

Annual Reports and Accounts 2010

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Presentation of Information

This document comprises the *Annual Report and Accounts 2010* for HSBC Bank plc ('the bank') and its subsidiary undertakings (together 'the group'). It contains the Report of the Directors and Financial Statements, together with the Auditor's report, as required by the UK Companies Act 2006. References to 'HSBC' or 'the Group' within this document mean HSBC Holdings plc together with its subsidiaries.

Cautionary Statement Regarding Forward-Looking Statements

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

Statements that are not historical facts, including statements about the bank's beliefs and expectations, are forward-looking statements. Words such as 'expects', 'anticipates', 'intends', 'plans', 'believes', 'seeks', 'estimates', 'potential' and 'reasonably possible', variations of these words and similar expressions are intended to identify forward-looking statements. These statements are based on current plans, estimates and projections, and therefore undue reliance should not be placed on them. Forward-looking statements speak only as of the date they are made, and it should not be assumed that they have been revised or updated in the light of new information or future events.

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

Financial Highlights of the group

	2010	2009	2008
For the year (£m)			
Profit on ordinary activities before tax	4,011	4,014	4,366
Total operating income	18,099	19,102	16,175
Net operating income before loan impairment charges and other credit risk provisions	15,076	15,562	14,340
Profit attributable to shareholders of the parent company	2,959	3,092	3,441
At year-end (£m)			
Shareholders' funds of the parent company	31,825	27,787	19,923
Risk weighted assets	201,720	203,281	257,883
Loans and advances to customers (net of impairment allowances)	285,218	274,659	298,304
Customer accounts	344,123	332,896	369,880
Capital ratios (%)			
Core Tier 1 ratio ¹	10.5	10.2	5.9
Tier 1 ratio	11.4	11.2	6.8
Total capital ratio	16.1	15.7	10.5
Performance ratios (%)			
Return on average invested capital (on underlying basis) ²	8.7	9.2	7.8
Return on average shareholders' funds (equity) of the parent company ³	9.9	13.2	14.5
Post-tax return on average total assets	0.3	0.4	0.5
Post-tax return on average risk-weighted assets	1.5	1.4	1.5
Credit coverage ratios (%)			
Loan impairment charges as a percentage of total operating income	9.0	13.7	10.6
Loan impairment charges as a percentage of average gross customer advances	0.7	1.1	0.7
Total impairment allowances outstanding as a percentage of impaired loans at the year end	52.8	55.1	68.0
Efficiency and revenue mix ratios (%)			
Cost efficiency ratio ⁴	60.5	52.7	56.6
As a percentage of total operating income:			
- net interest income	42.5	42.4	35.2
- net fee income	22.3	21.3	24.5
- net trading income	11.7	13.7	18.3
Financial ratios (%)			
Ratio of customer advances to customer accounts	82.9	82.5	80.6
Average total shareholders' equity to average total assets	3.4	2.7	3.0

1 As a result of changes to the definition of the Core Tier 1 made by the Financial Services Authority in May 2009, the basis of calculation of the 2008 ratio differs from that of the 2009 and 2010 ratios.

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

- adding back the average balance of goodwill amortised pre-transition to IFRSs or subsequently written off, directly to reserves (less goodwill previously amortised in respect of the French regional banks sold in 2008);
- deducting the average balance of HSBC's revaluation surplus relating to property held for own use. This reserve was generated when determining the deemed carrying cost of such properties on transition to IFRSs and will run down over time as the properties are sold;
- deducting average preference shares and other equity instruments issued by HSBC Bank plc (as defined in Note 36 Called up share capital and other equity instruments); and
- deducting average reserves for unrealised gains/ (losses) on effective cash flow hedges and available-for-sale securities.

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

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

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

Products and Services

Personal Financial Services

The group's Personal Financial services business offers products and services to customers based on their individual needs. Premier and Advance services are targeted at mass affluent and emerging affluent customers who value international connectivity and benefit from our global reach and scale. For customers who have simpler everyday banking needs, we offer a full range of banking products and services reflecting local requirements.

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

Commercial Banking

The group's Commercial Banking business is segmented into Corporate and Business Banking, enabling the development of tailored customer propositions while adopting a broader view of the entire commercial banking sector, from sole traders to large corporations. This allows the group to provide continuous support to companies as they grow in size both domestically and internationally, and ensures a clear focus on the business banking segments, which are typically the key to innovation and growth in market economies.

The group places particular emphasis on geographical collaboration to meet the needs of our business customers, and the group aims to be recognised as the leading international business bank and the best bank for business in target markets.

- **HSBC Premier** provides preferential banking services and global recognition to high net worth customers and their immediate families with a dedicated relationship manager, specialist wealth advice and tailored solutions. Customers can access emergency travel assistance, priority telephone banking and an online 'global' view of their Premier accounts around the world with free money transfers between them.
- **HSBC Advance** provides a range of preferential products and services customised to meet local needs. With a dedicated telephone service, access to wealth advice and online tools to support financial planning, it gives customers an online 'global view' of their Advance accounts with money transfers between them.
- **Wealth solutions and financial planning:** a financial planning process designed around individual customer needs to help clients to protect, grow and manage their wealth through best-in-class investment and wealth insurance products manufactured by in-house partners (Global Asset Management, Global Markets and HSBC Insurance) and by selected third party providers.

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

- **Financing:** the group offers a broad range of financing, both domestic and cross-border, including overdrafts, receivables finance, term loans and syndicated, leveraged, acquisition and project finance. Asset finance is offered in selected sites, focused on leasing and instalment finance for vehicles, plant and equipment.
- **Payments and cash management:** HSBC is a leading provider of domestic and cross-border payments and collections, liquidity management and account services worldwide, delivered through HSBCnet.
- **International trade:** the group provides various international trade products and services, to both buyers and suppliers such as export finance, guarantees, documentary collections and forfeiting to improve efficiency and mitigate risks throughout the supply chain.
- **Treasury:** Commercial Banking customers are volume users of the group's foreign exchange, derivatives and structured products.
- **Capital markets & advisory:** capital raising on debt and equity markets and advisory services are available
- **Commercial cards:** card issuing helps customers enhance cash management, credit control and purchasing. Card acquiring services enable merchants to accept credit and debit card payments in person or remotely.
- **Insurance:** Commercial Banking offers key person, employee benefits and a variety of commercial risk insurance.
- **Direct channels:** these include online and direct banking offerings such as HSBCnet and Business Internet Banking.

Products and services (continued)

Global Banking and Markets

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

Global Banking and Markets is managed as four principal business lines: Global Markets, Global Banking, Global Asset Management and Principal Investments. This structure allows us to focus on relationships and sectors that best fit the Group's footprint and facilitates seamless delivery of our products and services to clients.

Private Banking

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

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

- **Global Markets** operations consist of treasury and capital markets services. Products include foreign exchange; currency, interest rate, bond, credit, equity and other derivatives; government and non-government fixed income and money market instruments; precious metals and exchange-traded futures; equity services; distribution of capital markets instruments; and securities services, including custody and clearing services and funds administration to both domestic and cross-border investors.
 - **Global Banking** offers financing, advisory and transaction services. Products include:
 - Capital raising, advisory services, bilateral and syndicated lending, leveraged and acquisition finance, structured and product finance, lease finance and non-retail deposit taking;
 - International, regional and domestic payments and cash management services; and trade services for large corporate clients.
 - **Global Asset Management** offers investment solutions to institutions, financial intermediaries and individual investors globally.
 - **Principal Investments** includes the group's strategic relationships with third-party private equity managers and other investments.
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- **Private Banking** services comprise multi-currency deposit accounts and fiduciary deposits, credit and specialist lending, treasury trading services, cash management, securities custody and clearing. HSBC Private Bank works to ensure that its clients have full access to other products and services available in the group such as credit cards, internet banking, corporate banking and investment banking.
 - **Private Wealth Management** comprises both advisory and discretionary investment services. A wide range of investment vehicles is covered, including bonds, equities, derivatives, options, futures, structured products, mutual funds and alternatives (hedge funds, private equity and real estate).
 - **Corporate Finance Solutions** helps provide clients with cross border solutions for their companies, working in conjunction with Global Banking and Markets.
 - **Private Wealth Solutions** comprise inheritance planning, trustee and other fiduciary services designed to protect wealth and preserve it for future generations through structures tailored to meet the individual needs of each family. Areas of expertise include trusts, foundation and company administration, charitable trusts and foundations, insurance, family office advisory and philanthropy.

Report of the Directors: Operating and Financial Review

Introduction

While 2010 remained a challenging operating environment for most European economies, HSBC's financial strength, premium customer base and ability to leverage its brand and global networks ensured that all business segments of the group remained strong and profitable. HSBC Bank plc maintained its well-funded balance sheet and strong capital position.

Results for 2010

The consolidated profit for the year attributable to the shareholders of the bank was £2,959 million.

Interim dividends of £850 million (in lieu of a final dividend in respect of the previous financial year) and £900 million were paid on the ordinary share capital during the year.

A second interim dividend of £915 million in respect of 2010 was declared after 31 December 2010, payable on 28 February 2011.

Further information about the results is given in the consolidated income statement on page 79.

Principal activities

The group provides a comprehensive range of banking and related financial services. The group divides its activities into the business segments: UK Retail Banking; Continental Europe Retail Banking; Global Banking and Markets; and Private Banking.

As at 31 December 2010, the bank had 1,311 branches in the United Kingdom, 14 branches in the Isle of Man and the Channel Islands with further branches in Belgium, the Czech Republic, France, Greece, the Hong Kong Special Administrative Region, Ireland, Israel, Italy, Netherlands, Slovakia, and Spain.

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

Business segments

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

UK Retail Banking

UK Retail Banking comprises two customer groups: Personal Financial Services and Commercial Banking. UK Personal Financial Services provides current accounts, savings, personal loans, mortgages, cards, financial planning, as well as life and general insurance to UK personal customers through a variety of

distribution channels under various brands, including HSBC, first direct, Marks & Spencer Money and partnership card™. UK Commercial Banking provides a wide range of products and services to commercial organisations, from sole proprietors to quoted companies. These include current and savings accounts, payments, electronic banking, trade finance, loans, overdrafts, asset finance, foreign exchange and other treasury and capital markets instruments, wealth management services and general insurance.

Continental Europe Retail Banking

Continental Europe Retail Banking comprises the customer groups Personal Financial Services and Commercial Banking, providing a comprehensive range of retail financial services to local and expatriate personal and commercial customers in Europe. The principal Continental European Retail Banking operations are in France, Turkey, Malta and Germany.

Global Banking and Markets

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

Private Banking

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

Other

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

Strategic direction

The group's strategy reflects HSBC's position as 'The world's local bank' and is focused on delivering superior growth and earnings over time by building HSBC's heritage, skills and investment. In particular, the group aims to leverage the HSBC brand and network to reach new customers and offer more services to existing customers, to maximise efficiency by taking advantage of local, regional and global economies of scale and to ensure staff are engaged by aligning objectives and incentives.

Report of the Directors: Operating and financial review (continued)

The strategy has identified three main business models for its customer groups and global businesses that embody HSBC's areas of natural advantage:

- businesses with international customers for whom developing connectivity across markets is crucial – Global Banking and Markets, Private Banking, the large business segment of Commercial Banking and the mass affluent segment of Personal Financial Services;
- businesses with local customers where efficiency can be enhanced through global scale – the small and medium business segments of Commercial Banking and the mass market segment of Personal Financial Services; and
- products where global scale can be achieved through building efficiency, expertise and brand awareness – global product platforms include global transaction banking.

As part of HSBC, the group has an ambitious programme of rationalising and simplifying the number of core systems it deploys across the world. Standardised systems common to multiple geographies are being developed to reduce operating expenses and improve the speed of upgrade. Within this programme the group continues to invest heavily in straight-through-processing technology to improve customer experience and reduce servicing costs.

UK Retail Banking

The UK Personal Financial Services business continues to build its position as a leading provider of financial services to mass affluent customers in the UK through the Premier and Advance propositions.

The UK Commercial Banking strategy is to be:

- the 'Leading International Business' bank, using HSBC's extensive geographical network together with product expertise in payments, trade, receivables finance and foreign exchange to actively support customers who are trading and investing across borders; and
- the best bank for small and medium-sized enterprises ('SMEs') in target markets, building global scale and creating efficiencies by sharing systems and best practice, including customer experience, training and product offerings, and selectively applying a direct banking model.

Continental Europe Retail Banking

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

The Continental Europe Personal Financial Services strategy builds on its strength in mass affluent

markets by providing relevant, efficient and sustainable propositions to Premier and Advance customers in selected markets across the region. During 2011, the group intends to further develop its direct distribution channels to expand customer choice and improve efficiency.

In Commercial Banking, the strategy focuses on leveraging HSBC's expansive international connectivity to meet the needs of customers around the world; 'Leading International Business'. Selective investments including the launch of receivables finance in Germany and the first corporate branch in Switzerland have been made in the region to support this strategy.

Global Banking and Markets

Global Banking and Markets continues to pursue its now well established 'emerging markets-led and financing-focused' strategy, encompassing its objective to be a leading wholesale bank by:

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

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

Private Banking

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

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

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

Key Performance Indicators ('KPIs')

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

Report of the Directors: Operating and financial review (continued)

Following a review of the high-level KPIs, changes to the group's published indicators were made in order to restrict the number to those which most accurately reflect management priorities. The group now has five financial and three non-financial KPIs.

Financial KPIs

	2010	2009	2008
	%	%	%
Risk adjusted revenue growth ¹	7.6	(2.3)	6.1
Cost efficiency ²	60.5	52.7	56.6
Return on average total shareholders' equity ³	9.9	13.2	14.5
Tier 1 capital	11.4	11.2	6.8
Advances to core funding ratio ⁴	95.7	96.5	—

1 The percentage increase/ (decrease) in 'Net operating income' after loan impairment charges and other credit risk provisions compared with the previous reporting period.

2 Total operating expenses divided by net operating income before loan impairment charges and other credit risk provisions.

3 Profit attributable to ordinary shareholders divided by average shareholders' equity.

4 Loans and advances to customers as a percentage of the total of core current and savings accounts and term funding with a remaining term to maturity in excess of one year. Data for 2008 is not included due to change in basis of calculation from 2009.

Risk-adjusted revenue growth provides an important guide to the group's success in generating business. In 2010, revenues fell primarily in Global Banking and Markets as uncertainty in the Eurozone resulted in a deterioration in market conditions and, as anticipated, Balance Sheet Management revenues were lower. However, this was more than offset by lower loan impairment charges across all business lines.

Cost efficiency is a relative measure that indicates the consumption of cost resources in generating revenue. Management uses this to assess the success of technology utilisation and, more generally, the productivity of the group's distribution platforms and sales forces. The deterioration in the cost efficiency ratio reflected a combination of one-off costs and accounting gains but also increased investment in operational infrastructure.

Return on average total shareholders' equity measures the return on the equity held in the business enabling management to benchmark HSBC against competitors. The fall in return on equity reflected the impact of the share capital issued during 2009. As the impact of new regulation becomes clearer, management believe that the impact of increased regulatory capital requirements will depress returns for shareholders of banks.

Tier 1 capital measures the component of regulatory capital comprising core tier 1 and other tier 1 capital. In 2010, the group's ratio marginally strengthened.

Advances to core funding ratio describes loans and advances to customers as a percentage of the total of core current and savings accounts and term funding

with a remaining term to maturity in excess of one year. Management uses this ratio to ensure that customer advances are being funded from stable funding sources and not short term wholesale market sources. In 2010, customer advances remained funded by core funding.

Non-financial KPIs

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

Employee engagement

Employee engagement is a measure of employees' emotional and rational attachment to HSBC that motivates them to remain with the group and align themselves wholeheartedly with its success. HSBC measures employee engagement through its annual Global People Survey ('GPS'), which took place in the middle of 2010. Over 65,000 employees from HSBC's UK and European businesses shared their views. Compared with 2009, employee engagement fell by 2 per cent to 64 per cent, mirroring the fall in global best in class.

Management have discussed the results of the GPS with their respective teams and are currently formulating action plans to address key focus areas. Actions will centre upon bringing leaders closer to their people, enhancing career development and driving diversity and inclusion across the businesses.

Brand perception

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

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

Customer recommendation

In addition to tracking the strength of its brand, HSBC closely tracks the satisfaction of its customers by examining how likely they are to recommend the bank to others.

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

Results 2010

The benchmark recommendations seen in 2010 for Personal Financial Services and Commercial Banking were ahead of the competitor average by 2 points and 1 point respectively on a 100 point scale.

first direct, HSBC's internet and telephone bank, achieved the highest level of customer satisfaction in the UK according to research company TNS.

Report of the Directors: Operating and financial review (continued)

Awards

HSBC was recognised in several industry awards throughout 2010. A small selection of those follows:

- ‘Best Bank Mortgage Provider’ - Moneyfacts 2010 (HSBC)
- ‘Most Trusted Financial Provider’ - Moneywise 2010 (first direct)
- ‘Best Lender for First Time Buyers’ - Moneywise 2010 (HSBC)
- ‘Best Trade Finance Provider’ - Global Finance Magazine 2010
- ‘Best Service from a Business Bank’ – Moneyfacts 2010
- ‘Best Bank for FX for Corporate Customers 2010’ FX Week
- The *Euromoney* ‘Best Debt House’ in Central and Eastern Europe
- ‘Best Global Wealth Manager’ – *Euromoney Awards for Excellence 2010*
- The *Euromoney* 2011 Private Banking Survey named HSBC ‘Best Private Bank in Asia’
- ‘Outstanding Private Bank’ – Middle East *Private Banker International Awards 2010*

Economy

After falling 4.9 per cent in 2009, UK Gross Domestic Product (‘GDP’) partially recovered in 2010 rising 1.4 per cent. The unemployment rate stayed at 7.9 per cent. Despite the weakness of activity, the annual rate of Consumer Price Index (‘CPI’) inflation rose during the course of the year and reached 3.7 per cent in December. Rising inflation was partially driven by food and energy prices, and an increase in VAT in January 2010. Wage growth remained subdued with average earnings rising at a rate close to 2 per cent through the course of 2010. The Bank of England maintained the base rate at 0.5 per cent throughout the year.

The Eurozone economy also made a partial recovery over the course of the year. The region benefited from the improvement in the global economy and an increase in domestic demand. Within the region, Germany saw the strongest recovery with GDP growing by 3.5 per cent. The German unemployment rate fell during the year but for the Eurozone as a whole, it remained near 10%. Large increases in government debt that have emerged in certain parts of Europe over the last three years started to put upward pressure on government bond yields and some governments

encountered funding difficulties. To assist these governments, the European Union established stability funds in liaison with the International Monetary Fund and Eurozone governments. The European Central Bank left its key interest rate at 1.0 per cent throughout the year.

Reconciliation of reported and underlying profit before tax

The group measures its performance internally on a like-for-like basis by eliminating acquisitions, disposals of subsidiaries and businesses, and fair value movements on own debt designated at fair value attributable to credit spread where the net result of such movements will be zero upon maturity of the debt, all of which distort period-on-period comparisons. The group refers to this as its underlying performance. Reported results include the effects of the above items.

This approach is used to monitor progress against operating plans and previous period results because management believes that the underlying basis more accurately reflects operating performance.

Underlying performance

The tables below compare the group’s underlying performance in 2010, 2009 and 2008 with reported profits in those years.

The following items comprise the underlying adjustments:

- the change in own credit spread on long-term debt which resulted in a loss of £122 million in 2010; a loss of £439 million in 2009 and a gain of £477 million for 2008 in *Net income/(expense) from financial instruments designated at fair value*;
- £163 million gain on the disposal of Eversholt Rail Group in December 2010 in *Other operating income*;
- disposal of HSBC Insurance Brokers Limited in April 2010, including the profit on disposal of £83 million;
- £180 million gain on the disposal of the residual 49 per cent stake in a UK merchant acquiring business in June 2009 in *Other operating income*. This was further to the initial gain of £215 million on the initial disposal in June 2008; and
- £644 million gain on the disposal of seven regional banks in France in July 2008 in *Other operating income*. As well as adjusting for the £80 million operating profit from the seven regional banks sold in 2008.

Report of the Directors: Operating and Financial Review (continued)

Reconciliation of reported and underlying profit before tax

	2010 compared with 2009							
	2010 reported £m	2010 adjust- ments	2010 under- lying £m	2009 reported £m	2009 adjust- ments	2009 under- lying £m	Reported change %	Under- lying change %
Net interest income.....	7,694	—	7,694	8,091	(1)	8,090	(5%)	(5%)
Net fee income	4,040	(31)	4,009	4,077	(185)	3,892	(1%)	3%
Trading income	2,117	—	2,117	2,626	—	2,626	(19%)	(19%)
Net income from financial instruments designated at fair value ¹	276	122	398	543	439	982	(49%)	(59%)
Gains less losses from financial investments.....	537	—	537	(73)	—	(73)	836%	836%
Net earned insurance premiums.....	2,635	—	2,635	2,716	—	2,716	(3%)	(3%)
Other operating income.....	800	(246)	554	1,122	(182)	940	(29%)	(41%)
Total operating income	18,099	(155)	17,944	19,102	71	19,173	(5%)	(6%)
Net insurance claims incurred and movement in liabilities to policyholders.....	(3,023)	—	(3,023)	(3,540)	—	(3,540)	(15%)	(15%)
Net operating income before impairments and provisions....	15,076	(155)	14,921	15,562	71	15,633	(3%)	(5%)
Loan impairment charges and other credit risk provisions	(1,951)	—	(1,951)	(3,364)	—	(3,364)	(42%)	(42%)
Net operating income	13,125	(155)	12,970	12,198	71	12,269	8%	6%
Total operating expenses.....	(9,119)	52	(9,067)	(8,198)	176	(8,022)	11%	13%
Operating profit.....	4,006	(103)	3,903	4,000	247	4,247	0%	(8%)
Share of profit in associates and joint ventures.....	5	—	5	14	(1)	13	(64%)	(61%)
Profit on ordinary activities before tax	4,011	(103)	3,908	4,014	246	4,260	0%	(8%)
	2009 compared with 2008							
	2009 reported £m	2009 adjust- ments	2009 under- lying £m	2008 reported £m	2008 adjust- ments	2008 under- lying £m	Reported change %	Under- lying change %
Net interest income.....	8,091	-	8,091	5,697	(37)	5,660	42%	43%
Net fee income	4,077	-	4,077	3,957	(33)	3,924	3%	4%
Trading income	2,626	-	2,626	2,967	-	2,967	(11%)	(11%)
Net income / (expense) from financial instruments designated at fair value ¹	543	439	982	(1,097)	(477)	(1,574)	(149%)	(162%)
Gains less losses from financial investments.....	(73)	-	(73)	82	(33)	49	(189%)	(249%)
Net earned insurance premiums.....	2,716	-	2,716	2,891	-	2,891	(6%)	(6%)
Other operating income.....	1,122	(180)	942	1,678	(878)	800	(33%)	18%
Total operating income	19,102	259	19,361	16,175	(1,458)	14,717	18%	32%
Net insurance claims incurred and movement in liabilities to policyholders.....	(3,540)	-	(3,540)	(1,835)	-	(1,835)	93%	93%
Net operating income before impairments and provisions....	15,562	259	15,821	14,340	(1,458)	12,882	9%	23%
Loan impairment charges and other credit risk provisions	(3,364)	-	(3,364)	(1,861)	3	(1,858)	81%	81%
Net operating income	12,198	259	12,457	12,479	(1,455)	11,024	(2%)	13%
Total operating expenses.....	(8,198)	-	(8,198)	(8,122)	39	(8,083)	1%	1%
Operating profit.....	4,000	259	4,259	4,357	(1,416)	2,941	(8%)	45%
Share of profit in associates and joint ventures.....	14	-	14	9	-	9	56%	56%
Profit on ordinary activities before tax	4,014	259	4,273	4,366	(1,416)	2,950	(8%)	45%

1 Changes in fair value due to movements in own credit spread on long-term debt issued. This does not include the fair value changes due to own credit spread on structured notes issues and other hybrid instruments included within trading liabilities.

Report of the Directors: Operating and Financial Review (continued)

Financial summary

Summary consolidated income statement

	2010	2009	2008
	£m	£m	£m
Net interest income	7,694	8,091	5,697
Net fee income	4,040	4,077	3,957
Trading income	2,117	2,626	2,967
Net income / (expense) from financial instruments designated at fair value	276	543	(1,097)
Gains less losses from financial investments	537	(73)	82
Net earned insurance premiums	2,635	2,716	2,891
Other operating income	800	1,122	1,678
Total operating income	18,099	19,102	16,175
Net insurance claims incurred and movement in liabilities to policyholders	(3,023)	(3,540)	(1,835)
Net operating income before impairments and provisions	15,076	15,562	14,340
Loan impairment charges and other credit risk provisions	(1,951)	(3,364)	(1,861)
Net operating income	13,125	12,198	12,479
Total operating expenses	(9,119)	(8,198)	(8,122)
Operating profit	4,006	4,000	4,357
Share of profit in associates and joint ventures	5	14	9
Profit on ordinary activities before tax	4,011	4,014	4,366
Tax Expense	(996)	(856)	(843)
Profit for the year	3,015	3,158	3,523
Profit attributable to shareholders of the parent company	2,959	3,092	3,441
Profit attributable to non-controlling interests	56	66	82

Review of business performance

2010 compared with 2009

HSBC Bank plc and its subsidiary undertakings reported profit before tax of £4,011 million, in line with the £4,014 million in 2009, but 8 per cent lower on an underlying basis. The differences between reported and underlying results are explained on page 7. The fall in underlying profits was largely due to lower levels of Global Banking and Markets income, where the exceptional results of 2009 were not repeated.

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

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

international business and the group actively supported corporates and SMEs in response to changing economic circumstances.

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

- the sale and leaseback of the Paris headquarters building in February 2010 resulted in a gain of £125 million being reported as an increase in *Other operating income* in 2010;
- one-off payroll and bonus taxes amounting to £218 million in respect of certain 2009 bonuses was recognised and paid in 2010 reported as an increase in *Total operating expenses*;
- a loss of £179 million, booked across various lines, for HSBC Insurance (UK) Limited in 2009 (as the UK motor insurance underwriter was significantly affected by adverse claims experience during the year) compared with £7 million profit in 2010. The motor insurance underwriting business was placed into run-off during 2009 with no new customer business written in 2010;
- a gain of £322 million related to a change in the delivery of certain staff benefits in the main UK pension scheme reported as a reduction in *Total operating expenses* in 2009;
- a gain of £353 million on the sale of the Group's London headquarters building reported as an increase in *Other operating income* in 2009.

Report of the Directors: Operating and Financial Review (continued)

The commentary that follows is on an underlying basis.

Net interest income decreased by £397 million or 5 per cent. Net interest income in Balance Sheet Management decreased, as expected, from the strong levels in 2009 as higher yielding positions taken in prior years matured and opportunities for reinvestment at equivalent yields were limited by prevailing low interest rates and flatter yield curves. The fall in income from interest-earning assets was driven by the group repositioning its lending portfolios towards lower yielding but higher quality secured assets. In Private Banking, the continuing low interest rate environment impacted customer deposit margins resulting lower in net interest income. These reductions were offset, in part, by a £6 billion increase in average mortgage balances in the UK and improved asset margins.

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

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

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

Net income from financial instruments designated at fair value decreased by £584 million. The growth in equity markets in 2010 was lower than 2009 resulting in lower investment gains recognised on the fair value of assets held to meet liabilities under insurance and investment contracts. To the extent that these gains accrued to policyholders holding unit-linked insurance policies and insurance or investment contracts with discretionary participation features ('DPF'), there was a corresponding decrease in *Net insurance claims incurred and movement in liabilities to policyholders*. In addition, foreign exchange losses were reported in the year on foreign currency debt designated at fair

value, issued as part of our overall funding strategy with an offset from trading assets held as economic hedges reported in *Trading income*.

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

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

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

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

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

The loan impairment charges in both UK and Continental Europe Retailing Banking were significantly lower than in 2009. In Personal Financial Services, lower loan impairment charges were driven by improved delinquencies across both the secured and unsecured lending portfolios due to enhanced credit risk management practices and improved collections. In UK Commercial Banking, loan impairments were lower, with the improvement spread across most industry

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sectors. Reductions were also seen across the Commercial Banking business in Continental Europe.

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

The effective tax rate was 25 per cent (2009: 21 per cent). This is lower than the UK statutory tax rate of 28 per cent (2009: 28 per cent). The major items of note are the benefit of tax free capital gains and profits earned in lower tax jurisdictions, partially offset by the non-deductibility of the one-off bonus tax paid in the UK.

2009 compared with 2008

The group reported pre-tax profit of £4,014 million, compared with £4,366 million in 2008. On an underlying basis pre-tax profit was £4,273 million, against £2,950 million in 2008.

The following items are significant in a comparison of 2009's underlying results to 2008:

- a gain of £353 million on the sale of the Group's London headquarters building. In 2008 the group reported a gain of £265 million from the cancellation of an agreement to sell this building;
- a change in the basis of delivering death-in-service, ill health and early retirement benefits for some UK employees generated an accounting gain of £322 million in 2009;
- a loss of £179 million for HSBC Insurance (UK) Limited, compared with a loss of £19 million in 2008. The UK motor insurance underwriter was very significantly affected by adverse claims experience during the year and a decision was taken to close to new business in September 2009 with the company now in run off.

The commentary that follows is on an underlying basis.

Net interest income increased by £2,431 million, or 43 per cent. Balance Sheet Management revenues in Global Banking and Markets rose significantly due to the early positioning of balance sheet in anticipation of decisions by central banks to preserve a low base rate

environment. Net interest income also benefited from a reduction in the cost of funding trading activities as interest rates fell. Conversely, the Retail business and payments and cash management were adversely affected by margin compression following interest rate reductions in late 2008 and early 2009. Mortgage balances increased as the bank gained market share in the UK, through the success of a new Rate Matcher mortgage promotion and other campaigns launched in line with its secured lending growth strategy. In 2009 the bank more than met its commitment to make available £15 billion of new mortgage lending.

In Commercial Banking, net lending fell compared with 2008 as a result of muted customer demand. Customer utilisation of committed overdraft facilities provided by the bank in the UK to commercial customers was only 40 per cent at the end of 2009 illustrating the availability of credit when demand resumes. Across most businesses asset balances declined reflecting; reduced customer demand for credit, increased debt issuance as the bond markets reopened in 2009 and the group's diminished appetite for unsecured lending in the UK and Continental Europe. Asset spreads widened, most notably in the UK and Turkey, as funding costs reduced in the low interest rate environment and the market pricing of corporate lending increased.

Throughout 2009, the group worked to retain and build on the deposit base gained in the last quarter of 2008, in the face of fierce competition and narrowing of spreads across the region following interest rate cuts.

Net fee income increased by £153 million, or 4 per cent. The group generated higher underwriting fees from increased government and corporate debt issuances, and by taking market share in equity capital markets issues as corporates and financial institutions restructured their balance sheets by raising share capital. As part of its wealth management strategy the bank continued to grow the Premier customer base and successfully launched the World Selection fund in the UK with £959 million invested during the year. This was partially offset by lower equity brokerage commissions and reduced performance and management fees in Private Banking as investor sentiment for risk and structured products remained subdued.

Trading income decreased by £341 million, or 11 per cent. This reflects £981 million of foreign exchange losses on trading assets, held as economic hedges of foreign currency debt designated at fair value, which offset the £640 million increase in other trading income arising from a strong performance in Global Banking and Markets.

A net gain of £982 million was recognised as *Net income from financial instruments designated at fair value*, compared with a loss in 2008. This was primarily

Report of the Directors: Operating and Financial Review (continued)

due to gains on the fair value of assets held to meet liabilities under insurance and investment contracts as equity markets recovered from declines experienced in 2008. To the extent that these gains were attributed to policyholders holding either insurance contracts or investment contracts with DPF, there was a corresponding increase in *Net insurance claims incurred and movement in liabilities to policyholders*. Foreign exchange gains on debt designated at fair value were largely offset by losses on the tightening of credit spreads on own debt.

Gains less losses from financial investments were £122 million lower than in 2008 mainly due to the non-recurrence of certain disposals in that year, including MasterCard shares, private equity investments and the remaining stake in the Hermitage Fund.

Net earned insurance premiums decreased by 6 per cent. In the UK, an insurance linked Guaranteed Income Bond offered in 2008 was replaced with an alternative banking deposit product, giving rise to a decrease in insurance premium income, with an equivalent decrease in *Net insurance claims incurred and movement in liabilities to policyholders*. Adjusting for the impact of a significant re-insurance transaction in 2008 which passed insurance premiums to a third-party reinsurer, net premiums in France increased by 5 per cent, despite a significant reduction in the distribution network following the disposal of the regional banks network in July 2008.

Other operating income increased by 18 per cent, mainly due to the £353 million gain on the sale and leaseback of 8 Canada Square in London which was effected through the disposal of HSBC's entire shareholding in the company which is the legal owner of the building and long leasehold interest in 8 Canada Square. In 2008, HSBC recognised a gain of £265 million representing the equity deposit on a previously negotiated sale of the building which ultimately did not complete. The growth in revenue also reflected lower costs associated with the provision of support to certain money market funds in Global Asset Management.

Net insurance claims incurred and movement in liabilities to policyholders increased by £1,705 million. The majority of the movement was due to the change in liabilities to policyholders reported above in *Financial instruments designated at fair value*, and the large one-off reinsurance transaction in France in 2008. In addition, an increase of £200 million in claims reserving was required to reflect a higher incidence and severity of insurance claims in the UK motor underwriting business and a higher incidence of credit protection claims through the reinsurance business in Ireland. Risk mitigation measures implemented in 2009 included the decision to cease originations of UK motor

insurance premiums. This was partly offset by the decrease in liabilities following reduced sales of the personal insurance bond product offering noted above.

Loan impairment charges and other credit risk provisions increased by £1,506 million, or 81 per cent, as the impact of weaker economic conditions across the region fed through to higher delinquency and default. In Global Banking and Markets, loan impairment charges and credit risk provisions increased, with the charges concentrated among a small number of clients. The emergence in the year of cash flow impairment on certain asset-backed debt securities held within the available-for-sale portfolios added £745 million to the charge. Impairment booked on these exposures reflects mark-to-market losses which the bank judges to be significantly in excess of the likely ultimate cash losses.

In Commercial Banking, loan impairment charges rose from a low base by £318 million, reflecting the general economic downturn with a small number of larger cases having a material impact. In the personal sector loan impairments rose by £248 million, with deterioration most evident in the cards and other unsecured portfolios as unemployment rose.

Operating expenses increased by £115 million, or 1 per cent. Excluding an accounting gain of £322 million following a change in the basis of delivering death-in-service, ill health and early retirement benefits for some UK employees, operating expenses increased despite efficiency benefits as higher performance-related awards were made to reflect exceptional revenue and profit growth in Global Banking and Markets.

In the UK and Continental Europe Retail businesses, operational cost savings reflected the group's leverage of its global technology platforms and processes to reduce costs and improve customer experience, complemented by tight control over discretionary expenditure and a reduction in staff numbers.

In Europe overall, full time equivalent staff numbers fell by some 6,000 during the year.

The bank's *share of profit in associates and joint ventures* increased by £5 million.

The effective tax rate was 21.3 per cent (2008: 19.3 per cent). This rate is lower than the UK statutory tax rate of 28 per cent (2008: 28.5 per cent) reflecting the benefit of tax free gains in both years. In 2009, the most significant tax free gain related to the sale of the bank's London head office building.

Report of the Directors: Operating and Financial Review (continued)

Summary consolidated balance sheet

	2010 £m	2009 £m	2008 £m
Total assets	798,494	751,928	924,231
Cash and balances at central banks	24,495	14,274	9,470
Trading assets	159,552	165,008	172,026
Financial assets designated at fair value	15,467	16,435	13,895
Derivative assets	129,158	118,516	243,084
Loans and advances to banks	57,027	46,994	50,719
Loans and advances to customers	285,218	274,659	298,304
Financial investments	102,086	86,695	103,511
Other	25,491	29,347	33,222
Total liabilities	766,137	723,500	903,570
Deposits by banks	48,287	57,729	61,431
Customer accounts	344,123	332,896	369,880
Trading liabilities	132,360	118,881	124,450
Financial liabilities designated at fair value	27,935	18,164	15,184
Derivative liabilities	129,204	118,689	241,031
Debt securities in issue	48,119	39,340	52,308
Liabilities under insurance contracts issued	17,116	16,505	16,132
Other	18,993	21,296	23,154
Total equity	32,357	28,428	20,661
Total shareholders' equity	31,825	27,787	19,923
Non-controlling interests	532	641	738

Movements in 2010

Total assets amounted to £798 billion, 6 per cent higher than at 31 December 2009 reflecting higher levels of secured lending in the UK, strong demand for commercial loans and a rise in derivative assets as a result of a downward shift in yield curves. The group maintained a strong and liquid balance sheet with the ratio of customer advances to customer accounts at 82.9 per cent (2009: 82.5 per cent, 2008: 80.6 per cent). The group's reported tier 1 ratio remained stable at 11.4 per cent.

Assets

Cash and balances at central banks grew 72 per cent as residual cash from daily operations was placed with the central banks.

Trading assets fell by 3 per cent. This was primarily driven by lower levels of reverse repo activities and a decrease in holdings of treasury bills and debt securities to reduce exposures to Eurozone peripheral countries. This was partially offset by increased holdings of equities to hedge derivative positions arising from a rise in client trading activity.

Financial assets designated at fair value fell by 6 per cent following as the sale of European government debt securities by Balance Sheet Management. This was partially offset by an increase in the fair value of equity securities held within the insurance business as market values recovered.

Derivative assets rose by 9 per cent. This was primarily driven by increases in the fair value of interest rate contracts as a result of downward shifts in major

yield curves. The notional value of outstanding contracts also rose, reflecting an increase in the number of open transactions compared with 2009.

Loans and advances to banks increased by 21 per cent due to higher levels of reverse repo transactions transacted with bank counterparties, fewer of which meet the accounting netting criteria.

Loans and advances to customers grew by 4 per cent through targeted commercial loans growth. Competitive pricing continued to drive growth in mortgage lending in the UK.

Financial investments rose by 18 per cent as Balance Sheet Management redeployed cash into available-for-sale treasury bills and government agency debt securities.

Liabilities

Deposits by banks decreased by 16 per cent primarily driven by lower levels of repo activity and a fall in central bank deposits in France.

Customer accounts were 3 per cent higher driven by an overall increase in savings accounts. Growth in Premier and online savings contributed to an increase in current account balances as customers responded well to targeted promotional campaigns. This was partially offset by a fall in repo activity.

Trading liabilities increased by 11 per cent primarily due to increased short bond and equity positions used to hedge derivative transactions, reflecting higher client demand.

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Financial liabilities designated at fair value rose by 54 per cent due to new debt issuances during 2010.

Derivative liabilities increased by 9 per cent. The derivative businesses are managed within market risk limits and, as a consequence, the increase in the value of derivative liabilities broadly matched that of derivative assets.

Debt securities in issue rose by 22 percent as result of new issuances of medium-term notes during 2010.

Liabilities under insurance contracts grew by 4 per cent. This was driven by gains on unit-linked products as investment market values improved.

Equity

Total shareholders' equity increased by 15 per cent, driven by profits generated during the year. In addition, the negative balance on the available-for-sale reserve declined from £6 billion at 31 December 2009 to £3 billion at 31 December 2010, largely reflecting improvements in the market value of assets.

Performance and Business Review

Profit on ordinary activities before tax

	2010 £m Reported	2009 £m Reported	2008 £m Reported	2010 £m Underlying	2009 £m Underlying	2008 £m Underlying
UK Retail Banking	1,313	988	2,139	1,265	791	1,924
Continental Europe Retail Banking	322	197	236	322	197	156
Global Banking and Markets	1,876	2,511	122	1,699	2,515	122
Private Banking	616	728	726	616	728	726
Other/Intersegment	(116)	(410)	1,143	6	29	22
	4,011	4,014	4,366	3,908	4,260	2,950

HSBC Bank plc and its subsidiary undertakings reported a pre-tax profit of £4,011 million, in line with 2009, and 8 per cent lower on an underlying basis.

Retail Banking operations in both the UK and Continental Europe recorded significant increases in profits. Lower levels of profit were recorded in Global Banking and Markets, where the exceptional performance of 2009 was not repeated, and in Private Banking.

UK Retail Banking

	2010 £m	2009 £m	2008 £m
Net interest income	3,536	3,361	3,692
Net fee income	1,852	1,913	1,917
Trading income	9	28	61
Other income	255	241	770
Net operating income before impairments and provisions	5,652	5,543	6,440
Loan impairment charges and other credit risk provisions	(1,221)	(1,600)	(1,095)
Net operating income	4,431	3,943	5,345
Total operating expenses	(3,121)	(2,968)	(3,214)
Operating profit	1,310	975	2,131
Share of profit in associates and joint ventures	3	13	8
Profit on ordinary activities before tax	1,313	988	2,139

The above is on a reported basis.

2010 compared with 2009

Overview

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

UK Retail Banking reported strong profit before tax of £1,313 million in the period, compared with £988 million in 2009, an increase of 33 per cent. This was primarily as a result of significantly lower loan impairment charges in both the personal and commercial sectors. The lower charge was as a result of actions taken to improve collections performance, together with the change in mix of new business towards secured and away from unsecured lending. The continuing low interest environment in the UK has also allowed many customers to reduce debt levels.

On an underlying basis, adjusting for the disposal of the residual stake in the UK card acquiring joint venture in June 2009 and UK Retail Banking's element of the disposal of the Insurance Brokers business in April 2010, profit before tax was £1,265 million in 2010, an increase of 60 per cent.

Report of the Directors: Operating and Financial Review (continued)

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

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

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

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

Financial performance

The commentary that follows is on an underlying basis.

Net interest income increased by £176 million or 5 per cent mainly driven by growth in mortgage balances and wider asset margins. This was partly offset by a narrowing of liability spreads. The group built on its strong deposit base, despite fierce competition for liability balances, with personal customer deposits increasing by 9 per cent. In Commercial Banking, net lending balances grew 3 per cent, with new advances up 17 per cent, despite increased customer propensity to reduce borrowing.

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

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

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

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

Total operating expenses increased by £242 million or 9 per cent but were broadly flat against prior year after adjusting for the accounting gain of £264 million resulting from the change in delivery of certain staff benefits in the UK main pension scheme. Cost savings achieved by delivering sustainable long-term reductions in the cost base by re-engineering business processes funded strategic investment in people and infrastructure to support customers. In Personal Financial Services, the group recruited additional wealth advisors, provided a new range of financial planning tools and continued to invest in the branch network, with 243 branches refurbished in 2010. In Commercial Banking, 160 new international relationship managers and 180 new local business manager roles were created.

2009 compared with 2008

Overview

UK Retail Banking reported a profit of £988 million for 2009, against £2,139 million in 2008.

Underlying basis is adjusted for the £180 million gain on the disposal of the residual 49 per cent stake in the UK card acquiring joint venture with Global Payments Inc. in June 2009 and adjustments in relation to the Insurance Brokers business. The 2008 results included a £215 million gain realised on the sale of the first tranche.

Report of the Directors: Operating and Financial Review (continued)

For UK Retail Banking, the following items are significant in a comparison of 2009's underlying results to 2008:

- a change in the basis of delivering death-in-service, ill health and early retirement benefits for some UK employees generated an accounting gain;
- a loss of £179 million for HSBC Insurance (UK) Limited, compared with a loss of £19 million in 2008 as the UK motor insurance underwriter was very significantly affected by adverse claims experience during the year.

In a challenging year, and despite a domestic economy in recession, HSBC's financial strength enabled the bank to continue to support personal and commercial customers in the UK throughout 2009 making available £15 billion in residential mortgages, and helping 121,000 business start-ups in the commercial sector.

