fees and dividends. This action is pending, but is not expected to move forward until the resolution of the Trustee's US actions against Kingate and HBBM.

Thema Fund Limited and Hermes each brought three actions in 2009. The first set of actions seeks recovery of funds in frozen accounts held at HSBC Institutional Trust Services (Bermuda) Limited. The second set of actions asserts liability against HSBC Institutional Trust Services (Bermuda) Limited in relation to claims for mistake, recovery of fees and damages for breach of contract. The third set of actions seeks return of fees from HBBM and HSBC Securities Services (Bermuda) Limited. The parties have agreed to a standstill in respect of all three sets of actions.

Cayman Islands litigation: In February 2013, Primeo Fund Limited ('Primeo') (in liquidation since April 2009) brought an action against HSBC Securities Services Luxembourg ('HSSL') and Bank of Bermuda (Cayman) Limited, alleging breach of contract and breach of fiduciary duty, and claiming damages and equitable compensation. The trial concluded in February 2017, and in August 2017, the court dismissed all claims against the defendants. In September 2017, Primeo appealed to the Court of Appeal of the Cayman Islands, where the matter is pending.

There are many factors that may affect the range of possible outcomes, and the resulting financial impact, of the various Madoff-related proceedings described above, including but not limited to the multiple jurisdictions in which the proceedings have been brought. For these reasons, among others, it is not practicable at this time for the group to estimate reliably the aggregate liabilities, or ranges of liabilities, that might arise as a result of all claims in the various Madoff-related proceedings, but they could be significant.

(In US dollar thousands) 31 December 2017

24 Related party transactions

Related parties of the group include subsidiaries, associates, post-employment benefit plans for group employees, Key Management Personnel, close family members of Key Management Personnel and entities which are controlled or jointly controlled by Key Management Personnel or their close family members.

Key Management Personnel are defined as those persons having authority and responsibility for planning, directing and controlling the activities of the group. The group classifies the Directors of the Bank and members of the Executive Management Committee as the Key Management Personnel of the group.

Particulars of transactions, arrangements and agreements entered into by the group with its Key Management Personnel, connected persons and companies controlled by them or the group are as follows:

	Loans and mortgages	Deposits
Balance at 1 January 2016	5,312	49,328
Advances and transfers in during the year	71	80,789
Repayments and transfers out during the year	(1,728)	(44,668)
Balance at 31 December 2016	3,655	85,449
Advances and transfers in during the year	-	24,724
Repayments and transfers out during the year	(356)	(25,845)
Balance at 31 December 2017	3,299	84,328

The above transactions were made in the ordinary course of business and substantially on the same terms, including interest rates and security, as for comparable transactions with other employees of the group which are at favourable rates. Normal banking risks are associated with these transactions.

Compensation of Key Management Personnel

	2017	2016
Short-term employee benefits	7,019	6,983
Post-employment benefits	199	251
Other long-term employee benefits	47	54
Termination benefits	-	62
Share-based payments	317	423
	7,582	7,773

Amounts included in balance sheet due from HSBC affiliated companies

	2017	2016
Loans and advances to banks	1,676,382	1,516,017
Financial investments	12,311	36,369
Derivatives	6,333	6,679
Other assets	307	636

Amounts included in balance sheet due to HSBC affiliated companies

	2017	2016
Deposits by banks	21,106	756,373
Derivatives	3,953	18,712
Customer accounts	39,652	27,799
Other liabilities	4,090	3,238

(In US dollar thousands) 31 December 2017

Amounts in income statement received from HSBC affiliated companies

	2017	2016
Interest income	14,743	13,023
Fee income	2,954	2,937
Gains from financial investments	22,232	-

Amounts in income statement paid to HSBC affiliated companies

	2017	2016
Fee expense	6	9
General and administrative expenses	11,578	7,807

There are no individually assessed loan impairment allowances in respect of outstanding balances in 2017 (2016: $NIL). No impairment charges were recognised during the year in respect of loans to related parties (2016: $NIL).

25 Equity

(a) Called up share capital and share premium

The total number of authorised ordinary shares at 31 December 2017 was 140,000,000 (2016: 140,000,000) with a par value of $1 per share (2016: $1 per share). The total number of shares issued and fully paid at 31 December 2017 was 30,026,671 (2016: 30,026,671). These figures and amounts are exact (not rounded or shown to the nearest thousand). Share premium comprises additional paid in capital in excess of the par value. Share premium is not ordinarily available for distribution. The holders of ordinary shares are entitled to receive dividends as declared from time to time, and are entitled to one vote per share at meetings of the Bank.

(b) Dividends

A final dividend of $19,750,000 ($0.66 per ordinary share), was declared by the Board of Directors on 22 February 2017 in respect of the 2016 financial year.

Interim dividends were declared by the Board of Directors on:

- 7 June 2017 in respect of the period 1 January 2017 to 31 March 2017, for $31,000,000 ($1.03 per ordinary share);
- 27 July 2017 in respect of the period 1 April 2017 to 30 June 2017, for $37,000,000 ($1.23 per ordinary share)
- 2 November 2017 in respect of the period 1 July 2017 to 30 September 2017, for $115,000,000 ($3.83 per ordinary share).

These figures and amounts are exact (not rounded or shown to the nearest thousand).

Issued by HSBC Bank Bermuda Limited
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www.hsbc.bm

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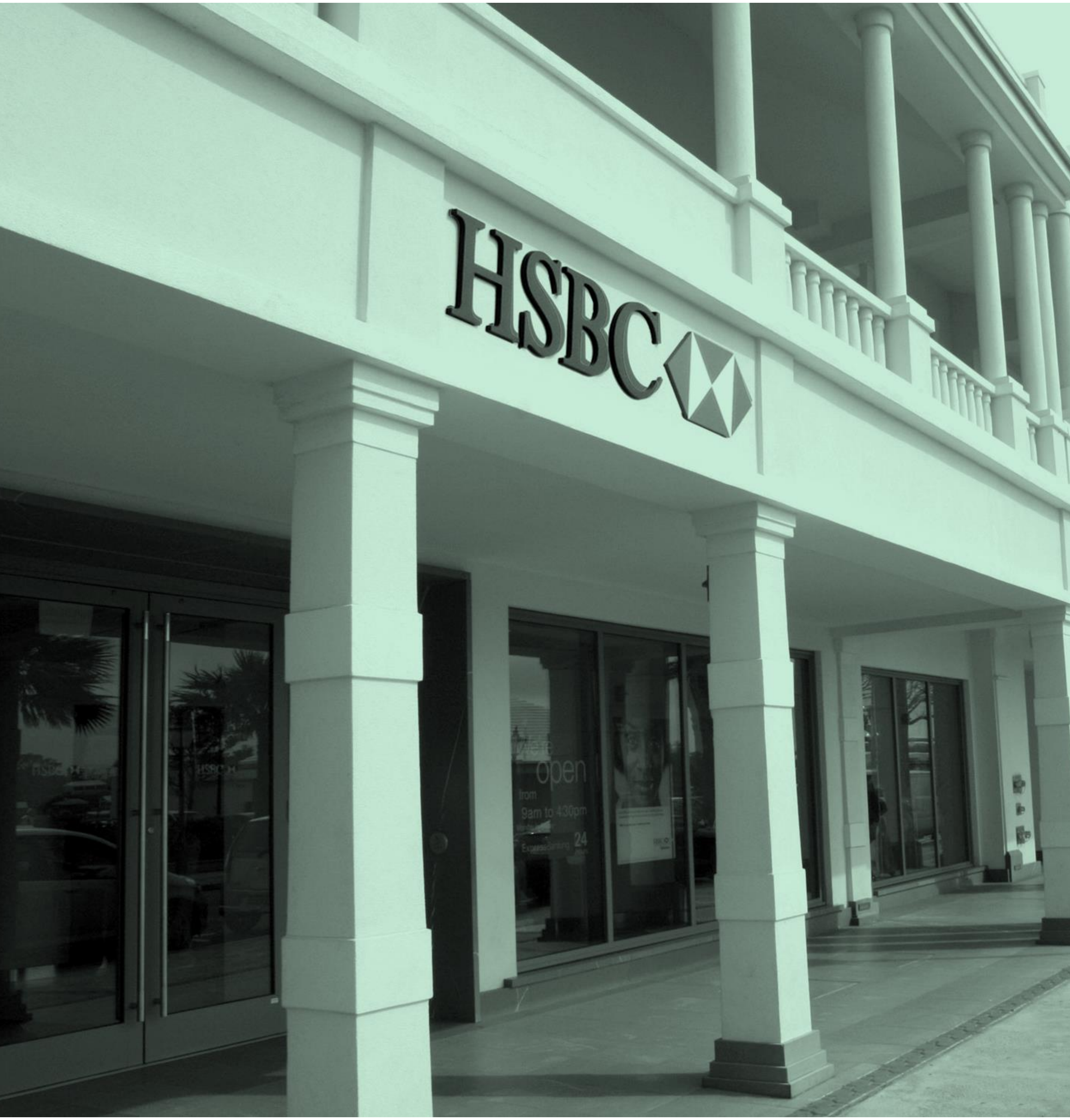

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