HSBC continued to build its premium customer base and the number of UK based international customers in the commercial segment. Customer deposit levels increased despite intense competition and margin compression.

On an underlying basis, and excluding the losses from HSBC Insurance (UK) Limited and the accounting gain for some UK employee benefits in 2009, UK Retail Banking pre-tax profits fell by 63 per cent. This was primarily driven by higher impairments in both the personal and commercial segments due to deterioration in the economic environment, margin compression impacting liability spreads and lower fee income, partially as a result of strategic re-positioning.

Financial performance

The commentary that follows is on an underlying basis.

Net interest income decreased by 9 per cent, mainly driven by the narrowing of liability spreads following interest rate cuts. The bank has however built on its strong deposit base in 2009, despite fierce competition for liability balances. Mortgage balances also increased as the bank gained market share in the UK through the success of a new Rate Matcher mortgage promotion and other campaigns launched in line with the secured lending growth strategy. New mortgage sales were in line with the commitment to lend made in December 2008. In Commercial Banking, net lending has reduced from prior year as a result of muted customer demand. Customer utilisation of committed overdraft facilities was only 40 per cent at the end of 2009. Asset spreads widened in the UK as funding costs reduced in a low interest rate environment and the pricing of corporate lending increased.

Net fee income remained flat. In line with strategy the bank continues to grow the Premier customer base. In Commercial Banking, significant growth was seen in trade revenues which increased 18 per cent on 2008 where the bank responded to the challenge of the recession by increasing the availability of Trade Finance to companies trading internationally. However, fees declined overall following the part disposal of the card-acquiring business to a joint venture in 2008, lower overdraft fees as a result of reduced utilisation and higher operational liquidity costs.

Other income decreased by 89 per cent primarily due to the income realised as a result of the sale of MasterCard and Visa shares in 2008 of £191 million not being repeated in 2009, a decline in income of £134 million in the insurance brokers business driven by adverse motor insurance claims experience mentioned above, sale and leaseback profits made in 2008 and 2009 and the ongoing impacts of the decision in December 2007 to cease selling Payment Protection Insurance ('PPI') products.

Loan impairment charges and other credit risk provisions increased by 46 per cent to £1,600 million. In Commercial Banking, loan impairment charges rose by £285 million, reflecting the general economic downturn with a small number of large cases having a material impact. Exposure to the commercial property portfolio in the UK declined by £0.8 billion to £10.3 billion during 2009, reflecting HSBC's efforts to reduce risk in this sector.

In the personal sector, loan impairment charges rose by £222 million. Stresses were most evident in cards and other unsecured lending, as unemployment rose. However unsecured lending at £13.4 billion is only 18.4 per cent of the aggregate portfolio, as the bulk of the portfolio is residential mortgage. Despite declines in property values from the peak in 2007, residential sector impairment charges as a percentage of total lending remained low at 0.157 per cent, reflecting the bank's conservative lending approach.

Total operating expenses decreased by 8 per cent to £2,968 million. Excluding an accounting gain of £264 million following a change in the basis of delivering death-in-service, ill health and early retirement benefits for some UK employees, operating expenses were 3 per cent lower than 2008. The UK business has leveraged global scale and technology platforms to re-engineer the business. This has improved the customer experience and has allowed a reduction of the core operating expenses in the UK Retail businesses.

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Continental Europe Retail Banking

	2010	2009	2008
	£m	£m	£m
Net interest income	1,725	1,681	1,505
Net fee income	465	423	532
Trading income	22	28	11
Other income	(4)	6	(14)
Net operating income before impairments and provisions	2,208	2,138	2,034
Loan impairment charges and other credit risk provisions	(195)	(338)	(279)
Net operating income	2,013	1,800	1,755
Total operating expenses	(1,691)	(1,603)	(1,519)
Operating profit	322	197	236
Share of profit in associates and joint ventures	—	—	—
Profit on ordinary activities before tax	322	197	236

Profit on ordinary Activities before tax - by country

	2010	2009	2008
	£m	£m	£m
France	159	101	154
Germany	21	14	16
Turkey	135	125	64
Malta	59	58	68
Other	(52)	(101)	(66)
Profit on ordinary activities before tax	322	197	236

These tables are on a reported basis.

2010 compared with 2009

Overview

Continental Europe Retail Banking reported a profit of £322 million in 2010, against £197 million in 2009, an increase of 63 per cent. Increased revenues and lower loan impairment charges were partly offset by rising costs, driven largely by investment to achieve business growth. There was no difference between profits on a reported and underlying basis.

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

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

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

Financial Performance

The comments that follow are on an underlying basis.

Net interest income increased by £44 million or 3 per cent. In Personal Financial Services, asset margins improved in France and Malta partially offset by narrowing margins in Turkey following the imposition of a government-regulated cap on credit card interest rates. The severe deposit spread compression seen in Malta in 2009 eased in 2010 and deposit spreads widened as maturing fixed rate deposits rolled over at lower interest rates. The strategic re-focus of the group's personal banking business depressed net interest income but the resultant sharp increase in the number of target segment customers acquired across the region provides a good revenue base going forward.

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

Net fee income increased £42 million or 10 per cent compared with 2009. Fee income in Personal Financial Services was 30 per cent higher as growth in France, Turkey and Malta reflected the success of the penetration of the target segment and wealth management business. Growth in Greece, Ireland, Czech Republic and Spain boosted fee income in Commercial Banking.

Loan impairment charges and other credit risk provisions decreased by £143 million or 42 per cent compared with 2009. In Personal Financial Services, impairments were sharply lower in Turkey where limit reductions, changes in approval thresholds and a strong focus on collections yielded substantial improvements in recoveries and a reduction in delinquency rates. The closure of Consumer Finance business in Continental

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Europe in 2009 also contributed to the fall in the 2010 impairment charges.

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

Total operating expenses increased by £88 million or 5 per cent. The higher cost levels were principally due to expansion of the Personal Financial Services business in France, Turkey and Poland; and Commercial Banking business in Turkey and Germany. The acquisition of a retail business in Kazakhstan also added to the cost base.

2009 compared with 2008

Overview

Continental Europe Retail Banking reported a profit of £197 million for 2009, against £236 million in 2008.

On an underlying basis, adjusting for £80 million operating profit from the seven regional banks in France that were disposed of in July 2008, and excluding foreign exchange movements, profit before tax increased by £22 million. Commercial Banking profits increased by 31 per cent as a result of improved lending margins. This was partially offset by higher loan impairment charges, with a small number of larger cases having a material impact reflecting the general economic downturn. The bank continued to support small business through the economic cycle, lending £165 million to the SME sector in France and Malta. Despite sharp falls in international trade volumes across the region, the group's trade business continued to grow with revenues up 4 per cent on 2008 with particularly strong growth in key markets such as Poland and Turkey, and record results in Spain, Armenia, Israel and Ireland. Despite steady net interest income growth, Personal Banking losses increased in 2009 due to a large re-insurance loss of £49 million in Ireland and an increase in impairment charges.

Financial performance

Net interest income increased by 15 per cent. Adjusting for the impact of foreign exchange movements, net interest income increased by 6 per cent. Net interest spreads improved in Commercial Banking although the impact was reduced by lower asset balances reflecting a decline in customer demand for credit and a change in investor preference from bank lending to debt issuance. Personal banking net interest income increased due to a significant growth in the Premier customer base, predominantly in France, in line with the premium banking strategy. However this was largely offset by the group's diminished appetite for unsecured lending

and by losses of income resulting from the closure of the Consumer Finance businesses in Eastern Europe.

Net fee income decreased by 15 per cent mainly driven by an increase in fee expense due to a rise in business written in HSBC Reinsurance through the HSBC Preferred Strategic partner network, which is used for certain products in locations where HSBC does not have a manufacturing presence. This was partially offset by higher service and arrangement fees in Turkey due to increased personal banking card volumes.

Loan impairment charges and other credit risk provisions increased by 23 per cent to £338 million. Loan impairment charges for commercial loans rose by £35 million reflecting the general economic downturn and a small number of larger cases having a material impact. Loan impairment charges were £27 million higher in the personal banking sector, due in part to a £16 million write-off relating to a fraud case in France. Despite uncertainty in European property markets, impairment charges from the residential sector remained relatively low, benefiting from the bank's conservative approach to lending.

Total operating expenses increased by 8 per cent to £1,603 million. Excluding the impact of foreign exchange movements, £12 million additional investment spend in Russia and £18 million write-off costs relating to a number of personal banking and Consumer Finance withdrawals from Eastern Europe, operating expenses remained flat reflecting tight cost control across the region.

Global Banking and Markets

	2010 £m	2009 £m	2008 £m
Net interest income ¹	1,914	2,849	1,963
Net fee income.....	1,053	1,060	845
Trading income	1,711	1,972	318
Other income	927	708	(110)
Net operating income before impairments and provisions	5,605	6,589	3,016
Loan impairment charges and other credit risk provisions	(518)	(1,405)	(453)
Net operating income	5,087	5,184	2,563
Total operating expenses.....	(3,213)	(2,674)	(2,442)
Operating profit.....	1,874	2,510	121
Share of profit in associates and joint ventures.....	2	1	1
Profit on ordinary activities before tax.....	1,876	2,511	122

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Profit on ordinary Activities before tax - by country

	2010	2009	2008
	£m	£m	£m
UK	1,231	1,523	(188)
France	257	594	107
Germany	139	127	93
Turkey	79	92	83
Other	170	175	27
Profit on ordinary activities before tax	1,876	2,511	122

1 The bank's Balance Sheet Management business, reported within Global Banking and Markets, provides funding to the trading businesses. To report Global Banking and Markets Trading income on a fully funded basis, Net interest income and Trading income are grossed up to reflect internal funding transactions prior to their elimination in the Inter Segment column (refer to Note 12).

These tables are on a reported basis.

2010 compared with 2009

Overview

Global Banking and Markets reported a pre-tax profit of £1,876 million in the period compared with £2,511 million in 2009, a decrease of 25 per cent. The 2010 results, however, remained strong by historical standards and were second only to the exceptional performance of 2009.

On an underlying basis, adjusting for the Global Banking and Markets' element of the disposal of the Insurance Brokers' business in April 2010 and the disposal of Eversholt Rail Group in December 2010, profit before tax was £1,699 million, 32 per cent lower than 2009.

Revenues slowed in 2010, due to less favourable market conditions caused by the impact of the European sovereign debt crisis and the anticipated lower revenues in Balance Sheet Management. Operating expenses included a £207 million charge from the one-off UK and French bonus and payroll taxes applied on certain 2009 bonus payments.

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

Financial performance

The commentary that follows is on an underlying basis.

Net interest income decreased by £935 million, or 33 per cent against 2009. As anticipated, Balance Sheet

Management revenues fell against the exceptional performance of 2009 driven by the maturity of higher yielding positions, low interest rates and flatter yield curves. In Global Banking, the continuation of margin compression resulted in lower levels of income in the credit and lending business.

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

Trading income was £261 million or 13 per cent lower than 2009. Credit and Rates reported lower income as a result of the unfavourable market conditions caused by the impact of the European sovereign debt crisis. This was partly mitigated by a net release of previous write-downs on legacy positions and on monoline exposures. Foreign exchange revenues declined, reflecting margin compression from increased competition. This was partly offset by lower net fair value losses reported on structured liabilities of £18 million compared with losses of £215 million in 2009. Foreign exchange gains were reported on trading assets held as economic hedges of foreign currency debt designated at fair value, compared with losses reported in 2009. The offset is reported in Other income.

Other income increased by £38 million or 5 per cent due to higher realisations and lower impairment charges in Principal Investments as market conditions improved. This was partly offset by foreign exchange losses on debt designated at fair value, compared with a gain reported in 2009. The offset is reported in Trading income.

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

Total operating expenses increased by £574 million or 22 per cent due to the inclusion of £207 million payroll taxes on certain bonuses and continued investment in strategic initiatives to drive future revenue growth, including the development of Prime Services and equity market capabilities and expansion of the Rates and foreign exchange e-commerce platforms. This was compounded by the non-recurrence of a £58 million pension accounting gain recorded in 2009.

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2009 compared with 2008

Overview

Global Banking and Markets recorded an exceptional pre-tax profit of £2,511 million in 2009, primarily resulting from an outstanding performance in Rates and Balance Sheet Management.

Financial performance

Net interest income increased by 45 per cent. Balance Sheet Management revenues increased due to early positioning of the balance sheet in anticipation of decisions by central banks to preserve a low base rate environment. Conversely, the payments and cash management business was adversely affected by margin compression following interest rate reductions in late 2008 and early 2009.

Net fee income increased by 25 per cent due to a rise in underwriting fees from an increase in government and corporate debt issuances, and higher revenues in equity capital markets driven by the return of client activity and gains in market share.

Trading income increased by £1,654 million. A particularly strong performance in Rates reflected increases in market share and client trading volumes, coupled with wider bid-offer spreads. Similarly, revenue in the Credit trading business rose as credit prices improved and client activity increased with the return of liquidity to the market. Foreign exchange revenue fell, however, reflecting a combination of reduced customer volumes and relatively lower market volatility when compared with the exceptional experience of 2008. Trading income benefited from the non-recurrence of write-downs on legacy positions in credit trading, leveraged and acquisition financing and monoline exposures, and from the non-recurrence of a £585 million charge in 2008 following the fraud at Madoff Securities. This was partly offset by losses on tightening of credit spreads on structured liabilities, compared to gains in 2008. The tightening of credit spreads led to a reduction in the carrying value of credit default swap transactions held as hedges in parts of the Global Banking portfolio. In 2008, gains were reported on these credit default swaps following widening credit spreads.

Loan impairment charges and other credit risk provisions increased by £952 million to £1,405 million with charges concentrated among a small number of clients. The emergence in the year of cash flow impairment on certain asset-backed debt securities held within the available-for-sale portfolios added £745 million to the charge. Impairment booked on these exposures reflects mark-to-market losses which the bank judges to be significantly in excess of the likely ultimate cash losses.

Total operating expenses increased by 10 per cent to £2,674 million as efficiency benefits were offset by higher performance-related awards made to reflect exceptional revenue and profit growth.

Private Banking

	2010	2009	2008
	£m	£m	£m
Net interest income.....	724	815	746
Net fee income.....	650	626	627
Trading income.....	253	210	212
Other income.....	22	28	49
Net operating income			
before impairments and			
provisions.....	1,649	1,679	1,634
Loan impairment charges			
and other credit risk			
provisions.....	(17)	(19)	(31)
Net operating income.....	1,632	1,660	1,603
Total operating expenses.....	(1,016)	(932)	(877)
Operating profit.....	616	728	726
Share of profit in associates			
and joint ventures.....	—	—	—
Profit on ordinary			
activities before tax.....	616	728	726

This table is on a reported basis, there is no difference between reported and underlying bases.

2010 compared with 2009

Overview

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

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

Financial performance

The commentary that follows is on an underlying basis.

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

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

Trading income increased by £43 million or 20 per cent in 2010 driven by higher client transaction volumes

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as client risk appetite returned, particularly in foreign exchange and debt securities trading.

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

2009 compared with 2008

Overview

Private Banking reported pre-tax profit of £728 million for 2009, in line with 2008. Client-related income decreased as a result of the lower average value of funds under management and increased client aversion to risk. However, strong cost control and reduced performance-related costs mitigated the impact.

Financial performance

Net interest income increased by 9 per cent to £815 million, due to foreign currency movements. Excluding these movements net interest income declined by 3 per cent in 2009 due mainly as a result of tighter spreads and reduced deposit volumes following aggressive deposit price competition.

Net fee income and *Trading income* were both broadly unchanged.

Other income decreased by 43 per cent, primarily due to the sale of investment in Hermitage Fund in 2008.

Total operating expenses increased by 6 per cent to £932 million. Excluding unfavourable movements on foreign exchange, operating expenses were 7 per cent lower due to a reduction in performance-related costs, lower staff numbers and savings on discretionary costs. These were partially offset by £12 million of integration costs relating to the merger of HSBC's two Swiss private banks and £8 million of redundancy costs.

	£m	£m	£m
Net interest income.....	(100)	(192)	(108)
Net fee income.....	20	55	36
Trading income.....	(8)	(35)	264
Other income.....	73	(152)	1,082
Net operating income before impairments and provisions.....	(15)	(324)	1,274
Loan impairment charges and other credit risk provisions.....	—	(2)	(3)
Net operating income.....	(15)	(326)	1,271
Total operating expenses.....	(101)	(84)	(128)
Operating profit.....	(116)	(410)	1,143
Share of profit in associates and joint ventures.....	—	—	—
Profit on ordinary activities before tax.....	(116)	(410)	1,143

This table is on a reported basis.

2010 compared with 2009

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

Other includes:

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

2009 compared with 2008

The reported loss before tax in Other was £410 million, compared with a profit of £1,143 million in 2008.

Other includes:

- the change in own credit spread on long-term debt which resulted in a £439 million loss in 2009 compared with a gain of £477 million for 2008;
- the £644 million gain on the disposal of seven regional banks in France in July 2008; and
- the gain of £353 million on the sale of the Group's London headquarters building. In 2008 the group reported a gain of £265 million from the cancellation of an agreement to sell this building.

Other

2010	2009	2008
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Other information

Average balance sheet and net interest income

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

the income statement by the average interest-earning assets from which interest income is reported within the "Net interest income" line of the income statement.

Interest income and interest expense arising from trading assets and liabilities and the funding thereof is included within "Net trading income" in the income statement

Assets

	2010			2009			2008		
	Average balance £m	Interest income £m	Yield %	Average balance £m	Interest income £m	Yield %	Average balance £m	Interest income £m	Yield %
Short-term funds and loans and advances to banks	76,665	1,111	1.45%	61,378	1,307	2.13	70,342	2,508	3.57
Loans and advances to customers	244,544	7,891	3.23%	242,776	8,720	3.59	226,366	13,089	5.78
Financial investments	97,264	2,101	2.16%	91,624	2,604	2.84	75,168	3,375	4.49
Other interest-earning assets	642	7	1.09%	1,006	12	1.19	2,327	26	1.12
Total interest-earning assets ...	419,115	11,110	2.65%	396,784	12,643	3.19	374,203	18,998	5.08
Trading assets	138,639	2,492	1.80%	150,491	3,548	2.36	163,239	6,376	3.91
Financial assets designated at fair value	7,558	253	3.35%	8,763	285	3.25	8,219	192	2.34
Impairment provisions	(4,134)	-	-	(3,302)	-	-	(1,965)	-	-
Non-interest-earning assets	313,626	-	-	311,518	-	-	237,027	-	-
Total assets and interest income	874,804	13,855	1.58%	864,254	16,476	1.91	780,723	25,566	3.27

Total equity and liabilities

	2010			2009			2008		
	Average balance £m	Interest expense £m	Cost %	Average balance £m	Interest expense £m	Cost %	Average balance £m	Interest expense £m	Cost %
Deposits by banks	62,060	553	0.89%	62,187	928	1.49	65,264	2,263	3.47
Financial liabilities designated at fair value own debt issued	14,431	247	1.71%	8,233	211	2.56	5,840	331	5.67
Customer accounts	268,034	1,834	0.68%	283,204	2,412	0.85	247,462	7,944	3.21
Debt securities in issue	54,427	725	1.33%	62,744	947	1.51	69,713	2,690	3.86
Other interest-bearing liabilities	1,423	57	4.01%	1,245	54	4.34	4,812	73	1.52
Total interest-bearing liabilities	400,375	3,416	0.85%	417,613	4,552	1.09	393,091	13,301	3.38
Trading liabilities	72,690	1,585	2.18%	91,033	1,892	2.08	112,233	4,574	4.08
Financial liabilities designated at fair value (excluding own debt issued)	10,580	181	1.71%	9,002	185	2.06	10,251	181	1.77
Non-interest bearing current accounts	36,831	-	-	32,520	-	-	21,296	-	-
Total equity and other non- interest-bearing liabilities ...	354,328	-	-	314,086	-	-	243,852	-	-
Total equity and liabilities	874,804	5,182	0.59%	864,254	6,629	0.77	780,723	18,056	2.31

Report of the Directors: Operating and Financial Review (continued)

Net interest margin

	2010	2009	2008
	%	%	%
Net interest margin	1.84	2.04	1.52

Analysis of changes in net interest income

The following table allocates changes in net interest income between volume and rate for 2010 compared to 2009, and for 2009 compared to 2008.

	2010 £m	Increase/(decrease) in 2010 compared with 2009		2009 £m	Increase/(decrease) in 2009 compared with 2008		2008 £m
		Volume £m	Rate £m		Volume £m	Rate £m	
Interest income							
Short-term funds and loans and advances to banks	1,111	326	(522)	1,307	(320)	(881)	2,508
Loans and advances to customers.....	7,891	64	(893)	8,720	949	(5,318)	13,089
Financial investments	2,101	160	(663)	2,604	739	(1,510)	3,375
Interest expense							
Deposits by banks.....	553	(2)	(373)	928	(107)	(1,228)	2,263
Customer accounts.....	1,834	(129)	(449)	2,412	1,147	(6,679)	7,944
Financial liabilities designated at fair value – own debt issued	247	159	(123)	211	136	(256)	331
Debt securities in issue	725	(126)	(96)	947	(269)	(1,474)	2,690

Deposits

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

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

	2010		2009		2008	
	Average balance £m	Average rate %	Average balance £m	Average rate %	Average balance £m	Average rate %
Deposits by banks	80,944		66,330		70,471	
Demand and other – non-interest bearing	4,360	–	4,143	–	5,207	–
Demand – interest bearing.....	8,913	0.6	9,019	1.0	11,361	2.9
Time.....	18,310	0.9	19,169	1.7	26,149	3.5
Other	49,361	0.7	33,999	1.5	27,754	3.7
Customer accounts	296,930		320,010		271,804	
Demand and other – non-interest bearing	43,419	–	36,806	–	24,342	–
Demand – interest bearing.....	140,666	0.4	141,965	0.4	125,634	2.7
Savings.....	33,514	1.8	36,642	2.2	41,377	4.2
Time.....	49,017	1.1	56,013	1.3	58,621	3.5
Other	30,314	0.6	48,584	0.6	21,830	3.1
CDs and other money market instruments.....	37,006	0.4	41,564	1.0	43,237	4.2

Report of the Directors: Operating and Financial Review (continued)**Certificates of deposit and other time deposits**

At 31 December 2010, the maturity analysis of CDs and other wholesale time deposits, by remaining maturity, was as follows:

	3 months or less £m	After 3 months but within 6 months £m	After 6 months but within 12 months £m	After 12 months £m	Total £m
Certificates of deposit	9,117	4,934	3,877	–	17,928
Time deposits					
- banks	19,449	1,640	1,105	1,472	23,666
- customers	50,928	6,859	5,458	3,779	67,024

Contractual obligations

The table below provides details of selected known contractual obligations of the group as at 31 December 2010.

	Payments due by period			
	Total £m	Less than 1 year £m	1-5 years £m	More than 5 years £m
Long-term debt obligations.....	70,543	24,206	26,240	20,097
Term deposits and certificates of deposit	108,618	103,367	4,391	860
Capital (finance) lease obligations	307	12	52	243
Operating lease obligations.....	2,082	189	680	1,213
Purchase obligations	4	4	–	–
Short positions in debt securities and equity shares....	51,941	35,401	4,606	11,934
Current tax liability	153	153	–	–
Pension/healthcare obligation.....	7,118	564	2,446	4,108
	240,766	163,896	38,415	38,455

Report of the Directors: Risk

Risk Management

(Unaudited)

The group's risk management framework is designed to provide appropriate monitoring and assessment.

The bank's Risk Committee was established in 2010 to increase the focus on risk governance and to provide an increasingly forward-looking view of risks and their mitigation.

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

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

Challenges and Uncertainties

(Unaudited)

Business operations, governance and control

Operational risks are inherent in the group's business

The group is exposed to many types of operational risk, including fraudulent and other criminal activities (both internal and external), breakdowns in processes or procedures, systems failure or non-availability, and regulatory compliance and legal risks. The group is also subject to the risk of disruption to its business arising from events that are wholly or partially beyond its control (for example: natural disasters, acts of terrorism, epidemics, and transport or utility failures) which may give rise to losses in service to customers and/or economic losses to the group. All of these risks are also applicable where the group is reliant on suppliers or vendors to provide services to it and its customers.

The reliability and security of information technology infrastructure and customer databases are crucial to maintaining the service availability of banking applications and processes and to protecting the group brand. Critical system failure, any prolonged loss of service availability or any material breach of data security, particularly involving confidential customer data, could cause serious damage to the group's ability to service its clients. Subsequently, this could cause a breach in regulations under which the group operates and could cause long-term damage to the group's business and brand.

The group is subject to legal and compliance risks that could have an adverse affect on its business

Legal and compliance risks arise from a variety of sources with the potential to cause harm to the group and its ability to operate. These issues require the group to deal appropriately with potential conflicts of interest, regulatory requirements, ethical issues, anti-money laundering laws and regulations, privacy laws, information security policies, sales and trading practices, and the conduct of companies with which it is associated. Failure to address these issues appropriately may give rise to additional legal and compliance risk to the group, with an increase in the number of litigation claims and the amounts of damages asserted against the group, or subject the group to regulatory enforcement actions, fines or penalties or reputational damage.

The group is subject to tax-related risks in the countries in which it operates

The group is subject to the substance and interpretation of tax laws in all countries in which it operates. Failure to respond to changes in tax law or the interpretation of tax law and changes in tax rates and not complying with procedures required by tax authorities could lead to increased tax charges, including financial or operating penalties.

Liquidity and funding risks are inherent in the group's business

The group's business model is founded upon having ready access to financial resources, whenever required, to meet its obligations and grow its business. To this end, the group entities seek to maintain a diversified and stable funding base comprising core retail and corporate customer deposits and institutional balances. In certain entities, this is augmented with amounts of long-term wholesale funding. In addition, the group holds portfolios of highly liquid assets to enable it to respond to unusual liquidity requirements.

Where markets become illiquid, the value at which financial instruments can be realised is highly uncertain, and capital resources may shrink as valuations decline. Rating agency downgrades of instruments, to which the group has exposure, can exacerbate the effect. The liquidity of those group entities that utilise long-term wholesale markets could be constrained by an inability to access them due to a variety of unforeseen market dislocations or interruptions.

The market conditions that the financial services industry experienced during the recent financial crisis highlighted the significant benefits of a diversified core deposit base, leading to increased competition for such deposits and the greater risk of deposit migration between competitors.

Report of the Directors: Risk (continued)

The group's Global Banking and Markets business operates in many markets affected by illiquidity and is subject to the threat of extreme price volatility, either directly or indirectly, through exposures to securities, loans, derivatives and other commitments. At the height of the financial crisis during 2008, the group made substantial write-downs and recognised impairments on illiquid legacy credit and structured credit positions. Although 2010 continued to reflect a moderation in market conditions, it is difficult to predict if this trend will continue and, if conditions worsen, which of the group's markets, products and other businesses will be impacted. Any repeat of these factors could have an adverse effect on the group's results.

Macro-economic and geopolitical

Current economic and market conditions may adversely affect the group's results

The group's earnings are affected by global and local economic and market conditions. The dislocations in financial markets and the broad economy in 2007-8 were eased by concerted government actions to boost liquidity and confidence in financial systems, stimulate lending, support institutions judged to be at risk of failure, and extend stimulus programmes. The general economic environment improved further in 2010, although recovery was variable between regions, with Eurozone economies coming under greater pressure, the dominant concern being over sovereign debt. The financial services industry continued to face an unusually high degree of uncertainty.

With unemployment remaining high and consumer confidence weak in developed markets, amid signs of emerging inflationary pressures, economic conditions remain fragile and volatile.

There is a risk that, in some countries, recovery to past levels of growth will be slow, with the possibility of a return to recessionary conditions in more sluggish economies. Others, which are growing very rapidly, may need to undertake major adjustments. This could have an adverse effect on the operating results of the group. In particular, the group may face the following challenges in connection with these events:

- the demand for borrowing from creditworthy customers may diminish, especially if economic activity slows;
- trade and capital flows may contract as a result of protectionist measures being introduced in certain markets;
- a prolonged period of low interest rates will constrain net interest income;
- the group's ability to borrow from other financial institutions or to engage in funding transactions could be adversely affected;

- market developments may depress consumer and business confidence causing adverse changes in asset prices and payment patterns, leading to increases in delinquencies and default rates, write-offs and loan impairment charges.

The group is subject to political and economic risks in the countries in which it operates

As an organisation which operates in multiple countries, the group's results are subject to the risk of loss from unfavourable political developments, currency fluctuations, social instability and changes in government policies on such matters as expropriation, authorisations, international ownership, interest-rate caps, foreign exchange transferability and tax in the jurisdictions in which we operate. The ability of the group's subsidiaries and affiliates to pay dividends could be restricted by changes in official banking measures, exchange controls and other requirements.

The group has significant exposure to counterparty risk within its portfolio

The group is exposed to virtually all major industries and counterparties, and it routinely executes transactions with counterparties in financial services, including brokers and dealers, commercial banks, investment banks, mutual and hedge funds, and other institutional clients. Many of these transactions expose the group to credit risk in the event of default by its counterparty or client. Financial institutions are necessarily interdependent because of trading, clearing, counterparty or other relationships. As a consequence, a default by, or decline in market confidence in, individual institutions, or anxiety about the financial services industry generally, can lead to further individual and/or systemic losses. The group's credit risk may remain high if the collateral taken to mitigate counterparty risk cannot be realised or has to be liquidated at prices which are insufficient to recover the full amount of its loan or derivative exposure.

Macro-prudential and regulatory

Current challenges in regulation and supervision

Recent regulatory and supervisory developments have largely been shaped by the leaders, Finance Ministers and Central Bank Governors of the Group of Twenty nations ('the G20'), who delegated the development and issuance of standards to the Basel Committee. The G20 also established the Financial Stability Board ('FSB') to assess vulnerabilities affecting the financial system as a whole, as well as to monitor and advise on market developments and best practice in meeting regulatory standards. In looking to address the systemic failures that caused the financial crisis, the authorities highlighted the following priorities:

- a stronger international framework for prudential regulation, ensuring significantly increased liquidity

Report of the Directors: Risk (continued)

- and regulatory capital buffers and enhanced quality of capital;
- convergence towards a single set of high quality, global, independent accounting standards on financial instruments, loan loss provisioning, off-balance sheet exposures and the impairment and valuation of financial assets;
- strengthening of the regulation of hedge funds and credit rating agencies, and an improved infrastructure for derivative transactions, including central counterparty clearing of over-the-counter derivatives;
- design and implementation of a system which will allow for the restructuring or resolution of financial institutions, without taxpayers ultimately bearing the burden;
- an increased role for colleges of supervisors to coordinate oversight of systemically significant institutions such as the group, and effective coordination of resolution regimes for failed banks;
- measures on financial sector compensation arrangements to prevent excessive short-term risk taking and mitigate systematic risk on a globally consistent basis;
- a fair and substantial contribution by the financial sector towards paying for any burden associated with government interventions, where they occur, to repair and reduce risks from the financial system or to fund the resolution of problems.

Governments and regulators have embarked on significant change in the regulatory structure of the financial system with two primary objectives: establishing a resilient system to reduce substantially the risks of failure of financial institutions and, in case failure should in the end prove unavoidable, to have in place measures to achieve orderly resolution without cost to taxpayers.

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

Regulation and supervision

(Unaudited)

Measures proposed by the Basel Committee to increase resilience in the financial system

The Basel Committee, following consultation, impact analysis and draft proposals during 2010, issued final proposals in December 2010 on the twin areas of capital and liquidity, the key aspects of which are set out below:

- **Risk weightings:** increased weightings for the trading book, securitisations, off-balance sheet exposures and derivatives are to be implemented by the end of 2011.
- **Quality of capital:** there is renewed emphasis on common equity as the principal component of core tier 1 equity, with increased deductions from shareholders' equity (calculated on an accounting basis) to determine the level of regulatory capital. The phasing-in periods for these new deductions will start in 2014, with full implementation by 2018.
- **Minimum ratios:** a new minimum common equity requirement of 4.5% is to be implemented by 1 January 2015. An additional capital conservation buffer of 2.5% in common equity will effectively trigger restrictions on corporate activity (such as the payment of dividends or bonuses) if breached, so that the capital structure can be rebuilt. This will be phased in between 1 January 2016 and 1 January 2019. Additional requirements from the Basel Committee for tier 1 capital of 1.5% and tier 2 capital of 2.0%, by 2019, will lift the minimum total capital requirement for banks to around 10.5%.
- **Countercyclical buffer:** the Basel Committee has finalised its proposals for a countercyclical buffer of up to 2.5% in common equity, to be built up in periods during which credit growth exceeds GDP growth. It is not clear how such buffers may operate in practice, since they may be required only once every 10-20 years, and there is uncertainty over whether supervisors or the market would support the release of a buffer when the economic cycle had turned.
- **Total leverage:** the Committee has proposed a leverage ratio of 3% of total non-risk weighted assets to constrain aggregate size relative to the capital base. An observation period of parallel running will start in 2013, with the aim of a minimum standard becoming mandatory in 2018.
- **Liquidity and funding:** a new minimum standard, the Liquidity Coverage Ratio, has been proposed for liquidity to extend, under stressed conditions, the period during which a bank can continue to operate when it is unable to dispose of assets to repay withdrawals. Proposals are also being introduced for a Net Stable Funding Ratio. Although these have yet to be finalised, they are expected to require banks to match more accurately the maturities of liabilities to assets held. As it is not clear what secondary effects these measures may have, they will be phased in after observation periods, in 2015 and 2018 respectively.
- The Basel Committee is also considering proposals to define Global Systemically Important Financial Institutions ('G-SIFI's), introduce more rigorous oversight and co-ordinated assessment of their risks through international supervisory colleges, provide for higher levels of capital and liquidity resilience and require mandatory recovery and resolution plans with

Report of the Directors: Risk (continued)

institution-specific crisis cooperation agreements between cross-border crisis management groups. It is proposed that the additional capital requirements could be met through a variety of instruments such as a core tier 1 surcharge, contingent capital or debt securities with specific bail-in provisions. Further measures may include liquidity surcharges, tighter large exposure restrictions, levies, and structural measures to reduce the risks that a G-SIFI poses. Studies will be completed by mid-2011 and final recommendations presented by December 2011. US regulators are conducting a related study of the relationship between bank size and systemic risk, the results of which are expected to lead to new rules requiring enhanced prudential standards, including capital, liquidity and leverage requirements for the largest financial institutions.

Other measures

- **Remuneration:** the Financial Stability Board has issued principles on remuneration designed to guide regional and national authorities in establishing appropriate regimes to align remuneration in a risk-based manner with the long-term interests of stakeholders. The EU has implemented rule changes in the Capital Requirements Directive ('CRD') 3 which impact the balance between fixed and variable remuneration, establishing limits on the percentage of bonus which can be paid in cash. Approaches to the issue, however, remain inconsistent globally.
- **Other taxes:** other areas of financial sector taxation being considered by the authorities are a Financial Activities Tax (FAT) – a tax on profit and remuneration, and a Financial Transaction Tax (FTT) – applied to a specified range of financial transactions. An IMF report for the G20 in 2010 saw merit in a FAT but did not recommend a FTT as it was felt not to address the key issues within the G20 mandate and might have unintended economic and regulatory consequences. In its Seoul 2010 communique the G20 did not promote any one approach for adoption. Both the EU Commission and the UK Government are considering a FAT, which the former believes can work at EU level. The EU also sees merit in a FTT but, recognising the dependency on an international consensus, will continue to work within the G20 for its adoption.
- **Central counterparties:** the authorities seek to reduce systemic risk and volatility through greater control and transparency in the clearing and information requirements relating to derivatives trading in Europe. In September 2010, the EU Commission presented proposals, currently in negotiation, for all eligible standardised over-the-counter ('OTC') derivatives to be cleared through central counterparties by the end of 2012. All OTC derivative contracts would need to be reported to trade repositories subject to new capital requirements and rules on structure and governance. The proposal discourages derivative contracts which are not eligible for central clearing by proposing that they will attract higher capital requirements. It currently holds no exemption for foreign exchange, though this is being considered.
- **Markets in financial instruments:** the European Commission is conducting a major Review of the Markets in Financial Instruments Directive, potentially to extend its scope beyond equities to other asset classes including bonds, exchange-traded funds and other equity-like and non-equity instruments, and to promote their trading on exchanges and other markets that will be subject to regulation. It also proposes giving additional power to regulators to ban trading in products that are eligible to be cleared but for which no clearing solution is currently available
- **The UK Independent Commission on Banking:** this Commission has been established to examine issues of banking activity and competition, including the potential impact on financial markets of a number of options to separate the retail and wholesale activities of universal banks. A paper setting out the Commission's thinking is expected in early 2011, with further consultation prior to a final report in September 2011. The UK government is not bound to adopt the Commission's recommendations.
- **Recovery and resolution plans:** such plans are considered a key element in improving the ability of regulators to rescue (or 'resolve') firms when they get into difficulties without putting taxpayer monies at risk. Studies and pilots have been initiated by various official bodies on the resolution of financial firms and the international coordination of such exercises; the UK authorities have been at the forefront of work to develop approaches to this subject. The EU has consulted on a new framework for crisis management, focused on expanded supervisory powers, a cross-border coordination framework; a network of national resolution funds and harmonised resolution tools, including so called 'bail-in' creditor write-down resolution. Legislative proposals are expected in the middle of 2011. There is currently no consistent approach globally and a number of key areas need to be addressed, including an international legal framework for addressing competing creditor claims and the application of collateral.

Restructuring of regulatory bodies

In the EU, new authorities for segments of the financial services sector took up their powers with effect from 1 January 2011: the European Banking Authority, the European Securities Markets Authority and the European

Report of the Directors: Risk (continued)

Insurance and Occupational Pension Authority. In addition, a European Systemic Risk Board will consider emerging macro-prudential risks.

In the UK, the FSA's prudential supervisory responsibilities will be transferred in 2012 to a Bank of England agency, the Prudential Regulatory Authority, while the Financial Conduct Authority will act as a single regulator of conduct of business for both retail and wholesale firms.

Bank Levies

A number of levies are being raised on banks, notably by the UK, Germany and France. These are calculated with reference to measures of stability of funding in order to encourage more stable structures. For example, in the UK, the levy is to be charged at a rate of 0.075% on all liabilities, excluding insured deposits and certain other elements but with a lower rate of charge for longer term liabilities and uninsured deposits. Germany will hypothecate levy income to create resolution funds to support failing banks, while in others it will accrue to general tax revenues. Under the draft legislation the charge for the UK levy is not a deductible expense for the purposes of calculating the Group's UK tax liability and it does not meet the definition of an income tax for income statement purposes. For indicative purposes only, the UK levy that would be payable based on the closing 2010 Group balance sheet, after taking into account announced changes to deposit protection schemes in 2011, is estimated at £0.4bn. The portion of the levy charge that will be attributable to the group using the balance sheet at the 31 December 2010 is estimated to be £0.2bn.

Outlook

(Unaudited)

The bank expects global economic conditions to improve during the course of 2011, although the pace of recovery is expected to remain uneven across the regions.

The bank expects UK GDP to rise by some 1.7 per cent in 2011. The effects of fiscal consolidation and subdued recovery in the labour markets are expected to constrain the growth of domestic demand, while only modest growth is expected from exports. Consumer price inflation is expected to remain at an elevated level during 2011, reflecting the rise in global commodity prices and the further increase in the rate of VAT.

Eurozone GDP is expected to grow by some 1.5 per cent in 2011. The impact of fiscal austerity is likely to be felt, especially in the Eurozone periphery, and concerns surrounding the sovereign debt levels in these countries are likely to persist in 2011. However, a continuation of economic recovery can be expected for the core Eurozone countries including Germany and France, led by the re-acceleration in the global trade cycle as well as improving domestic labour markets that will support consumer spending over 2011. Rising global food and energy prices

are likely to cause a temporary period of higher consumer price inflation in early 2011.

Credit risk

(Audited)

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

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

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

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

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

Report of the Directors: Risk (continued)

group's capital base, and remain within internal and regulatory limits;

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

Credit quality

(Audited)

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

The group's risk rating system facilitates the internal ratings-based ('IRB') approach under Basel II adopted by the Group to support calculation of our minimum credit regulatory capital requirement. For further details, see 'Credit quality of financial instruments' on page 36.

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

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

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

Impairment Assessment

(Audited)

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

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

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

Maximum exposure to credit risk

(Audited)

The following table presents the maximum exposure to credit risk from balance sheet and off-balance sheet financial instruments, before taking account of any collateral held or other credit enhancements (unless such credit enhancements meet offsetting requirements). For financial assets recognised on the balance sheet, the maximum exposure to credit risk equals their carrying amount; for financial guarantees granted, it is the maximum amount that the group would have to pay if the guarantees were called upon. For loan commitments and other credit-related commitments that are irrevocable over the life of the respective facilities, it is generally the full amount of the committed facilities.

Report of the Directors: Risk (continued)

The group

	At 31 December 2010			At 31 December 2009		
	Maximum exposure £m	Offset £m	Exposure to credit risk (net) £m	Maximum exposure £m	Offset £m	Exposure to credit risk (net) £m
Cash and balances at central banks.....	24,495	–	24,495	14,274	–	14,274
Items in the course of collection from other banks	1,932	–	1,932	2,082	–	2,082
Trading assets	135,047	(2,401)	132,646	145,604	(3,800)	141,804
treasury and other eligible bills	2,529	–	2,529	789	–	789
debt securities	73,771	–	73,771	75,566	–	75,566
loans and advances to banks	26,525	–	26,525	30,857	–	30,857
loans and advances to customers	32,222	(2,401)	29,821	38,392	(3,800)	34,592
Financial assets designated at fair value	7,717	–	7,717	9,480	–	9,480
treasury and other eligible bills	20	–	20	35	–	35
debt securities	7,161	–	7,161	8,706	–	8,706
loans and advances to banks	27	–	27	214	–	214
loans and advances to customers	509	–	509	525	–	525
Derivatives	129,158	(86,254)	42,904	118,516	(81,508)	37,008
Loans and advances held at amortised cost.....	342,245	(54,588)	287,657	321,653	(52,530)	269,123
loans and advances to banks.....	57,027	(1,996)	55,031	46,994	(67)	46,927
loans and advances to customers.....	285,218	(52,592)	232,626	274,659	(52,463)	222,196
Financial investments	100,660	–	100,660	84,379	–	84,379
treasury and other similar bills	9,354	–	9,354	2,349	–	2,349
debt securities	91,306	–	91,306	82,030	–	82,030
Other assets	7,837	–	7,837	9,449	–	9,449
endorsements and acceptances	494	–	494	352	–	352
accrued income and other	7,343	–	7,343	9,097	–	9,097
Financial guarantees	14,631	–	14,631	17,992	–	17,992
Loan commitments and other credit-related commitments	114,043	–	114,043	116,083	–	116,083
	877,765	(143,243)	734,522	839,512	(137,838)	701,674

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

	At 31 December 2010			At 31 December 2009		
	Maximum exposure £m	Offset £m	Exposure to credit risk (net) £m	Maximum exposure £m	Offset £m	Exposure to credit risk (net) £m
Cash and balances at central banks	22,357	–	22,357	13,130	–	13,130
Items in the course of collection from other banks	1,030	–	1,030	1,071	–	1,071
Trading assets	102,704	(2,401)	100,303	105,164	(3,800)	101,364
treasury and other eligible bills.....	945	–	945	741	–	741
debt securities	39,202	–	39,202	35,314	–	35,314
loans and advances to banks	33,011	–	33,011	34,111	–	34,111
loans and advances to customers	29,546	(2,401)	27,145	34,998	(3,800)	31,198
Financial assets designated at fair value	4,505	–	4,505	6,592	–	6,592
debt securities	4,428	–	4,428	6,515	–	6,515
loans and advances to banks	77	–	77	77	–	77
Derivatives	108,905	(93,503)	15,402	100,800	(52,553)	48,247
Loans and advances held at amortised cost	236,408	(42,962)	193,446	229,398	(38,748)	190,650
loans and advances to banks	27,860	–	27,860	20,729	–	20,729
loans and advances to customers	208,548	(42,962)	165,586	208,669	(38,748)	169,921
Financial investments.....	40,788	–	40,788	26,452	–	26,452
treasury and other similar bills	3,296	–	3,296	799	–	799
debt securities.....	37,492	–	37,492	25,653	–	25,653
Other assets.....	3,880	–	3,880	4,696	–	4,696
endorsements and acceptances	231	–	231	191	–	191
accrued income and other	3,649	–	3,649	4,505	–	4,505
Financial guarantees	10,388	–	10,388	12,181	–	12,181
Loan commitments and other credit-related commitments	82,916	–	82,916	83,531	–	83,531
	613,881	(138,866)	475,015	583,015	(95,101)	487,914

Collateral and other credit enhancements

Collateral held against financial instruments presented in the above table is described in more detail below.

Items in the course of collection from other banks

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

Treasury, other eligible bills and debt securities

Debt securities, treasury and other eligible bills are generally unsecured, except for ABSs and similar instruments, which are secured by pools of financial assets.

Derivatives

The International Swaps and Derivatives Association ('ISDA') Master Agreement is the group's preferred agreement for documenting derivatives activity. It provides the contractual framework within which dealing activity across a full range of over-the-counter products is conducted, and contractually binds both parties to apply close-out netting across all outstanding transactions

covered by an agreement if either party defaults or other pre agreed termination events occur. It is common, and the group's preferred practice, for the parties to execute a Credit Support Annex ('CSA') in conjunction with the ISDA Master Agreement. Under a CSA, collateral is passed between the parties to mitigate the market-contingent counterparty risk inherent in the outstanding positions. The majority of the group's CSAs are within financial institutional clients.

Loans and advances

Although collateral can be an important mitigant of credit risk, it is the group's policy to lend on the basis of the customer's capacity to repay rather than rely on the value of security offered. Depending on the customer's standing and the type of product, facilities may be provided unsecured. The principal collateral types employed by the group are as follows:

- in the personal sector, mortgages over residential properties;
- in the commercial and industrial sector, charges over business assets such as premises, stock and debtors;

Report of the Directors: Risk (continued)

- in the commercial real estate sector, charges over the properties being financed; and
- in the financial sector, charges over financial instruments such as debt securities and equities in support of trading facilities.

In addition, credit derivatives and securitisation structures are used to hedge or transfer credit risk in the group's loan portfolio.

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

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

Concentrations of credit risk exposure

(Audited)

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

Exposure to selected countries in the eurozone

(Unaudited)

	31 December 2010						
	Belgium	Greece	Ireland	Italy	Portugal	Spain	Total
	£m	£m	£m	£m	£m	£m	£m
Total							
Held for trading	1,348	890	745	1,305	90	1,360	5,738
Not held for trading	4,649	234	590	1,648	376	947	8,444
	5,997	1,124	1,335	2,953	466	2,307	14,182
Sovereign & Agencies							
Held for trading	387	525	60	1,157	20	432	2,581
Not held for trading	398	211	188	583	70	394	1,844
	785	736	248	1,740	90	826	4,425
Banks							
Held for trading	961	365	685	148	70	928	3,157
Not held for trading	4,251	23	402	1,065	306	553	6,600
	5,212	388	1,087	1,213	376	1,481	9,757

concentration of exposure in the group's portfolios across industry, country and customer groups. These include portfolio and counterparty limits, approval and review controls, and stress testing.

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

Exposure to selected countries in the eurozone

(Unaudited)

Intervention by government to stabilise and re-capitalise banks and other financial intermediaries during the financial crisis helped to reduce the possibility of a systemic threat to financial markets by transferring risk from the private sector to sovereign bodies. In 2010, this contributed to the creation of large fiscal imbalances in some industrialised economies and as a result, market concerns about sovereign credit risk in these countries intensified. Credit spreads for the affected sovereign and bank credit markets remained volatile during most of the 2010. Risk aversion resurfaced, and the assumption of higher sovereign risk premia in private securities prices trigger portfolio reallocation to safer assets and a tightening of market liquidity. Initial concerns over liquidity and funding spread to doubts about solvency in a number of cases. The table below summarises the group's exposures to governments and central banks of selected eurozone countries, and near/quasi government agencies and banks domiciled in those countries.

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

	At 31 December 2010		At 31 December 2009	
	Gross loans and advances to customers £m	Gross loans by industry sector as a % of total gross loans %	Gross loans and advances to customers £m	Gross loans by industry sector as a % of total gross loans %
Personal				
Residential mortgages	72,327	25.05%	68,028	24.45%
Other personal	35,008	12.12%	33,588	12.07%
	107,335	37.17%	101,616	36.52%
Corporate and commercial				
Commercial, industrial and international trade	72,006	24.94%	69,211	24.88%
Commercial real estate	19,970	6.92%	20,987	7.54%
Other property-related	4,125	1.43%	3,840	1.38%
Government	1,452	0.49%	1,357	0.48%
Other commercial.....	33,771	11.70%	29,858	10.73%
	131,324	45.48%	125,253	45.01%
Financial				
Non-bank financial institutions	46,087	15.96%	47,008	16.89%
Settlement accounts	612	0.21%	502	0.18%
	46,699	16.17%	47,510	17.07%
Other	3,390	1.18%	3,872	1.40%
Total gross loans and advances	288,748	100.00%	278,251	100.00%

The bank

	At 31 December 2010		At 31 December 2009	
	Gross loans and advances to customers £m	Gross loans by industry sector as a % of total gross loans %	Gross loans and advances to customers £m	Gross loans by industry sector as a % of total gross loans %
Personal				
Residential mortgages	65,304	30.87%	60,642	28.66%
Other personal	9,894	4.68%	11,097	5.25%
	75,198	35.55%	71,739	33.91%
Corporate and commercial				
Commercial, industrial and international trade	52,115	24.64%	51,242	24.22%
Commercial real estate	12,090	5.71%	12,981	6.13%
Other property-related	3,120	1.47%	2,852	1.35%
Government	845	0.40%	858	0.41%
Other commercial.....	25,134	11.88%	21,115	9.98%
	93,304	44.10%	89,048	42.09%
Financial				
Non-bank financial institutions	39,616	18.73%	46,839	22.15%
Settlement accounts	50	0.02%	47	0.02%
	39,666	18.75%	46,886	22.17%
Other	3,390	1.60%	3,872	1.83%
Total gross loans and advances	211,558	100.00%	211,545	100.00%

Report of the Directors: Risk (continued)

Mortgage lending products

(Unaudited)

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

	UK £m	Continental Europe £m
At 31 December 2010		
Total residential mortgage lending	66,368	5,959
Total impairment allowances on residential mortgage lending.....	(177)	(37)
Interest-only (including endowment) mortgages.....	29,012	77
Affordability mortgages, including adjustable rate mortgages	644	210
Other.....	66	-
Total interest-only and affordability mortgages	29,722	287
As a percentage of total mortgage lending	44.8%	4.8%
Negative equity mortgages ^{1 2}	1,569	3
Other loan to value ratios greater than 90 per cent ²	3,738	168
	5,307	171
-as a percentage of total mortgage lending	8.0%	2.9%
At 31 December 2009		
Total residential mortgage lending	62,037	5,991
Total impairment allowances on residential mortgage lending.....	(92)	(26)
Interest-only (including endowment) mortgages.....	28,024	47
Affordability mortgages, including ARMs.....	1,566	668
Other.....	71	-
Total interest-only and affordability mortgages	29,661	715
As a percentage of total mortgage lending	47.8%	11.9%
Negative equity mortgages ^{1 2}	3,842	3
Other loan to value ratios greater than 90 per cent ²	6,133	-
	9,975	3
as a percentage of total mortgage lending	16.1%	0.1%

1 Negative equity arises when the value of the loan exceeds the value of available equity.

2 Loan to value ratios are generally based on estimated values at the balance sheet date.

Forbearance strategies and renegotiated loans

(Audited)

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

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

The group's credit risk management policy sets out restrictions on the number and frequency of restructures, the minimum period an account must have been opened before any restructure can be considered and the number of qualifying payments that must be received before an account may be considered restructured and up to date. The application of this policy varies according to the nature of the market, the product, and the management of

customer relationships through the occurrence of exceptional events.

Loans that are subject to restructuring may only be classified as restructured and up to date once a specified number and/or amount of qualifying payments have been received. These qualifying payments are set at a level appropriate to the nature of the loan and the customer's ability to make the repayment going forward. Typically the receipt of two or more qualifying payments is required within a certain period, generally 60 days. Loans that have been restructured and would otherwise have been past due or impaired are classified as renegotiated

Renegotiated loans are segregated from other parts of the loan portfolio for collective impairment assessment, to reflect the higher rates of losses often encountered in this segment of the portfolio. When empirical evidence indicates an increased propensity to default and higher losses on such accounts, the use of roll rate methodology ensures this factor is taken into account when calculating impairment allowances. The carrying amount of loans that have been classified as renegotiated retain this classification until maturity or derecognition. Interest is

Report of the Directors: Risk (continued)

recorded on renegotiated loans on the basis of the new

contractual terms following renegotiation.

Renegotiated loans that would otherwise be past due or impaired

The group

	At 31 December	
	2010 £m	2009 £m
Loans and advances to customers	<u>1,424</u>	<u>1,545</u>

The bank

	At 31 December	
	2010 £m	2009 £m
Loans and advances to customers	<u>1,302</u>	<u>1,423</u>

Credit quality of financial instruments

(Audited)

The five credit quality classifications defined below each encompass a range more granular, internal credit rating grades assigned to wholesale and retail lending business, as well as the external rating, attributed by external

agencies to debt securities. There is no direct correlation between the internal and external ratings at granular level, except to the extent each falls within a single quality classification.

Credit quality

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

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

Quality classification definitions

(Audited)

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

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

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

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

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

Risk rating scales

(Audited)

The Customer Risk Rating (‘CRR’) 10-grade scale above summarises a more granular underlying 23-grade scale (2009: 22-grade scale) of obligor probability of default (‘PD’). The 23-grade scale was introduced in September 2010 following the harmonisation of PDs for three asset classes (banks, sovereigns and corporate) into one scale which required an additional PD band. All distinct HSBC customers are rated using one of these two PD scales, depending on the degree of sophistication of the Basel II approach adopted for the exposure.

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

For debt securities and certain other financial instruments, external ratings have been aligned to the five quality classifications. The ratings of Standard and Poor’s are cited, with those of other agencies being treated equivalently. Debt securities with short-term issue ratings are reported against the long-term rating of the issuer of those securities. If major rating agencies have different

Report of the Directors: Risk (continued)

ratings for the same debt securities, a prudent rating selection is made in line with regulatory requirements.

For the purpose of the following disclosure, retail loans which are past due up to 89 days and are not

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

Distribution of financial instruments by credit quality*(Audited)**The group*

31 December 2010

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

Report of the Directors: Risk (continued)

The group

31 December 2009

	Neither past due nor impaired							Total £m
	Strong £m	Medium		Sub- Standard £m	Past due not impaired £m	Impaired £m	Impairment allowances £m	
		Good £m	Satisfactory £m					
Cash and balances at central banks	14,274	-	-	-	-	-	-	14,274
Items in the course of collection from other banks	2,082	-	-	-	-	-	-	2,082
Trading assets	115,484	13,436	16,202	482	-	-	-	145,604
- treasury and other eligible bills	747	42	-	-	-	-	-	789
- debt securities	66,516	2,781	5,877	392	-	-	-	75,566
- loans and advances to banks	22,268	5,754	2,807	28	-	-	-	30,857
- loans and advances to customers	25,953	4,859	7,518	62	-	-	-	38,392
Financial assets designated at fair value	5,217	63	4,200	-	-	-	-	9,480
- treasury and other eligible bills	35	-	-	-	-	-	-	35
- debt securities	4,450	63	4,193	-	-	-	-	8,706
- loans and advances to banks	207	-	7	-	-	-	-	214
- loans and advances to customers	525	-	-	-	-	-	-	525
Derivatives	82,706	27,368	6,465	1,977	-	-	-	118,516
Loans and advances held at amortised cost	186,225	69,142	49,533	11,625	2,154	6,623	(3,649)	321,653
- loans and advances to banks	36,545	7,546	2,443	420	-	97	(57)	46,994
- loans and advances to customers	149,680	61,596	47,090	11,205	2,154	6,526	(3,592)	274,659
Financial investments	76,591	1,790	3,260	1,336	-	1,402	-	84,379
- treasury and other eligible bills	2,345	-	-	1	-	3	-	2,349
- debt securities	74,246	1,790	3,260	1,335	-	1,399	-	82,030
Other assets	5,846	894	2,238	405	16	50	-	9,449
- endorsements and acceptances	190	64	98	-	-	-	-	352
- accrued income and other	5,656	830	2,140	405	16	50	-	9,097

Report of the Directors: Risk (continued)

The bank

31 December 2010

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

Report of the Directors: Risk (continued)

The bank

31 December 2009

	Neither past due nor impaired							Total £m
	Strong £m	Medium		Sub- Standard £m	Past due not impaired £m	Impaired £m	Impairment allowances £m	
		Good £m	Satisfactory £m					
Cash and balances at central banks	13,130	-	-	-	-	-	-	13,130
Items in the course of collection from other banks	1,071	-	-	-	-	-	-	1,071
Trading assets	80,457	11,015	13,224	468	-	-	-	105,164
– treasury and other eligible bills	699	42	-	-	-	-	-	741
– debt securities	29,121	1,443	4,360	390	-	-	-	35,314
– loans and advances to banks	26,657	4,844	2,594	16	-	-	-	34,111
– loans and advances to customers	23,980	4,686	6,270	62	-	-	-	34,998
Financial assets designated at fair value	2,788	77	3,727	-	-	-	-	6,592
– debt securities	2,788	-	3,727	-	-	-	-	6,515
– loans and advances to banks	-	77	-	-	-	-	-	77
Derivatives	80,403	14,782	3,964	1,651	-	-	-	100,800
Loans and advances held at amortised cost	139,798	44,485	32,231	9,985	797	4,293	(2,191)	229,398
– loans and advances to banks	14,882	4,261	1,254	324	-	35	(27)	20,729
– loans and advances to customers	124,916	40,224	30,977	9,661	797	4,258	(2,164)	208,669
Financial investments ...	24,246	266	1,600	221	-	119	-	26,452
– treasury and other similar bills	799	-	-	-	-	-	-	799
– debt securities	23,447	266	1,600	221	-	119	-	25,653
Other assets.....	3,338	779	573	6	-	-	-	4,696
– endorsements and acceptances	33	61	97	-	-	-	-	191
– accrued income and other	3,305	718	476	6	-	-	-	4,505

Report of the Directors: Risk

Past due but not impaired gross financial instruments

Examples of exposures past due but not impaired include overdue loans fully secured by cash collateral; mortgages that are individually assessed for impairment and that are in arrears more than 90 days, but where the value of

collateral is sufficient to repay both the principal debt and all potential interest for at least one year; and short-term trade facilities past due more than 90 days for technical reasons such as delays in documentation, but where there is no concern over the creditworthiness of the counterparty.

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

(Audited)

The group

	Up to 29 days £m	30-59 days £m	60-89 days £m	90-179 days £m	Over 180 days £m	Total £m
At 31 December 2010						
Loans and advances held at amortised costs.....	944	290	239	19	22	1,514
Other assets.....	3	4	–	3	2	12
	947	294	239	22	24	1,526
At 31 December 2009						
Loans and advances held at amortised cost.....	1,518	366	235	19	16	2,154
Other assets.....	4	–	8	3	1	16
	1,522	366	243	22	17	2,170

The bank

	Up to 29 days £m	30-59 days £m	60-89 days £m	90-179 days £m	Over 180 days £m	Total £m
At 31 December 2010						
Loans and advances held at amortised cost.....	399	171	125	7	–	702
At 31 December 2009						
Loans and advances held at amortised cost.....	440	204	152	1	–	797

Impaired loans and advances to customers and banks by industry sector

(Audited)

	Impaired loans and advances at 31 December 2010			Impaired loans and advances at 31 December 2009		
	Individually assessed £m	Collectively assessed £m	Total £m	Individually assessed £m	Collectively assessed £m	Total £m
Banks.....	71	–	71	97	–	97
Customers.....	5,651	1,061	6,712	5,438	1,088	6,526
Personal.....	895	1,010	1,905	801	1,035	1,836
Corporate and commercial.....	4,174	51	4,225	4,280	53	4,333
Financial.....	582	–	582	357	–	357
	5,722	1,061	6,783	5,535	1,088	6,623

Collateral and other credit enhancements obtained

(Audited)

	The group		The bank	
	2010 £m	2009 £m	2010 £m	2009 £m
Nature of assets				
Residential property.....	61	75	58	72

Report of the Directors: Risk

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

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

Impairment allowances and charges on loans and advances to customers

(Audited)

The table below analyses the impairment allowances recognised for impaired loans and advances that are either

individually assessed or collectively assessed, and collective impairment allowances on loans and advances classified as not impaired.

	As at 31 December	
	2010 £m	2009 £m
Gross loans and advances		
Individually assessed impaired loans ¹	5,651	5,438
Collectively assessed ²	283,097	272,813
Impaired loans ¹	1,061	1,088
Non-Impaired loans ³	282,036	271,725
Total gross loans and advances	288,748	278,251
Impairment allowances		
Individually assessed	2,248	2,312
Collectively assessed	1,282	1,280
Total impairment allowances	3,530	3,592
Individually assessed allowances as a percentage of individually assessed loans and advances	39.8%	42.5%
Collectively assessed allowances as a percentage of collectively assessed loans and advances	0.45%	0.47%

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

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

(Audited)

	At 31 December 2010			At 31 December 2009		
	Individually assessed allowances £m	Collectively assessed allowances £m	Total allowances £m	Individually assessed allowances £m	Collectively assessed allowances £m	Total allowances £m
Banks	50	–	50	57	–	57
Customers	2,248	1,282	3,530	2,312	1,280	3,592
Personal	313	1,005	1,318	246	969	1,215
Corporate and commercial	1,665	271	1,936	1,926	306	2,232
Financial	270	6	276	140	5	145
	2,298	1,282	3,580	2,369	1,280	3,649

Report of the Directors: Risk (continued)

Impairment allowances as a percentage of gross loans and advances¹

(Audited)

The group

	At 31 December	
	2010 %	2009 %
<i>Banks</i>		
Individually assessed impairment allowances	0.19	0.26
<i>Customers</i>		
Individually assessed impairment allowances	0.87	0.95
Collectively assessed impairment allowances	0.50	0.52
	1.56	1.73

The bank

	At 31 December	
	2010 %	2009 %
<i>Banks</i>		
Individually assessed impairment allowances	0.08	0.19
<i>Customers</i>		
Individually assessed impairment allowances	1.19	1.17
Collectively assessed impairment allowances	0.31	0.31
	1.58	1.67

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

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

(Audited)

The group

	Banks		Customers		Total £m
	Individually assessed £m	Individually assessed £m	Individually assessed £m	Collectively assessed £m	
At 1 January 2010.....	57	2,312	1,280		3,649
Amounts written off	(6)	(933)	(885)		(1,824)
Recoveries of loans and advances written off in previous years	1	21	137		159
Charge to income statement	2	877	754		1,633
Foreign exchange and other movements	(4)	(29)	(4)		(37)
At 31 December 2010	50	2,248	1,282		3,580
At 1 January 2009	43	1,380	1,122		2,545
Amounts written off	(21)	(440)	(1,119)		(1,580)
Recoveries of loans and advances written off in previous years.....	4	40	126		170
Charge to income statement	35	1,408	1,176		2,619
Foreign exchange and other movements	(4)	(76)	(25)		(105)
At 31 December 2009	57	2,312	1,280		3,649

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

	Banks	Customers		Total £m
	Individually assessed £m	Individually assessed £m	Collectively assessed £m	
At 1 January 2010	28	2,267	608	2,903
Amounts written off	(6)	(826)	(707)	(1,539)
Recoveries of loans and advances written off in previous years	1	19	132	152
Charge to income statement	(1)	951	588	1,538
Foreign exchange and other movements	(1)	(22)	–	(23)
At 31 December 2010	21	2,389	621	3,031
At 1 January 2009	43	808	560	1,411
Amounts written off	(20)	(314)	(964)	(1,298)
Recoveries of loans and advances written off in previous years	4	49	132	185
Charge to income statement	5	1,754	883	2,642
Foreign exchange and other movements	(4)	(30)	(3)	(37)
At 31 December 2009	28	2,267	608	2,903

Report of the Directors: Risk (continued)

Movement in impairment allowances by industry sector

(Unaudited)

	2010 £m	2009 £m	2008 £m	2007 £m	2006 £m
Impairment allowances at 1 January	3,649	2,545	1,796	1,766	1,885
Amounts written off	(1,824)	(1,580)	(1,150)	(1,297)	(1,238)
Personal	(834)	(1,012)	(859)	(1,031)	(880)
– residential mortgages	(31)	(25)	(2)	(1)	(1)
– other personal	(803)	(987)	(857)	(1,030)	(879)
Corporate and commercial	(980)	(508)	(280)	(264)	(348)
– commercial, industrial and international trade.....	(247)	(275)	(200)	(183)	(245)
– commercial real estate and other property-related.....	(648)	(93)	(42)	(36)	(37)
– other commercial	(85)	(140)	(38)	(45)	(66)
Financial ¹	(10)	(60)	(11)	(2)	(10)
Recoveries of amounts written off in previous years	159	170	157	268	227
Personal	136	133	150	231	194
– residential mortgages	19	17	–	–	–
– other personal	117	116	150	231	194
Corporate and commercial	22	32	7	34	33
– commercial, industrial and international trade.....	11	30	4	8	13
– commercial real estate and other property-related.....	4	2	3	9	8
– other commercial	7	–	–	17	12
Financial ¹	1	5	–	3	–
Charge to income statement	1,633	2,619	1,716	1,043	935
Personal	803	1,130	876	789	776
– residential mortgages	99	100	11	4	13
– other personal	704	1,030	865	785	763
Corporate and commercial	709	1,329	749	248	169
– commercial, industrial and international trade.....	322	543	304	176	133
– commercial real estate and other property-related.....	232	626	304	60	20
– other commercial	155	160	141	12	16
Financial ¹	121	160	91	7	(3)
Governments	–	–	–	(1)	(7)
Exchange and other movements	(37)	(105)	26	16	(43)
Impairment allowances at 31 December.....	3,580	3,649	2,545	1,796	1,766
Impaired allowances against banks:					
– individually assessed	50	57	43	3	4
Impaired allowances against customers					
– individually assessed.....	2,248	2,312	1,380	920	878
– collectively assessed.....	1,282	1,280	1,122	873	884
Impairment allowances at 31 December	3,580	3,649	2,545	1,796	1,766
Impairment allowances against customers as a percentage of loans and advances to customers	%	%	%	%	%
– individually assessed.....	0.78	0.84	0.46	0.40	0.44
– collectively assessed.....	0.45	0.47	0.38	0.38	0.44
At 31 December	1.23	1.31	0.84	0.78	0.88

1 Includes movements in impairment allowances against banks.

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

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

	2009		
	Individually assessed £m	Collectively assessed £m	Total £m
Banks	35	–	35
Personal	125	1,005	1,130
– Residential mortgages	89	11	100
– Other personal	36	994	1,030
Corporate and commercial	1,153	176	1,329
– Commercial, industrial and international trade	434	109	543
– Commercial real estate and other property-related	559	67	626
– Other commercial	160	–	160
Financial ¹	130	(5)	125
Total charge to income statement	1,443	1,176	2,619

1 Includes movements in impairment allowances against banks.

Net loan impairment charge to the income statement*(Unaudited)*

	2010 £m	2009 £m	2008 £m	2007 £m	2006 £m
Individually assessed impairment allowances					
New allowances	1,157	1,654	893	390	388
Release of allowances no longer required	(256)	(167)	(180)	(194)	(240)
Recoveries of amounts previously written off	(22)	(44)	(22)	(21)	(19)
	879	1,443	691	175	129
Collectively assessed impairment allowances					
New allowances net of allowance required	1,008	1,445	1,266	1,228	1,123
Release of allowances no longer required	(117)	(143)	(106)	(113)	(109)
Recoveries of amounts previously written off	(137)	(126)	(135)	(247)	(208)
	754	1,176	1,025	868	806
Total charge for impairment losses	1,633	2,619	1,716	1,043	935
Banks	2	35	35	–	–
Customers	1,631	2,584	1,681	1,043	935
Charge for impairment losses as a percentage of closing gross loans and advances	0.47	0.81	0.49	0.36	0.38
At 31 December	£m	£m	£m	£m	£m
Impaired loans	6,783	6,623	3,744	2,959	2,773
Impairment allowances	3,580	3,649	2,545	1,796	1,766

Charge for impairment losses as a percentage of average gross loans and advances to customers*(Unaudited)*

	2010 %	2009 %	2008 %	2007 %	2006 %
Net allowances net of allowances releases	0.72	1.11	0.78	0.72	0.71
Recoveries	(0.06)	(0.07)	(0.07)	(0.15)	(0.14)
Total charge for impairment losses	0.66	1.04	0.71	0.57	0.57
Amount written off net of recoveries	0.67	0.63	0.48	0.71	0.75

Report of the Directors: Risk (continued)

Liquidity and funding

(Audited)

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

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

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

The group adapts its liquidity and funding risk management framework in response to changes in the mix of business that it undertakes, and to changes in the nature of the markets in which it operates. The group also seeks to continuously evolve and strengthen its liquidity and funding risk management framework. As part of this process, the group has refined the way in which it characterises core deposits. The characterisation takes into account the activities and operating environment in the entity originating the deposit, the nature of the customer and the size and pricing of the deposit. This exercise has resulted in a revised internal calculation of advances to core funding ratio (discussed more fully below), and comparatives have been restated accordingly.

The group employs a number of measures to monitor liquidity risk. The emphasis on the ratio of net liquid assets to customer deposits, as reported in the *Annual Report and Accounts 2009*, has been reduced and a 'stressed one month coverage ratio', an extension of the group's projected cash flow scenario analysis, is now used by the RMM as a simple and more useful metric to express liquidity risk.

Maturity analyses of assets and liabilities are provided in Note 33.

The management of liquidity and funding is primarily undertaken locally in the group's operating entities in

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

The group's liquidity and funding management process includes:

- projecting cash flows by major currency under various stress scenarios and considering the level of liquid assets necessary in relation thereto;
- monitoring balance sheet liquidity and advances to core funding ratios against internal and regulatory requirements;
- maintaining a diverse range of funding sources with back-up facilities;
- managing the concentration and profile of debt maturities;
- managing contingent liquidity commitment exposures within pre-determined caps;
- maintaining debt financing plans;
- monitoring depositor concentration in order to avoid undue reliance on large individual depositors and ensure a satisfactory overall funding mix; and
- maintaining liquidity and funding contingency plans. These plans identify early indicators of stress conditions and describe actions to be taken in the event of difficulties arising from systemic or other crises, while minimising adverse long-term implications for the business.

Primary sources of funding

(Audited)

Current accounts and savings deposits payable on demand or at short notice form a significant part of the group's funding, and the group places considerable importance on maintaining their stability. For deposits, stability depends upon preserving depositor confidence in the group's capital strength and liquidity, and on competitive and transparent pricing.

The group also accesses professional markets in order to provide funding for non-banking subsidiaries that do not accept deposits, to maintain a presence in local money

Report of the Directors: Risk (continued)

markets and to optimise the funding of asset maturities not naturally matched by core deposit funding.

Of total liabilities of £766 billion at 31 December 2010, funding from customers amounted to £344 billion, of which £338 billion was contractually repayable within one year.

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

Assets available to meet these liabilities, and to cover outstanding commitments to lend (£798 billion), included cash, central bank balances, items in the course of collection and treasury and other bills (£38 billion); loans to banks (£57 billion, including £54 billion repayable within one year); and loans to customers (£285 billion, including £140 billion repayable within one year). In the normal course of business, a proportion of customer loans contractually repayable within one year will be extended. In addition, the group held debt securities marketable at a value of £172 billion. Of these assets, £112 billion of debt securities and treasury and other bills had been pledged to secure liabilities.

Advances to core funding ratio

(Audited)

The group emphasises the importance of core customer deposits as a source of funds to finance lending to customers, and discourages reliance on short-term professional funding. This is achieved by placing limits on

banking entities which restrict their ability to increase loans and advances to customers without corresponding growth in core customer deposits or long term debt funding. This measure is referred to as the 'advances to core funding' ratio (previously referred to as the 'advances to deposits' ratio). Advances to core funding ratio limits are set by the RMM. The ratio expresses loans and advances to customers as a percentage of the total of core customer deposits and term funding with a remaining term to maturity in excess of one year. Loans and advances to customers which are part of reverse repurchase arrangements, and where the group receives securities which are deemed to be liquid, are excluded from the advances to core funding ratio.

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

The group also uses measures other than the advances to core funding ratio to manage liquidity risk, including projected cash flow scenario analyses.

Stressed one month coverage ratio

(Unaudited)

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

Advances to core funding ratios

(Audited)

	The group		The bank	
	2010 (%)	2009 (%)	2010 (%)	2009 (%)
Year end	95.7	96.5	103.0	105.0
Maximum	97.9	109.2	109.7	116.0
Minimum	94.5	92.3	102.6	105.0
Average	96.3	99.3	106.0	110.6

Stressed one month coverage ratio

(Unaudited)

	The group		The bank	
	2010 (%)	2009 (%)	2010 (%)	2009 (%)
Year end	111.7	106.7	111.1	103.2
Maximum	114.3	110.4	111.3	108.1
Minimum	106.7	106.1	103.2	101.3
Average	110.9	107.9	108.2	103.9

Projected cash flow scenario analyses

(Audited)

The group uses a number of standard projected cash flow scenarios designed to model both group-specific and market-wide liquidity crises, in which the rate and timing

of deposit withdrawals and drawdowns on committed lending facilities are varied and the ability to access interbank funding and term debt markets and generate funds from asset portfolios is restricted. The scenarios are modelled by all group banking entities. The

Report of the Directors: Risk (continued)

appropriateness of the assumptions under each scenario is regularly reviewed. In addition to the group's standard projected cash flow scenarios, individual entities are required to design their own scenarios tailored to reflect specific local market conditions, products and funding bases.

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

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

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

	The group		The bank	
	2010 £bn	2009 £bn	2010 £bn	2009 £bn
Conduits				
Client-originated assets ¹				
– total lines	5.1	4.6	3.5	3.1
– largest individual lines	0.4	0.6	0.4	0.6
Assets managed by the group ²	16.5	17.9	16.5	17.9
Single-issuer liquidity facilities				
– five largest ³	2.7	2.8	2.7	2.8
– largest market sector ⁴	5.4	4.8	5.4	4.8

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

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

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

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

Market risk

(Audited)

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

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

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

Contingent Liquidity risk

(Audited)

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

For market risk arising in the group's insurance business, refer to page 59.

Monitoring and limiting market risk exposure

(Audited)

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

The management of market risk is principally undertaken in Global Markets using risk limits approved by the Group Management Board. Limits are set for portfolios, products and risk types, with market liquidity being a primary factor in determining the level of limits set. Group Risk, an independent unit within the

Report of the Directors: Risk (continued)

Group Management Office, is responsible for HSBC's market risk management policies and measurement techniques. Each major operating entity has an independent market risk management and control function which is responsible for measuring market risk exposures in accordance with the policies defined by Group Risk, and monitoring and reporting these exposures against the prescribed limits on a daily basis.

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

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

Sensitivity analysis

(Unaudited)

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

Value at risk ('VAR')

(Audited)

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

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

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

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

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

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

Stress testing

(Audited)

In recognition of VAR's limitations, the group augments VAR with stress testing to evaluate the potential impact on portfolio values of more extreme, although plausible, events or movements in a set of financial variables. The process is governed by the 'Stress Testing Review Group' forum which, in conjunction with regional risk managers determines the scenarios to be applied at portfolio and consolidated level, as follows:

- sensitivity scenarios consider the impact of any single risk factor or a set of factors that are unlikely to be captured within the VAR models, such as the break of a currency peg;
- technical scenarios consider the largest move in each risk factor, without consideration of any underlying market correlation;

Report of the Directors: Risk (continued)

- hypothetical scenarios consider potential macro economic events, for example, a global flu pandemic; and
- historical scenarios incorporate historical observations of market movement during previous periods of stress which would not be captured within VAR.

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

Trading and non-trading portfolios

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

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

- The reporting of commodity risk is consolidated with foreign exchange risk and is not applicable to non-trading portfolios.
- Non-trading credit spread for AFS positions only.

Trading portfolios

(Audited)

Risk measurement and control

The group's control of market risk in the trading portfolios is based on a policy of restricting individual operations to trading within a list of permissible instruments authorised for each site by Group Risk, of enforcing rigorous new product approval procedures, and of restricting trading in

Total trading VAR by risk type

	Foreign exchange and commodity	Interest rate	Equity	Credit	Total ¹
	£m	£m	£m	£m	£m
At 31 December 2010	12.0	27.6	7.5	20.8	43.0
At 31 December 2009	11.0	34.4	11.3	25.4	42.0
Average					
2010	16.4	31.5	5.5	26.6	56.7
2009	12.0	37.1	7.1	28.5	48.9
Minimum					
2010	3.6	18.3	1.6	14.7	26.3
2009	6.4	24.1	2.9	14.5	28.4
Maximum					
2010	41.0	53.2	12.8	41.3	85.1
2009	33.0	68.6	13.4	55.3	85.7

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

The VAR for the overall trading activity as at 31 December 2010 is relatively unchanged from 2009.

Value at risk of the trading and non-trading portfolios

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

Value at risk

(Audited)

	2010 £m	2009 £m
At 31 December (excluding non-trading credit spread VAR)	95.0	53.5

The rise in interest rate volatility, coupled with a modest increase in underlying interest exposure, resulted in a higher VAR and the end of 2010 compared with the end of 2009.

With effect from 21 May 2010, the basis of the VAR computation was changed to include non-trading credit spread VAR. At 31 December 2010, the total VAR (including non-trading credit spread VAR for available-for-sale positions) was £169.2 million. The 2010 average, minimum and maximum calculations, included in the table below, include the impact of non-trading credit spread VAR from 21 May 2010.

	2010 £m	2009 £m
Average	211.3	89.6
Minimum	147.5	49.7
Maximum	279.4	166.1

the more complex derivative products only to offices with appropriate levels of product expertise and robust control systems.

The VAR for such trading activity within Global Markets at 31 December 2010 was £43.0 million (2009: £42.0 million). This is analysed below by risk type:

Report of the Directors: Risk (continued)

Credit spread risk

Credit spread risk also arises on credit derivative transactions entered into by Global Banking in order to manage the risk concentrations within the group's corporate loan portfolio and so enhance capital efficiency. The mark-to-market of these transactions is reflected in the income statement.

At 31 December 2010, the credit VAR on the credit derivatives transactions entered into by Global Banking was £20.8 million (2009 £25.4 million).

Gap risk

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

Given their characteristics, these transactions make little or no contribution to VAR or to traditional market risk sensitivity measures. The group captures the risks within the stress testing scenarios and monitors gap risk on an ongoing basis. The group regularly considers the probability of gap loss and fair value adjustments are booked against this risk. We have not incurred any material gap loss in respect of such transactions in the 12 months ended 31 December 2010.

Non-trading portfolios

(Audited)

Risk measurement and control

The principal objective of market risk management of non-trading portfolios is to optimise net interest income. Interest rate risk in non-trading portfolios arises principally from mismatches between the future yield on assets and their funding cost, as a result of interest rate changes. Analysis of this risk is complicated by having to make assumptions on embedded optionality within certain product areas such as the incidence of mortgage prepayments, and from behavioural assumptions regarding the economic duration of liabilities which are contractually repayable on demand such as current accounts.

The group's control of market risk in non-trading portfolios is based on transferring the risks to the books managed by Global Markets or the local ALCO. The net exposure is typically managed through the use of interest rate swaps within agreed limits. The VAR for these portfolios is included within the group VAR (see 'Value at risk of the trading and non-trading portfolios' above).

Credit spread risk

The risk associated with movements in credit spreads is primarily managed through sensitivity limits, stress testing, and VAR for those portfolios where VAR is calculated. We have introduced credit spread as a separate risk type within the group's VAR models on a global basis. The VAR shows the effect on income from a one-day movement in credit spreads over a two-year period, calculated to a 99 per cent confidence interval.

At 31 December 2010, the sensitivity of equity capital to the effect of movements in credit spreads based on credit spread VAR, on the group's available-for-sale debt securities was £157.1 million (2009: £207.8 million). The sensitivity was calculated on the same basis as for the trading portfolio. It increased to £181.3 million after including the gross exposure for the SICs consolidated within the group's balance sheet. This sensitivity is calculated before taking into account losses which would have been absorbed by the capital note holders. At 31 December 2010, the capital note holders can absorb the first US\$2.2 billion (2009: US\$2.2 billion) of any losses incurred by the SICs prior to us incurring any equity losses.

The notable decrease in this sensitivity at 31 December 2010 compared with 31 December 2009 was due to the effect of lower volatility in credit spreads observed during 2010.

Fixed-rate securities

The principal non-trading risk which is not included in the VAR reported for Global Banking and Markets arises out of Fixed Rate Subordinated Notes. The VAR related to these instruments was £26.2 million at 31 December 2010 (2009: £30.6 million); whilst the average, minimum and maximum during the year was £31.4 million, £19.0 million and £36.8 million respectively (2009: £31.6 million, £29.4 million and £34.7 million).

Equity securities held as available-for-sale

Market risk arises on equity securities held as available-for-sale. The fair value of these securities at 31 December 2010 was £1,426 million (2009: £2,316 million).

The fair value of the constituents of equity securities held as available-for-sale can fluctuate considerably. A 10 per cent reduction in the value of the available-for-sale equities at 31 December 2010 would have reduced equity by £143 million (2009: £203 million). For details of the impairment incurred on available-for-sale equity securities see the accounting policies in Note 2(j).

Structural foreign exchange exposures

(Unaudited)

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

Report of the Directors: Risk (continued)

of the primary economic environment in which the entity operates.

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

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

The group may also transact hedges where a currency in which the group have structural exposures is considered to be significantly overvalued and it is possible in practice to transact a hedge. Any hedging is undertaken using forward foreign exchange contracts which are accounted for under IFRSs as hedges of a net investment in a foreign operation, or by financing with borrowings in the same currencies as the functional currencies involved. No forward foreign exchange hedges were in place during 2010 or at the end of 2009.

For details of structural foreign exchange exposures see Note 34 Foreign exchange exposures.

Sensitivity of net interest income

(Unaudited)

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

For simulation modelling, businesses use a combination of scenarios relevant to them and their local markets and standard scenarios which are required throughout the group. The standard scenarios are

consolidated to illustrate the combined pro forma effect on the group's consolidated portfolio valuations and net interest income.

Defined benefit pension scheme

(Audited)

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

The present value of the group's defined benefit pension schemes' liabilities was £15.6 billion at 31 December 2010 compared with £14.1 billion at 31 December 2009. Assets of the defined benefit schemes at 31 December 2010 comprised: equity investments 16 per cent (17 per cent at 31 December 2009); debt securities 69 per cent (70 per cent at 31 December 2009) and other (including property) 15 per cent (13 per cent at 31 December 2009).

Concentrations of market risk exposures

(Audited)

Analysis of asset-backed securities

During the period a total valuation increase of £2,914 million on available-for-sale assets was recognised in other comprehensive income. This primarily relates to valuation gains on asset-backed securities. The table shows the group's market risk exposure to asset-backed securities (including those carried at fair value through profit and loss and those classified as available-for-sale).

Report of the Directors: Risk (continued)**Asset Backed Securities**

	31 December 2010				31 December 2009			
	Gross principal ² £m	CDS gross protection ³ £m	Net Principal exposure ^{4,6} £m	Carrying Amount ^{5,6} £m	Gross principal £m	CDS gross protection £m	Net Principal exposure ⁶ £m	Carrying Amount ⁶ £m
High grade ¹	22,313	4,145	18,168	15,631	28,161	5,367	22,794	18,466
rated C to A	16,295	141	16,154	9,850	14,696	564	14,132	6,832
not publicly rated	493	-	493	215	121	-	121	62
Total asset-backed securities...	39,101	4,286	34,815	25,696	42,978	5,931	37,047	25,360

1 High grade assets rated AA or AAA.

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

3 A CDS is a credit default swap. CDS protection principal is the gross principal of the underlying instrument that is protected by CDSs.

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

5 Carrying amount of the net principal exposure.

6 The asset backed securities are primarily US dollar ('USD') denominated. Principal and carrying amounts are converted into sterling ('GBP') at the prevailing exchange rates at 31 December (2010: 1GBP:USD 1.552; 2009: 1GBP:USD 1.560).

Included in the above table is carrying amount of £8,752 million (2009: £8,642 million) held through SPEs that are consolidated by the group. Although the group includes these assets in full on its balance sheet, significant first loss risks are borne by third party investors, through the investors' holdings of capital notes subordinate to the

group's holdings. The carrying amount of the capital note liabilities has been reduced by impairment charges of £265 million for the year ended 31 December 2010 (2009: £408 million).

Special purpose entities

(Audited)

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

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

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

Conduits

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

Securities investment conduits

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

Multi-seller conduits

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

Money market funds

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

Non-money market investment funds

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

Securitisations

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

Other

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

Report of the Directors: Risk (continued)

Third party sponsored SPEs

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

Additional off-balance sheet arrangements and commitments

Additional off-balance sheet commitments such as financial guarantees, letters of credit and commitments to lend are disclosed in Note 38.

Leveraged finance transactions

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

Operational risk

(Unaudited)

Operational risk is relevant to every aspect of the group's business and covers a wide spectrum of issues. Losses arising through fraud, unauthorised activities, errors, omission, inefficiency, systems failure or from external events all fall within the definition of operational risk.

The objective of the group's operational risk management is to manage and control operational risk in a cost effective manner within targeted levels of operational risk consistent with the Group's risk appetite, as defined by the Group Management Board.

A formal group-wide governance structure provides oversight over the management of operational risk. A Global Operational Risk and Internal Control Committee ('GORICC'), which reports to the Group RMM, meets at least quarterly to discuss key risk issues and review the effective implementation of the Group's operational risk management framework. Regions are responsible for ensuring that country and business unit Operational Risk and Internal Control Committees ('ORICC') are established within the Region and Global Business consistent with the need to maintain oversight over all businesses and operations. Accordingly, at the regional level, the group's Operational Risk and Internal Control Committee ('HBEU ORICC') meets monthly to ensure that the operational risks inherent in the regional activities are identified, assessed and controlled in accordance with the regional risk appetite. Local country and business line ORICCs feed into the HBEU ORICC and are held at least quarterly. In addition, output and significant issues from the regional, country and business line ORICCs are fed into the group's Risk Management Meeting and the group's Board as appropriate. The HBEU ORICC also reports to the GORICC.

The group's Regional Operational Risk and Internal Control team supports the European Chief Financial Officer and Chief Risk Officer through continuing oversight and assurance over the management of operational risk by businesses and operations. Operational Risk and Internal Control teams have also been established in all countries in the region with responsibility for coordinating and providing oversight over implementation of the Operational Risk Management Framework within their respective countries.

Business managers are responsible for maintaining an acceptable level of internal control, commensurate with the scale and nature of operations across Europe. They are responsible for identifying and assessing risks, designing controls and monitoring the effectiveness of these controls. The operational risk management framework assists managers to fulfil these responsibilities by defining a standard risk assessment methodology and providing a tool for the systematic reporting of operational loss data. Central Operational Risk and Internal Control teams within the country and at the regional level provide assurance and oversight over the business control activities through a programme of risk and control reviews during the year.

A centralised database is used to record the results of the operational risk management process. Operational risk control assessments are input and maintained by business units. To ensure that operational risk losses are consistently reported and monitored at country, regional and group level, all group companies are required to report individual losses when the net loss is expected to exceed US\$10,000.

Legal risk

Each operating company is required to implement procedures to manage legal risk that conform to the Group's standards. Legal risk falls within the definition of operational risk and includes contractual risk, dispute risk, legislative risk and non-contractual rights risk.

- Contractual risk is the risk that the rights and/or obligations of a group company within a contractual relationship are defective.
- Dispute risk is made up of the risks that a group company is subject to when it is involved in or managing a potential or actual dispute.
- Legislative risk is the risk that a group company fails to adhere to the laws of the jurisdictions in which it operates.
- Non-contractual rights risk is the risk that a group company's assets are not properly owned or are infringed by others, or a group company infringes another party's rights.

Report of the Directors: Risk (continued)

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

The group's operating companies must notify the appropriate legal department immediately any litigation is either threatened or commenced against the group or an employee. Any claims which exceed £1 million or equivalent must be advised to the General Counsel for Europe. The General Counsel for Europe must also be immediately advised of any action by a regulatory authority, where the proceedings are criminal, or where the claim might materially affect the group's reputation.

In addition, the group's operating companies are required to submit semi annual returns detailing outstanding claims where the claim (or group of similar claims) exceeds £6.5 million, where the action is by a regulatory authority, where the proceedings are criminal or where the claim might materially affect the group's reputation. These returns are used for reporting to various committees within the group.

Compliance risk

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

The Group Compliance function supports line management in ensuring that there are adequate policies, procedures and resources to mitigate compliance risk. The Regional Compliance Officer, Europe oversees compliance teams in all of the countries where the group operates. Additionally, Global Compliance Officers oversee compliance arrangements within large and complex businesses such as the bank and Global Banking and Markets.

Group Compliance policies and procedures require the prompt identification and escalation of all actual and suspected breaches of any law, rule, regulation, Group policy or other relevant requirement. These escalation procedures are supplemented by a requirement for the submission of compliance certificate at the half-year and year-end by all group companies detailing any known breaches. The contents of these escalation and certification processes are used for reporting to the RMM, the Risk Committee and the Board and disclosure in the Annual Report and Accounts and Interim Report, if appropriate.

Group security and fraud risk

Security and Fraud Risk, Europe, which has responsibility for physical risk, fraud, information and contingency risk, is fully integrated within the group's Technology and Services function, but with functional direction from Group Security and Fraud Risk. All group companies manage their risk in accordance with standards set by Security and Fraud Risk, Europe, which also provides expert advice and support.

Data security

In March 2010 HSBC Private Bank (Suisse) SA announced that it had been the victim of a significant data theft. In 2010, HSBC Private Bank (Suisse) SA conducted a comprehensive review of its information security procedures, formulated and implemented major security upgrade programmes and continued a multi-million franc investment programme in systems to ensure industry-leading security standards. It also reviewed and strengthened risk management and operational controls and will continue to invest in these areas. In March 2010, the Swiss Financial Market Supervisory Authority ('FINMA') launched an investigation into the circumstances of the data theft. On 22 February 2011, a notice of decision with a declaratory ruling was received from FINMA following such investigation which found that, because of deficiencies in its internal organisation and oversight of its IT activities, HSBC Private Bank (Suisse) SA had breached various supervisory requirements. HSBC Private Bank (Suisse) SA is currently considering the details of the notice of decision and actions required by FINMA.

Risk management of insurance operations

(Audited)

The group operates a bancassurance model which provides insurance products for customers with whom the group has a banking relationship. Insurance products are sold to all customer groups, mainly utilising retail branches, the internet and phone centres. Personal Financial Services customers attract the majority of sales and comprise the majority of policyholders.

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

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

Report of the Directors: Risk (continued)

The majority of the risk in the group's insurance business derives from manufacturing activities and can be categorised as insurance risk and financial risks. The insurance manufacturers set their own control procedures in addition to complying with guidelines issued by the Group Insurance Head Office.

The control framework for monitoring risk includes the UK, European and Middle East Insurance Regional Risk Committee, which oversees the status of the significant risk categories in the insurance operations. Four subcommittees of this Committee focus on products and pricing, market, liquidity risk and credit risk, operational risk and insurance risk, respectively. In addition, local ALCOs and Risk Management Committees monitor certain risk exposures, mainly for life business where the duration and cash flow matching of insurance assets and liabilities are reviewed.

All insurance products, whether manufactured internally or by a third party, are subjected to a product approval process. Approval is provided by the UK, European and Middle East Regional Insurance Head Office or Group Insurance Head Office depending on the type of product and its risk profile. The approval process is formalised through the Product and Pricing Committee, which comprises the heads of the relevant risk functions within insurance.

Insurance risk of insurance operations

(Audited)

Insurance risk is the risk, other than financial risk, transferred from the holder of the insurance contract to the issuer (the group). The principal insurance risk faced by the group is that, over time, the cost of acquiring and administering a contract, claims and benefits may exceed the aggregate amount of premiums received and investment income.

The cost of claims and benefits can be influenced by many factors, including mortality and morbidity experience, lapse and surrender rates and, if the policy has a savings element, the performance of the assets held to support the liabilities.

The insurance contracts sold by the group relate, primarily, to core underlying banking activities, such as savings, investment and/or credit life products. Life and non-life business insurance risks are controlled by high level policies and procedures set centrally, taking into account, where appropriate, local market conditions and regulatory requirements.

Reinsurance is also used as a means of mitigating exposure, in particular to aggregation of catastrophe risk. Although reinsurance provides a means of managing insurance risk, such contracts expose the group to counterparty risk, the risk of default by the reinsurer.

A principal tool used by the group to manage its exposure to insurance risk, in particular for life insurance contracts, is asset and liability matching. Of particular importance is the need to match the expected pattern of cash inflows with the benefits payable on the underlying contracts, which can extend for many years.

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

Analysis of life insurance risk – liabilities to policyholders

(Audited)

	2010 £m	2009 £m
Life (non-linked)		
– Insurance contracts with DPF ¹	211	695
– Credit life	169	247
– Annuities	304	278
Term assurance and other long-term contracts	204	286
Total life (non-linked)	888	1,506
Life (linked)	1,464	1,310
Investment contracts with DPF ^{1,2}	14,205	12,930
Insurance liabilities to policyholders	16,557	15,746

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

2 Although investment contracts with DPF are financial investments, the group continues to account for them as insurance contracts as permitted by IFRS 4.

Insurance risk arising from life insurance depends on the type of business, and varies considerably. The principal drivers of insurance risks are mortality, morbidity, lapse, surrender and expense levels. The liabilities for long-term contracts are set by reference to a range of assumptions around these drivers, typically reflecting each entity's own experience. Economic assumptions, such as investment returns and interest rates, are usually based on observable market data. Changes in underlying assumptions affect the liabilities.

Non-life insurance risk – net written insurance premiums

(Audited)

Non-life insurance contracts include motor, fire and other damage to property, accident and health, and repayment protection. Credit non-life insurance is originated in conjunction with the provision of loans.

Net written insurance premiums amounted to: Accident and health: £53 million (2009: £60 million), Motor: £nil (2009: £82 million), Fire and other damage: £25m (2009: £46 million), Credit: £16 million (2009: £22 million) and Marine, aviation and other: £14 million (2009: £22 million).

Report of the Directors: Risk (continued)

Financial risks of insurance operations

(Audited)

The group's insurance businesses are exposed to a range of financial risks, including market risk, credit risk and liquidity risk. The nature and management of these risks is described below.

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

Local regulatory requirements prescribe the type, quality and concentration of assets that the group's insurance

manufacturing subsidiaries must maintain to meet insurance liabilities. These requirements complement Group-wide policies.

The following table analyses the assets held in the group's insurance manufacturing subsidiaries as at 31 December 2010 by type of contract, and provides a view of the exposure to financial risk.

Financial assets held by insurance manufacturing subsidiaries

(Audited)

	At 31 December 2010				
	Life linked contracts £m	Life non-linked contracts £m	Non-life insurance £m	Other assets £m	Total £m
Financial assets designated at fair value					
Treasury bills	8	5	–	6	19
Debt securities	1,679	730	–	220	2,629
Equity securities	4,082	3,280	–	383	7,745
	5,769	4,015	–	609	10,393
Financial investments - available-for-sale					
Treasury bills	–	–	–	–	–
Other eligible bills	–	23	90	140	253
Debt securities	–	9,454	86	757	10,297
Equity securities	–	–	–	16	16
	–	9,477	176	913	10,566
Derivatives.....	5	147	–	2	154
Other financial assets	427	710	278	244	1,659
	6,201	14,349	454	1,768	22,772
	At 31 December 2009				
	Life linked contracts £m	Life non-linked contracts £m	Non-life insurance £m	Other assets £m	Total £m
Financial assets designated at fair value					
Treasury bills	28	5	–	2	35
Debt securities	1,145	808	–	156	2,109
Equity securities	3,645	2,769	–	531	6,945
	4,818	3,582	–	689	9,089
Financial investments - available-for-sale					
Treasury bills	–	–	130	51	181
Other eligible bills	–	16	78	78	172
Debt securities	–	9,217	–	716	9,933
Equity securities	–	–	–	18	18
	–	9,233	208	863	10,304
Derivatives.....	185	89	–	1	275
Other financial assets	293	817	400	281	1,791
	5,296	13,721	608	1,834	21,459

Report of the Directors: Risk (continued)

Approximately 57 per cent of financial assets were invested in debt securities at 31 December 2010 (2009: 56 per cent), with 34 per cent invested in equity securities (2009: 32 per cent).

In life linked insurance, premium income less charges levied is invested in a portfolio of assets. The group manages the financial risks of this product on behalf of the policyholders by holding appropriate assets in segregated funds or portfolios to which the liabilities are linked.

These assets represented 27 per cent of the total financial assets of the group's insurance manufacturing subsidiaries at the end of 2010 (2009: 25 per cent).

Market risk of insurance operations

(Audited)

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

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

Long-term insurance or investment products may incorporate either investment return or capital repayment guarantees or both. Subsidiaries manufacturing products with guarantees are usually exposed to falls in market interest rates as they result in lower yields on the assets supporting guaranteed investment returns payable to policyholders.

The proceeds from insurance and investment products with DPF are primarily invested in bonds with a proportion allocated to equity securities in order to provide customers with the potential for enhanced returns.

Subsidiaries with portfolios of such products are exposed to the risk of falls in the market prices when they cannot be fully reflected in the discretionary bonuses. An increase in market volatility could also result in an increase in the value of the guarantee to the policyholder.

Long-term insurance and investment products typically permit the policyholder to surrender the policy or let it lapse at any time. When the surrender value is not linked to the value realised from the sale of the associated supporting assets, the subsidiary is exposed to market risk.

For unit-linked contracts, market risk is substantially borne by the policyholder, but the group typically remains exposed to market risk as the market value of the linked assets influences the fees earned for managing them.

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

- for products with DPF, adjusting bonus rates to manage the liabilities to policyholders;

- as far as possible, matching assets to liabilities;
- using derivatives to a limited extent;
- for new products with investment guarantees, considering the cost when determining the level of premiums or the price structure;
- periodically reviewing products identified as higher risk, which contain guarantees and embedded optionality features linked to savings and investment products;
- including features designed to mitigate market risk in new products; and
- exiting, to the extent possible, investment portfolios whose risk is considered unacceptable.

The group's insurance manufacturing subsidiaries monitor exposures against mandated limits regularly and report these quarterly to the Regional Insurance Head Office. Exposures are aggregated and reported to senior risk management forums, including the Regional Insurance Market, Liquidity and Credit Risk Committee, the Regional Insurance Risk Committee and the Regional Stress Testing Committee.

Standard measures for quantifying market risks are as follows:

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

The standard measures are relatively straightforward to calculate and aggregate, but have limitations. The most significant is that a parallel shift in yield curves of one basis point does not capture the non-linear relationships between the values of certain assets and liabilities and interest rates. Non-linearity arises, for example, from investment return guarantees and product features which enable policyholders to surrender their policies.

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

Report of the Directors: Risk (continued)

The following table illustrates the effect of various interest rates, equity price and credit spread scenarios on the profits for the year and total equity of insurance manufacturing subsidiaries. Where appropriate, the impact of the stress on the present value of the in-force long-term insurance business asset ('PVIF') is included in the results of the stress tests. The relationship between the values of certain assets and liabilities and the risk factors may be

non-linear and, therefore, the results disclosed cannot be extrapolated to measure sensitivities to different levels of stress. The sensitivities are stated before allowance for the effect of management actions which may mitigate changes in market rates, and for any factors such as policyholder behaviour that may change in response to changes in market risk.

Sensitivity of the group's insurance subsidiaries to risk factors

(Audited)

	2010		2009	
	Effect on profit for the year £m	Effect on total equity £m	Effect on profit for the year £m	Effect on total equity £m
+ 100 basis points parallel shift in yield curves.....	12	(6)	10	(12)
- 100 basis points parallel shift in yield curves.....	(17)	2	(14)	10
10 per cent increase in equity prices.....	10	10	7	7
10 per cent decrease in equity prices.....	(10)	(10)	(7)	(7)
Sensitivity to credit spread increases.....	(1)	(5)	(1)	(5)

Credit risk of insurance operations

(Audited)

Credit risk can give rise to losses through default and can lead to volatility in income statement and balance sheet figures through movements in credit spreads, principally on the £11.5 billion (2009: £11.3 billion) non-linked bond portfolio.

As tabulated above, the exposure of the income statement to the effect of changes in credit spreads is small; this is because 92 per cent of the financial assets held by insurance manufacturing subsidiaries are classified as available-for-sale, and consequently any changes in the fair value of these financial investments would have no impact on the profit after tax, to the extent that the financial assets are not deemed impaired. The sensitivity is calculated using simplified assumptions based on a one-day movement in credit spreads over a two-year period. A confidence level of 99 per cent, consistent with the Group's VAR, has been applied.

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

Investment credit exposures are monitored against limits by the local insurance manufacturing subsidiaries, and are

aggregated by the Regional Insurance Head Office and reported to the Regional Insurance Market, Liquidity and Credit Risk Committee and the Regional Insurance Risk Committee. Stress testing is performed by the Regional Insurance Head Office on the investment credit exposures using credit spread sensitivities and default probabilities. The stresses are reported to the Regional Insurance Market, Liquidity and Credit Risk Committee.

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

Credit quality

(Audited)

The following table presents an analysis of treasury bills, other eligible bills and debt securities within the group's insurance business by measures of credit quality. Only assets supporting liabilities under non-linked insurance and investment contracts and supporting shareholders' funds are included in the table, as financial risk on assets supporting linked liabilities is predominantly borne by the policyholder.

Report of the Directors: Risk (continued)

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

(Audited)

	At 31 December 2010			At 31 December 2009		
	Strong £m	Good/ Satisfactory £m	Total ^{1,2,3} £m	Strong £m	Good/ Satisfactory £m	Total ^{1,2,3} £m
Financial assets designated at fair value	840	123	963	509	462	971
– Treasury and other eligible bills	13	–	13	7	–	7
– debt securities	827	123	950	502	462	964
Financial investments	10,273	277	10,550	10,009	277	10,286
– treasury and other similar bills	253	–	253	353	–	353
– debt securities	10,020	277	10,297	9,656	277	9,933
	11,113	400	11,513	10,518	739	11,257

- 1 No treasury bills, other eligible bills or debt securities were classified as sub-standard, past due not impaired or impaired.
- 2 Impairment is not measured for debt securities designated at fair value, as assets in such portfolios are managed according to movements in fair value, and the fair value movement is taken directly through the income statement.
- 3 Total is the maximum exposure to credit risk on the treasury bills, other eligible bills and debt securities in the group's insurance subsidiaries.

Issuers of treasury bills, other eligible bills and debt securities in the group's insurance subsidiaries

(Audited)

	Treasury bills £m	Other eligible bills £m	Debt securities £m	Total £m
At 31 December 2010				
Governments and local authorities	13	78	3,713	3,804
Corporates and other	–	175	7,534	7,709
	13	253	11,247	11,513
At 31 December 2009				
Governments and local authorities	106	4	3,371	3,481
Corporates and other	82	168	7,526	7,776
	188	172	10,897	11,257

Credit risk also arises when part of the insurance risk incurred by the group is assumed by reinsurers. The split of liabilities ceded to reinsurers and outstanding reinsurance recoveries, analysed by credit quality, is

shown below. The group's exposure to third parties under the reinsurance agreements is included in this table.

Reinsurers' share of liabilities under insurance contracts

(Audited)

	Neither past due nor impaired					Total ^{1,2} £m
	Strong £m	Good/ Satisfactory £m	Sub-standard £m	Past due not impaired £m		
At 31 December 2010						
Linked insurance contracts	28	–	–	–	–	28
Non-linked insurance contracts	395	4	5	–	–	404
Total	423	4	5	–	–	432
Reinsurance debtors	14	–	–	–	–	14
At 31 December 2009						
Linked insurance contracts	17	–	–	–	–	17
Non-linked insurance contracts	380	8	2	–	–	390
Total	397	8	2	–	–	407
Reinsurance debtors	9	–	–	1	–	10

- 1 No amounts reported within Reinsurers' share of liabilities under insurance contracts were classified as impaired.
- 2 Total is the maximum exposure to credit risk in respect of reinsurers' share of liabilities under insurance contracts.

Report of the Directors: Risk (continued)

Liquidity risk of insurance operations

(Audited)

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

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

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

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

They manage liquidity risk by utilising some or all of the following techniques:

- matching cash inflows with expected cash outflows using specific cash flow projections or more general asset and liability matching techniques such as duration matching;
- maintaining sufficient cash resources;
- investing in good credit-quality investments with deep and liquid markets to the degree to which they exist;
- monitoring investment concentrations and restricting them where appropriate, for example, by debt issues or issuers; and
- establishing committed contingency borrowing facilities.

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

Every quarter, the group's insurance manufacturing subsidiaries are required to complete and submit liquidity risk reports to the Regional Insurance Head Office for collation and review by the Regional Insurance Market, Liquidity and Credit Risk Committee.

The following tables show the expected undiscounted cash flows for insurance contract liabilities and the remaining contractual maturity of investment contract liabilities.

Expected maturity of insurance contract liabilities

(Audited)

	Expected cash flows (undiscounted)				Total £m
	Within 1 year £m	1-5 years £m	5-15 years £m	Over 15 years £m	
At 31 December 2010					
Non-life insurance	235	270	12	42	559
Life insurance (non-linked)	123	197	458	181	959
Life insurance (linked)	35	205	614	617	1,471
Total	393	672	1,084	840	2,989
At 31 December 2009					
Non-life insurance	396	336	27	–	759
Life insurance (non-linked)	364	600	445	268	1,677
Life insurance (linked)	90	248	562	628	1,528
Total	850	1,184	1,034	896	3,964

Report of the Directors: Risk (continued)

Remaining contractual maturity of investment contract liabilities

(Audited)

	Liabilities under investment contracts by insurance underwriting subsidiaries					Total £m
	Within 1 year £m	1-5 years £m	5-10 years £m	Over 10 years £m	Undated ¹ £m	
At 31 December 2010						
Linked investment contracts	249	606	735	1,374	1,777	4,741
Non-linked investment contracts	–	–	–	–	–	–
Investment contracts with DCF	–	–	–	–	14,205	14,205
Total.....	249	606	735	1,374	15,982	18,946
At 31 December 2009						
Linked investment contracts	287	558	400	1,290	1,445	3,980
Non-linked investment contracts	–	–	–	–	26	26
Investment contracts with DCF	–	–	–	–	12,930	12,930
Total.....	287	558	400	1,290	14,401	16,936

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

Present value of in-force long-term insurance business

(Audited)

The group's life insurance business is accounted for using the embedded value approach which, *inter alia*, provides a comprehensive risk and valuation framework. The sensitivity of the present value of the in-force long-term ('PVI') asset to changes in economic and non-economic assumptions is described in Note 21 of the Notes on the Financial Statements.

Other material risks

Pension risk

(Unaudited)

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

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

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

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

- investments delivering a return below that required to provide the projected plan benefits. This could arise, for example, when there is a fall in the market value of equities, or when increases in long-term interest rates cause a fall in the value of fixed income securities held;
- the prevailing economic environment leading to corporate failures, thus triggering write-downs in asset values (both equity and debt);
- a change in either interest rates or inflation which causes an increase in the value of the scheme liabilities; and
- scheme members living longer than expected (known as longevity risk).

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

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

In pursuit of these long-term objectives, a benchmark is established for the allocation of the defined benefit plan assets between asset classes. In addition, each permitted asset class has its own benchmarks, such as stock market or property valuation indices and, where relevant, desired levels of out-performance. The benchmarks are reviewed

Report of the Directors: Risk (continued)

at least triennially within 18 months of the date at which an actuarial valuation is made, or more frequently if required by local legislation or circumstances. The process generally involves an extensive asset and liability review.

Ultimate responsibility for investment strategy rests with either the trustees or, in certain circumstances, a management committee. The degree of independence of the trustees from the group varies in different jurisdictions. For example, the principal plan, which accounts for approximately 94% of the obligations of our defined benefit pension plans, is overseen by a corporate trustee who regularly monitors the market risks inherent in the scheme.

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

In 2006, the bank and the trustee of the principal plan agreed to change the investment strategy in order to reduce the investment risk. The target asset allocations for this strategy at that time and as revised in 2010 is shown below. The strategy is to hold the majority of assets in bonds, with the remainder in a more diverse range of investments, and includes a commitment to undertake a programme of swap arrangements (see Note 41 on the Financial Statements) by which the principal plan makes LIBOR-related interest payments in exchange for the receipt of cash flows which are based on projected future benefit payments to be made from the principal plan.

	2010	2006
	%	%
Equities	15.5	15.0
Bonds	56.5	50.0
Alternative assets ¹	10.5	10.0
Property	9.0	10.0
Cash.....	8.5	15.0
	100.0	100.0

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

Reputational risk

(Unaudited)

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

The group always aspires to the highest standards of conduct and, as a matter of routine, takes account of

reputational risks to its business. Reputational risks can arise from a wide variety of causes, including Environmental, Social and Governance ('ESG') issues and operational risk events. The group's good reputation depends upon the way in which the bank conducts business, but it can also be affected by the way in which clients, to whom the group provides financial services, conduct themselves; accordingly second order reputational risks are also regularly reviewed within the group.

Standards on all major aspects of business are set for the Group and for individual subsidiaries, businesses and functions. Reputational risks, including ESG matters, are considered and assessed by regional and local committees and management during the formulation of policy and the establishment of the Group's standards. These policies, which form an integral part of the internal control system, are communicated through manuals and statements of policy and are promulgated through internal communications and training. The policies cover ESG issues and set out operational procedures in all areas of reputational risk, including money laundering and terrorist financing deterrence, environmental impact, anti-corruption measures and employee relations. Group policies and procedures for safeguarding against reputational and operational risks are regularly reviewed and updated. This is an evolutionary process which takes account of relevant developments and industry guidance on best practice when responding to ESG risks.

A Reputational Risk Committee ('HRCC') exists to manage reputational risks across HSBC Bank plc. The HRCC meets on a regular basis, and includes regular consideration of issues relating to communications and corporate sustainability, significant customer complaints and any new products and business initiatives. Minutes from the HRCC are tabled at GRRC. In addition, all businesses are required to perform a Risk and Control Assessment ('RCA') at least annually that covers all material activities within their businesses. The RCA requires an assessment of operational risk exposures, including specific consideration of reputational impacts, to determine whether additional mitigating controls should be implemented.

Report of the Directors: Capital Management

Capital management and allocation

(Audited)

Capital management

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

The group manages its own capital within the context of an approved capital plan that determines the optimal amount and mix of capital required to support planned business growth and meet local regulatory capital requirements. Capital generated in excess of planned requirements is returned to the Group in the form of dividends.

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

- invested capital is the equity capital provided to the group by HSBC;
- economic capital is the internally calculated capital requirement which is deemed necessary by the group to support the risks to which it is exposed at a confidence level consistent with a target credit rating of AA; and
- regulatory capital is the minimum level of capital which the group is required to hold in accordance with the rules set by the FSA for the bank and the consolidated group and by the local regulators for individual subsidiary companies.

Through the capital management framework the group manages the following identified material risks: credit, market, operational, interest rate risk in the banking book, pension fund, insurance and residual risks.

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

Other stress tests are also carried out, both at the request of regulators and by the regulators themselves

using their prescribed assumptions. The group takes into account the results of all such regulatory stress testing when undertaking its internal capital management assessment.

The group's capital management process is articulated in an annual capital plan which is approved by the Board.

Capital measurement

The FSA is the supervisor of the bank and lead supervisor of the group. The FSA sets capital requirements and receives information on the capital adequacy for the bank and the group. The bank and the group complied with the FSA's capital adequacy requirements throughout 2010 and 2009.

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

The group calculates capital using the Basel II framework of the Basel Committee on Banking Supervision. Basel II is structured around three 'pillars': Pillar 1: minimum capital requirements, Pillar 2: Supervisory Review and Evaluation Process and Pillar 3: market discipline. The Capital Requirements Directive ('CRD') implemented Basel II in the EU and the FSA then gave effect to the CRD by including the requirements of the CRD in its own rulebooks.

It is the group's policy to maintain a strong capital base to support the development of its business and to meet regulatory capital requirements at all times.

Regulatory capital

The group's capital is comprised of tier 1 capital and tier 2 capital:

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

To ensure the overall quality of the capital base, the FSA's rules set limits on the amount of hybrid capital instruments that can be included in tier 1 capital relative to

Report of the Directors: Capital Management (continued)

core tier 1 capital and also limits total tier 2 capital to no more than tier 1 capital.

The basis of consolidation for financial accounting purposes is described on page 90 and differs from that used for regulatory purposes. Investments in banking associates, which are equity accounted in the financial accounting consolidation, are proportionally consolidated for regulatory purposes. Subsidiaries and associates engaged in insurance and non-financial activities are excluded from the regulatory consolidation and are deducted from regulatory capital. The regulatory consolidation also excludes Special Purpose Entities ('SPEs') where significant risk has been transferred to third parties. Exposures to these SPEs are risk weighted as securitisation positions for regulatory purposes.

Pillar 1 capital requirements

Pillar 1 covers the capital resources requirements for credit risk (including counterparty credit risk and securitisations), market risk and operational risk. These requirements are expressed in terms of risk-weighted assets.

Credit risk capital requirements

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

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

For credit risk, with the FSA's approval, the group has adopted the IRB advanced approach for the majority of its business, with the remainder on either IRB foundation or standardised approaches or under exemption from IRB treatment. A rollout plan is in place, over the next few years, to extend coverage of the advanced approaches, for

both local and consolidated group reporting, leaving a small residue of exposures on the standardised approach.

Counterparty credit risk

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

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

Securitisation

Basel II specifies two methods for calculating credit risk requirements for securitisation positions in the non-trading book, being the standardised and IRB approaches. Both approaches rely on the mapping of rating agency credit ratings to risk weights which range between 7% and 1,250%. Positions that would otherwise be weighted at 1,250% are deducted from capital.

Within the IRB approach, the group uses the Ratings Based Method for the majority of its non-trading book securitisation positions, and the Internal Assessment Approach for unrated liquidity facilities and programme wide enhancements for asset-backed securitisations.

The group uses the IRB approach for the majority of its non-trading book securitisation positions, while those in the trading book are treated like other market risk positions.

Market risk capital requirement

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

The group uses both VAR and standard rules approaches for market risk. Its aim is to migrate more positions from standard rules to VAR.

Operational risk capital requirement

Basel II includes a capital requirement for operational risk, again utilising three levels of sophistication. The capital required under the basic indicator approach is a simple

Report of the Directors: Capital Management (continued)

percentage of gross revenues, whereas under the standardised approach it is one of three different percentages of gross revenues allocated to each of eight defined business lines. Both these approaches use an average of the last three financial years' revenues. Finally, the advanced measurement approach uses banks' own statistical analysis and modelling of operational risk data to determine capital requirements.

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

Pillar 2 capital requirement

The second pillar of Basel II (Supervisory Review and Evaluation Process) involves both firms and regulators taking a view on whether a firm should hold additional capital against risks not covered in pillar 1. Part of the pillar 2 process is the Internal Capital Adequacy Assessment Process which is the firm's self assessment of the levels of capital that it needs to hold. The pillar 2 process culminates in the FSA providing firms with Individual Capital Guidance ('ICG'). The ICG is set as a capital resources requirement higher than that required under pillar 1. In 2011, this will be supplemented by an additional Capital Planning Buffer, set by the FSA, to cover capital demand should economic conditions worsen considerably against current outlook.

Pillar 3 disclosure requirements

Pillar 3 of Basel II is related to market discipline and aims to make firms more transparent by requiring them to publish specific details of their risks, capital and risk management under the Basel II framework. Pillar 3 disclosures are published as a separate document on the bank's website.

Future developments

The regulation and supervision of financial institutions continues to undergo significant change in response to the global financial crisis. In December 2010, the Basel Committee issued final rules in two documents 'A global regulatory framework for more resilient banks and banking systems' and 'International framework for liquidity risk measurement, standards and monitoring', which together are commonly referred to as 'Basel III'. The new minimum capital requirements will be phased in from 1 January 2013, with full implementation required by 1 January 2019. The capital conservation buffer and the countercyclical capital buffer will be phased-in in parallel from 1 January 2016 becoming fully effective on 1 January 2019. The leverage ratio will be subject to a supervisory monitoring period, which commenced 1 January 2011; and a parallel run period which will run from 1 January 2013 until 1 January 2017. Further calibration of the leverage ratio will be carried out in the first half of 2017, with a view to migrate to a Pillar 1

requirement from 1 January 2018. The Basel Committee has increased the capital requirements for the trading book and complex securitisation exposures, which must be implemented by the 31 December 2011. They will continue to conduct the fundamental review of the trading book, which is targeted for completion by the end of 2011. In addition to the reforms discussed above, identified Global Systemically Important Financial Institutions ('GSIFIs') may be subjected to a further capital requirement, which has not yet been announced. On 13 January 2011, the Basel Committee issued 'Further minimum requirements to ensure that all classes of capital instruments fully absorb losses at the point of non-viability before taxpayers are exposed to loss'. Instruments issued on or after 1 January 2013 may only be included in regulatory capital if the new requirements are met. The regulatory capital recognition of securities issued prior to 1 January 2013 will decline from 1 January 2013 in line with Basel III grandfathering rules.

Report of the Directors: Capital Management (continued)

Capital structure at 31 December

	31 Dec 2010 £m	31 Dec 2009 £m
Composition of regulatory capital (Audited)		
Shareholders' equity ¹	31,379	32,248
Shareholders' equity per balance sheet	31,825	27,787
Preference share & related premium	(431)	(431)
Other equity instruments	(1,750)	(1,750)
Deconsolidation of special purpose entities ^{2, 4}	1,735	6,642
Non controlling interests	382	491
Non-controlling interests per balance sheet	532	641
Of which representing non-controlling interests in preference shares	(150)	(150)
Regulatory adjustments to the accounting basis	748	(562)
Unrealised (gains)/losses on available-for-sale debt securities ^{3, 4}	1,545	(109)
Own credit spread	(170)	(168)
Defined benefit pension fund adjustment ⁵	288	695
Cash flow hedging reserve	(190)	(350)
Reserves arising from revaluation of property & unrealised gains on available-for-sale equities	(373)	(480)
Other regulatory adjustments	(352)	(150)
Deductions	(11,428)	(11,518)
Goodwill capitalised & intangible assets	(10,436)	(10,560)
50% of securitisation positions	(679)	(514)
50% of excess expected losses over impairment allowances	(439)	(616)
50% of tax credit adjustment for excess expected losses	126	172
Core tier 1 capital	21,081	20,659
Other tier 1 capital before deductions	2,374	2,391
Preference shares & related premium	581	581
Hybrid capital securities	1,793	1,810
Deductions	(500)	(343)
Unconsolidated investments ⁶	(626)	(515)
50% of tax credit adjustment for excess expected losses	126	172
Tier 1 capital	22,955	22,707
Total qualifying tier 2 capital before deductions	11,758	11,272
Reserves arising from unrealised gains on revaluation of property & available-for-sale equities	373	480
Collective impairment allowances ⁷	338	368
Perpetual subordinated debt	2,762	3,320
Term subordinated debt	8,285	7,104
Total deductions other than from tier 1 capital	(2,302)	(2,139)
Unconsolidated investments ⁶	(1,177)	(1,004)
50% of securitisation positions	(679)	(514)
50% of excess expected losses over impairment allowances	(439)	(616)
Other deductions	(7)	(5)
Total regulatory capital	32,411	31,840
Risk-weighted assets (Unaudited)		
Credit and counterparty risk	164,372	167,259
Market risk	12,762	12,655
Operational risk	24,586	23,367
Total	201,720	203,281
Capital ratios (Unaudited)		
Core tier 1 ratio	10.5	10.2
Tier 1 ratio	11.4	11.2
Total capital ratio	16.1	15.7

1 Includes externally verified profits for the year to 31 December 2010. Does not include the interim dividend of £915 million declared by the Board of Directors after 31 December 2010.

2 Mainly comprises unrealised losses on available-for-sale debt securities owned by deconsolidated special purpose entities.

3 Under FSA rules unrealised gains/losses on available-for-sale debt securities must be excluded from capital resources.

4 In December 2010, the bank agreed with the FSA that, going forward for regulatory purposes it would consolidate one of its special purpose entities.

5 FSA rules permit banks to replace a liability in a defined benefit pension scheme by the additional funding that will be paid into the scheme over a 5 year period.

6 Mainly comprise investments in insurance entities.

7 Under Basel II rules collective impairment allowances on loan portfolios under the standardised approach may be included in tier 2 capital.

Report of the Directors: Governance

Directors

A A Flockhart, Chairman

Age 59. Chairman since 1 January 2011 and a Director since July 2010. An executive Director of HSBC Holdings plc and Chairman, Europe, Middle East, Africa, Latin America and Commercial Banking. Joined HSBC in 1974.

B Robertson, Chief Executive

Age 56. Chief Executive and a Director since December 2010. A Group Managing Director since 2008. Group Chief Risk Officer from September 2007 to December 2010. Joined HSBC in 1975.

P W Boyles

Age 55. Chief Executive Officer, Continental Europe, and a Director since July 2010. A Group General Manager since 2006. Joined HSBC in 1975.

J D Garner

Age 41. Deputy Chief Executive and Head of UK Retail Bank and a Director since December 2010. A Group General Manager since 2006. General Manager, Customer Propositions from 2004 to 2006. Joined HSBC in 2004.

P J C Houzé**

Age 63. A Director since October 2010. Chief Executive Officer of Galeries Lafayette Group and Chief Executive of Monoprix SA. A Director and Chairman of the Nomination and Remuneration Committees of HSBC France. A member of the Supervisory Board of BHV (2002) and Casino SA and a director of Cofinoga.

Dame Denise Holt**

Age 61. A Director since 1 February 2011. Formerly a senior British Ambassador with 40 years' experience of working in Government, including postings in Ireland, Mexico, Brazil and, most recently, as British Ambassador to Spain from 2007 until her retirement in 2009.

J W Leng*

Age 65. A Director since October 2010. A member of the HSBC European Advisory Council. European Chairman of American European Associates and a non-executive Director of TNK-BP and Alstom SA. Lead non-executive of the Departmental Board of the UK Government's Ministry of Justice. A Governor at Ashridge College and the National Institute of Economic & Social Research. Former Chairman of Corus Group and former Chief Executive of Laporte plc.

Dame Mary Marsh**

Age 64. A Director since January 2009. A member of the Corporate Sustainability Committee of HSBC Holdings plc. Director of the Clore Social Leadership Programme. Governor and Chair of the International Alumni Council, London Business School. Formerly Chief Executive of the NSPCC.

R E S Martin**

Age 50. A Director since 2005. General Counsel & Company Secretary, Vodafone Group plc. Member of the Legal Services Board.

A R D Monro-Davies**

Age 70. A Director since 2004. A member of the Audit and Risk Committees. A Director and member of the Audit Committee of HSBC Bank Middle East Limited. Formerly Chief Executive Officer, Fitch Ratings.

P M Shawyer**

Age 60. A Director since 2004. A member of the Audit and Risk Committees. A Director and a member of the Audit Committee of HSBC France. Formerly a Managing Partner of Deloitte.

P A Thurston

Age 57. A Director since 2008. Chief Executive, Retail Banking and Wealth Management, HSBC Holdings plc. A Group Managing Director since 2008 and Chief Executive, HSBC Bank plc, from 2009 to December 2010. Joined HSBC in 1975.

J F Trueman**

Age 68. A Director since 2004. Chairman of the Audit and Risk Committees. Formerly Deputy Chairman of S G Warburg & Co.

* *Non-Executive Director*

** *Independent Non-Executive Director*

Secretary

J H McKenzie

Age 57. Joined HSBC in 1987.

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Report of the Directors: Governance (continued)

Board of Directors

The objectives of the management structures within the bank, headed by the Board of Directors and led by the Chairman, are to deliver sustainable value to shareholders. Implementation of the strategy set by the Board is delegated to the bank's Executive Committee.

The Board meets regularly and Directors receive information between meetings about the activities of committees and developments in the bank's business. All Directors have full and timely access to all relevant information and may take independent professional advice if necessary.

The names of Directors serving at the date of this report and brief biographical particulars for each of them are set out on page 69.

All Directors, including those appointed by the Board to fill a casual vacancy, are subject to annual re-election at the bank's Annual General Meeting. Non-executive Directors have no service contracts.

S K Green retired as Chairman on 21 April 2010 and as a Director on 3 December 2010. S T Gulliver was appointed as Chairman on 21 April 2010 and resigned as a Director and Chairman on 31 December 2010. A A Flockhart was appointed a Director on 22 July 2010 and as Chairman on 1 January 2011.

B Robertson was appointed as a Director and Chief Executive on 3 December 2010.

P W Boyles and J D Garner were appointed as Directors on 22 July 2010 and 20 December 2010 respectively. J W Leng was appointed as a non-executive Director on 12 October 2010. P J C Houzé and Dame Denise Holt were appointed as independent non-executive Directors on 1 October 2010 and 1 February 2011, respectively.

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

Directors' emoluments

Details on the emoluments of the Directors of the bank for 2010, disclosed in accordance with the Companies Act, are shown in Note 7 'Employee compensation and benefits' in the Notes on the Financial statements.

Board committees

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

As at the date of this report, the following are the principal committees:

Audit Committee

The Audit Committee meets regularly with the bank's senior financial management and the external auditor to consider, inter alia, the bank's financial reporting, the nature and scope of audit reviews and the effectiveness of the systems of internal control.

The members of the Audit Committee are J F Trueman (Chairman), A R D Monro-Davies, and P M Shawyer. All of the members of the Audit Committee who served during 2010 are independent non-executive Directors.

Risk Committee

The bank's Risk Committee was established in 2010, following publication of the final recommendations of Sir David Walker's 'Review of Corporate Governance in UK Banks and other Financial Industry Entities', to increase focus on risk governance and to provide an increasingly forward-looking view of risks and their mitigation. The responsibilities of the Risk Committee were previously undertaken by the Audit Committee.

The Risk Committee meets regularly with the bank's senior financial, risk, internal audit and compliance management and the external auditor to consider, inter alia, risk reports and internal audit reports and the effectiveness of compliance.

The members of the Risk Committee are J F Trueman (Chairman), A R D Monro-Davies, and P M Shawyer. All of the members of the Risk Committee who served during 2010 are independent non-executive Directors.

Executive Committee

The Executive Committee meets regularly and operates as a general management committee under the direct authority of the Board, exercising all of the powers, authorities and discretions of the Board in so far as they concern the management and day to day running of the bank, in accordance with such policies and directions as the Board may from time to time determine. The members of the Executive Committee include the bank's Executive Directors: A A Flockhart (Committee Chairman), B Robertson, P W Boyles and J D Garner.

Remuneration Committee

The functions of the Remuneration Committee are fulfilled by the Remuneration Committee of the Board of the bank's parent company, HSBC Holdings plc.

Internal control

The Directors are responsible for internal control in the group and for reviewing its effectiveness. Procedures

Report of the Directors: Governance (continued)

have been designed for safeguarding assets against unauthorised use or disposition; for maintaining proper accounting records; and for the reliability and usefulness of financial information used within the business or for publication. Such procedures are designed to manage rather than eliminate the risk of failure to achieve business objectives and can only provide reasonable and not absolute assurance against material misstatement, errors, losses or fraud. The procedures also enable the bank to discharge its obligations under the Handbook of Rules and Guidance issued by the Financial Services Authority, the bank's lead regulator.

The key procedures that the Directors have established are designed to provide effective internal control within the group and accord with the Internal Control: Revised Guidance for Directors on the Combined Code issued by the Financial Reporting Council. Such procedures for the ongoing identification, evaluation and management of the significant risks faced by the group have been in place throughout the year and up to 28 February 2011, the date of approval of the *Annual Report and Accounts 2010*. In the case of companies acquired during the year, the internal controls in place are being reviewed against the group's benchmarks and integrated into the group's processes.

Key internal control procedures include the following:

- Authority to operate the bank and responsibility for financial performance against plans and capital expenditure, is delegated to the Chairman who has responsibility for overseeing the establishment and maintenance of systems of control appropriate to the business and who has the authority to delegate such duties and responsibilities as he sees fit. The appointment of executives to the most senior positions within the group requires the approval of the Board of Directors of HSBC Holdings.
- Functional, operating, financial reporting and certain management reporting standards are established by the HSBC Holdings Group Management Office management committees, for application across the whole of HSBC. These are supplemented by operating standards set by the bank as required.
- Systems and procedures are in place in the group to identify, control and report on the major risks including credit, market, liquidity and operational risk (including accounting, tax, legal, compliance, fiduciary, information, physical security, business continuity fraud, systems and people risk). Exposure to these risks is monitored by the bank's or other major subsidiaries' risk management committees, asset and liability committees and executive committees in subsidiaries. The bank's Risk Management Meeting ('RMM') is held in each month to address asset, liability and risk management issues. The minutes of this meeting are submitted to the Group RMM.
- The group's financial reporting process for preparing the consolidated Annual Report and Accounts 2010 is controlled using documented accounting policies and reporting formats, supported by a chart of accounts with detailed instructions and guidance on reporting requirements, issued by Group Finance to the bank and all reporting entities within the Group in advance of each reporting period end. The submission of financial information from each reporting entity is subject to certification by the responsible financial officer, and analytical review procedures at reporting entity and group levels.
- Processes are in place to identify new risks from changes in market conditions/practices or customer behaviours, which could expose the group to heightened risk of loss or reputational damage. During 2010, attention was focused on refinement and operation of the stress testing framework; the roll-out of enhanced counterparty risk aggregation, risk management information, portfolio and crisis management processes; the mitigation of information risks; enhancement of policies and practices relevant to the prevention of financial crimes; greater focus by risk review and audit functions on global thematic risks with effect from January 2011; and changes in the regulation and public policy towards the financial services industry.
- Periodic strategic plans are prepared for key customer groups, global product groups, support functions and certain geographies within the framework of the Group Strategic Roadmap. The bank prepares rolling operating plans which set out the key business initiatives and the likely financial effects of those initiatives, which are informed by detailed analysis of risk appetite describing the types and quantum of risk that the group is prepared to take in executing its strategy.
- Governance arrangements are in place to provide oversight of, and advice to the Board on, material risk-related matters including assurance that risk analytical models are fit for purpose, used accordingly and complemented by both model-specific and enterprise-wide stress tests that evaluate the impact of severe yet plausible events and other unusual circumstances not fully captured by quantitative models.

Report of the Directors: Governance (continued)

- Centralised functional control is exercised over all IT developments and operations. Common systems are employed for similar business processes wherever practicable. Credit and market risks are measured and reported on in subsidiaries and aggregated for review of risk concentrations on a HSBC Group-wide basis.
- HSBC Holdings sets policies, procedures and standards for the following risks to which the group adheres: credit; market; liquidity; operations; IT; fraud; business continuity; security; information; insurance; accounting; tax; legal; regulatory compliance; fiduciary; human resources; reputational; sustainability; residual value; shariah and strategic risks. Responsibility for exposure to market risk and to credit risk with specified risk characteristics is delegated with limits to line management.
- Policies have been established to guide the bank, subsidiary companies and management at all levels in the conduct of business to avoid reputational risks which can arise from environmental, social or governance issues, or as a consequence of operational risk events. As a banking group, HSBC's good reputation depends upon the way in which it conducts its business but it can also be affected by the way in which clients, to which it provides financial services, conduct their business or use financial products and services.
- The establishment and maintenance of appropriate systems of internal control is primarily the responsibility of business management. The Internal Audit function, which is centrally controlled, monitors the effectiveness of internal control structures across the whole of the HSBC Group focusing on the areas of greatest risk to HSBC as determined by a risk-based grading approach.
- Executive management is responsible for ensuring that recommendations made by the Internal Audit function are implemented within an appropriate and agreed timetable. Confirmation to this effect must be provided to Internal Audit. Executive management must also confirm annually as part of the Internal Audit process that offices under their control have taken, or are in the process of taking, the appropriate actions to deal with all significant recommendations made by external auditors in management letters or by regulators following regulatory inspections.

The Audit Committee has kept under review the effectiveness of this system of internal control and has reported regularly to the Board of Directors. The key processes used by the Committee in carrying out its

reviews include: regular business and operational risk assessments; regular reports from the heads of key risk functions; the production annually of reviews of key internal controls measured against group benchmarks, which cover all internal controls, both financial and non-financial; semi-annual confirmations from senior executives that there have been no material losses, contingencies or uncertainties caused by weaknesses in internal controls; internal audit reports; external audit reports; prudential reviews; and regulatory reports. The Risk Committee keeps under review a 'Risk Map' of the status of key risk areas which impact the group and considers whether the mitigating actions put in place are appropriate. In addition, when unexpected losses have arisen or when incidents have occurred which indicate gaps in the control framework or in adherence to HSBC Group policies, the Audit Committee reviews special reports, prepared at the instigation of management, which analyse the cause of the issue, the lessons learned and the actions proposed by management to address the issue.

The Directors, through the Audit Committee, have conducted an annual review of the effectiveness of the group's system of internal control covering all material controls, including financial, operational and compliance controls and risk management systems, the adequacy of resources, qualifications and experience of staff of the issuer's accounting and financial reporting function, and their training programmes and budget. The Audit Committee has received confirmation that executive management has taken or is taking the necessary actions to remedy any failings or weaknesses identified through the operation of the group's framework of controls.

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

The financial risk management objectives and policies of the bank and its subsidiaries, including those in respect of financial instruments, together with an analysis of the exposure to such risks, as required under the Companies Act and International Financial Reporting Standards are set out on pages 25 to 64.

The reliability and security of HSBC's information and technology infrastructure and its customer databases are crucial to maintaining the service availability of banking applications and processes and to protecting the HSBC brand. Critical system failure,

Report of the Directors: Governance (continued)

any prolonged loss of service availability or any material breach of data security, particularly involving confidential customer data, could cause serious damage to the Group's ability to service its clients, could breach regulations under which HSBC operates and could cause long term damage to its business and brand.

Health and safety

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

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

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

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

Diversity and inclusion

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

Progress in this area is measured by our Diversity & Inclusion Index which is part of our Global People Survey. All survey items in the Diversity & Inclusion Index performed above the UK&I best Class Index and the Financial Services norm.

83 per cent of staff feel they are treated with respect and dignity at work, 84 per cent feel that they work in an environment where people from diverse perspectives can succeed.

Employees with disabilities

The group continues to recruit, train and develop disabled employees and make reasonable adjustments where employees become disabled during their employment. The bank continues to support the commitments of the two tick symbol employability campaign to interview disabled candidates who meet the minimum job criteria.

The symbol is a recognition given by Jobcentre Plus to employers who have agreed to make certain positive commitments regarding the employment, retention, training and career development of disabled people.

Corporate sustainability

HSBC recognises that environmental, social and economic issues can impact on the Group's long term success as a business. Corporate Sustainability means achieving sustainable profit growth so that HSBC can continue to reward shareholders and employees, build long-lasting relationships with customers and suppliers, pay taxes and duties in those countries where it operates, and invest in communities for future growth.

As a whole, HSBC Holdings plc reports on its progress in developing and implementing its sustainability strategy annually in the HSBC Sustainability Report, which is subject to third party assurance. The HSBC Sustainability Report 2010 will be issued on 27 May 2011 and will be available at www.hsbc.com/sustainability.

The bank manages its business in accordance with overarching Group policies and adopts the same long-term approach to managing economic, social and environmental issues which present a risk or opportunity to the business. These can affect HSBC's reputation, drive employee engagement, help manage the risks of lending, leverage savings through eco-efficiency and secure new revenue streams. These generally fall into one or more of the following four broad areas:

- Sustainable finance
- Operational environmental management
- Community investment
- Employee issues

Sustainable Finance

HSBC aims to build long term customer relationships around the world through the provision of a consistent and high quality service and customer experience. HSBC uses the benefits of its scale, financial strength, geographic reach and strong brand value to achieve this.

Report of the Directors: Governance (continued)

HSBC aims to take advantage of the opportunities and manage the risks presented by emerging global trends by leading the development of sustainable business models to address them. As an HSBC Group member, the bank considers factors such as increased longevity, the relative growth rates of emerging and mature economies and the need to move to a lower-carbon economy when setting its strategy and considering its product offerings.

Operational Environmental Management

HSBC focuses its environmental initiatives primarily on addressing and responding to issues associated with climate change, including energy use, water and waste management and biodiversity. Climate change has the potential to materially affect HSBC's customers and, by extension, HSBC's long-term success, introducing new risks to business activity. However, it also has the potential to stimulate a new era of low carbon growth, innovation and development. In response to this opportunity, a new role was created in 2010 to lead climate business development in the UK Commercial Bank.

In 2010, the UK Bank received a Leader and a Platinum Award, as part of the Mayor of London Green 500 Awards, which focuses on initiatives to reduce carbon emissions.

Community Investment

HSBC has a long record of support for the communities in which it operates and aims to encourage social and economic opportunity through its community investment activity. HSBC supports a wide variety of initiatives with the main focus being education and the environment.

During 2010, the bank gave £5 million in charitable donations to support community activities in the UK. UK employees volunteered 43,865 hours in work time. Outside the UK, since the launch in 2006, HSBC France's Foundation for Education has supported more than 10,000 children and 70 Non-governmental organisations. In 2010, £2 million was donated to various charities on behalf of the Staff Charity Scheme.

Employee Engagement

'Employee engagement' describes employees' emotional and intellectual commitment to any organisation. For the bank, employee engagement is critical to its long term ability to deliver the highest quality of financial services. HSBC's annual surveys of employees show that they value HSBC's commitment to sustainable business practices and view the bank as being a leader in this regard.

As an HSBC Group member, the bank has a well established framework for employees to provide feedback and develop action plans at local and national level to improve the working experience and engagement.

In the HSBC Group annual employee engagement survey undertaken in June 2010, the UK achieved a response rate of 85 per cent. The UK employee engagement score fell from 72 per cent in 2009 to 68 per cent in 2010. However, this remains above the UK and Ireland external 'Best in Class' average. The strongest performing areas against external 'Best in Class' average are corporate sustainability and leadership provided by employees' direct manager.

The key objective for 2011 is sustaining this high level of engagement, and priorities for action include managing and developing people and supporting career development.

In the UK, the bank has continued to use numerous complementary programmes to involve employees – 'Best Place to Discuss'; 'Best Place to Workout'; 'Best Place to Blog'; 'Best Place to Meet' and 'Best Place to Bank for Employees'.

Sustainability risk

Assessing the environmental and social impacts of providing finance to the bank's customers has been firmly embedded into its overall risk management processes. Sustainability risks arise from the provision of financial services to companies or projects which run counter to the needs of sustainable development; in effect this risk arises when the environmental and social effects outweigh economic benefits. HSBC has adopted The Equator Principles for project finance lending and sector-based sustainability policies covering those sectors with high environmental or social impacts (forestry, freshwater infrastructure, chemicals, energy, mining and metals, and defence-related lending). Where sustainability risks are assessed to be high, an independent review of transactions is undertaken.

Sustainability Governance

The Corporate Sustainability Committee of the HSBC Holdings Board is responsible for advising on corporate sustainability policies across the Group including environmental, social and ethical issues. Dame Mary Marsh, an independent Non-Executive Director of the Bank is a member of the Corporate Sustainability Committee.

Implementation of these policies is managed primarily by the Human Resources, Risk, Compliance and Corporate Sustainability functions. At Group level, Corporate Sustainability exists as a business function,

Report of the Directors: Governance (continued)

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

Valuation of freehold and leasehold land and buildings

The group's freehold and long leasehold properties were valued in 2010. The value of these properties was £237 million in excess of their carrying amount in the consolidated balance sheet. The group no longer revalues freehold and long leasehold properties under IFRSs.

Share capital

There were no changes to the issued ordinary or preference share capital of the bank in the year ended 31 December 2010.

Supplier payment policy

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

The amount due to the bank's trade creditors at 31 December 2010 represented 27 days' average daily purchases of goods and services received from those creditors, calculated in accordance with the Companies Act 2006, as amended by Statutory Instrument 2008/410.

Auditor

KPMG Audit Plc has expressed its willingness to continue in office and the Board recommends that it be reappointed. A resolution proposing the reappointment of KPMG Audit Plc as auditor of the bank and giving authority to the Directors to determine its remuneration will be submitted to the forthcoming Annual General Meeting.

Conflicts of interest and indemnification of Directors

The bank's Articles of Association give the Board authority to approve Directors' conflicts and potential conflicts of interest. The board has adopted a policy and procedures for the approval of Director's conflicts or potential conflicts of interest. The Board's powers to authorise conflicts are operating effectively and the procedures are being followed. A review of situational conflicts which have been authorised, including the terms of authorisation, is undertaken annually.

The Articles of Association of the Bank provide that Directors are entitled to be indemnified out of the assets of the company against claims from third parties in respect of certain liabilities arising in connection with the performance of their functions, in accordance with the provisions of the UK Companies Act 2006. Such indemnity provisions have been in place during the financial year but have not been utilised by the Directors.

Going concern basis

The Financial Statements are prepared on a going concern basis, as the Directors are satisfied that the group and bank have the resources to continue in business for the foreseeable future. In making this assessment, the Directors have considered a wide range of information relating to present and future conditions. Further information relevant to the assessment is provided in the Report of the Directors, in particular:

A description of the group's principal activities, strategic direction and challenges and uncertainties.

A summary of financial performance and review of business performance.

The group's approach to capital management and allocation.

In addition, the objectives, policies and processes for managing credit, liquidity and market risk are set out in the 'Report of the Directors: Risk'.

The Directors have also considered future projections of profitability, cash flows and capital resources in making their assessment.

Report of the Directors: Governance (continued)

Disclosure of information to the Auditor

The Directors who held office at the date of approval of this Directors' report confirm that, so far as they are each aware, there is no relevant audit information of which the bank's auditors are unaware; and each Director has taken all the steps that he ought to have taken as a Director to make himself aware of any relevant audit information and to establish that the company's auditors are aware of that information.

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

28 February 2011

Statement of Directors' Responsibilities in Respect of the *Annual Report and Accounts 2010* and the Financial Statements

The following statement, which should be read in conjunction with the Auditor's statement of their responsibilities set out in their report on the next page, is made with a view to distinguishing for shareholders the respective responsibilities of the Directors and of the Auditors in relation to the financial statements.

The Directors are responsible for preparing the Annual Report, the consolidated financial statements of HSBC Bank plc and its subsidiaries (the 'group') and parent company financial statements for HSBC Bank plc (the 'bank') in accordance with applicable law and regulations.

Company law requires the Directors to prepare group and parent company financial statements for each financial year. The Directors are required to prepare the group financial statements in accordance with IFRSs as adopted by the EU and have elected to prepare the bank financial statements on the same basis.

Under company law the directors must not approve the financial statements unless they are satisfied that they give a true and fair view of the state of affairs of the group and parent company and of their profit or loss for that period. In preparing each of the group and parent company financial statements, the directors are required to:

- select suitable accounting policies and then apply them consistently;
- make judgments and estimates that are reasonable and prudent; and
- state whether they have been prepared in accordance with IFRSs as adopted by the EU.

The Directors are required to prepare the financial statements on the going concern basis unless it is not appropriate. Since the Directors are satisfied that the group has the resources to continue in business for the foreseeable future, the financial statements continue to be prepared on a going concern basis.

The Directors have responsibility for ensuring that sufficient accounting records are kept that disclose with reasonable accuracy at any time the financial position of the bank and enable them to ensure that its financial statements comply with the Companies Act 2006.

The Directors have general responsibility for taking such steps as are reasonably open to them to safeguard the assets of the group and to prevent and detect fraud and other irregularities.

The Directors have responsibility for the maintenance and integrity of the Annual Report and Accounts as they appear on the bank's website. Legislation in the UK governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

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

28 February 2011

Independent Auditor's Report to the Members of the HSBC Bank plc

We have audited the group and parent company financial statements of HSBC Bank plc ('the bank') for the year ended 31 December 2010 set out on pages 79 to 195. The financial reporting framework that has been applied in their preparation is applicable law and International Financial Reporting Standards ('IFRSs') as adopted by the EU, as applied in accordance with the provisions of the Companies Act 2006.

This report is made solely to the bank's members, as a body, in accordance with Chapter 3 of Part 16 of the Companies Act 2006. Our audit work has been undertaken so that we might state to the bank's members those matters we are required to state to them in an auditor's report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the bank and the bank's members, as a body, for our audit work, for this report, or for the opinions we have formed.

Respective responsibilities of directors and auditor

As explained more fully in the Directors' Responsibilities Statement set out on page 77, the directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view. Our responsibility is to audit and express an opinion on the financial statements in accordance with applicable law and International Standards on Auditing (UK and Ireland). Those standards require us to comply with the Auditing Practices Board's (APB's) Ethical Standards for Auditors.

Scope of the audit of the financial statements

A description of the scope of an audit of financial statements is provided on the APB's web-site at www.frc.org.uk/apb/scope/private.cfm.

Opinion on financial statements

In our opinion:

- the financial statements give a true and fair view of the state of the group's and of the parent company's affairs as at 31 December 2010 and of the group's profit for the year then ended;
- the group financial statements have been properly prepared in accordance with IFRSs as adopted by the EU;
- the parent company financial statements have been properly prepared in accordance with IFRSs as adopted by the EU and as applied in accordance with the provisions of the Companies Act 2006; and
- the financial statements have been prepared in accordance with the requirements of the Companies Act 2006 and, as regards the group financial statements, Article 4 of the IAS Regulation.

Opinion on other matter prescribed by the Companies Act 2006

In our opinion the information given in the Directors' Report for the financial year for which the financial statements are prepared is consistent with the financial statements.

Matters on which we are required to report by exception

We have nothing to report in respect of the following matters where the Companies Act 2006 requires us to report to you if, in our opinion:

- adequate accounting records have not been kept by the parent company, or returns adequate for our audit have not been received from branches not visited by us; or
- the parent company financial statements are not in agreement with the accounting records and returns; or
- certain disclosures of directors' remuneration specified by law are not made; or
- we have not received all the information and explanations we require for our audit.

P McIntyre, Senior Statutory Auditor

for and on behalf of KPMG Audit Plc, Statutory Auditor
Chartered Accountants
London, England

28 February 2011

Financial Statements

Consolidated income statement for the year ended 31 December 2010

	Notes	2010 £m	2009 £m
Interest income		11,110	12,643
Interest expense		(3,416)	(4,552)
Net interest income		7,694	8,091
Fee income		5,311	5,560
Fee expense		(1,271)	(1,483)
Net fee income		4,040	4,077
Trading income excluding net interest income		1,210	970
Net interest income on trading activities		907	1,656
Net trading income		2,117	2,626
Net income from financial instruments designated at fair value		276	543
Gains less losses from financial investments		537	(73)
Dividend income		18	29
Net earned insurance premiums	4	2,635	2,716
Other operating income		782	1,093
Total operating income		18,099	19,102
Net insurance claims incurred and movement in liabilities to policyholders	5	(3,023)	(3,540)
Net operating income before loan impairment charges and other credit risk provisions		15,076	15,562
Loan impairment charges and other credit risk provisions		(1,951)	(3,364)
Net operating income	6	13,125	12,198
Employee compensation and benefits	7	(4,961)	(4,452)
General and administrative expenses		(3,536)	(3,114)
Depreciation and impairment of property, plant and equipment	22	(460)	(482)
Amortisation and impairment of intangible assets	21	(162)	(150)
Total operating expenses		(9,119)	(8,198)
Operating profit		4,006	4,000
Share of profit in associates and joint ventures		5	14
Profit before tax		4,011	4,014
Tax expense	10	(996)	(856)
Profit for the year		3,015	3,158
Profit attributable to shareholders of the parent company		2,959	3,092
Profit attributable to non-controlling interests		56	66

The accompanying notes on pages 89 to 195 and the audited sections of 'Report of the Directors: Risk' on pages 25 to 64 and 'Report of the Directors: Capital Management' on pages 65 to 68 form an integral part of these financial statements.

Financial Statements (continued)**Consolidated statement of comprehensive income for the year ended 31 December 2010**

	2010	2009
	£m	£m
Profit for the year	3,015	3,158
Other comprehensive income		
Available-for-sale investments		
– fair value gains/ (losses)	2,914	4,666
– fair value losses/ (gains) transferred to income statement on disposal	(419)	49
– amounts transferred to the income statement in respect of impairment losses	721	1,317
– income taxes	(254)	(248)
Cash flow hedges		
– fair value gains	307	133
– fair value gains transferred to income statement	(530)	(91)
– income taxes	63	(19)
Actuarial losses on defined benefit plans		
– before income taxes	179	(2,396)
– income taxes	(63)	676
Exchange differences and other	(114)	(848)
Other comprehensive income/ (expense) for the year, net of tax	2,804	3,239
Total comprehensive income/ (expense) for the year	5,819	6,397
Total comprehensive income/ (expense) for the year attributable to:		
– shareholders of the parent company	5,777	6,352
– non – controlling interests	42	45
	5,819	6,397

The accompanying notes on pages 89 to 195 and the audited sections of 'Report of the Directors: Risk' on pages 25 to 64 and 'Report of the Directors: Capital Management' on pages 65 to 68 form an integral part of these financial statements.

Financial Statements (continued)

Consolidated statement of financial position at 31 December 2010

	Notes	2010 £m	2009 £m
ASSETS			
Cash and balances at central banks		24,495	14,274
Items in the course of collection from other banks		1,932	2,082
Trading assets	15	159,552	165,008
Financial assets designated at fair value	16	15,467	16,435
Derivatives	17	129,158	118,516
Loans and advances to banks	32	57,027	46,994
Loans and advances to customers	32	285,218	274,659
Financial investments	18	102,086	86,695
Other assets	24	6,118	8,013
Current tax assets		216	172
Prepayments and accrued income		3,568	3,357
Interests in associates and joint ventures	20	76	79
Goodwill and intangible assets	21	11,143	11,199
Property, plant and equipment	22	2,108	4,090
Deferred tax assets	10	330	355
Total assets		798,494	751,928
LIABILITIES AND EQUITY			
Liabilities			
Deposits by banks	32	48,287	57,729
Customer accounts	32	344,123	332,896
Items in the course of transmission to other banks		1,411	1,477
Trading liabilities	25	132,360	118,881
Financial liabilities designated at fair value	26	27,935	18,164
Derivatives	17	129,204	118,689
Debt securities in issue	32	48,119	39,340
Other liabilities	27	4,860	5,867
Current tax liability		153	197
Liabilities under insurance contracts issued	28	17,116	16,505
Accruals and deferred income		3,950	3,752
Provisions	29	425	368
Deferred tax liability	10	54	158
Retirement benefit liabilities	7	733	2,678
Subordinated liabilities	30	7,407	6,799
Total liabilities		766,137	723,500
Equity			
Called up share capital	36	797	797
Share premium account		20,025	20,025
Other equity instruments	36	1,750	1,750
Other reserves		(220)	(2,920)
Retained earnings		9,473	8,135
Total equity attributable to shareholders of the parent company		31,825	27,787
Non-controlling interests		532	641
Total equity		32,357	28,428
Total equity and liabilities		798,494	751,928

The accompanying notes on pages 89 to 195 and the audited sections of 'Report of the Directors: Risk' on pages 25 to 64 and 'Report of the Directors: Capital Management' on pages 65 to 68 form an integral part of these financial statements.

Financial Statements (continued)

Consolidated cash flow statement for the year ended 31 December 2010

	Notes	2010 £m	2009 £m
Cash flows from operating activities			
Profit before tax		4,011	4,014
Adjustments for:			
– non-cash items included in profit before tax	37	2,837	4,224
– change in operating assets	37	17,225	25,222
– change in operating liabilities	37	20,868	(53,082)
– elimination of exchange differences ¹		(3,613)	9,707
– net gain from investing activities		(925)	(657)
– share of profits in associates and joint ventures		(5)	(14)
– distributions from associates		-	8
– contributions paid to defined benefit plans		(1,985)	(258)
– tax paid		(1,087)	(923)
Net cash (used in)/generated from operating activities		<u>37,326</u>	<u>(11,759)</u>
Cash flows from investing activities			
Purchase of financial investments		(68,653)	(73,475)
Proceeds from the sale and maturity of financial investments		57,569	87,764
Purchase of property, plant and equipment		(511)	(613)
Proceeds from the sale of property, plant and equipment		141	897
Purchase of intangible assets		(184)	(162)
Proceeds from the sale of intangible assets		3	-
Net cash outflow from acquisition of and increase in stake of subsidiaries		-	(247)
Net cash outflow from acquisition of and increase in stake of associates		-	(16)
Proceeds from disposal of subsidiaries		517	-
Proceeds from disposal of associates		-	215
Purchases of HSBC Holdings plc shares to satisfy share based payment transactions		-	(15)
Net cash generated from/(used in) investing activities		<u>(11,118)</u>	<u>14,348</u>
Cash flows from financing activities			
Issue of share capital		-	2,776
Issue of preference share capital		25	-
Subordinated loan capital repaid		-	(101)
Subordinated loan capital issued		633	-
Dividends paid to shareholders		(1,874)	(1,067)
Dividends paid to minority interests		(22)	(7)
Net cash outflow from acquisition of and increase in stake of subsidiaries		(194)	-
Net cash generated from financing activities		<u>(1,432)</u>	<u>1,601</u>
Net increase/(decrease) in cash and cash equivalents		24,776	4,190
Cash and cash equivalents at 1 January		60,806	60,855
Effect of exchange rate changes on cash and cash equivalents		423	(4,239)
Cash and cash equivalents at 31 December	37	<u>86,005</u>	<u>60,806</u>

1 Adjustment to bring changes between opening and closing balance sheet amounts to average rates. This is not done on a line-by-line basis, as details cannot be determined without unreasonable expense.

The accompanying notes on pages 89 to 195 and the audited sections of 'Report of the Directors: Risk' on pages 25 to 64 and 'Report of the Directors: Capital Management' on pages 65 to 68 form an integral part of these financial statements.

Consolidated statement of changes in equity for the year ended 31 December 2010

	2010									
	Called up share capital £m	Share premium £m	Other equity instruments £m	Retained earnings £m	Other reserves			Total share- holders' equity £m	Non- controlling interests £m	Total equity £m
					Available- for-sale fair value reserve £m	Cash flow hedging reserve ² £m	Foreign exchange reserve £m			
At 1 January	797	20,025	1,750	8,135	(5,911)	350	2,641	27,787	641	28,428
Profit for the year	-	-	-	2,959	-	-	-	2,959	56	3,015
Other comprehensive income (net of tax)	-	-	-	118	2,962	(160)	(102)	2,818	14	2,804
Available-for-sale investments	-	-	-	-	2,962	-	-	2,962	-	2,962
Cash flow hedges	-	-	-	-	-	(160)	-	(160)	-	(160)
Actuarial gains/(losses) on defined benefit plans	-	-	-	118	-	-	-	118	(2)	116
Exchange differences and other	-	-	-	-	-	-	(102)	(102)	(12)	(114)
Total comprehensive income for the year.....	-	-	-	3,077	2,962	(160)	(102)	5,777	42	5,804
Dividends to shareholders	-	-	-	(1,868)	-	-	-	(1,868)	(22)	(1,890)
Net impact of equity-settled share-based payments	-	-	-	163	-	-	-	163	-	163
Other movements	-	-	-	-	-	-	-	-	-	-
Change in ownership interest in subsidiaries ¹	-	-	-	(56)	-	-	-	(56)	(129)	(185)
Tax on items taken directly to equity	-	-	-	22	-	-	-	22	-	22
At 31 December	797	20,025	1,750	9,473	(2,949)	190	(2,539)	31,825	532	32,357

1 Relates to the purchase of non-controlling interests in HSBC Europe B.V. See Note 41 for further details.

2 Movements in the cash flow hedging reserve include amounts transferred to the income statement of £530 million comprising a £514 million loss taken to 'Net interest income' and a £16 million loss taken to 'Net trading income'.

The accompanying notes on pages 89 to 195 and the audited sections of 'Report of the Directors: Risk' on pages 25 to 64 and 'Report of the Directors: Capital Management' on pages 65 to 68 form an integral part of these financial statements.

	2009									
	Other reserves									
	Called up share capital £m	Share premium £m	Other equity Instruments £m	Retained earnings £m	Available- for-sale fair value reserve £m	Cash flow hedging reserve ³ £m	Foreign exchange reserve £m	Total share- holders' equity £m	Non- controlling interests £m	Total equity £m
At 1 January	797	17,249	1,750	7,969	(11,627)	327	3,458	19,923	738	20,661
Profit for the year	-	-	-	3,092	-	-	-	3,092	66	3,158
Other comprehensive income (net of tax)	-	-	-	(1,716)	5,770	23	(817)	3,260	(21)	3,239
Available-for-sale investments	-	-	-	-	5,770	-	-	5,770	14	5,784
Cash flow hedges	-	-	-	-	-	23	-	23	-	23
Actuarial gains/(losses) on defined benefit plans	-	-	-	(1,721)	-	-	-	(1,721)	1	(1,720)
Exchange differences and other	-	-	-	5	-	-	(817)	(812)	(36)	(848)
Total comprehensive income for the year.....	-	-	-	1,376	5,770	23	(817)	6,352	45	6,397
Share capital issued, net of costs ¹	-	2,776	-	-	-	-	-	2,776	-	2,776
Dividends to shareholders	-	-	-	(1,067)	-	-	-	(1,067)	(42)	(1,109)
Net impact of equity-settled share-based payments	-	-	-	(190)	-	-	-	(190)	-	(190)
Other movements	-	-	-	(7)	-	-	-	(7)	-	(7)
Change in ownership interest in subsidiaries ²	-	-	-	54	(54)	-	-	-	(100)	(100)
At 31 December	797	20,025	1,750	8,135	(5,911)	350	2,641	27,787	641	28,428

1 All new capital subscribed in the year was issued to HSBC Holdings plc. See note 36 for further details.

2 Relates to the purchase of non-controlling interest in HSBC Private Bank (Suisse) SA. See Note 41 for further details.

3 Movements in the cash flow hedging reserve include amounts transferred to the income statement of £91 million comprising a £120 million loss taken to 'Net interest income' and a £29 million gain taken to 'Net trading income'.

The accompanying notes on pages 89 to 195 and the audited sections of 'Report of the Directors: Risk' on pages 25 to 64 and 'Report of the Directors: Capital Management' on pages 65 to 68 form an integral part of these financial statements.

Financial Statements (continued)

HSBC Bank plc statement of financial position at 31 December 2010

	Notes	2010 £m	2009 £m
ASSETS			
Cash and balances at central banks		22,357	13,130
Items in the course of collection from other banks		1,030	1,071
Trading assets	15	126,493	123,957
Financial assets designated at fair value	16	4,505	6,592
Derivatives	17	108,905	100,800
Loans and advances to banks	32	27,860	20,729
Loans and advances to customers	32	208,548	208,669
Financial investments	18	41,338	27,389
Other assets	24	3,354	4,230
Current tax assets		216	160
Prepayments and accrued income		1,557	1,263
Interests in associates and joint ventures	20	63	63
Investments in subsidiary undertakings	23	15,459	15,226
Goodwill and intangible assets	21	686	632
Property, plant and equipment	22	1,343	1,280
Deferred tax assets	10	617	779
Total assets		564,331	525,970
LIABILITIES AND EQUITY			
Liabilities			
Deposits by banks	32	38,873	39,346
Customer accounts	32	230,795	223,652
Items in the course of transmission to other banks		577	595
Trading liabilities	25	98,412	96,821
Financial liabilities designated at fair value	26	18,334	10,675
Derivatives	17	108,786	101,161
Debt securities in issue	32	29,417	14,636
Other liabilities	27	2,221	2,636
Current taxation		11	8
Accruals and deferred income		1,955	1,852
Provisions	29	229	176
Deferred tax liability	10	2	2
Retirement benefit liabilities	7	575	2,524
Subordinated liabilities	30	7,562	6,955
Total liabilities		537,749	501,039
Equity			
Called up share capital	36	797	797
Share premium account		20,025	20,025
Other equity instruments	36	1,750	1,750
Other reserves		42	(356)
Retained earnings		3,968	2,715
Total equity		26,582	24,931
Total equity and liabilities		564,331	525,970

The accompanying notes on pages 89 to 195 and the audited sections of 'Report of the Directors: Risk' on pages 25 to 64 and 'Report of the Directors: Capital Management' on pages 65 to 68 form an integral part of these financial statements.

Financial Statements (continued)

HSBC Bank plc cash flow statement for the year ended 31 December 2010

	Notes	2010 £m	2009 £m
Cash flows from operating activities			
Profit before tax		3,396	2,967
Adjustments for:			
– non-cash items included in profit before tax	37	2,215	3,126
– change in operating assets	37	(5,523)	14,404
– change in operating liabilities	37	28,734	(26,542)
– elimination of exchange differences ¹		(1,189)	377
– net gain from investing activities		(329)	(535)
– contributions paid to defined benefit plans		(1,933)	(236)
– tax paid		(674)	(461)
Net cash (used in)/generated from operating activities		<u>24,697</u>	<u>(6,900)</u>
Cash flows from investing activities			
Purchase of financial investments		(27,066)	(31,309)
Proceeds from the sale of financial investments		14,849	50,482
Purchase of property, plant and equipment		(316)	(312)
Proceeds from the sale of property, plant and equipment		5	791
Purchase of goodwill and intangible assets		(163)	(133)
Net cash outflow from acquisition of and increase in stake of associates		–	(16)
Proceeds from disposal of associates		2	188
Net cash generated from/(used in) investing activities		<u>(12,689)</u>	<u>19,691</u>
Cash flows from financing activities			
Issue of ordinary share capital		–	2,776
Net cash outflow from acquisition of and increase in stake of subsidiaries ..		(442)	–
Subordinated loan capital issued		633	–
Dividends paid		(1,868)	(1,067)
Net cash generated from financing activities		<u>(1,677)</u>	<u>1,709</u>
Net increase in cash and cash equivalents		10,331	14,500
Cash and cash equivalents at 1 January		40,702	27,791
Effect of exchange rate changes on cash and cash equivalents		326	(1,589)
Cash and cash equivalents at 31 December	37	<u>51,359</u>	<u>40,702</u>

¹ Adjustment to bring changes between opening and closing balance sheet amounts to average rates. This is not done on a line-by-line basis, as details cannot be determined without unreasonable expense.

The accompanying notes on pages 89 to 195 and the audited sections of 'Report of the Directors: Risk' on pages 25 to 64 and 'Report of the Directors: Capital Management' on pages 65 to 68 form an integral part of these financial statements.

HSBC Bank plc statement of changes in equity for the year ended 31 December 2010

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

1 Movements in the cash flow hedging reserve include an amount transferred to the income statement of £558 million loss taken to 'Net interest income'.

The accompanying notes on pages 89 to 195 and the audited sections of 'Report of the Directors: Risk' on pages 25 to 64 and 'Report of the Directors: Capital Management' on pages 65 to 68 form an integral part of these financial statements.

	2009							Total equity £m
	Called up share capital £m	Share premium £m	Other equity Instruments £m	Retained earnings £m	Other reserves			
					Available- for- sale fair value reserve £m	Cash flow hedging reserve ² £m	Foreign exchange reserve £m	
At 1 January	797	17,249	1,750	3,081	(977)	407	(52)	22,255
Profit for the year	–	–	–	2,531	–	–	–	2,531
Other comprehensive income (net of tax)	–	–	–	(1,764)	313	(75)	28	(1,498)
Available-for-sale investments	–	–	–	–	313	–	–	313
Cash flow hedges	–	–	–	–	–	(75)	–	(75)
Actuarial losses on defined benefit plans	–	–	–	(1,769)	–	–	–	(1,769)
Exchange differences and other	–	–	–	5	–	–	28	33
Total comprehensive income for the year.....	–	–	–	767	313	(75)	28	1,033
∞ Share capital issued, net of costs ¹	–	2,776	–	–	–	–	–	2,776
Dividends to shareholders	–	–	–	(1,067)	–	–	–	(1,067)
Net impact of equity-settled share-based payments	–	–	–	(66)	–	–	–	(66)
Other movements	–	–	–	–	–	–	–	–
At 31 December	797	20,025	1,750	2,715	(664)	332	(24)	24,931

¹ All new capital subscribed in the year was issued to HSBC Holdings plc. See note 36 for further details.

² Movements in the cash flow hedging reserve include an amount transferred to the income statement of a £148 million loss taken to 'Net interest income'.

The accompanying notes on pages 89 to 195 and the audited sections of 'Report of the Directors: Risk' on pages 25 to 64 and 'Report of the Directors: Capital Management' on pages 65 to 68 form an integral part of these financial statements.

Notes on the Financial Statements (continued)

1 Basis of preparation

(a) Compliance with International Financial Reporting Standards

The consolidated financial statements of the group and the separate financial statements of HSBC Bank plc have been prepared in accordance with International Financial Reporting Standards ('IFRSs') as issued by the International Accounting Standards Board ('IASB') and as endorsed by the EU. EU-endorsed IFRSs may differ from IFRSs as issued by the IASB if, at any point in time, new or amended IFRSs have not been endorsed by the EU. At 31 December 2010, there were no unendorsed standards effective for the year ended 31 December 2010 affecting these consolidated and separate financial statements, and there was no difference between IFRSs endorsed by the EU and IFRSs issued by the IASB in terms of their application to the group. Accordingly, the group's financial statements for the year ended 31 December 2010 are prepared in accordance with IFRSs as issued by the IASB.

IFRSs comprise accounting standards issued by the IASB and its predecessor body as well as interpretations issued by the IFRS Interpretations Committee ('IFRIC') and its predecessor body. During 2010, the group adopted the following major revisions and amendments to standards:

The group adopted the revised IFRS 3 'Business Combinations' and amendments to IAS 27 'Consolidated and Separate Financial Statements'. The main changes under the standards are that:

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

In terms of their application to the group, the revised IFRS 3 and the amendments to IAS 27 apply prospectively to acquisitions and transactions taking place on or after 1 January 2010, and have no significant effect on these consolidated financial statements of the group and the separate financial statements of HSBC Bank plc.

During 2010, in addition to the above, the group adopted a number of standards, interpretations and amendments to standards which had an insignificant effect on the consolidated financial statements of the group and the separate financial statements of HSBC Bank plc.

(b) Presentation of information

Disclosures under IFRS 4 'Insurance Contracts' ('IFRS 4') and IFRS 7 'Financial Instruments: Disclosures' ('IFRS 7') concerning the nature and extent of risks relating to insurance contracts and financial instruments have been included in the audited sections of the 'Report of the Directors: Risk' on pages 56 to 63.

Certain partnerships have taken advantage of the exemption under Regulation 7 of the Partnership (Accounts) Regulations 2008 from preparing their own financial statements by virtue of being consolidated with these group financial statements.

Capital disclosures under IAS 1 'Presentation of Financial Statements' ('IAS 1') have been included in the audited sections of the 'Report of the Directors: Capital Management' on pages 65 to 68.

Disclosures relating to the group's securitisation activities and structured products have been included in the audited section of 'Report of the Directors: Risk' on pages 54 to 55.

In accordance with the group's policy to provide meaningful disclosures that help investors and other stakeholders understand the group's performance, financial position and changes thereto, the information provided in the Notes on the Financial Statements and the Report of the Directors goes beyond the minimum

Notes on the Financial Statements (continued)

levels required by accounting standards, statutory and regulatory requirements. In particular, the group has adopted the British Bankers' Association Code for Financial Reporting Disclosure ('the BBA Code'). The BBA Code aims to increase the quality and comparability of banks' disclosures and sets out five disclosure principles together with supporting guidance. In line with the principles of the BBA Code, the group assesses good practice recommendations issued from time to time by relevant regulators and standard setters, and will assess the applicability and relevance of such guidance, enhancing disclosures where appropriate.

In publishing the parent company financial statements here together with the Group financial statements, HSBC Bank has taken advantage of the exemption in section 408(3) of the Companies Act 2006 not to present its individual income statement, individual statement of comprehensive income and related notes that form a part of these financial statements.

The functional currency of the bank is Sterling, which is also the presentation currency of the consolidated financial statements of the group.

(c) Consolidation

The consolidated financial statements of the group comprise the financial statements of HSBC Bank plc and its subsidiaries made up to 31 December.

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

Changes in a parent's ownership interest in a subsidiary that do not result in a loss of control are treated as transactions between equity holders and are reported in equity.

Entities that are controlled by the group are consolidated until the date that control ceases.

In the context of Special Purpose Entities ('SPEs'), the following circumstances may indicate a relationship in which, in substance, the group controls and, consequently, consolidates an SPE:

- the activities of the SPE are being conducted on behalf of the group according to its specific business needs so that the group obtains benefits from the SPE's operation;
- the group has the decision-making powers to obtain the majority of the benefits of the activities of the SPE or, by setting up an 'autopilot' mechanism, the group has delegated these decision-making powers;
- the group has rights to obtain the majority of the benefits of the SPE and therefore may be exposed to risks incident to the activities of the SPE; or
- the group retains the majority of the residual or ownership risks related to the SPE or its assets in order to obtain benefits from its activities.

The group performs a re-assessment of consolidation whenever there is a change in the substance of the relationship between the group and an SPE. All intra-group transactions are eliminated on consolidation.

The consolidated financial statements of the group also include the attributable share of the results and reserves of joint ventures and associates. These are based on financial statements made up to dates not earlier than three months prior to 31 December, adjusted for the effect of any significant transactions or events that occur between that date and the group's reporting date.

Notes on the Financial Statements (continued)

(d) Future accounting developments

At 31 December 2010, a number of standards and interpretations, and amendments thereto, had been issued by the IASB, which are not effective for the group's consolidated financial statements or the separate financial statements of HSBC Bank plc as at 31 December 2010. Those which are expected to have a significant effect on the group's consolidated financial statements and the separate financial statements of HSBC Bank plc are discussed below.

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

In November 2009, the IASB issued IFRS 9 'Financial Instruments' ('IFRS 9') which introduced new requirements for the classification and measurement of financial assets. In October 2010, the IASB issued additions to IFRS 9 relating to financial liabilities. Together, these changes represent the first phase instalments in the IASB's planned phased replacement of 'IAS 39 Financial Instruments: Recognition and Measurement' ('IAS 39') with a less complex and improved standard for financial instruments.

The standard is effective for annual periods beginning on or after 1 January 2013 with early adoption permitted. IFRS 9 is required to be applied retrospectively. If the standard is adopted prior to 1 January 2012, an entity will be exempt from the requirement to restate prior period comparative information. IFRS 9 is subject to EU endorsement, the timing of which is uncertain. Accordingly, the group is unable to provide a date by which it plans to apply IFRS 9.

The main changes to the requirements of IAS 39 are summarised below.

- all financial assets that are currently in the scope of IAS 39 will be classified as either amortised cost or fair value. The available-for-sale, held-to-maturity and loans and receivables categories will no longer exist.
- classification of financial assets is based on an entity's business model for managing the financial assets and their contractual cash flow characteristics. Reclassifications between the two categories are prohibited unless there is a change in the entity's business model.
- a financial asset is measured at amortised cost if two criteria are met: i) the objective of the business model is to hold the financial asset for the collection of the contractual cash flows; and ii) the contractual cash flows of the instrument are solely payments of principal and interest on the principal outstanding. All other financial assets are measured at fair value. Movements in the fair value of financial assets classified at fair value are recognised in profit or loss, except for equity investments where an entity takes the option to designate an equity instrument that is not held for trading at fair value through other comprehensive income. If this option is taken, all subsequent changes in fair value are recognised in other comprehensive income with no recycling of gains or losses to the income statement. Dividend income would continue to be recognised in the income statement.
- an entity is only permitted to designate a financial asset otherwise meeting the amortised cost criteria at fair value through profit or loss if doing so significantly reduces or eliminates an accounting mismatch. This designation is made on initial recognition and is irrevocable.
- financial assets which contain embedded derivatives are to be classified in their entirety either at fair value or amortised cost depending on whether the contracts as a whole meet the relevant criteria under IFRS 9.
- most of IAS 39's requirements for financial liabilities are retained, including amortised cost accounting for most financial liabilities. The guidance on separation of embedded derivatives will continue to apply to host contracts that are financial liabilities. However, fair value changes attributable to changes in own credit risk for financial liabilities designated under the fair value option other than loan commitments and financial guarantee contracts are to be presented in the statement of other comprehensive income unless the treatment would create or enlarge an accounting mismatch in profit or loss. These amounts are not subsequently reclassified to the income statement but may be transferred within equity.

The second and third phases in the IASB's project to replace IAS 39 will address the impairment of financial assets measured at amortised cost and hedge accounting. The IASB has indicated that it expects to finalise the replacement of IAS 39 by June 2011. In addition, the IASB is working with the US Financial Accounting Standards Board to reduce inconsistencies between US GAAP and IFRS in accounting for financial instruments. The impact of IFRS 9 may change as a consequence of further developments resulting from the IASB's financial instruments project. As a result, it is impracticable to quantify the impact of IFRS 9 as at the date of publication of these financial statements.

Notes on the Financial Statements (continued)

2 Summary of significant accounting policies

(a) Interest income and expense

Interest income and expense for all financial instruments except for those classified as held-for-trading or designated at fair value (other than debt securities issued by the group and derivatives managed in conjunction with such debt securities issued) are recognised in 'Interest income' and 'Interest expense' in the income statement using the effective interest method. The latter is a way of calculating the amortised cost of a financial asset or a financial liability (or groups of financial assets or financial liabilities) and of allocating the interest income or interest expense over the relevant period.

The effective interest rate is the rate that exactly discounts estimated future cash receipts or payments through the expected life of the financial instrument or, where appropriate, a shorter period, to the net carrying amount of the financial asset or financial liability. When calculating the effective interest rate, the group estimates cash flows considering all contractual terms of the financial instrument but not future credit losses. The calculation includes all amounts paid or received by the group that are an integral part of the effective interest rate of a financial instrument, including transaction costs and all other premiums or discounts.

Interest on impaired financial assets is recognised using the rate of interest used to discount the future cash flows for the purpose of measuring the impairment loss.

(b) Non interest income

Fee income is earned from a diverse range of services provided by the group to its customers. Fee income is accounted for as follows:

- income earned on the execution of a significant act is recognised as revenue when the act is completed (for example, fees arising from negotiating, or participating in the negotiation of, a transaction for a third party, such as an arrangement for the acquisition of shares or other securities);
- income earned from the provision of services is recognised as revenue as the services are provided (for example, asset management, portfolio and other management advisory and service fees); and
- income which forms an integral part of the effective interest rate of a financial instrument is recognised as an adjustment to the effective interest rate (for example, certain loan commitment fees) and recorded in 'Interest income' (Note 2(a)).

Net trading income comprises all gains and losses from changes in the fair value of financial assets and financial liabilities held for trading, together with related interest income, expense and dividends.

Net income from financial instruments designated at fair value includes all gains and losses from changes in the fair value of financial assets and financial liabilities designated at fair value through profit or loss. Interest income and expense and dividend income arising on those financial instruments are also included in 'Net income from financial instruments designated at fair value', except for interest arising from debt securities issued, and derivatives managed in conjunction with those debt securities, which is recognised in 'Interest expense' (Note 2(a)).

Dividend income is recognised when the right to receive payment is established. This is the ex-dividend date for equity securities, and usually the date when shareholders have approved the dividend for unlisted equity securities.

(c) Operating Segments

The group's operating segments are organised as follows: UK Retail Banking, Continental Europe Retail, Global Banking and Markets, Private Banking and Other. Due to the nature of the group, the chief operating decision-maker regularly reviews operating activity on a number of bases, including by geography, by customer group, and by retail businesses and global businesses. The group's operating segments were determined using the same measure reported to the chief operating decision-maker for the purpose of making decisions about allocating resources and assessing performance.

Measurement of segment assets, liabilities, income and expenses is based on the group's accounting policies. Segment income and expenses include transfers between segments and these transfers are conducted on arm's length terms and conditions. Shared costs are included in segments on the basis of the actual recharges made.

Notes on the Financial Statements (continued)

(d) Determination of fair value

All financial instruments are recognised initially at fair value. In the normal course of business, the fair value of a financial instrument on initial recognition is the transaction price (that is, the fair value of the consideration given or received). In certain circumstances, however, the fair value will be based on other observable current market transactions in the same instrument, without modification or repackaging, or on a valuation technique whose variables include only data from observable markets, such as interest rate yield curves, option volatilities and currency rates. When such evidence exists, the group recognises a trading gain or loss on inception of the financial instrument, being the difference between the transaction price and the fair value. When unobservable market data have a significant impact on the valuation of financial instruments, the entire initial difference in fair value indicated by the valuation model from the transaction price is not recognised immediately in the income statement but is recognised over the life of the transaction on an appropriate basis, or when the inputs become observable, or the transaction matures or is closed out, or when the group enters into an offsetting transaction.

Subsequent to initial recognition, the fair values of financial instruments measured at fair value are measured in accordance with the group's valuation methodologies, which are described in Note 31 Fair value of financial instruments.

(e) Reclassification of financial assets

Non-derivative financial assets (other than those designated at fair value through profit or loss upon initial recognition) may be reclassified out of the fair value through profit or loss category in the following circumstances:

- financial assets that would have met the definition of loans and receivables at initial recognition (if the financial asset had not been required to be classified as held for trading) may be reclassified out of the fair value through profit or loss category if there is the intention and ability to hold the financial asset for the foreseeable future or until maturity; and
- financial assets (except financial assets that would have met the definition of loans and receivables at initial recognition) may be reclassified out of the fair value through profit or loss category and into another category in rare circumstances.

When a financial asset is reclassified as described in the above circumstances, the financial asset is reclassified at its fair value on the date of reclassification. Any gain or loss already recognised in the income statement is not reversed. The fair value of the financial asset on the date of reclassification becomes its new cost or amortised cost, as applicable.

(f) Loans and advances to banks and customers

Loans and advances to banks and customers include loans and advances originated by the group which are not classified either as held for trading or designated at fair value. Loans and advances are recognised when cash is advanced to borrowers. They are derecognised when either borrower repays their obligations, or the loans are sold or written off, or substantially all the risks and rewards of ownership are transferred. They are initially recorded at fair value plus any directly attributable transaction costs and are subsequently measured at amortised cost using the effective interest method, less impairment losses. Where exposures are hedged by derivatives designated and qualifying as fair value hedges, the carrying value of the loans and advances so hedged includes a fair value adjustment for the hedged risk only.

The group may commit to underwrite loans on fixed contractual terms for specified periods of time, where the drawdown of the loan is contingent upon certain future events outside the control of the group. Where the loan arising from the lending commitment is expected to be held for trading, the commitment to lend is recorded as a trading derivative and measured at fair value through profit and loss. On drawdown, the loan is classified as held for trading and measured at fair value through profit and loss. Where it is not the group's intention to trade the loan, a provision on the loan commitment is only recorded where it is probable that the group will incur a loss. This may occur, for example, where a loss of principal is probable or the interest rate charged on the loan is lower than the cost of funding. On inception the loan, the hold portion is recorded at its fair value and subsequently measured at amortised cost using the effective interest method. However, where the initial fair value is lower than the cash amount advanced (for example, due to the rate of interest charged on the loan being below the market rate of interest), the write down is charged to the income statement. The write down will be

Notes on the Financial Statements (continued)

recovered over the life of the loan, through the recognition of interest income using the effective interest method, unless the loan becomes impaired. The write down is recorded as a reduction to other operating income.

Financial assets which have been reclassified out of the fair value through profit and loss category into the loans and receivables category are initially recorded at the fair value at the date of reclassification. The reclassified assets are subsequently measured at amortised cost, using the effective interest rate determined at the date of reclassification.

(g) Impairment of loans and advances

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

Individually assessed loans and advances

For all loans that are considered individually significant, the group assesses on a case-by-case basis at each balance sheet date whether there is any objective evidence that a loan is impaired. The criteria used by the group to determine that there is such objective evidence include:

- known cash flow difficulties experienced by the borrower;
- past due contractual payments of either principal or interest;
- breach of loan covenants or conditions;
- the probability that the borrower will enter bankruptcy or other financial realisation; and
- a significant downgrading in credit rating by an external credit rating agency

For those loans where objective evidence of impairment exists, impairment losses are determined considering the following factors:

- the group's aggregate exposure to the customer;
- the viability of the customer's business model and its capability to trade successfully out of financial difficulties and generate sufficient cash flow to service its debt obligations;
- the amount and timing of expected receipts and recoveries;
- the likely dividend available on liquidation or bankruptcy;
- the extent of other creditors' commitments ranking ahead of, or *pari passu* with, the group and the likelihood of other creditors continuing to support the company;
- the complexity of determining the aggregate amount and ranking of all creditor claims and the extent to which legal and insurance uncertainties are evident;
- the realisable value of security (or other credit mitigants) and likelihood of successful repossession;
- the likely deduction of any costs involved in recovery of amounts outstanding;
- the ability of the borrower to obtain, and make payments in, the currency of the loan if not denominated in local currency; and
- when available, the secondary market price of the debt.

Impairment losses are calculated by discounting the expected future cash flows of a loan at its original effective interest rate, and comparing the resultant present value with the loan's current carrying amount. The impairment allowances on individually significant accounts are reviewed at least quarterly, and more regularly when circumstances require. This normally encompasses re-assessment of the enforceability of any collateral held and the timing and amount of actual and anticipated receipts. Individually assessed impairment allowances are only released when there is reasonable and objective evidence of a reduction in the established loss estimate.

Notes on the Financial Statements (continued)

Collectively assessed loans and advances

Impairment is assessed on a collective basis in two circumstances:

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

Incurred but not yet identified impairment

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

The collective impairment allowance is determined after taking into account:

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

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

Homogeneous groups of loans and advances

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

- when appropriate empirical information is available, the group uses roll-rate methodology. This methodology employs statistical analyses of historical data and experience of delinquency and default to estimate the amount of loans that will eventually be written off as a result of the events occurring before the balance sheet date which the group is not able to identify on an individual loan basis, and that can be reliably estimated. Under this methodology, loans are grouped into ranges according to the number of days past due, and statistical analysis is used to estimate the likelihood that loans in each range will progress through the various stages of delinquency and ultimately prove irrecoverable. Current economic conditions are also evaluated when calculating the appropriate level of allowance required to cover inherent loss. The estimated loss is the difference between the present value of expected future cash flows, discounted at the original effective interest rate of the portfolio, and the carrying amount of the portfolio. In certain highly developed markets, sophisticated models also take into account behavioural and account management trends as revealed in, for example, bankruptcy and rescheduling statistics.
- when the portfolio size is small or when information is insufficient or not reliable enough to adopt a roll-rate methodology, the group adopts a basic approach based on historical experience.

In normal circumstances, historical experience provides the most objective and relevant information from which to assess inherent loss within each portfolio, though sometimes it provides less relevant information about the inherent loss in a given portfolio at the balance sheet date, for example, when there have been changes in economic, regulatory or behavioural conditions which result in the most recent trends in portfolio risk factors

Notes on the Financial Statements (continued)

being not fully reflected in the statistical models. In these circumstances, the risk factors are taken into account by adjusting the impairment allowances derived solely from historical loss experience.

These additional portfolio risk factors may include recent loan portfolio growth and product mix, unemployment rates, bankruptcy trends, geographic concentrations, loan product features (such as the ability of borrowers to repay adjustable-rate loans where reset interest rates give rise to increases in interest charges), economic conditions such as national and local trends in housing markets and interest rates, portfolio seasoning, account management policies and practices, current levels of write-offs, changes in laws and regulations and other items which can affect customer payment patterns on outstanding loans, such as natural disasters. These risk factors, where relevant, are taken into account when calculating the appropriate level of impairment allowances by adjusting the impairment allowances derived solely from historical loss experience.

Roll rates, loss rates and the expected timing of future recoveries are regularly benchmarked against actual outcomes to ensure they remain appropriate.

Write-off of loans and advances

Loans (and the related impairment allowance account) are normally written off, either partially or in full, when there is no realistic prospect of recovery. Where loans are secured, this is generally after receipt of any proceeds from the realisation of security. In circumstances where the net realisable value of any collateral has been determined and there is no reasonable expectation of further recovery, write off may be earlier.

Reversals of impairment

If the amount of an impairment loss decreases in a subsequent period, and the decrease can be related objectively to an event occurring after the impairment was recognised, the excess is written back by reducing the loan impairment allowance account accordingly. The write-back is recognised in the income statement.

Reclassified loans and advances

Where financial assets have been reclassified out of the fair value through profit or loss category to the loans and receivables category, the effective interest rate determined at the date of reclassification is used to calculate any impairment losses.

Following reclassification, where there is a subsequent increase in the estimates of future cash receipts as a result of increased recoverability of those cash receipts, the effect of that increase is recognised as an adjustment to the effective interest rate from the date of change in the estimate rather than as an adjustment to the carrying amount of the asset at the date of change in the estimate.

Assets acquired in exchange for loans

Non-financial assets acquired in exchange for loans as part of an orderly realisation are recorded as assets held for sale and reported in 'Other assets' if the carrying amounts of the assets are recovered principally through sale, the assets are available for sale in their present condition and their sale is highly probable. The asset acquired is recorded at the lower of its fair value less costs to sell and the carrying amount of the loan (net of impairment allowance) at the date of exchange. No depreciation is charged in respect of assets held for sale. Any subsequent write-down of the acquired asset to fair value less costs to sell is recognised in the income statement, in 'Other operating income'. Any subsequent increase in the fair value less costs to sell, to the extent this does not exceed the cumulative write down, is also recognised in 'Other operating income', together with any realised gains or losses on disposal.

Renegotiated loans

Loans subject to collective impairment assessment whose terms have been renegotiated are no longer considered past due, but are treated as up to date loans for measurement purposes once the minimum numbers of payments required under the new arrangements have been received. These renegotiated loans are segregated from other parts of the loan portfolio for the purpose of collective impairment assessment, to reflect their risk profile. Loans subject to individual impairment assessment, whose terms have been renegotiated, are subject to ongoing review to determine whether they remain impaired or should be considered past due. The carrying amount of loans that have been classified as renegotiated retain this classification until maturity or derecognition. Interest is recorded on renegotiated loans taking into account the new contractual terms following renegotiation.

Notes on the Financial Statements (continued)

(h) Trading assets and trading liabilities

Treasury bills, debt securities, equity shares, loans, deposits, debt securities in issue, and short positions in securities are classified as held for trading if they have been acquired principally for the purpose of selling or repurchasing in the near term, or they form part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent pattern of short-term profit-taking. These financial assets or financial liabilities are recognised on trade date, when the group enters into contractual arrangements with counterparties to purchase or sell financial instruments, and are normally derecognised when either sold (assets) or extinguished (liabilities). Measurement is initially at fair value, with transaction costs taken to the income statement. Subsequently their fair values are remeasured, and gains and losses from changes therein are recognised in the income statement in 'Net trading income'.

(i) Financial instruments designated at fair value

Financial instruments, other than those held for trading, are classified in this category if they meet one or more of the criteria set out below, and are so designated by management. The group may designate financial instruments at fair value when the designation:

- eliminates or significantly reduces measurement or recognition inconsistencies that would otherwise arise from measuring financial assets or financial liabilities, or recognising gains and losses on them, on different bases. Under this criterion, the main classes of financial instruments designated by the group are:

Long-term debt issues – The interest payable on certain fixed rate long-term debt securities issued has been matched with the interest on 'receive fixed/pay variable' interest rate swaps as part of a documented interest rate risk management strategy. An accounting mismatch would arise if the debt securities issued were accounted for at amortised cost, because the related derivatives are measured at fair value with changes in the fair value recognised in the income statement. By designating the long-term debt at fair value, the movement in the fair value of the long-term debt will also be recognised in the income statement.

Financial assets and financial liabilities under investment contracts – Liabilities to customers under linked contracts are determined based on the fair value of the assets held in the linked funds, with changes recognised in the income statement. If no designation was made for the assets relating to the customer liabilities they would be classified as available-for-sale and the changes in fair value would be recorded directly in other comprehensive income. These financial instruments are managed on a fair value basis and information is provided to management on that basis. Designation at fair value of the financial assets and liabilities under investment contracts allows the changes in fair values to be recorded in the income statement and presented in the same line.

- applies to groups of financial assets, financial liabilities or combinations thereof that are managed, and their performance evaluated, on a fair value basis in accordance with a documented risk management or investment strategy, and where information about the groups of financial instruments is reported to management on that basis. Under this criterion, certain financial assets held to meet liabilities under insurance contracts are the main class of financial instrument so designated. The group has documented risk management and investment strategies designed to manage such assets at fair value, taking into consideration the relationship of assets to liabilities in a way that mitigates market risks. Reports are provided to management on the fair value of the assets. Fair value measurement is also consistent with the regulatory reporting requirements under the appropriate regulations for these insurance operations.
- relates to financial instruments containing one or more embedded derivatives that significantly modify the cash flows resulting from those financial instruments, including certain debt issues and debt securities held.

The fair value designation, once made, is irrevocable. Designated financial assets and financial liabilities are recognised when the group enters into the contractual provisions of the arrangements with counterparties, which is generally on trade date, and are normally derecognised when sold (assets) or extinguished (liabilities). Measurement is initially at fair value, with transaction costs taken directly to the income statement. Subsequently, the fair values are remeasured, and gains and losses from changes therein are recognised in the income statement in 'Net income from financial instruments designated at fair value'.

Notes on the Financial Statements (continued)

(j) Financial investments

Treasury bills, debt securities and equity shares intended to be held on a continuing basis, other than those designated at fair value, are classified as available-for-sale or held-to-maturity. Financial investments are recognised on trade date, when the group enters into contractual arrangements with counterparties to purchase securities, and are normally derecognised when either the securities are sold or the borrowers repay their obligations.

- (i) Available-for-sale financial assets are initially measured at fair value plus direct and incremental transaction costs. They are subsequently remeasured at fair value, and changes therein are recognised in other comprehensive income in “Available-for-sale investments – fair value gains/ (losses)” until the financial assets are either sold or become impaired. When available-for-sale financial assets are sold, cumulative gains or losses previously recognised in other comprehensive income are recognised in the income statement as ‘Gains less losses from financial investments’.

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

At each balance sheet date an assessment is made of whether there is any objective evidence of impairment in the value of a financial asset. Impairment losses are recognised if, and only if, there is objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the financial asset (a ‘loss event’) and that loss event (or events) has an impact on the estimated future cash flows of the financial asset that can be reliably estimated.

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

Impairment losses for available-for-sale debt securities are recognised within ‘Loan impairment charges and other credit risk provision’ in the income statement and impairment losses for available-for-sale equity securities are recognised within ‘Gains less losses from financial investments’ in the income statement. The impairment methodologies for available-for-sale financial assets are set out in more detail below.

- Available-for-sale debt securities: When assessing available-for-sale debt securities for objective evidence of impairment at the reporting date, the group considers all available evidence, including observable data or information about events specifically relating to the securities which may result in a shortfall in recovery of future cash flows. These events may include a significant financial difficulty of the issuer, a breach of contract such as a default, bankruptcy or other financial reorganisation, or the disappearance of an active market for the debt security because of financial difficulties relating to the issuer.

These types of specific event and other factors such as information about the issuers’ liquidity, business and financial risk exposures, levels of and trends in default for similar financial assets, national and local economic trends and conditions, and the fair value of collateral and guarantees may be considered individually, or in combination, to determine if there is objective evidence of impairment of a debt security.

In addition, when assessing available-for-sale asset-backed securities (‘ABS’s) for objective evidence of impairment, the group considers the performance of underlying collateral and the extent and depth of market price declines. Changes in credit ratings are considered but a downgrade of a security’s credit rating is not, of itself, evidence of impairment. The primary indicators of potential impairment are considered to be adverse fair value movements, and the disappearance of an active market for a security.

- Available-for-sale equity securities: Objective evidence of impairment for available-for sale equity securities may include specific information about the issuer as detailed above, but may also include information about significant changes in technology, markets, economics or the law that provides evidence that the cost of the equity securities may not be recovered.

Notes on the Financial Statements (continued)

A significant or prolonged decline in the fair value of the asset below its cost is also objective evidence of impairment. In assessing whether it is significant, the decline in fair value is evaluated against the original cost of the asset at initial recognition. In assessing whether it is prolonged, the decline is evaluated against the period in which the fair value of the asset has been below its original cost at initial recognition.

Once an impairment loss has been recognised on an available-for-sale financial asset, the subsequent accounting treatment for changes in the fair value of that asset differs depending on the nature of the available-for-sale financial asset concerned:

- for an available-for-sale debt security, a subsequent decline in the fair value of the instrument is recognised in the income statement when there is further objective evidence of impairment as a result of further decreases in the estimated future cash flows of the financial asset. Where there is no further objective evidence of impairment, the decline in fair value of the financial asset is recognised in other comprehensive income. If the fair value of the debt security increases in a subsequent period, and the increase can be objectively related to an event occurring after the impairment loss was recognised in the income statement, the impairment loss is reversed through the income statement to the extent of the increase in fair value.
- for an available-for-sale equity security, all subsequent increases in the fair value of the instrument are treated as a revaluation and are recognised directly in other comprehensive income. Impairment losses recognised on the equity security are not reversed through the income statement. Subsequent decreases in the fair value of the available-for-sale equity security are recognised in the income statement, to the extent that further cumulative impairment losses have been incurred in relation to the acquisition cost of the equity security.

(ii) Held-to-maturity investments are non-derivative financial assets with fixed or determinable payments and fixed maturities that the group positively intends, and is able, to hold until maturity. Held-to-maturity investments are initially recorded at fair value plus any directly attributable transaction costs, and are subsequently measured at amortised cost using the effective interest method, less any impairment losses.

(k) Sale and repurchase agreements (including stock lending and borrowing)

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

Securities lending and borrowing transactions are generally secured, with collateral taking the form of securities or cash advanced or received. The transfer of securities to counterparties under these agreements is not normally reflected on the balance sheet. Cash collateral advanced or received is recorded as an asset or a liability respectively.

Securities borrowed are not recognised on the balance sheet. If they are sold on to third parties, an obligation to return the securities is recorded as a trading liability and measured at fair value, and any gains or losses are included in 'Net trading income'.

(l) Derivatives and hedge accounting

Derivatives are recognised initially, and are subsequently remeasured, at fair value. Fair values of exchange-traded derivatives are obtained from quoted market prices. Fair values of over-the-counter derivatives are obtained using valuation techniques, including discounted cash flow models and option pricing models.

Derivatives may be embedded in other financial instruments, for example, a convertible bond with an embedded conversion option. Embedded derivatives are treated as separate derivatives when their economic characteristics and risks are not clearly and closely related to those of the host contract; the terms of the embedded derivative would meet the definition of a stand-alone derivative if they were contained in a separate contract, and the combined contract is not held for trading nor designated at fair value. These embedded derivatives are measured at fair value with changes therein recognised in the income statement.

Notes on the Financial Statements (continued)

Derivatives are classified as assets when their fair value is positive, or as liabilities when their fair value is negative. Derivative assets and liabilities arising from different transactions are offset only if the transactions are with the same counterparty, a legal right of offset exists, and the parties intend to settle the cash flows on a net basis.

The method of recognising fair value gains or losses depends on whether derivatives are held for trading or are designated as hedging instruments, and if the latter, the nature of the risks being hedged. All gains and losses from changes in the fair value of derivatives held for trading are recognised in the income statement. When derivatives are designated as hedges, the group classifies them as either: (i) hedges of the change in fair value of recognised assets or liabilities or firm commitments ('fair value hedges'); (ii) hedges of the variability in highly probable future cash flows attributable to a recognised asset or liability, or a forecast transaction ('cash flow hedges'). Hedge accounting is applied to derivatives designated as hedging instruments in a fair value, cash flow or net investment hedge provided certain criteria are met.

Hedge accounting

At the inception of a hedging relationship, the group documents the relationship between the hedging instruments and hedged items, its risk management objective and its strategy for undertaking the hedge. The group also requires a documented assessment, both at hedge inception and on an ongoing basis, of whether or not the hedging instruments, primarily derivatives, that are used in hedging transactions are highly effective in offsetting the changes attributable to the hedged risks in the fair values or cash flows of the hedged items. Interest on designated qualifying hedges is included in 'Net interest income'.

Fair value hedge

Changes in the fair value of derivatives that are designated and qualify as fair value hedging instruments are recorded in the income statement, along with changes in the fair value of the hedged assets, liabilities or group thereof that are attributable to the hedged risk.

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

Cash flow hedge

The effective portion of changes in the fair value of derivatives that are designated and qualify as cash flow hedges is recognised in other comprehensive income within the "Cash flow hedging reserve". Any gain or loss in fair value relating to an ineffective portion is recognised immediately in the income statement.

The accumulated gains and losses recognised in other comprehensive income are reclassified to the income statement in the periods in which the hedged item will affect profit or loss. However, when the forecast transaction that is hedged results in the recognition of a non-financial asset or a non-financial liability, the gains and losses previously recognised in other comprehensive income are reclassified and removed from equity and included in the initial measurement of the cost of the asset or liability.

When a hedging instrument expires or is sold, or when a hedge no longer meets the criteria for hedge accounting, any cumulative gain or loss existing in other comprehensive income at that time remains separately in equity until the forecast transaction is eventually recognised in the income statement. When a forecast transaction is no longer expected to occur, the cumulative gain or loss that was reported in other comprehensive income is immediately reclassified to the income statement.

Hedge effectiveness testing

To qualify for hedge accounting, the group requires that at the inception of the hedge and throughout its life, each hedge must be expected to be highly effective (prospective effectiveness) and demonstrate actual effectiveness (retrospective effectiveness) on an ongoing basis.

The documentation of each hedging relationship sets out how the effectiveness of the hedge is assessed. The method a group entity adopts for assessing hedge effectiveness will depend on its risk management strategy.

Notes on the Financial Statements (continued)

For prospective effectiveness the hedging instrument must be expected to be highly effective in offsetting changes in fair value or cash flows attributable to the hedged risk during the period for which the hedge is designated. For actual effectiveness to be achieved, the changes in fair value or cash flows must offset each other in the range of 80 per cent to 125 per cent.

Hedge ineffectiveness is recognised in the income statement in 'Net trading income'.

Derivatives that do not qualify for hedge accounting

All gains and losses from changes in the fair values of derivatives that do not qualify for hedge accounting are recognised immediately in the income statement. These gains and losses are reported in 'Net trading income', except where derivatives are managed in conjunction with financial instruments designated at fair value (other than derivatives managed in conjunction with debt securities issued by the group), in which case gains and losses are reported in 'Net income from financial instruments designated at fair value'. The interest on derivatives managed in conjunction with debt securities issued by the group which are designated at fair value is recognised in 'Interest expense'. All other gains and losses on these derivatives are reported in 'Net income from financial instruments designated at fair value'.

(m) Derecognition of financial assets and liabilities

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

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

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

(n) Offsetting financial assets and financial liabilities

Financial assets and financial liabilities are offset and the net amount is reported in the balance sheet when there is a legally enforceable right to offset the recognised amounts and there is an intention to settle on a net basis, or realise the asset and settle the liability simultaneously.

(o) Subsidiaries, associates and joint ventures

The group classifies investments in entities which it controls as subsidiaries. Where the group is a party to a contractual arrangement whereby, together with one or more parties, it undertakes an economic activity that is subject to joint control, the group classifies its interest in the venture as a joint venture. The group classifies investments in entities over which it has significant influence, and that are neither subsidiaries nor joint ventures, as associates. For the purpose of determining this classification, control is considered to be the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities.

The bank's investments in subsidiaries are stated at cost less any impairment losses. An impairment loss recognised in the prior period shall be reversed through profit and loss if, and only if, there has been a change in the estimates used to determine the investment in subsidiary's recoverable amount since the last impairment loss was recognised.

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

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

Notes on the Financial Statements (continued)

(p) Goodwill and intangible assets

- (i) Goodwill arises on the acquisition of subsidiaries, when the aggregate of the fair value of the consideration transferred, the amount of any non-controlling interest and the fair value of any previously held equity interests in the acquiree exceed the amounts of the identifiable assets and liabilities acquired. If they do not exceed the amounts of the identifiable assets and liabilities of an acquired business, the difference is recognised immediately in the income statement. Goodwill arises on the acquisition of interests in joint ventures and associates when the cost of investment exceeds the group's share of the net fair value of the associate's or joint venture's identifiable assets and liabilities.

Intangible assets are recognised separately from goodwill when they are separable or arise from contractual or other legal rights, and their fair value can be measured reliably.

Goodwill is allocated to cash-generating units for the purpose of impairment testing, which is undertaken at the lowest level at which goodwill is monitored for internal management purposes. Impairment testing is performed at least annually, and whenever there is an indication that the cash-generating unit may be impaired, by comparing the recoverable amount from a cash-generating unit with the carrying amount of its net assets, including attributable goodwill. The recoverable amount of an asset is the higher of its fair value less cost to sell and its value in use. Value in use is the present value of the expected future cash flows from a cash-generating unit. If the recoverable amount is less than the carrying value, an impairment loss is charged to the income statement. Goodwill is stated at cost less accumulated impairment losses.

Goodwill on acquisitions of interests in joint ventures and associates is included in 'Interests in associates and joint ventures' and is not tested separately for impairment.

At the date of disposal of a business, attributable goodwill is included in the group's share of net assets in the calculation of the gain or loss on disposal.

- (ii) Intangible assets include the present value of in-force long-term insurance business, computer software, trade names, mortgage service rights, customer lists, core deposit relationships, credit card customer relationships and merchant or other loan relationships. Intangible assets are subject to impairment review if there are events or changes in circumstances that indicate that the carrying amount may not be recoverable. Where:
- intangible assets that have an indefinite useful life, or are not yet ready for use, are tested for impairment annually. This impairment test may be performed at any time during the year, provided it is performed at the same time every year. An intangible asset recognised during the current period is tested before the end of the current year; and
 - intangible assets that have a finite useful life, except for the present value of in-force long-term insurance business, are stated at cost less amortisation and accumulated impairment losses and are amortised over their estimated useful lives. Estimated useful life is the lower of legal duration and expected useful life. The amortisation of mortgage servicing rights is included within 'Net fee income'.

For the accounting policy governing the present value of in-force long-term insurance businesses, see note 2(y).

- (iii) Intangible assets with finite useful lives are amortised, generally on a straight-line basis, over their useful lives as follows:

Trade names	10 years
Mortgage service rights	generally between 5 and 12 years
Internally generated software	between 3 and 5 years
Purchased software	between 3 and 5 years
Customer/merchant relationships	between 3 and 10 years
Other	generally 10 years

(q) Property, plant and equipment

Land and buildings are stated at historical cost, or fair value at the date of transition to IFRSs ('deemed costs'), less any impairment losses and depreciation calculated to write off the assets over their estimated useful lives as follows:

- freehold land is not depreciated;

Notes on the Financial Statements (continued)

- freehold buildings are depreciated at the greater of 2% per annum on a straight-line basis or over their remaining useful lives; and
- leasehold buildings are depreciated over the shorter of their unexpired terms of the leases or over their remaining useful lives.

Equipment, fixtures and fittings (including equipment on operating leases where the group is the lessor) are stated at cost less any impairment losses and depreciation calculated on a straight-line basis to write off the assets over their useful lives, which run to a maximum of 35 years but are generally between 5 years and 20 years.

Property, plant and equipment is subject to an impairment review if there are events or changes in circumstances which indicate that the carrying amount may not be recoverable.

The group holds certain properties as investments to earn rentals or for capital appreciation, or both. Investment properties are included in the balance sheet at fair value with changes therein recognised in the income statement in the period of change. Fair values are determined by independent professional valuers who apply recognised valuation techniques.

(r) Finance and operating leases

Agreements which transfer to counterparties substantially all the risks and rewards incidental to the ownership of assets, but not necessarily legal title, are classified as finance leases. When the group is a lessor under finance leases the amounts due under the leases, after deduction of unearned charges, are included in 'Loans and advances to banks' or 'Loans and advances to customers', as appropriate. The finance income receivable is recognised in 'Net interest income' over the periods of the leases so as to give a constant rate of return on the net investment in the leases.

When the group is a lessee under finance leases, the leased assets are capitalised and included in 'Property, plant and equipment' and the corresponding liability to the lessor is included in 'Other liabilities'. A finance lease and its corresponding liability are recognised initially at the fair value of the asset or, if lower, the present value of the minimum lease payments. Finance charges payable are recognised in 'Net interest income' over the period of the lease based on the interest rate implicit in the lease so as to give a constant rate of interest on the remaining balance of the liability.

All other leases are classified as operating leases. When acting as lessor, the group includes the assets subject to operating leases in 'Property, plant and equipment' and accounts for them accordingly. Impairment losses are recognised to the extent that residual values are not fully recoverable and the carrying value of the assets is thereby impaired. When the group is the lessee, leased assets are not recognised on the balance sheet. Rentals payable and receivable under operating leases are accounted for on a straight-line basis over the periods of the leases and are included in 'General and administrative expenses' and 'Other operating income' respectively.

A sale and leaseback transaction involves the sale of an asset followed by the leasing back of the same asset. The resulting lease is classified either as a finance lease or an operating lease and it is accounted for accordingly. If a sale and leaseback transaction results in the recognition of a finance lease, any excess of sales proceeds over the carrying amount is deferred and amortised over the lease term. If a sale and leaseback transaction results in an operating lease, and it is clear that the transaction is established at fair value, any profit or loss is recognised immediately. If the sale price is below fair value, any profit or loss is recognised immediately except that, if the loss is compensated for by future lease payments below market price, it is deferred and amortised in proportion to the lease payments over the period for which the asset is expected to be used. If the sale price is above fair value, the excess over fair value is deferred and amortised over the period for which the asset is expected to be used.

(s) Income tax

Income tax comprises current tax and deferred tax. Income tax is recognised in the income statement except to the extent that it relates to items recognised in other comprehensive income or directly in equity, in which case it is recognised in the same statement in which the related item appears.

Current tax is the tax expected to be payable on the taxable profit for the year, calculated using tax rates enacted or substantively enacted by the balance sheet date, and any adjustment to tax payable in respect of previous

Notes on the Financial Statements (continued)

years. Current tax assets and liabilities are offset when the group intends to settle on a net basis and the legal right to offset exists.

Deferred tax is recognised on temporary differences between the carrying amounts of assets and liabilities in the balance sheet and the amounts attributed to such assets and liabilities for tax purposes. Deferred tax liabilities are generally recognised for all taxable temporary differences and deferred tax assets are recognised to the extent that it is probable that future taxable profits will be available against which deductible temporary differences can be utilised.

Deferred tax is calculated using the tax rates expected to apply in the periods in which the assets will be realised or the liabilities settled based on tax rates and laws enacted, or substantively enacted, by the balance sheet date. Deferred tax assets and liabilities are offset when they arise in the same tax reporting group and relate to income taxes levied by the same taxation authority, and when the group has a legal right to offset.

Deferred tax relating to actuarial gains and losses on post-employment benefits is recognised directly in other comprehensive income. Deferred tax relating to share-based payment transaction is recognised directly in other comprehensive income to the extent that the amount of the estimated future tax deduction exceeds the amount of the related cumulative remuneration expense. Deferred tax relating to fair value remeasurement of available-for-sale investments and cash flow hedging instruments which are charged or credited directly to other comprehensive income, is also credited or charged directly to other comprehensive income and is subsequently recognised in the income statement when the deferred fair value gain or loss is recognised in the income statement.

(t) Pension and other post-employment benefits

The group operates a number of pension and other post-employment benefit plans. These plans include both defined benefit and defined contribution plans and various other post-employment benefits such as post-employment healthcare.

Payments to defined contribution plans and state-managed retirement benefit plans, where the group's obligations under the plans are equivalent to a defined contribution plan, are charged as an expense as they fall due.

The defined benefit pension costs and the present value of defined benefit obligations are calculated at the reporting date by the scheme's actuaries using the Projected Unit Credit Method. The net charge to the income statement mainly comprises the current service cost, plus the unwinding of the discount rate on plan liabilities, less the expected return on plan assets, and is presented in operating expenses. Past service costs are charged immediately to the income statement to the extent that the benefits have vested, and are otherwise recognised on a straight-line basis over the average period until the benefits vest. Actuarial gains and losses comprise experience adjustments (the effects of differences between the previous actuarial assumptions and what has actually occurred), as well as the effects of changes in actuarial assumptions. Actuarial gains and losses are recognised in other comprehensive income in the period in which they arise.

The defined benefit liability recognised in the balance sheet represents the present value of defined benefit obligations adjusted for unrecognised past service costs and reduced by the fair value of plan assets. Any net defined benefit surplus is limited to unrecognised past service costs plus the present value of available refunds and reductions in future contributions to the plan.

The costs of obligations arising from other defined post-employment benefits plans, such as defined benefit health-care plans, are accounted for on the same basis as defined benefit pension plans.

(u) Share-based payments

The cost of share-based payment arrangements with employees is measured by reference to the fair value of equity instruments on the date they are granted, and recognised as an expense on a straight-line basis over the vesting period, with a corresponding credit to 'Retained Earnings'. The vesting period is the period during which all the specified vesting conditions of a share-based payment arrangement are to be satisfied. The fair value of equity instruments that are made available immediately, with no vesting period attached to the award, are expensed immediately.

Fair value is determined by using appropriate valuation models, taking into account the terms and conditions upon which the equity instruments were granted. Vesting conditions include service conditions and performance

Notes on the Financial Statements (continued)

conditions. Market performance conditions are taken into account when estimating the fair value of equity instruments at the date of grant, so that an award is treated as vesting irrespective of whether the market performance condition or non-vesting condition is satisfied, provided all other conditions are satisfied.

Vesting conditions, other than market performance conditions, are not taken into account in the initial estimate of the fair value at the grant date. They are taken into account by adjusting the number of equity instruments included in the measurement of the transaction, so that the amount recognised for services received as consideration for the equity instruments granted shall be based on the number of equity instruments that eventually vest. On a cumulative basis, no expense is recognised for equity instruments that do not vest because of a failure to satisfy non-market performance or service conditions.

Where an award has been modified, as a minimum, the expense of the original award continues to be recognised as if it had not been modified. Where the effect of a modification is to increase the fair value of an award or increase the number of equity instruments, the incremental fair value of the award or incremental fair value of liabilities are measured at the higher of the initial fair value, less cumulative amortisation, and the best estimate of the expenditure required to settle the obligation.

A cancellation that occurs during the vesting period is treated as an acceleration of vesting, and recognised immediately for the amount that would otherwise have been recognised for services over the vesting period.

HSBC Holdings is the grantor of its equity instrument for all share awards and share options across the group. The credit to 'Retained earnings' on expensing an award represents the effective capital contribution from HSBC Holdings. To the extent the group will be, or has been, required to fund a share-based payment arrangement, this capital contribution is reduced and the fair value of shares expected to be released to employees is recorded within 'Other liabilities'.

(v) Foreign currencies

Items included in the financial statements of each of the group's entities are measured using the currency of the primary economic environment in which the entity operates ('the functional currency').

Transactions in foreign currencies are recorded in the functional currency at the rate of exchange prevailing on the date of the transaction. Monetary assets and liabilities denominated in foreign currencies are translated into the functional currency at the rate of exchange ruling at the balance sheet date. Any resulting exchange differences are included in the income statement. Non-monetary assets and liabilities that are measured at historical cost in a foreign currency are translated into the functional currency using the rate of exchange at the date of the initial transaction. Non-monetary assets and liabilities measured at fair value in a foreign currency are translated into the functional currency using the rate of exchange at the date the fair value was determined. Any exchange component of a gain or loss on a non-monetary item is recognised in other comprehensive income if the gain or loss on the non-monetary item is recognised in other comprehensive income. Any exchange component of a gain or loss on a non-monetary item is recognised in the income statement if the gain or loss on the non-monetary item is recognised in the income statement.

In the consolidated financial statements, the assets, including related goodwill where applicable, and liabilities of branches, subsidiaries, joint ventures and associates whose functional currency is not sterling, are translated into the group's presentational currency at the rate of exchange ruling at the balance sheet date. The results of branches, subsidiaries, joint ventures and associates whose function currency is not sterling are translated into sterling at the average rates of exchange for the reporting period. Exchange differences arising from the retranslation of opening foreign currency net investments, and exchange differences arising from retranslation of the result for the reporting period from the average rate to the exchange rate prevailing at the period end, are recognised in other comprehensive income. Exchange differences on a monetary item that is part of a net investment in a foreign operation are recognised in the income statement of the separate financial statements. In consolidated financial statements these exchange differences are recognised in other comprehensive income. On disposal of a foreign operation, exchange differences relating thereto and previously recognised in other comprehensive income are recognised in the income statement.

(w) Provisions

Provisions are recognised when it is probable that an outflow of economic benefits will be required to settle a current legal or constructive obligation, which has arisen as a result of past events, and for which a reliable estimate can be made of the amount of the obligation.

Notes on the Financial Statements (continued)

Contingent liabilities, which include certain guarantees and letters of credit pledged as collateral security, are possible obligations that arise from past events whose existence will be confirmed only by the occurrence, or non-occurrence, of one or more uncertain future events not wholly within the control of the group; or are present obligations that have arisen from past events but are not recognised because it not probable that settlement will require outflow of economic benefits, or because the amount of the obligations cannot be reliably measured. Contingent liabilities are not recognised in the financial statements but are disclosed unless the probability of settlement is remote.

(x) Financial guarantee contracts

Liabilities under financial guarantee contracts not classified as insurance contracts are recorded initially at their fair value, which is generally the fee received or receivable. Subsequently, the financial guarantee liabilities are measured at the higher of the initial fair value, less cumulative amortisation, and the best estimate of the expenditure required to settle the obligations.

The group has issued financial guarantees and similar contract to other group entities. Where it has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting applicable to insurance contracts, the group may elect to account for guarantees as insurance contracts. This election is made on a contract by contract basis, but the election for each contract is irrevocable. Where these guarantees have been classified as insurance contracts, they are measured and recognised as insurance liabilities.

Where the group is the recipient of a guarantee, including from other HSBC Group companies, amounts receivable under a claim are recognised when their receipt is virtually certain. Any fees payable to the guarantor are expensed over the period of the guarantee contract.

(y) Insurance contracts

Through its insurance subsidiaries, the group issues contracts to customers that contain insurance risk, financial risk or a combination thereof. A contract under which the group accepts significant insurance risk from another party by agreeing to compensate that party on the occurrence of a specified uncertain future event is classified as an insurance contract. An insurance contract may also transfer financial risk, but is accounted for as an insurance contract if the insurance risk is significant. While investment contracts with discretionary participation features are financial instruments, they continue to be treated as insurance contracts as permitted by IFRS 4.

Insurance contracts are accounted for as follows:

Premiums

Gross insurance premiums for non-life insurance business are reported as income over the term of the insurance contract based on the proportion of risks borne during the accounting period. The unearned premium (the proportion of the business underwritten in the accounting year relating to the period of risk after the balance sheet date) is calculated on a daily or monthly pro rata basis.

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

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

Claims and reinsurance recoveries

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

Gross insurance claims for life insurance contracts reflect the total cost of claims arising during the year, including claim handling costs and any policyholder bonuses allocated in anticipation of a bonus declaration. Claims arising in the year include maturities, surrenders and death claims.

Maturity claims are recognised when due for payment. Surrenders are recognised when paid or at an earlier date on which, following notification, the policy ceases to be included within the calculation of the related insurance liabilities. Death claims are recognised when notified.

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

Notes on the Financial Statements (continued)

Liabilities under insurance contracts

Outstanding claims liabilities for non-life insurance contracts are based on the estimated ultimate cost of all claims incurred but not settled at the balance sheet date, whether reported or not, together with related claim-handling costs and a reduction for the expected value of salvage and other recoveries. Liabilities for claims incurred but not reported are made on an estimated basis, using appropriate statistical techniques.

Liabilities under non-linked life insurance contracts are calculated by each life insurance operation based on local actuarial principles.

Liabilities under unit-linked life insurance contracts are at least equivalent to the surrender or transfer value which is calculated by reference to the value of the relevant underlying funds or indices.

A liability adequacy test is carried out on insurance liabilities to ensure that the carrying amount of the liabilities is sufficient in the light of current estimates of future cash flows. When performing the liability adequacy test, all contractual cash flows are discounted and compared with the carrying value of the liability. When a shortfall is identified it is charged immediately to the income statement.

Present value of in-force long-term insurance business

The value placed on insurance contracts that are classified as long-term insurance business or long term investment contracts with discretionary participating features (“DPF”) and are in force at the balance sheet date is recognised as an asset. The asset represents the present value of the equity holders’ interest in the profits expected to emerge from these contracts written at the balance sheet date.

The present value of in-force long-term insurance business and long term investment contracts with DPF, referred to as ‘PVIF’, is determined by discounting the equity holders’ interest in future profits expected to emerge from business currently in force using appropriate assumptions in assessing factors such as future mortality, lapse rates and levels of expenses and a risk discount rate that reflects the risk premium attributable to the respective contracts. The PVIF incorporates allowances for both non-market risk and the value of financial options and guarantees. The PVIF asset is presented gross of attributable tax in the balance sheet and movements in the PVIF asset are included in “Other operating income’ on a gross of tax basis.

Future profit participation

Where contracts provide discretionary profit participation benefits to policyholders, liabilities for these contracts include provisions for the future discretionary benefits to policyholders. These provisions reflect actual performance of the investment portfolio to date and management expectation on the future performance in connection with the assets backing the contracts, as well as other experience factors such as mortality, lapses and operational efficiency, where appropriate. This benefit may arise from the contractual terms, regulation, or past distribution policy.

In the case of net unrealised investment gain on contracts whose discretionary benefit principally reflect the actual performance of the portfolio, the corresponding increase in the liabilities is recognised in either the income statement or other comprehensive income, following the treatment of the unrealised gains on the relevant assets. In the case of net unrealised losses, a deferred participating asset is recognised only to the extent that its recoverability is highly probable. Movement in the liabilities arising from realised gains and losses on relevant assets are recognised in the income statement.

Investment contracts

Customer liabilities under linked and certain non-linked investment contracts and the corresponding financial assets are designated at fair value. Movements in fair value are recognised in ‘Net expense/income from financial instruments designated at fair value’. Premiums receivable and amounts withdrawn are accounted for as increases or decreases in the liability recorded in respect of investment contracts.

Liabilities under linked investment contracts are at least equivalent to the surrender or transfer value which is calculated by reference to the value of the relevant underlying funds or indices.

Investment management fees receivable are recognised in the income statement over the period of the provision of the investment management services, in ‘Net fee income’.

Notes on the Financial Statements (continued)

The incremental costs directly related to the acquisition of new investment contracts or renewing existing investment contracts are deferred and amortised over the period during which the investment management services are provided.

(z) Debt securities in issue and deposits by customers and banks

Financial liabilities are recognised when the group enters into the contractual provisions of the arrangements with counterparties, which is generally on trade date, and initially measured at fair value, which is normally the proceeds received net of directly attributable transaction costs incurred. Subsequent measurement of financial liabilities, other than those measured at fair value through profit or loss and financial guarantees, is at amortised cost, using the effective interest rate method to amortise the difference between proceeds received, net of directly attributable transaction costs incurred, and the redemption amount over the expected life of the instrument.

(aa) Share capital and other equity instruments

Shares are classified as equity when there is no contractual obligation to transfer cash or other financial assets. Incremental costs directly attributable to the issue of equity instruments are shown in equity as a deduction from the proceeds, net of tax.

(bb) Cash and cash equivalents

For the purpose of the cash flow statement, cash and cash equivalents include highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of change in value. Such investments are normally those with less than three months' maturity from the date of acquisition, and include cash and balances at central banks, treasury bills and other eligible bills, loans and advances to banks, items in the course of collection from or in transmission to other banks and certificates of deposit.

3 Critical accounting policies

The results of the group are sensitive to the accounting policies, assumptions and estimates that underlie the preparation of its consolidated financial statements. The accounting policies used in the preparation of the consolidated financial statements are described in detail in Note 2.

When preparing the financial statements, it is the Directors' responsibility under UK company law to select suitable accounting policies and to make judgements and estimates that are reasonable and prudent.

The accounting policies that are deemed critical to the group's results and financial position, in terms of the materiality of the items to which the policy is applied, or which involve a high degree of judgement including the use of assumptions and estimation, are disclosed below:

Impairment of loans and advances

The group's accounting policy for losses arising from the impairment of customer loans and advances is described in Note 2(g). Further information can be found in the Report of the Directors: Risk (Credit Risk). Loan impairment allowances represent management's best estimate of losses incurred in the loan portfolios at balance sheet date.

Management is required to exercise judgement in making assumptions and estimations when calculating loan impairment allowances on both individually and collectively assessed loans and advances. The most significant judgemental area is the calculation of collective impairment allowances.

The methods used to calculate collective impairment allowances on homogeneous groups of loans that are not considered individually significant are disclosed in Note 2(g). They are subject to estimation uncertainty, in part because it is not practicable to identify losses on an individual loan basis because of the large number of individually insignificant loans in the portfolio.

The method involve the use of statistically assessed historical information is supplemented with significant management judgement to assess whether current economic and credit conditions are such that the actual level of inherent losses is likely to be greater or less than that suggested by historical experience. In normal circumstances, historical experience provides the most objective and relevant information from which to assess inherent loss within each portfolio. In certain circumstances, historical loss experience provides less relevant information about the inherent loss in a given portfolio at the balance sheet date, for example, where there have been changes in economic,

Notes on the Financial Statements (continued)

regulatory or behavioural conditions such that the most recent trends in the portfolio risk factors are not fully reflected in the statistical models. In these circumstances, such risk factors are taken into account when calculating the appropriate levels of impairment allowances, by adjusting the impairment allowances derived solely from historical loss experience.

Risk factors include loan portfolio growth, product mix, unemployment rates, bankruptcy trends, geographic concentrations, loan product features, economic conditions such as national and local trends in housing markets, the level of interest rates, portfolio seasoning, account management policies and practices, changes in laws and regulations, and other factors that can affect customer payment patterns. Different factors are applied in different regions and countries to reflect different economic conditions and laws and regulations. The methodology and the assumptions used in calculating impairment losses are reviewed regularly in the light of differences between loss estimates and actual loss experience. For example, roll rates, loss rates and the expected timing of future recoveries are regularly benchmarked against actual outcomes to ensure they remain appropriate.

However, the exercise of judgement requires the use of assumptions which are highly sensitive to the risk factors, in particular, to changes in economic and credit conditions across geographical areas. Many of the factors have a high degree of interdependency and there is no one single factor to which the group's loan impairment allowances as a whole are sensitive. It is possible that the outcomes within the next financial year could be different from the assumptions built into the models, resulting in a material adjustment to the carrying amount of loans and advances.

Goodwill impairment

The group's accounting policy for goodwill is described in Note 2(p). The review of goodwill impairment represents management's best estimate of the factors below:

- the future cash flows of the cash-generating units ('CGUs') are sensitive to the cash flows projected for the periods for which detailed forecasts are available, and to assumptions regarding the long-term pattern of sustainable cash flows thereafter. Forecasts are compared with actual performance and verifiable economic data, but they necessarily and appropriately reflect management's view of future business prospects at the time of the assessment; and
- the discount rate used to discount the future expected cash flows is based on the cost of capital assigned to an individual CGU, and can have a significant effect on their valuation. The cost of capital percentage is generally derived from a Capital Asset Pricing Model, which incorporates inputs reflecting a number of financial and economic variables, including the risk-free interest rate in the country concerned and a premium for the inherent risk of the business being evaluated. These variables are subject to fluctuations in external market rates and economic conditions beyond management's control and are therefore require the exercise of significant management judgment and are consequently subject to uncertainty.

A decline in a CGU's expected cash flows and/ or an increase in its cost of capital reduces the CGU'S estimated recoverable amount. If this is lower than the carrying value of the CGU, a charge for impairment of goodwill is recognised in the income statement for the year.

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

Management reviewed the current and expected performance of the CGUs as at 31 December 2010 and determined that there was no indication of potential impairment of the goodwill allocated to the CGUs. However, in the event of further significant deterioration in the economic and credit conditions beyond the levels already reflected by management in the cash flow forecasts for the CGUs, a material adjustment to a CGU's recoverable amount may occur which may result in the recognition of an impairment charge in the income statement.

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

Valuation of financial instruments

The group's accounting policy for valuation of financial instruments is described in Note 2(d) on the Financial Statement. The best evidence of fair value is a quoted price in an actively traded market. In the event that the market

Notes on the Financial Statements (continued)

for a financial instrument is not active, a valuation technique is used. The majority of valuation techniques employ only observable market data, and so the reliability of the fair value measurement is high. However, certain financial instruments are valued on the basis of valuation techniques that feature one or more significant market inputs that are unobservable. Valuation techniques that rely to a greater extent on unobservable inputs require a higher level of management judgement to calculate a fair value than those based wholly on observable inputs.

Valuation techniques used to calculate fair values are discussed in Note 31. The main assumptions and estimates which management considers when applying a model with valuation techniques are:

- the likelihood and expected timing of future cash flows on the instrument. These cash flows are usually governed by the terms of the instrument, although management judgment may be required when the ability of the counterparty to service the instrument in accordance with the contractual terms is in doubt. Future cash flows may be sensitive to changes in market rates; selecting an appropriate discount rate for the instrument. Management bases the determination of this rate on its assessment of what a market participant would regard as the appropriate spread of the rate for the instrument over the appropriate risk-free rate; and
- judgment to determine what model to use to calculate fair value in areas where the choice of valuation model is particularly subjective, for example, when valuing complex derivative products.

When applying a model with unobservable inputs, estimates are made to reflect uncertainties in fair values resulting from a lack of market data inputs, for example, as a result of illiquidity in the market. For these instruments, the fair value measurement is less reliable. Inputs into valuations based on unobservable data are inherently uncertain because there are little or no current market data available from which to determine the level at which an arm's length transaction would occur under normal business conditions. However, in most cases there are some market data available on which to base a determination of fair value, for example historical data, and the fair values of most financial instruments will be based on some market observable inputs even where the unobservable inputs are significant.

Disclosure of types and amounts of fair value adjustments made in determining the fair value of financial instruments measured at fair value using valuation techniques is provided in Note 31. In addition a sensitivity analysis of fair value for financial instruments with significant unobservable inputs to reasonably possibly alternative assumption and a range of assumption can be found in Note 31. Given the uncertainty and subjective nature of valuing financial instruments at fair value, it is possible that the outcomes within the next financial year could differ from the assumptions used, and this would result in a material adjustment to the carrying amount of financial instruments measured at fair value.

Impairment of available-for-sale financial assets

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

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

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

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

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

Notes on the Financial Statements (continued)

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

Pensions

The group's accounting policy for pension and other post-employment benefits is described in Note 2(t) on the Financial Statements.

The most significant judgments in measuring the present value of defined benefit obligations relate to the determination of actuarial and financial assumptions. These assumptions include the nominal discount rate, rate of inflation over the period of projected cash flows and member longevity. Management reviews these assumptions in conjunction with its actuarial advisors and benchmarks its conclusions against market practice.

Judgment is also required in selecting the expected rate of return on plan assets which determines the net expense recognised. The expected rate of return on plan assets represents the best estimate of long-term future asset returns, which takes into account historical market returns plus additional factors such as the current rate of inflation and interest rates. The expected rates of return are weighted on the basis of the fair value of the plan assets.

The key assumptions used, and the sensitivity to changes in these assumptions, are disclosed in Note 7 Employee compensation and benefits. It is reasonably possible that asset returns in the next financial year, and the actuarial and financial assumptions determined at the end of the next year, are significantly different to these assumptions. This could result in the group recording material actuarial gains or losses in the next financial year.

Notes on the Financial Statements (continued)

4 Net earned insurance premiums

	Non-life insurance £m	Life insurance (non-linked) £m	Life insurance (linked) £m	Investment contracts with discretionary participation features £m	Total £m
2010					
Gross written premiums	113	339	257	1,910	2,619
Movement in unearned premiums	93	78	–	–	171
Gross earned premiums	206	417	257	1,910	2,790
Gross written premiums ceded to reinsurers	(5)	(125)	(5)	–	(135)
Reinsurers' share of movement in unearned premiums	(5)	(15)	–	–	(20)
Reinsurers' share of gross earned premiums	(10)	(140)	(5)	–	(155)
Net earned insurance premiums	196	277	252	1,910	2,635
2009					
Gross written premiums	275	551	198	1,784	2,808
Movement in unearned premiums	143	(43)	–	–	100
Gross earned premiums	418	508	198	1,784	2,908
Gross written premiums ceded to reinsurers	(43)	(134)	(6)	–	(183)
Reinsurers' share of movement in unearned premiums	(10)	1	–	–	(9)
Reinsurers' share of gross earned premiums	(53)	(133)	(6)	–	(192)
Net earned insurance premiums	365	375	192	1,784	2,716

5 Net insurance claims incurred and movement in liabilities to policyholders

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

Notes on the Financial Statements (continued)

	Non-life insurance £m	Life insurance (non-linked) £m	Life insurance (linked) £m	Investment contracts with discretionary participation features £m	Total £m
2009					
Claims, benefits and surrenders paid	358	802	134	1,154	2,448
Movement in liabilities	159	(561)	266	1,331	1,195
Gross claims incurred and movement in liabilities	517	241	400	2,485	3,643
Reinsurers' share of claims, benefits and surrenders paid	(45)	(79)	(5)	–	(129)
Reinsurers' share of movement in liabilities	1	35	(10)	–	26
Reinsurers' share of claims incurred and movement in liabilities	(44)	(44)	(15)	–	(103)
Net insurance claims incurred and movement in liabilities to policyholders	473	197	385	2,485	3,540

6 Net operating income

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

	2010 £m	2009 £m
Income		
Interest recognised on impaired financial assets	39	53
Fees earned on financial assets or liabilities not held for trading nor designated at fair value, other than fees included in effective interest rate calculations on these types of assets and liabilities	2,926	3,065
Fees earned on trust and other fiduciary activities where the group holds or invests assets on behalf of its customers	730	684
Expense		
Interest on financial instruments, excluding interest on financial liabilities held for trading or designated at fair value	3,158	4,325
Fees payable on financial assets or liabilities not held for trading nor designated at fair value, other than fees included in effective interest rate calculations on these types of assets and liabilities	536	614
Fees payable on trust and other fiduciary activities where the group holds or invests assets on behalf of its customers	2	2
Gains/(losses)		
(Loss)/gain on disposal of assets held for sale	–	(11)
Impairment of available-for-sale equity shares	(8)	(164)
Gain on disposal or settlement of loans and advances	34	8
Gain on financial liabilities measured at amortised cost	(1)	110
Gains on disposal of property, plant and equipment, intangible assets and non-financial investments:		
– Gain on disposal of HSBC Asset Finance (UK) Ltd Rail subsidiaries	163	–
– Gain on disposal of HSBC France headquarters	125	–
– Gain on disposal of HSBC Merchant Services LLP	–	180
– Gain on disposal of 8 Canada Square	–	353
– Other	89	33
Loan impairment charge and other credit risk provisions		
Net impairment charge on loans and advances	(1,633)	(2,619)
Net impairment of available-for-sale debt securities	(317)	(745)
Net impairment in respect of other credit risk provisions	(1)	–
	(1,951)	(3,364)

Notes on the Financial Statements (continued)

7 Employee compensation and benefits

Total employee compensation

	2010 £m	2009 £m
Wages and salaries.....	3,804	3,853
Social security costs	535	542
Post-employment benefits	404	57
One-off bonus tax	218	–
	<u>4,961</u>	<u>4,452</u>

Average number of persons employed by the group during the year¹

	2010	2009
UK Retail	40,110	41,969
Continental Europe Retail	15,157	17,827
Global Banking and Markets	9,764	10,597
Private Banking	5,604	5,436
Other ¹	7,297	6,467
Total	<u>77,932</u>	<u>82,296</u>

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

In December 2009, the governments of the UK and France introduced one-off taxes in respect of certain bonuses payable by banks and banking groups. In both countries the tax was levied at 50 per cent on bonuses awarded during a certain period and over a threshold amount. The taxes were liabilities of the employer and were payable on awards of both cash and shares. The amount payable and paid in 2010 in respect of the relevant taxes was £218 million (£191 million in the UK and £27 million in France).

Post-employment benefit plans

Income statement charge

	2010 £m	2009 £m
Defined benefit pension plans		
– HSBC Bank (UK) Pension Scheme	200	(116)
– Other plans	32	31
Defined contribution pension plans	165	136
	<u>397</u>	<u>51</u>
Defined benefit healthcare plans	7	6
	<u>404</u>	<u>57</u>

Notes on the Financial Statements (continued)

Defined benefit post-employment benefit plans

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

	2010 £m	2009 £m
Defined benefit pension plans	(569)	(2,525)
– HSBC Bank (UK) Pension Scheme	(395)	(2,354)
Fair value of plan assets	14,317	10,908
Present value of defined benefit obligations.....	(14,712)	(13,262)
– Other plans	(174)	(171)
Fair value of plan assets	738	649
Present value of defined benefit obligations	(912)	(805)
Effect of limit on plan surpluses	(5)	(21)
Unrecognised past service cost	5	6
Defined benefit healthcare plans	(164)	(153)
Fair value of plan assets	–	–
Present value of defined benefit obligations	(164)	(153)
Unrecognised past service cost	–	–
Fair value of plan assets	15,055	11,557
Present value of defined benefit obligations	(15,788)	(14,220)
Effect of limit on plan surpluses	(5)	(21)
Unrecognised past service cost	5	6
	(733)	(2,678)

Pension plans

The extant plans are funded defined benefit plans with assets held in trust or similar funds separate from the group. The plans are reviewed at least annually or in accordance with local practice and regulations by qualified actuaries. The actuarial assumptions used to calculate the defined benefit obligations and related current service costs vary according to the economic conditions of the countries in which the plans are situated.

Defined benefit pension arrangements for bank employees who are members of defined benefit pension plans, as well as certain other employees of the group and HSBC, are provided principally by the HSBC Bank (UK) Pension Scheme (the ‘Scheme’), the assets of which are held in a separate trust fund. The Pension Scheme is administered by a corporate trustee, HSBC Bank Pension Trust (UK) Limited (the ‘Trustee’), whose Board is comprised of 13 Directors, four of whom are elected by employees and two by pensioners. The Trustee Directors of the Pension Scheme are required to act in the best interest of the Scheme’s beneficiaries.

Healthcare benefit plans

The group provides post-employment healthcare benefits under plans in the United Kingdom, which are unfunded. Post-employment healthcare benefit plans are accounted for in the same manner as pension plans. The plans are reviewed at least annually or in accordance with local practice and regulations by qualified actuaries. The actuarial assumptions used to calculate the defined benefit obligation and related current service cost vary according to the economic conditions of the countries in which they are situated. The group’s total healthcare cost for the year was £7 million (2009: £6 million).

Post-employment defined benefit plans’ principal actuarial assumptions

The principal actuarial financial assumptions used to calculate the group’s obligations under its defined benefit pension and post-employment healthcare plans at 31 December 2010 were as follows. These assumptions will also form the basis for measuring periodic costs under the plans in 2011:

	Discount rate %	Inflation rate %	Rate of increase for pensions in payment and deferred pensions %	Deferred revaluation %	Rate of pay increase %	Healthcare cost trend rates %
UK	5.40	3.70	3.50	3.70	4.20	7.70
France	4.75	2.00	2.00	2.00	3.00	n/a
Switzerland	2.60	1.50	n/a	n/a	2.50	n/a
Germany	5.00	2.00	2.00	2.00	3.00	n/a

Notes on the Financial Statements (continued)

The principal actuarial financial assumptions used to calculate the group's obligations under its defined benefit pension and post-employment healthcare plans at 31 December 2009, were as follows. These assumptions also formed the basis for measuring periodic costs under the plans in 2010:

	Discount rate	Inflation rate	Rate of increase for pensions in payment and deferred pensions	Deferred revaluation	Rate of pay increase	Healthcare cost trend rates
	%	%	%	%	%	%
UK	5.70	3.70	3.50	3.70	4.20	7.70
France	5.50	2.00	2.00	2.00	3.00	n/a
Switzerland	3.25	1.50	n/a	n/a	2.50	n/a
Germany	5.50	2.00	2.00	2.00	3.00	n/a

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

The mortality tables and average life expectancy at 65 used at 31 December 2010 were as follows:

Mortality table	Life expectancy at age 65 for a male member currently:		Life expectancy at age 65 for a female member currently:	
	Aged 65	Aged 45	Aged 65	Aged 45
	UKSAPS MC ¹	22.4	24.3	23.4
FranceTG 05	23.4	26.1	26.8	29.7
SwitzerlandBVG 2005	17.9	17.9	21.0	21.0
GermanyHeubeck 2005 G	18.4	21.1	22.5	25.1

¹ Adjusted SAPS MC with medium cohort improvements and a 1 per cent minimum annual improvement. Light table with 1.08 rating for male pensioners and standard table with 1.06 rating for female pensioners. (Standard table with 1.08 rating for male dependants and light table with 1.10 rating for female dependants.)

The mortality tables and average life expectancy at 65 used at 31 December 2009 were as follows:

Mortality table	Life expectancy at age 65 for a male member currently:		Life expectancy at age 65 for a female member currently:	
	Aged 65	Aged 45	Aged 65	Aged 45
	UKSAPS MC ¹	22.3	24.2	23.3
FranceTG 05	23.2	26.0	26.7	29.6
SwitzerlandBVG 2005	17.9	17.9	21.0	21.0
GermanyHeubeck 2005 G	18.3	21.0	22.4	25.0

¹ Adjusted SAPS MC with medium cohort improvements and a 1 per cent minimum annual improvement

Actuarial assumption sensitivities

The discount rate is sensitive to changes in market conditions arising during the reporting period. The mortality rates used are sensitive to experience from the plan member profile. The following table shows the effect of changes in these and the other key assumptions on the principal plan:

Notes on the Financial Statements (continued)

	HSBC Bank(UK) Pension Scheme	
	2010 £m	2009 £m
Discount rate		
Change in pension obligation at year end from a 25bps increase	(606)	(542)
Change in pension obligation at year end from a 25bps decrease	646	583
Change in following year pension cost from a 25bps increase	(6)	(8)
Change in following year pension cost from a 25bps decrease	6	8
Rate of inflation		
Change in pension obligation at year end from a 25bps increase	663	594
Change in pension obligation at year end from a 25bps decrease	(630)	(559)
Change in following year pension cost from a 25bps increase	43	40
Change in following year pension cost from a 25bps decrease	(41)	(39)
Rate of increase for pensions in payment and deferred revaluation		
Change in pension obligation at year end from a 25bps increase	524	493
Change in pension obligation at year end from a 25bps decrease	(499)	(472)
Change in following year pension cost from a 25bps increase	31	31
Change in following year pension cost from a 25bps decrease	(29)	(30)
Rate of pay increase		
Change in pension obligation at year end from a 25bps increase	139	120
Change in pension obligation at year end from a 25bps decrease	(131)	(107)
Change in following year pension cost from a 25bps increase	13	11
Change in following year pension cost from a 25bps decrease	(11)	(10)
Investment return		
Change in following year pension cost from a 25bps increase.....	(35)	(27)
Change in following year pension cost from a 25bps decrease.....	35	27
Mortality		
Change in pension obligation from each additional year of longevity assumed	320	300

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

	Other Plans	
	2010 £m	2009 £m
Increase in pension obligation from each additional year of longevity assumed	15	12

Defined benefit pension plans

Value recognised on the balance sheet

	HSBC Bank (UK) Pension Scheme			
	2010		2009	
	Expected rates of return %	Value £m	Expected rates of return %	Value £m
Fair value of plan assets		14,317		10,908
Equities	8.4	2,200	8.4	1,707
Bonds	5.3	10,067	5.3	7,762
Property	7.6	926	7.7	926
Other	4.0	1,124	5.3	513
Defined benefit obligation (funded)		(14,712)		(13,262)
Net liability ¹		(395)		(2,354)

Notes on the Financial Statements (continued)

	Other plans			
	2010		2009	
	Expected rates of return ² %	Value £m	Expected rates of return ² %	Value £m
Fair value of plan assets		738		649
Equities	7.2	239	7.4	216
Bonds	3.7	305	4.0	312
Property	5.2	30	5.4	16
Other	5.3	164	4.6	105
Defined benefit obligation		(912)		(805)
Present value of funded obligations		(797)		(681)
Present value of unfunded obligations		(115)		(124)
Effect of limit on plan surpluses		(5)		(21)
Unrecognised past service cost		5		6
Net liability ¹		(174)		(171)

1 £411 million of the net liability for defined benefit pension plans relates to the bank (2009: £2,371 million).

2 The expected rates of return are weighted on the basis of the fair value of the plan assets.

The principal plan has entered into derivative transactions with the bank to manage the risks arising from its portfolio. These derivatives comprise interest rate (London Interbank Offered Rate – ‘LIBOR’) swaps and inflation (UK Retail Prices Index – ‘RPI’) swaps. Under the terms of these swaps, the plan is committed to making LIBOR-related interest payments in exchange for cash flows paid into the Scheme based on a projection of the future benefit payments to the Scheme members. Further details of these swap arrangements are included in Note 41 ‘Related party transactions’.

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

Notes on the Financial Statements (continued)

	2010		2009	
	HSBC Bank (UK) Pension Scheme	Other plans	HSBC Bank (UK) Pension Scheme	Other plans
	£m	£m	£m	£m
<i>Fair value of plan assets</i>				
At 1 January	10,908	649	10,191	617
Expected return on plan assets	706	32	613	30
Normal contributions by the group	173	52	236	22
Special contributions by the group	1,760	–	–	–
Contributions by employees	15	9	3	9
Experience gains/(losses)	1,150	(4)	424	41
Benefits paid	(483)	(26)	(559)	(33)
Assets distributed on settlements	–	(7)	–	–
Transfers	88	(7)	–	–
Exchange differences	–	40	–	(37)
At 31 December	14,317	738	10,908	649
<i>Present value of defined benefit obligations</i>				
At 1 January	13,262	805	10,460	889
Current service cost	163	30	168	31
Interest cost	743	31	651	32
Contributions by employees	15	9	3	9
Actuarial (gains)/losses	924	50	2,861	(40)
Benefits paid	(483)	(40)	(559)	(57)
Past service cost				
– vested immediately	–	3	–	2
Reduction in liabilities resulting from curtailments	–	–	–	(4)
Liabilities extinguished on settlements	–	(7)	(322)	–
Transfers	88	(5)	–	–
Exchange differences	–	36	–	(57)
At 31 December	14,712	912	13,262	805

The actual return on plan assets for the year ended 31 December 2010 was a positive return £1,883 million (2009: positive return of £1,108 million). The group expects to make £191 million of contributions to defined benefit pension plans during 2011.

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

	2010		2009	
	HSBC Bank (UK) Pension Scheme	Other plans	HSBC Bank (UK) Pension Scheme	Other plans
	£m	£m	£m	£m
Current service cost	163	30	168	31
Interest cost	743	31	651	32
Expected return on plan assets	(706)	(32)	(613)	(30)
Past service cost	–	3	–	2
Gains on curtailments	–	–	–	(4)
Gains on settlements	–	–	(322)	–
Total (gain)/ expense	200	32	(116)	31

Notes on the Financial Statements (continued)

Total net actuarial gains/(losses)

	2010		2009	
	HSBC Bank (UK) Pension Scheme £m	Other plans £m	HSBC Bank (UK) Pension Scheme £m	Other plans £m
Experience (losses)/gains on plan liabilities	(207)	11	(143)	15
Experience gains/(losses) on plan assets	1,150	(4)	424	41
(Losses)/gains from changes in actuarial assumptions	(717)	(61)	(2,718)	25
Total net actuarial gains/(losses)	226	(54)	(2,437)	81

Total net actuarial losses recognised in other comprehensive income since transition to IFRSs are £1,611 million. The total effect of the limit on plan surpluses recognised within actuarial losses in other comprehensive income during 2010 was a gain of £16 million (2009: loss of £20 million).

UK regulation requires pension schemes be valued formally every three years and a funding plan agreed between the trustee and scheme sponsor. The most recent triennial actuarial valuation of the UK Scheme performed by the Scheme Actuary on behalf of the Trustee has been carried out as at 31 December 2008. At that date, the market value of the Scheme's assets was £10.2 billion. The market value of the plan represented 76 per cent of the amount expected to be required, on the basis of the assumptions adopted, to provide the benefits accrued to members after allowing for expected future increases in earnings, and the resulting deficit amounted to £3.2 billion. The method adopted for this valuation was the projected unit method.

The expected cash flows from the plan were projected by reference to the UK Retail Prices Index ('RPI') swap break-even curve at 31 December 2008. Salary increases were assumed to be 0.5 per cent per annum above RPI and inflationary pension increases, subject to a minimum of 0 per cent per annum and a maximum of 5 per cent per annum (maximum of 3 per cent per annum in respect of service accrued since 1 July 2009) were assumed to be in line with RPI. The projected cash flows were discounted at the LIBOR swap curve at 31 December 2008 plus a margin for the expected return on the investment strategy of 190 basis points per annum.

The mortality experience of the Scheme's pensioners over the three year period since the previous valuation was analysed and the mortality assumption set on the basis of this, using the SAPS S1 series of tables with adjustment for the specific mortality experience of the Scheme. Allowance for future improvements in longevity was made in line with the medium cohort effect with minimum improvements of 1.75 per cent for males and 1.25 per cent for females.

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

Additional future funding payments to the principal plan

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

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

The group considers that the contribution set out above, together with investment returns at an expected level of 240 basis points above the LIBOR swap curve, would be sufficient to meet the deficit as at 31 December 2008 over the agreed period. At each subsequent actuarial valuation, the group has agreed with the Trustees that any shortfall in

Notes on the Financial Statements (continued)

investment returns relative to this expected level, subject to a maximum of 50 basis points per annum, will be eliminated by payment of equal cash instalments over the remaining years to the end of this recovery plan period.

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

As part of the 31 December 2008 valuation, calculations were also carried out as to the amount of assets that might be needed to meet the liabilities if the Scheme was discontinued and the members' benefits bought out with an insurance company (although in practice this may not be possible for a plan of this size) or the Trustee continued to run the plan without the support of the bank. The amount required under this approach was estimated to be £19,400 million as at 31 December 2008. In estimating the solvency position for this purpose, a more prudent assumption about future mortality was made than for the assessment of the ongoing position and it was assumed that the Trustee would alter the investment strategy to be an appropriately matched portfolio of cash and interest and inflation swaps. An explicit allowance for expenses was also included.

Move to using the Consumer Prices Index

The expected cash flows of the principal plan were projected by reference to the Retail Prices Index ('RPI') swap curve in calculating the liability recognised. The Occupational Pensions (Revaluation) Order 2010 confirmed the UK government's intention to move to using the Consumer Prices Index ('CPI') rather than RPI as the inflation measure for determining the minimum pension increases to be applied to the statutory index-linked features of retirement benefits. Historical annual CPI increases have generally been lower than annual RPI increases. The rules of the principal plan prescribe that annual increases will be in line with RPI for pensions in payment and statutory index-linked prior to retirement for deferred pensions. In respect of deferred pensioners, consistent with communications to Scheme members, the bank continued to use RPI in calculating the liability recognised as at 31 December 2010. Using CPI to value the Scheme's liabilities in respect of deferred pensioners would result in a reduction in the principal plan's liabilities of approximately £250 million based on the financial and demographic assumptions as at 31 December 2010.

Summary

	HSBC Bank (UK) Pension Scheme				
	2010 £m	2009 £m	2008 £m	2007 £m	2006 £m
Defined benefit obligation	(14,712)	(13,262)	(10,460)	(11,719)	(12,392)
Fair value of plan assets	14,317	10,908	10,191	11,316	10,485
Net deficit	(395)	(2,354)	(269)	(403)	(1,907)
Experience gains/(losses) on plan liabilities	(207)	(143)	(7)	(30)	300
Experience gains/(losses) on plan assets	1,150	424	(1,643)	6	–
Gains/(losses) from changes in actuarial assumptions	(717)	(2,718)	1,671	1,238	(298)
Total net actuarial gains/(losses)	226	(2,437)	21	1,214	2
	Other plans				
	2010 £m	2009 £m	2008 £m	2007 £m	2006 £m
Defined benefit obligation	(912)	(805)	(889)	(643)	(627)
Fair value of plan assets	738	649	617	557	460
Effect of limit on plan surpluses	(5)	(21)	–	(21)	2
Net deficit	(179)	(177)	(272)	(107)	(165)
Experience gains/(losses) on plan liabilities	11	15	(6)	(4)	1
Experience gains/(losses) on plan assets	(4)	41	(130)	3	7
Gains/(losses) from changes in actuarial assumptions	(61)	25	(47)	53	14
Total net actuarial gains/(losses)	(54)	81	(183)	52	22

Notes on the Financial Statements (continued)

Defined benefit healthcare plans

Liability recognised on the balance sheet

	2010 £m	2009 £m
Present value of unfunded obligations	164	153
Net liability ¹	164	153

1 £164 million of the net liability for defined benefit healthcare plans relates to the bank (2009: £153 million).

Present value of defined benefit healthcare obligations

	2010 £m	2009 £m
At 1 January	153	130
Interest cost	7	6
Actuarial gains	9	20
Benefits paid	(5)	(3)
At 31 December	164	153

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

	2010 £m	2009 £m
Interest cost	7	6
Total expense	7	6

Total net actuarial (losses)/gains

	Year ended 31 December	
	2010 £m	2009 £m
Experience gains/(losses) on healthcare plan liabilities	(3)	4
(Losses)/gains from changes in actuarial assumptions	(6)	(24)
Total net actuarial (losses)/gains	(9)	(20)

The actuarial assumptions of the healthcare cost trend rates have a significant effect on the amounts recognised. A one percentage point change in assumed healthcare cost trend rates would have the following effects on amounts recognised in 2010:

	1 per cent increase £m	1 per cent decrease £m
Increase/(decrease) of the aggregate of the current service cost and interest cost	1	(1)
Increase/(decrease) of defined benefit healthcare obligation	20	(17)

Notes on the Financial Statements (continued)

Directors' emoluments

The aggregate emoluments of the Directors of the bank, computed in accordance with the Companies Act 2006 as amended by statutory instrument 2008 No.410, were:

	2010	2009
	£000	£000
Fees	334	335
Salaries and other emoluments	1,317	1,114
Bonuses	1,044¹	1,628 ²
	2,695	3,077
Gains on the exercise of share options	1	-
Vesting of Restricted Share Plan awards	256	248

- Awards of £2,607,857 made to executive Directors in respect of 2010 performance will be 60 per cent deferred. 50 per cent of both the deferred and non-deferred components will be in the form of Restricted Shares issued under the HSBC Share Plan. The remaining 50 per cent will be delivered as cash.*
- Includes the sum of £1,176,800 deferred into shares which were not subject to performance conditions but were subject to a restricted period.*

No awards were made to Directors under long-term incentive plans in respect of qualifying services rendered in 2010 (2009: no awards).

Retirement benefits accrue to two Directors under a defined benefit scheme and to two Directors under a money purchase scheme. There were no contributions during the year to money purchase arrangements in respect of Directors' qualifying services (2009: £nil).

In addition, there were payments under retirement benefit agreements with former Directors of £763,666 (2009: £771,849), including payments in respect of unfunded pension obligations to former Directors of £644,954 (2009: £653,137). The provision as at 31 December 2010 in respect of unfunded pension obligations to former Directors amounted to £10,870,922 (2009: £10,806,455).

Discretionary bonuses for Directors are based on a combination of individual and corporate performance and are determined by the Remuneration Committee of the bank's parent company, HSBC Holdings plc. The cost of any conditional awards under the HSBC Holdings Restricted Share Plan 2000 and The HSBC Share Plan are recognised through an annual charge based on the fair value of the awards and the likely level of vesting of shares, apportioned over the period of service to which the award relates. Details of The HSBC Share Plan and performance conditions are contained within the Directors' Remuneration Report of HSBC Holdings plc.

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

	2010	2009
	£000	£000
Fees	-	-
Salaries and other emoluments	501	483
Bonuses	1,208¹	1,000 ²

- The awards made to the highest paid Director in respect of 2010 performance will be 60 per cent deferred and 40 per cent non-deferred. 50 per cent of both the deferred and non-deferred components will be in the form of Restricted Shares issued under the HSBC Share Plan. The remaining 50 per cent will be delivered as cash.*
- Includes the sum of £0.8 million deferred into shares which are not subject to performance conditions but are subject to a restricted period.*

The highest paid Director received 39,164 shares as the result of awards under long-term incentive plans that vested during the year. The highest paid Director did not exercise any share options over HSBC Holdings plc ordinary shares during the year.

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

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

Notes on the Financial Statements (continued)

8 Auditors' remuneration

Auditors' remuneration in relation to the statutory audit amounted to £9.5 million (2009: £10.2 million).

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

	2010	2009
	£m	£m
Audit fees for HSBC Bank plc statutory audit:		
– fees relating to current year	2.5	2.3
– fees relating to prior year	0.3	0.1
	2.8	2.4
Fees payable to KPMG for other services provided to the group		
Audit-related services:		
– audit of the group's subsidiaries, pursuant to legislation	6.9	7.5
– audit of pension schemes associated with the group, pursuant to legislation	0.1	0.4
– other services pursuant to legislation	4.6	4.5
Tax services	0.4	0.4
Other services:		
– services relating to information technology	–	0.2
– all other services	1.0	0.7
	13	13.7
Total fees payable	15.8	16.1

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

Fees payable to KPMG for non-audit services for HSBC Bank plc are not disclosed separately because such fees are disclosed on a consolidated basis for the group.

9 Share-based payments

During 2010, £246 million was charged to the income statement in respect of equity-settled share-based payment transactions (2009: £191 million). This expense, which was computed from the fair values of the share-based payment transactions when contracted, arose under employee share awards made in accordance with the HSBC Group's reward structures.

Calculation of fair values

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

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

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

Notes on the Financial Statements (continued)

	Savings-Related Share Option Plans		
	1-year plan	3-year plans	5-year plans
2009			
Risk-free interest rate ¹ (%)	0.7	2.1	2.4
Expected life ² (years)	1	3	5
Expected volatility ³ (%)	50	35	30
Share price at grant date (£)	4.65	4.65	4.65

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

2 Expected life is not a single input parameter but a function of various behavioural assumptions.

3 Expected volatility is estimated by considering both historic average share price volatility and implied volatility derived from traded options over HSBC shares of similar maturity to those of the employee options.

The expected US dollar denominated dividend yield was determined to be 4.5 per cent per annum in line with consensus analyst forecasts (2009: 4.5 per cent). Prior to 2009, HSBC adopted a dividend growth model and incorporated expected dividends into the valuation model for share options and awards and in 2009, the expected dividend growth was determined to be 8 per cent.

The HSBC Share Plan

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

In 2009, the remuneration committee agreed to make adjustments to all unexercised share options and share awards under HSBC's various share plans and share schemes as a consequence of the Group's rights issue. The adjustments were based on a theoretical ex-rights price, which was considered to be the most appropriate methodology to reflect the rights issue. The adjustments under certain share plans and share schemes were approved by the relevant tax authorities, where necessary. In the case of the HSBC France and HSBC Private Bank France share plans, similar adjustments were made by these subsidiaries as a consequence of the rights issue. The adjustments were to the ratios at which the subsidiary company shares are exchangeable for HSBC Holdings ordinary shares of US\$0.50 following the exercise of options.

Performance Share awards

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

	2010 Number (000's)	2009 Number (000's)
Outstanding at 1 January	200	1,228
Adjustment for rights issue	–	156
Granted in the year	58	–
Released in the year	(21)	(354)
Forfeited in the year	(138)	(830)
Outstanding at 31 December ¹	99	200

1 The above table includes the bank employee awards of 52,160 (2009: 111,349).

The weighted average fair value of shares awarded by the group for Performance Share Awards in 2010 was £6.47. No performance shares were awarded by HSBC in 2009.

Restricted share awards

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

Notes on the Financial Statements (continued)

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

	2010	2009
	Number	Number
	(000's)	(000's)
Outstanding at 1 January	71,780	42,881
Adjustment for rights issue	–	9,343
Granted in the year	51,434	48,750
Released in the year	(19,143)	(19,997)
Forfeited in the year	(9,064)	(9,197)
Outstanding at 31 December	95,007	71,780

The weighted average fair value of shares awarded by the group for Restricted Share Awards in 2010 was £6.81 (2009: £4.00).

Share options

A small number of discretionary share options were granted in 2005 exclusively to individuals employed by HSBC France under the HSBC Share Plan rules after the expiry of the Group share option plan rules.

Nil-cost share options were granted to senior executives on the basis of their performance in the previous year. The share options were subject to the achievement of the same corporate performance conditions as the 2005 Performance Share awards. The options vested after three years in the same proportion as the 2005 performance shares but were only exercisable up to the fourth anniversary of the date of grant. These options have now lapsed and there are currently no options with outstanding performance conditions.

Share options were also awarded to a number of employees under the HSBC share plan rules. These options may vest after three years and are exercisable up to the tenth anniversary of the grant, after which they will lapse.

	2010		2009	
	Number	Weighted average	Number	Weighted average
	(000's)	exercise price	(000's)	exercise price
		£		£
Outstanding at 1 January	86	7.99	300	8.89
Adjustment for rights issue	–	–	44	7.75
Forfeited in the year	–	–	(258)	7.66
Outstanding at 31 December	86	7.99	86	7.99

No options were granted in 2010 or 2009. The weighted average remaining contractual life of options outstanding at the balance sheet date was 4.8 years. (2009: 5.8 years). All of the options were exercisable.

Savings-related share option plans

Savings-related share option plans invite eligible employees to enter into savings contracts to save up to £250 per month, with the option to use the savings to acquire shares. The aim of the plans is to align the interests of all employees with the creation of shareholder value. The options are exercisable within three months following the first anniversary of the commencement of a one-year savings contract or within six months following either the third or the fifth anniversary of the commencement of three-year or five-year contracts, respectively. The exercise price is set at 20 per cent (2009: 20 per cent) discount to the market value immediately preceding the date of invitation.

Notes on the Financial Statements (continued)

Movement in savings-related share options

	2010		2009	
	Number (000's)	Weighted average exercise price £	Number (000's)	Weighted average exercise price £
Outstanding at 1 January	77,340	5.24	37,115	6.94
Adjustment for rights issue.....	–	–	4,276	7.00
Granted in the year	7,084	5.43	64,018	3.30
Exercised in the year	(4,795)	5.46	(3,116)	5.49
Transferred in the year	(113)	4.00	84	6.25
Expired and cancelled in the year	(8,980)	5.58	(25,037)	6.33
Outstanding at 31 December ^{1,2}	70,536	3.77	77,340	5.24

1 The above table includes the bank employee options of 69,911,144 outstanding at 1 January 2010 (2009: 33,404,227), 5,979,608 options granted in the year (2009: 57,743,478) and 63,583,389 options outstanding at 31 December 2010 (2009: 69,911,144).

2 The weighted average exercise price for bank employees at 1 January 2010 was £5.19 (2009: £6.94) and at 31 December 2010 was £3.77 (2009: £5.19).

The weighted average fair value of options granted during the year was £1.64 (2009: £1.37). The weighted average share price at the dates the share options were exercised was £6.65 (2009: £5.86). The weighted average exercise price, and the weighted average remaining contractual life for options outstanding at the balance sheet date, analysed by exercise price range, were as follows:

The group

	2010	2009
Exercise price range (£).....	£3.13-£9.08	£5.34-£9.77
Weighted average remaining contractual life (years)	2.51	3.10
Of which exercisable:		
– number (000's)	868	4,007
– weighted average exercise price (£)	6.14	6.23

The bank

	2010	2009
Exercise price range (£).....	£3.13-£9.08	£5.34-£9.77
Weighted average remaining contractual life (years)	2.61	3.12
Of which exercisable:		
– number (000's)	756	3,793
– weighted average exercise price (£)	6.08	6.21

HSBC Holdings Restricted Share Plan 2000

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

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

Notes on the Financial Statements (continued)

Movement on Restricted Share awards under the HSBC Holdings Restricted Share Plan

	2010 Number (000's)	2009 Number (000's)
Outstanding at 1 January	28	153
Adjustment for rights issue	–	21
Additions during the year ¹	412	3
Released in the year	–	(164)
Forfeited in the year	(440)	–
Transferred in the year	–	15
Outstanding at 31 December ²	–	28

1 Additions during the year comprised reinvested scrip dividends.

2 The above table includes bank employee shares of 27,868 outstanding at 1 January 2010 (2009: 85,051), nil shares granted in the year (2009: nil) and Nil outstanding at 31 December 2010 (2009: 27,868).

The HSBC Holdings Group Share Option Plan

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

Movement on the HSBC Holdings Group Share Option Plan awards

	2010		2009	
	Number (000's)	Weighted average exercise price £	Number (000's)	Weighted average exercise price £
Outstanding at 1 January	44,392	6.85	40,223	7.87
Adjustment for rights issue	–	–	6,014	7.86
Exercised in the year	(679)	6.05	(779)	6.26
Transferred in the year	(320)	7.08	661	7.94
Forfeited and expired in the year	(695)	6.95	(1,727)	7.34
Outstanding at 31 December	42,698	6.86	44,392	6.85

The weighted average share price at the date the share options were exercised was £6.86 (2009: £6.85). No share options were awarded by the group for the Group Share Option Plan in 2010 (2009: nil). The number of options, weighted average exercise price, and the weighted average remaining contractual life for options outstanding at the balance sheet date, analysed by exercise price range, were as follows:

The group

	2010		2009	
	£6.00-£6.99	£7.00-£7.99	£6.00-£6.99	£7.00-£7.99
Exercise price range (£)				
Number (000's)	37,413	5,285	13,934	30,458
Weighted average exercise price (£)	6.79	7.30	6.02	7.23
Of which exercisable:				
– number (000's)	37,413	5,285	13,934	30,458
– weighted average exercise price (£)	6.79	7.30	6.02	7.23

Notes on the Financial Statements (continued)

The bank

	2010		2009	
Exercise price range (£)	£6.00-£7.24	£7.25-£8.50	£6.00-£6.99	£7.00-£7.99
Number (000's)	20,261	271	6,823	14,568
Weighted average exercise price (£)	6.84	7.36	6.02	7.22
Of which exercisable:				
– number (000's)	20,261	271	6,823	14,568
– weighted average exercise price (£)	6.84	7.36	6.02	7.22

HSBC France and subsidiary company plans

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

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

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

Movement on HSBC France share options

	2010		2009	
	Number (000's)	Exercise price €	Number (000's)	Exercise price €
Outstanding at 1 January	604	142.50	604	142.50
Expired in the year	(604)	142.50	–	142.50
Outstanding and exercisable at 31 December	–	–	604	142.50

At the date of its acquisition in 2000, certain of HSBC France's subsidiary companies also operated employee share option plans under which options could be granted over their respective shares. On exercise of certain of these options, the subsidiary shares are exchanged for HSBC ordinary shares. The total number of HSBC Holdings ordinary shares exchanged under such arrangements in 2010 was 9,282(2009: 70,257).

Pre-IFRS 2 awards

Detailed below are the share-based payment awards made before the date of application of IFRS 2 on 7 November 2002 and therefore not accounted for within the balance sheet or income statement.

The HSBC Holdings Group Share Option Plan

	2010		2009	
	Number (000's)	Weighted average exercise price £	Number (000's)	Weighted average exercise price £
Outstanding at 1 January	32,162	7.38	30,942	8.30
Adjustment for rights issue.....	–	–	4,626	8.31
Exercised in the year	(1,414)	6.50	(773)	7.44
Transferred in the year	(125)	7.51	881	8.38
Expired in the year	(1,488)	7.04	(3,514)	6.08
Outstanding at 31 December ^{1,2}	29,135	7.44	32,162	7.38

1 The above includes the bank employee awards of 17,324,442 options outstanding at 1 January 2010 (2009: 17,857,524), and 14,767,030 options outstanding at 31 December 2010 (2009: 17,324,442).

2 The weighted average exercise price for bank employees was £7.35 at 1 January 2010 (2009: £8.17) and £7.45 at 31 December 2010 (2009: £7.35).

Notes on the Financial Statements (continued)

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

The group

	2010		2009	
	£5.56-£6.50	£6.51-£8.40	£5.56-£6.50	£6.51-£8.40
Exercise price range (£)				
Number (000's)	320	28,816	2,553	29,609
Weighted average exercise price (£)	6.50	7.45	6.50	7.46
Of which exercisable:				
– number (000's)	592	29,012	2,553	29,609
– weighted average exercise price (£)	6.50	7.45	6.50	7.46

The bank

	2010		2009	
	£5.56-£6.50	£6.51-£8.40	£5.56-£6.50	£6.51-£8.40
Exercise price range (£)				
Number (000's)	42	14,725	2,002	15,322
Weighted average exercise price (£)	6.50	7.45	6.50	7.46
Of which exercisable:				
– number (000's)	42	14,725	2,001	15,322
– weighted average exercise price (£)	6.50	7.45	6.50	7.46

10 Tax expense

	2010 £m	2009 £m
Current taxation		
UK corporation tax charge – on current year profit	536	446
UK corporation tax charge – adjustments in respect of prior years	6	14
Overseas tax – on current year profit	371	409
Overseas tax – adjustment in respect of prior years	37	(4)
	950	865
Deferred taxation		
Origination and reversal of temporary differences	29	(24)
Effect of changes in the tax rates	–	(3)
Adjustment in respect of prior years	17	18
	46	(9)
Tax expense	996	856

The UK corporation tax rate applying to HSBC Bank plc and its subsidiaries was 28 per cent (2009: 28 per cent). Other overseas subsidiaries and overseas branches provided for taxation at the appropriate rates in the countries in which they operate.

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

	2010		2009	
	£m	Percentage of overall tax charge %	£m	Percentage of overall tax charge %
Taxation at UK corporation tax rate of 28 per cent	1,123	28.0	1,124	28.0
Effect of taxing overseas profit at different rates	(47)	(1.2)	(50)	(1.2)
Gains subject to tax at a lower rate.....	(133)	(3.4)	(116)	(2.9)
Adjustment in respect of prior years	60	1.5	28	0.7
Effect of profits in associates and joint ventures	(1)	–	(4)	(0.1)
Deferred tax temporary differences not provided	16	0.4	5	0.1
Release of deferred tax consequent on the disposal of group properties	(18)	(0.4)	(90)	(2.3)
Non taxable income	(18)	(0.4)	(15)	(0.4)
Effect of UK bank payroll tax	53	1.3	–	–
Permanent disallowables.....	23	0.6	6	0.1
Other items	(62)	(1.6)	(32)	(0.7)
Tax expense.....	996	24.8	856	21.3

Notes on the Financial Statements (continued)

On 22 June 2010, the UK Government announced its intention to reduce the main rate of corporation tax from 28 per cent to 24 per cent. It is proposed that the fall will be phased in over a period of four years with a 1 per cent reduction in the main corporation tax rate for each year starting on 1 April 2011. As at 31 December 2010 only the initial phase to reduce the main rate of corporation tax from 28 per cent to 27 per cent has been substantively enacted and therefore only this change has been reflected in the amounts recognised as at that date. It is not expected that the proposed future rate changes will have a significant effect on the net UK deferred tax position.

The UK Government have announced its intention to allow UK resident entities to elect to exempt foreign branches from UK taxation. It is expected that if such an election is made, it will apply from the bank's accounting period beginning 1 January 2012. The bank will await the final legislation before making any decisions on whether to elect to exempt its branches. However it is not expected that such an election will have a material effect on the bank's tax position.

In addition to the amount charged to the income statement, the aggregate amount of current and deferred taxation relating to items that are taken directly to equity was a £247 million decrease in other comprehensive income (2009: £414 million increase in other comprehensive income).

Movement of net deferred tax assets before offsetting balances within countries

The group

	Retirement benefits £m	Loan impairment allowances £m	Unused tax losses £m	Property, plant and equipment £m	Available- for-sale investments £m	Cash flow hedges £m	Share-based payments £m	Assets leased to customers £m	Revaluation of property £m	Other £m	Total £m
Assets	735	116	–	76	13	10	63	–	–	298	1,311
Liabilities	–	(30)	–	(2)	(16)	(131)	(7)	(438)	(78)	(412)	(1,114)
At 1 January 2010.....	735	86	–	74	(3)	(121)	56	(438)	(78)	(114)	197
Income statement.....	(134)	(24)	–	(15)	–	–	31	133	55	(92)	(46)
Other comprehensive income:											
- available-for-sale investments	–	–	–	–	9	–	–	–	–	–	9
- cash flow hedges	–	–	–	–	–	63	–	–	–	–	63
- actuarial movements	(67)	–	–	–	–	–	–	–	–	–	(67)
Equity:											
- share-based payments	–	–	–	–	–	–	(10)	–	–	–	(10)
Acquisitions and disposals	–	–	–	–	(6)	–	–	99	–	15	108
Foreign exchange and other adjustments	–	(10)	4	–	(4)	(1)	(1)	12	1	21	22
	(201)	(34)	4	(15)	(1)	62	20	244	56	(56)	79
Assets	534	52	4	60	7	–	76	–	–	–	733
Liabilities	–	–	–	(1)	(11)	(59)	–	(194)	(22)	(170)	(457)
At 31 December 2010.....	534	52	4	59	(4)	(59)	76	(194)	(22)	(170)	276

Movement of net deferred tax assets before offsetting balances within countries

The group

	Retirement benefits £m	Loan impairment allowances £m	Unused tax losses £m	Property, plant and equipment £m	Available- for-sale investments £m	Cash flow hedges £m	Share-based payments £m	Assets leased to customers £m	Revaluation of property £m	Other £m	Total £m
Assets	194	137	3	9	116	61	40	–	–	238	798
Liabilities	–	–	–	(39)	(16)	(160)	–	(499)	(82)	(332)	(1,128)
At 1 January 2009.....	194	137	3	(30)	100	(99)	40	(499)	(82)	(94)	(330)
Income statement.....	(135)	(51)	(3)	104	44	(3)	11	57	4	(19)	9
Other comprehensive income:											
- available-for-sale investments	–	–	–	–	(147)	–	–	–	–	–	(147)
- cash flow hedges	–	–	–	–	–	(19)	–	–	–	–	(19)
- actuarial movements	676	–	–	–	–	–	–	–	–	–	676
Equity:											
- share-based payments	–	–	–	–	–	–	5	–	–	–	5
Foreign exchange and other adjustments	–	–	–	–	–	–	–	4	–	(1)	3
	541	(51)	(3)	104	(103)	(22)	16	61	4	(20)	527
Assets	735	116	–	76	13	10	63	–	–	298	1,311
Liabilities	–	(30)	–	(2)	(16)	(131)	(7)	(438)	(78)	(412)	(1,114)
At 31 December 2009.....	735	86	–	74	(3)	(121)	56	(438)	(78)	(114)	197

Movement of net deferred tax assets before offsetting balances within countries

The bank

	Retirement benefits £m	Loan impairment allowances £m	Property, plant and equipment £m	Available- for-sale investments £m	Cash flow hedges £m	Share-based payments £m	Revaluation of property £m	Other £m	Total £m
Assets	698	44	65	–	–	46	–	69	922
Liabilities	–	–	–	(1)	(131)	–	(11)	(2)	(145)
At 1 January 2010.....	698	44	65	(1)	(131)	46	(11)	67	777
Income statement.....	(172)	(9)	3	–	–	35	–	(14)	(157)
Other comprehensive income:									
- cash flow hedges	–	–	–	–	81	–	–	–	81
- actuarial movements	(77)	–	–	–	–	–	–	–	(77)
Equity:									
- share-based payments	–	–	–	–	–	(10)	–	–	(10)
Foreign exchange and other adjustments	–	–	(10)	–	–	–	11	–	1
	(249)	(9)	(7)	–	81	25	11	(14)	(162)
Assets	449	35	58	–	–	71	–	55	668
Liabilities	–	–	–	(1)	(50)	–	–	(2)	(53)
At 31 December 2010.....	449	35	58	(1)	(50)	71	–	53	615

Movement of net deferred tax assets before offsetting balances within countries

The bank

	Retirement benefits £m	Loan impairment allowances £m	Property, plant and equipment £m	Available- for-sale investments £m	Cash flow hedges £m	Share-based payments £m	Revaluation of property £m	Other £m	Total £m
Assets	135	56	–	–	–	24	–	133	348
Liabilities	–	–	(37)	(2)	(160)	–	(11)	(2)	(212)
At 1 January 2009.....	135	56	(37)	(2)	(160)	24	(11)	131	136
Income statement	(125)	(12)	102	1	–	17	–	(62)	(79)
Other comprehensive income:									
- cash flow hedges	–	–	–	–	29	–	–	–	29
- actuarial movements	688	–	–	–	–	–	–	–	688
Equity:									
- share-based payments	–	–	–	–	–	5	–	–	5
Foreign exchange and other adjustments	–	–	–	–	–	–	–	(2)	(2)
	563	(12)	102	1	29	22	–	(64)	641
Assets	698	44	65	–	–	46	–	69	922
Liabilities	–	–	–	(1)	(131)	–	(11)	(2)	(145)
At 31 December 2009.....	698	44	65	(1)	(131)	46	(11)	67	777

Notes on the Financial Statements (continued)

After netting off balances within countries, the balances as disclosed in the accounts are as follows:

	The group		The bank	
	2010 £m	2009 £m	2010 £m	2009 £m
Deferred tax assets	330	355	617	779
Deferred tax liabilities	(54)	(158)	(2)	(2)
	276	197	615	777

For the group, the amount of temporary differences for which no deferred tax asset is recognised in the balance sheet is £576 million (2009: £36 million). This amount is in respect of losses where the recoverability of potential benefits is not considered likely.

For the bank, there are no temporary differences for which no deferred tax asset is recognised in the balance sheet (2009: Nil).

Deferred tax is not recognised in respect of the group's investments in subsidiaries and branches where remittance is not contemplated, and for associates and interests in joint ventures where it has been determined that no additional tax will arise. The aggregate amount of temporary differences associated with such investments is nil (2009: Nil). Following the change in the UK tax treatment of dividends on 1 July 2009, no UK tax is expected to arise on distributions from group entities and no temporary difference exists except where withholding tax or other foreign tax could arise on the investments. No meaningful amount of temporary differences associated with such investments can be disclosed.

11 Dividends

Dividends to shareholders of the parent company were as follows:

	2010		2009	
	£ per share	Total £m	£ per share	Total £m
Dividends declared on ordinary shares				
Third interim dividend in respect of previous year	1.07	850	–	–
First interim dividend in respect of current year	1.13	900	0.55	441
Second interim dividend in respect of current year	–	–	0.63	500
	2.20	1,750	1.18	941

	2010		2009	
	£ per share	Total £m	£ per share	Total £m
Dividends on preference shares classified as equity				
Dividend on HSBC Bank plc non-cumulative third dollar preference shares.....	1.18	41	1.13	40
	1.18	41	1.13	40

	2010	2009
	£m	£m
Coupons on capital securities classified as equity		
Coupon in respect of the first quarter of the year	4	11
Coupon in respect of the second quarter of the year	63	66
Coupon in respect of the third quarter of the year	5	5
Coupon in respect of the fourth quarter of the year	5	4
	77	86

Notes on the Financial Statements (continued)

12 Segment analysis

The factors used in identifying the group's reporting segments are discussed in Note 2(c) Operating Segments.

The types of products and services from which each reportable segment derives its revenue are discussed in the Report of the Directors: Operating and Financial Review – Business segments.

Profit/(loss) for the year

	Year ended 31 December 2010						Total £m
	UK Retail £m	Continental Europe Retail £m	Global Banking and Markets £m	Private Banking £m	Other £m	Inter Segment £m	
Net interest income	3,536	1,725	1,914	724	(100)	(105)	7,694
Net fee income	1,852	465	1,053	650	20	–	4,040
Net trading income	9	22	1,711	253	(8)	130	2,117
Net (expense)/income from financial instruments designated at fair value	157	222	(24)	–	(54)	(25)	276
Gains less losses from financial investments ¹ ..	–	18	467	15	37	–	537
Net earned insurance premiums	380	2,260	(4)	–	(1)	–	2,635
Other operating income	145	67	488	7	117	(24)	800
Total operating income	6,079	4,779	5,605	1,649	11	(24)	18,099
Net insurance claims incurred and movement in liabilities to policyholders	(427)	(2,571)	–	–	(26)	1	(3,023)
Net operating income before loan impairment charges and other credit risk provisions	5,652	2,208	5,605	1,649	(15)	(23)	15,076
Loan impairment charges and other credit risk provisions ¹	(1,221)	(195)	(518)	(17)	–	–	(1,951)
Net operating income	4,431	2,013	5,087	1,632	(15)	(23)	13,125
Employee compensation and benefits	(1,210)	(614)	(1,596)	(656)	(885)	–	(4,961)
General and administrative expenses	(1,783)	(1,008)	(1,475)	(338)	1,045	23	(3,536)
Depreciation and impairment of property, plant and equipment ¹	(23)	(57)	(109)	(22)	(249)	–	(460)
Amortisation and impairment of intangible assets ¹	(105)	(12)	(33)	–	(12)	–	(162)
Total operating expenses	(3,121)	(1,691)	(3,213)	(1,016)	(101)	23	(9,119)
Operating profit	1,310	322	1,874	616	(116)	–	4,006
Share of profit in associates and joint ventures	3	–	2	–	–	–	5
Profit before tax	1,313	322	1,876	616	(116)	–	4,011
Tax expense	(364)	(112)	(341)	(114)	(65)	–	(996)
Profit for the year	949	210	1,535	502	(181)	–	3,015

¹ Significant non-cash item.

Notes on the Financial Statements (continued)

	Year ended 31 December 2009						Total £m
	UK Retail £m	Continental Europe Retail £m	Global Banking and Markets £m	Private Banking £m	Other £m	Inter Segment £m	
Net interest income	3,361	1,681	2,849	815	(192)	(423)	8,091
Net fee income	1,913	423	1,060	626	55	–	4,077
Net trading income	28	28	1,972	210	(35)	423	2,626
Net (expense)/income from financial instruments designated at fair value	181	509	227	–	(374)	–	543
Gains less losses from financial investments ¹	(1)	15	39	(1)	(125)	–	(73)
Dividend income	2	2	19	6	–	–	29
Net earned insurance premiums	468	2,250	(1)	–	(1)	–	2,716
Other operating income	311	49	424	23	349	(63)	1,093
Total operating income	6,263	4,957	6,589	1,679	(323)	(63)	19,102
Net insurance claims incurred and movement in liabilities to policyholders.....	(720)	(2,819)	–	–	(1)	–	(3,540)
Net operating income before loan impairment charges and other credit risk provisions	5,543	2,138	6,589	1,679	(324)	(63)	15,562
Loan impairment charges and other credit risk provisions ²	(1,600)	(338)	(1,405)	(19)	(2)	–	(3,364)
Net operating income	3,943	1,800	5,184	1,660	(326)	(63)	12,198
Employee compensation and benefits	(1,011)	(843)	(1,452)	(629)	(517)	–	(4,452)
General and administrative expenses	(1,675)	(646)	(1,021)	(279)	444	63	(3,114)
Depreciation and impairment of property, plant and equipment ¹	(187)	(97)	(174)	(23)	(1)	–	(482)
Amortisation and impairment of intangible assets ²	(95)	(17)	(27)	(1)	(10)	–	(150)
Total operating expenses	(2,968)	(1,603)	(2,674)	(932)	(84)	63	(8,198)
Operating profit	975	197	2,510	728	(410)	–	4,000
Share of profit in associates and joint ventures	13	–	1	–	–	–	14
Profit before tax	988	197	2,511	728	(410)	–	4,014
Tax expense	(192)	(20)	(531)	(86)	(27)	–	(856)
Profit for the year	796	177	1,980	642	(437)	–	3,158

1 Significant non-cash item.

Notes on the Financial Statements (continued)

Other information about the profit/(loss) for the year

	UK Retail £m	Continental Europe Retail £m	Global Banking and Markets £m	Private Banking £m	Other £m	Inter Segment £m	Total £m
Year ended 31 December 2010							
Net operating income:	4,431	2,013	5,087	1,632	(15)	(23)	13,125
External	4,344	2,040	5,405	1,427	(91)	-	13,125
Inter-segment	87	(27)	(318)	205	76	(23)	-
Year ended 31 December 2009							
Net operating income:	3,943	1,800	5,184	1,660	(326)	(63)	12,198
External	4,004	1,760	5,384	1,311	(261)	-	12,198
Inter-segment	(61)	40	(200)	349	(65)	(63)	-

Performance ratios

	UK Retail £m	Continental Europe Retail £m	Global Banking and Markets £m	Private Banking £m	Other £m	Inter Segment £m	Total £m
Year ended 31 December 2010							
Share of the group's profit before tax	1,313	322	1,876	616	(116)	-	4,011
Cost efficiency ratio	55.22%	76.59%	57.32%	61.61%	-	-	60.49%
Year ended 31 December 2009							
Share of the group's profit before tax	988	197	2,511	728	(410)	-	4,014
Cost efficiency ratio	53.55%	74.98%	40.58%	55.51%	-	-	52.68%

Balance sheet information

	UK Retail £m	Continental Europe Retail £m	Global Banking and Markets £m	Private Banking £m	Other £m	Inter Segment £m	Total £m
Year ended 31 December 2010							
Loans and advances to customers (net)	115,950	35,505	110,691	22,436	636	-	285,218
Investment in associates and joint venture	28	3	35	1	9	-	76
Total assets	169,604	61,403	608,229	69,748	12,007	(122,497)	798,494
Customer accounts	139,168	31,907	117,727	55,321	-	-	344,123
Total liabilities	145,266	56,152	601,486	64,320	17,574	(118,661)	766,137
Capital expenditure incurred ¹	299	64	241	26	24	-	654
Year ended 31 December 2009							
Loans and advances to customers (net)	111,251	33,136	110,580	19,091	601	-	274,659
Investment in associates and joint venture	31	3	35	1	9	-	79
Total assets	152,935	61,628	578,994	69,514	12,650	(123,793)	751,928
Customer accounts	134,707	30,102	113,602	54,482	3	-	332,896
Total liabilities	144,306	51,807	570,874	62,252	15,959	(121,698)	723,500
Capital expenditure incurred ¹	343	74	313	14	31	-	775

1 Expenditure incurred on property, plant and equipment and other intangible assets. Excludes assets acquired as part of business combination and goodwill.

Notes on the Financial Statements (continued)

Other financial information

Net operating income by customer group and global business

	Personal Financial Services £m	Commercial Banking £m	Global Banking and Markets £m	Private Banking £m	Other £m	Inter Segment £m	Total £m
Year ended 31 December 2010							
Net operating income:	4,117	2,327	5,087	1,632	(15)	(23)	13,125
External	4,118	2,266	5,405	1,427	(91)	-	13,125
Inter-segment	(1)	61	(318)	205	76	(23)	-
Year ended 31 December 2009							
Net operating income:	3,441	2,302	5,184	1,660	(326)	(63)	12,198
External	3,544	2,220	5,384	1,311	(261)	-	12,198
Inter-segment	(103)	82	(200)	349	(65)	(63)	-

Information by country

	31 December 2010		31 December 2009	
	External net operating income ¹ £m	Non-current assets ² £m	External net operating income ¹ £m	Non-current assets ² £m
United Kingdom.....	8,381	3,596	7,594	5,327
France	2,072	6,385	2,119	6,579
Switzerland	514	2,612	512	2,590
Other countries	2,158	1,003	1,973	1,001
TOTAL.....	13,125	13,596	12,198	15,497

1 Net operating income is attributed to countries on the basis of the customers' location.

2 Non current assets consist of property, plant and equipment, goodwill, other intangible assets and certain other assets expected to be recovered more than twelve months after the reporting period.

13 Analysis of financial assets and liabilities by measurement basis

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

The group

At 31 December 2010

	Held for trading £m	Designated at fair value £m	Held-to-maturity securities £m	Loans and receivables £m	Available-for-sale securities £m	Financial assets and liabilities at amortised cost £m	Derivatives designated as fair value hedging instruments £m	Derivatives designated as cash flow hedging instruments £m	Total £m
Financial assets									
Cash and balances at central banks	-	-	-	-	-	24,495	-	-	24,495
Items in the course of collection from other banks	-	-	-	-	-	1,932	-	-	1,932
Trading assets	159,552	-	-	-	-	-	-	-	159,552
Financial assets designated at fair value	-	15,467	-	-	-	-	-	-	15,467
Derivatives	127,823	-	-	-	-	-	180	1,155	129,158
Loans and advances to banks	-	-	-	57,027	-	-	-	-	57,027
Loans and advances to customers	-	-	-	285,218	-	-	-	-	285,218
Financial investments	-	-	4,281	-	97,805	-	-	-	102,086
Other assets	-	-	-	-	-	4,502	-	-	4,502
Accrued income	-	-	-	-	-	3,335	-	-	3,335
Total financial assets	<u>287,375</u>	<u>15,467</u>	<u>4,281</u>	<u>342,245</u>	<u>97,805</u>	<u>34,264</u>	<u>180</u>	<u>1,155</u>	<u>782,772</u>
Total non-financial assets	-	-	-	-	-	-	-	-	<u>15,722</u>
Total assets	-	-	-	-	-	-	-	-	<u>798,494</u>
Financial liabilities									
Deposits by banks	-	-	-	-	-	48,287	-	-	48,287
Customer accounts	-	-	-	-	-	344,123	-	-	344,123
Items in the course of transmission to other banks	-	-	-	-	-	1,411	-	-	1,411
Trading liabilities	132,360	-	-	-	-	-	-	-	132,360
Financial liabilities designated at fair value	-	27,935	-	-	-	-	-	-	27,935
Derivatives	127,852	-	-	-	-	-	705	647	129,204
Debt securities in issue	-	-	-	-	-	48,119	-	-	48,119
Other liabilities	-	-	-	-	-	4,334	-	-	4,334
Accruals	-	-	-	-	-	3,630	-	-	3,630
Subordinated liabilities	-	-	-	-	-	7,407	-	-	7,407
Total financial liabilities	<u>260,212</u>	<u>27,935</u>	-	-	-	<u>457,311</u>	<u>705</u>	<u>647</u>	<u>746,810</u>
Total non-financial liabilities	-	-	-	-	-	-	-	-	<u>19,327</u>
Total liabilities	-	-	-	-	-	-	-	-	<u>766,137</u>

The group

At 31 December 2009

	Held for trading £m	Designated at fair value £m	Held-to-maturity securities £m	Loans and receivables £m	Available-for-sale securities £m	Financial assets and liabilities at amortised cost £m	Derivatives designated as fair value hedging instruments £m	Derivatives designated as cash flow hedging instruments £m	Total £m
Financial assets									
Cash and balances at central banks	-	-	-	-	-	14,274	-	-	14,274
Items in the course of collection from other banks	-	-	-	-	-	2,082	-	-	2,082
Trading assets	165,008	-	-	-	-	-	-	-	165,008
Financial assets designated at fair value	-	16,435	-	-	-	-	-	-	16,435
Derivatives	116,845	-	-	-	-	-	55	1,616	118,516
Loans and advances to banks	-	-	-	46,994	-	-	-	-	46,994
Loans and advances to customers	-	-	-	274,659	-	-	-	-	274,659
Financial investments	-	-	4,851	-	81,844	-	-	-	86,695
Other assets	-	-	-	-	-	6,282	-	-	6,282
Accrued income	-	-	-	-	-	3,167	-	-	3,167
Total financial assets	281,853	16,435	4,851	321,653	81,844	25,805	55	1,616	734,112
Total non-financial assets									17,816
Total assets									751,928
Financial liabilities									
Deposits by banks	-	-	-	-	-	57,729	-	-	57,729
Customer accounts	-	-	-	-	-	332,896	-	-	332,896
Items in the course of transmission to other banks	-	-	-	-	-	1,477	-	-	1,477
Trading liabilities	118,881	-	-	-	-	-	-	-	118,881
Financial liabilities designated at fair value	-	18,164	-	-	-	-	-	-	18,164
Derivatives	117,331	-	-	-	-	-	399	959	118,689
Debt securities in issue	-	-	-	-	-	39,340	-	-	39,340
Other liabilities	-	-	-	-	-	5,294	-	-	5,294
Accruals	-	-	-	-	-	3,291	-	-	3,291
Subordinated liabilities	-	-	-	-	-	6,799	-	-	6,799
Total financial liabilities	236,212	18,164	-	-	-	446,826	399	959	702,560
Total non-financial liabilities									20,940
Total liabilities									723,500

The bank

At 31 December 2010

	Held for trading £m	Designated at fair value £m	Held-to-maturity securities £m	Loans and receivables £m	Available-for-sale securities £m	Financial assets and liabilities at amortised cost £m	Derivatives designated as fair value hedging instruments £m	Derivatives designated as cash flow hedging instruments £m	Total £m
Financial assets									
Cash and balances at central banks	-	-	-	-	-	22,357	-	-	22,357
Items in the course of collection from other banks	-	-	-	-	-	1,030	-	-	1,030
Trading assets	126,493	-	-	-	-	-	-	-	126,493
Financial assets designated at fair value	-	4,505	-	-	-	-	-	-	4,505
Derivatives	107,991	-	-	-	-	-	133	781	108,905
Loans and advances to banks	-	-	-	27,860	-	-	-	-	27,860
Loans and advances to customers	-	-	-	208,548	-	-	-	-	208,548
Financial investments	-	-	-	-	41,338	-	-	-	41,338
Other assets	-	-	-	-	-	2,436	-	-	2,436
Accrued income	-	-	-	-	-	1,444	-	-	1,444
Total financial assets	<u>234,484</u>	<u>4,505</u>	<u>-</u>	<u>236,408</u>	<u>41,338</u>	<u>27,267</u>	<u>133</u>	<u>781</u>	<u>544,916</u>
Total non-financial assets	-	-	-	-	-	-	-	-	<u>19,415</u>
Total assets	-	-	-	-	-	-	-	-	<u>564,331</u>
Financial liabilities									
Deposits by banks	-	-	-	-	-	38,873	-	-	38,873
Customer accounts	-	-	-	-	-	230,795	-	-	230,795
Items in the course of transmission to other banks	-	-	-	-	-	577	-	-	577
Trading liabilities	98,412	-	-	-	-	-	-	-	98,412
Financial liabilities designated at fair value	-	18,334	-	-	-	-	-	-	18,334
Derivatives	108,028	-	-	-	-	-	382	376	108,786
Debt securities in issue	-	-	-	-	-	29,417	-	-	29,417
Other liabilities	-	-	-	-	-	2,024	-	-	2,024
Accruals	-	-	-	-	-	1,748	-	-	1,748
Subordinated liabilities	-	-	-	-	-	7,562	-	-	7,562
Total financial liabilities	<u>206,440</u>	<u>18,334</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>310,996</u>	<u>382</u>	<u>376</u>	<u>536,528</u>
Total non-financial liabilities	-	-	-	-	-	-	-	-	<u>1,221</u>
Total liabilities	-	-	-	-	-	-	-	-	<u>537,749</u>

The bank

At 31 December 2009

	Held for trading £m	Designated at fair value £m	Held-to-maturity securities £m	Loans and receivables £m	Available-for- sale securities £m	Financial assets and liabilities at amortised cost £m	Derivatives designated as fair value hedging instruments £m	Derivatives designated as cash flow hedging instruments £m	Total £m
Financial assets									
Cash and balances at central banks	–	–	–	–	–	13,130	–	–	13,130
Items in the course of collection from other banks	–	–	–	–	–	1,071	–	–	1,071
Trading assets	123,957	–	–	–	–	–	–	–	123,957
Financial assets designated at fair value	–	6,592	–	–	–	–	–	–	6,592
Derivatives	99,734	–	–	–	–	–	24	1,042	100,800
Loans and advances to banks	–	–	–	20,729	–	–	–	–	20,729
Loans and advances to customers	–	–	–	208,669	–	–	–	–	208,669
Financial investments	–	–	–	–	27,389	–	–	–	27,389
Other assets	–	–	–	–	–	3,501	–	–	3,501
Accrued income	–	–	–	–	–	1,195	–	–	1,195
Total financial assets	223,691	6,592	–	229,398	27,389	18,897	24	1,042	507,033
Total non-financial assets									18,937
Total assets									525,970
Financial liabilities									
Deposits by banks	–	–	–	–	–	39,346	–	–	39,346
Customer accounts	–	–	–	–	–	223,652	–	–	223,652
Items in the course of transmission to other banks	–	–	–	–	–	595	–	–	595
Trading liabilities	96,821	–	–	–	–	–	–	–	96,821
Financial liabilities designated at fair value	–	10,675	–	–	–	–	–	–	10,675
Derivatives	100,673	–	–	–	–	–	1	487	101,161
Debt securities in issue	–	–	–	–	–	14,636	–	–	14,636
Other liabilities	–	–	–	–	–	2,513	–	–	2,513
Accruals	–	–	–	–	–	1,601	–	–	1,601
Subordinated liabilities	–	–	–	–	–	6,955	–	–	6,955
Total financial liabilities	197,494	10,675	–	–	–	289,298	1	487	497,955
Total non-financial liabilities									3,084
Total liabilities									501,039

Notes on the Financial Statements (continued)

14 Reclassification of financial assets

Reclassification from Available-for-sale to Held-to-maturity

On 7 January 2009, the group reclassified £6.0 billion of financial assets from the available-for-sale category to the held-to-maturity category. The reclassification was made as a result of the change in intention to hold the assets until maturity.

Reclassification from Held for trading to Loans and receivables/Available-for-sale

In October 2008, the group and the bank reclassified £5.0 billion and £0.2 billion of financial assets classified as held for trading assets into the loans and receivables and available-for-sale categories respectively, with effect from 1 July 2008. During November and December 2008, the group and the bank reclassified £0.9 billion and £1.4 billion of financial assets classified as held for trading into loans and receivables and available-for-sale respectively. These latter reclassifications took effect prospectively.

	At 31 December 2010		At 31 December 2009	
	Carrying amount £m	Fair value £m	Carrying amount £m	Fair value £m
Reclassification to loans and receivables				
ABSs	3,360	2,820	3,872	2,994
Trading loans – commercial mortgage loans	336	317	341	312
Leverage finance and syndicated loans	2,032	1,882	2,346	2,183
	5,728	5,019	6,559	5,489
Reclassification to available for sale				
Corporate debt and other securities	59	59	847	847
	5,787	5,078	7,406	6,336

The reclassifications were made as a result of significant reduction in market liquidity for these assets, and a change in the group's intention to hold the assets for the foreseeable future or to maturity. These circumstances form part of the wider context of market turmoil and are considered a rare event and, as such, the reclassification is permitted under the amendment to IAS 39. On the date of reclassification, the fair value of the asset is deemed to be the asset's new amortised cost, and the assets are thereafter tested for impairment.

If these reclassifications had not been made, the group's profit before tax in 2010 would have been increased by £367 million from £4,011 million to £4,378 million (2009: an increase of £587 million from £4,014 million to £4,601 million). The changes in group profit would have been entirely in the Global Banking & Markets segment.

The following table shows the fair value gains and losses recognised in the income statement as a result of the reclassification from Held for trading to Loans and receivables/Available-for-sale:

	Effect on income statement for 2010			Effect on income statement for 2009		
	Recorded in the income statement £m	Assuming no reclassification £m	Net effect of reclassification £m	Recorded in the income statement £m	Assuming no reclassification £m	Net effect of reclassification £m
Financial asset reclassified to loans and receivables						
ABS	131	472	(341)	229	361	(132)
Trading loans – commercial mortgage loans..	19	29	(10)	19	9	10
Leverage finance and syndicated loans	166	181	(15)	179	540	(361)
	316	682	(366)	427	910	(483)
Financial assets reclassified to available for sale						
Corporate debt and other securities	37	38	(1)	76	180	(104)
	353	720	(367)	503	1,090	(587)

Notes on the Financial Statements (continued)

15 Trading assets

	The group		The bank	
	2010 £m	2009 £m	2010 £m	2009 £m
Trading assets:				
– which may be repledged or resold by counterparties	55,281	55,528	27,466	24,013
– not subject to repledge or resale by counterparties	104,271	109,480	99,027	99,944
	159,552	165,008	126,493	123,957
Treasury and other eligible bills	2,529	789	945	741
Debt securities	73,771	75,566	39,202	35,314
Equity securities	24,505	19,404	23,789	18,793
Loans and advances to banks	26,525	30,857	33,011	34,111
Loans and advances to customers	32,222	38,392	29,546	34,998
	159,552	165,008	126,493	123,957

Included within the above figures for the group are debt securities issued by banks and other financial institutions of £19,307 million (2009: £21,952 million), of which £4,733 million (2009: £3,740 million) are guaranteed by various governments.

Included within the above figures for the bank are debt securities issued by banks and other financial institutions of £9,795 million (2009: £11,752 million), of which £1,244 million (2008: £1,113 million) are guaranteed by various governments.

16 Financial assets designated at fair value through profit or loss

	The group		The bank	
	2010 £m	2009 £m	2010 £m	2009 £m
Financial assets designated at fair value:				
– not subject to repledge or resale by counterparties	15,467	16,435	4,505	6,592
Treasury and other eligible bills	20	35	–	–
Debt securities	7,161	8,706	4,428	6,515
Equity securities	7,750	6,955	–	–
Loans and advances to banks	27	214	77	77
Loans and advances to customers	509	525	–	–
	15,467	16,435	4,505	6,592

Notes on the Financial Statements (continued)

17 Derivatives

Fair values of derivatives by product contract type held

The group

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

	At 31 December 2009					
	Assets			Liabilities		
	Trading £m	Hedging £m	Total £m	Trading £m	Hedging £m	Total £m
Foreign exchange	25,056	–	25,056	(25,713)	(9)	(25,722)
Interest rate	114,875	1,671	116,546	(114,452)	(1,349)	(115,801)
Equity	9,388	–	9,388	(10,487)	–	(10,487)
Credit	8,345	–	8,345	(7,563)	–	(7,563)
Commodity and other	348	–	348	(272)	–	(272)
Gross total fair values	158,012	1,671	159,683	(158,487)	(1,358)	(159,845)
Netting			(41,167)			41,156
Total			118,516			(118,689)

The bank

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

	At 31 December 2009					
	Assets			Liabilities		
	Trading £m	Hedging £m	Total £m	Trading £m	Hedging £m	Total £m
Foreign exchange	24,479	–	24,479	(25,757)	–	(25,757)
Interest rate	89,253	1,066	90,319	(87,984)	(488)	(88,472)
Equity	8,240	–	8,240	(10,144)	–	(10,144)
Credit	8,350	–	8,350	(7,449)	–	(7,449)
Commodity and other	451	–	451	(378)	–	(378)
Gross total fair values	130,773	1,066	131,839	(131,712)	(488)	(132,200)
Netting			(31,039)			31,039
Total			100,800			(101,161)

Notes on the Financial Statements (continued)

Use of derivatives

The group transacts derivatives for three primary purposes: to create risk management solutions for clients, to manage the portfolio of risks arising from client business, and to manage and hedge the group's own risks. Derivatives (except for derivatives which are designated as effective hedging instruments as defined in IAS 39) are held for trading. The held for trading classification includes two types of derivatives: those used in sales and trading activities, and those used for risk management purposes but which for various reasons do not meet the qualifying criteria for hedge accounting. The second category includes derivatives managed in conjunction with financial instruments designated at fair value. These activities are described more fully below.

The group's derivative activities give rise to significant open positions in portfolios of derivatives. These positions are managed constantly to ensure that they remain within acceptable risk levels, with matching deals being used to achieve this where necessary. When entering into derivative transactions, the group employs the same credit risk management procedures to assess and approve potential credit exposures that are used for traditional lending.

Trading derivatives

Most of the group's derivative transactions relate to sales and trading activities. Sales activities include the structuring and marketing of derivative products to customers to enable them to take, transfer, modify or reduce current or expected risks. Trading activities in derivatives are entered into principally for the purpose of generating profits from short-term fluctuations in price or margin. Positions may be traded actively or be held over a period of time to benefit from expected changes in currency rates, interest rates, equity prices or other market parameters. Trading includes market-making, positioning and arbitrage activities. Market-making entails quoting bid and offer prices to other market participants for the purpose of generating revenues based on spread and volume; positioning means managing market risk positions in the expectation of benefiting from favourable movements in prices, rates or indices; arbitrage involves identifying and profiting from price differentials between markets and products.

As mentioned above, other derivatives classified as held-for-trading include non-qualifying hedging derivatives, ineffective hedging derivatives and the components of hedging derivatives that are excluded from assessing hedge effectiveness. Non-qualifying hedging derivatives are entered into for risk management purposes but do not meet the criteria for hedge accounting. These include derivatives managed in conjunction with financial instruments designated at fair value.

Gains and losses from changes in the fair value of derivatives, including the contractual interest, that do not qualify for hedge accounting are reported in 'Net trading income', except for derivatives managed in conjunction with financial instruments designated at fair value, where gains and losses are reported in 'Net income from financial instruments designated at fair value', together with the gains and losses on the hedged items. Where the derivatives are managed with debt securities in issue, the contractual interest is shown in 'interest expense' together with the interest payable on the issued debt. Substantially all of the group's derivatives entered into with the group's undertakings are managed in conjunction with financial liabilities designated at fair value.

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

	At 31 December			
	The group		The bank	
	2010	2009	2010	2009
	£m	£m	£m	£m
Foreign exchange	1,617,429	1,250,874	1,590,774	1,204,294
Interest rate	9,723,176	7,428,567	6,491,919	5,587,747
Equity	171,061	162,637	163,737	144,659
Credit	317,373	400,712	317,378	403,569
Commodity	41,696	22,666	40,834	21,947
Total derivatives	11,870,735	9,265,456	8,604,642	7,362,216

The notional or contractual amounts of these instruments indicate the nominal value of transactions outstanding at the balance sheet date; they do not represent amounts at risk.

Notes on the Financial Statements (continued)

Derivatives valued using models with unobservable inputs

The difference between the fair value at initial recognition (the transaction price) and the value that would have been derived had valuation techniques used for subsequent measurement been applied at initial recognition, less subsequent releases, is as follows.

	The group		The bank	
	2010 £m	2009 £m	2010 £m	2009 £m
Unamortised balance at 1 January	101	98	94	54
Deferral on new transactions ¹	199	85	198	76
Recognised in the income statement during the period:				
– amortisation	(60)	(47)	(60)	(14)
– subsequent to unobservable inputs becoming observable	(7)	(11)	(6)	(10)
– maturity or termination, or offsetting derivative.....	(103)	(21)	(102)	(8)
Exchange differences	–	(3)	(1)	(2)
Unamortised balance at 31 December ²	130	101	123	96

1 The bank 2009 balance includes £40m on an intra-group business transfer to the bank.

2 This amount is yet to be recognised in the income statement.

Hedging instruments

The group uses derivatives (principally interest rate swaps) for hedging purposes in the management of its own asset and liability portfolios and structural positions. This enables the group to optimise the overall cost to the group of accessing debt capital markets, and to mitigate the market risk which would otherwise arise from structural imbalances in the maturity and other profiles of its assets and liabilities.

The accounting treatment of hedge transactions varies according to the nature of the instrument hedged and the type of hedge transactions. Derivatives may qualify as hedges for accounting purposes if they are fair value hedges, cash flow hedges, or hedges in net investment of foreign operations. These are described under the relevant headings below.

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

The notional contract amounts of these instruments indicate the nominal value of transactions outstanding at the balance sheet date; they do not represent amounts at risk.

	The group			
	At 31 December 2010		At 31 December 2009	
	Cash flow hedge £m	Fair value hedge £m	Cash flow hedge £m	Fair value hedge £m
Exchange rate	351	86	182	444
Interest rate	123,244	18,920	97,749	11,083

	The bank			
	At 31 December 2010		At 31 December 2009	
	Cash flow hedge £m	Fair value hedge £m	Cash flow hedge £m	Fair value hedge £m
Interest rate	53,475	11,326	47,038	1,398

Fair value hedges

The group's fair value hedges principally consist of interest rate swaps that are used to protect against changes in the fair value of fixed-rate long-term financial instruments due to movements in market interest rates. For qualifying fair value hedges, all changes in the fair value of the derivative and in the fair value of the item in relation to the risk being hedged are recognised in the income statement. If the hedge relationship is terminated, the fair value adjustment to the hedged item continues to be reported as part of the basis of the item and is amortised to the income statement as a yield adjustment over the remainder of the hedging period.

Notes on the Financial Statements (continued)

The group

	At 31 December 2010		At 31 December 2009	
	Assets £m	Liabilities £m	Assets £m	Liabilities £m
Foreign Exchange	3	–	–	–
Interest rate	177	(705)	55	(399)
	180	(705)	55	(399)

The bank

	At 31 December 2010		At 31 December 2009	
	Assets £m	Liabilities £m	Assets £m	Liabilities £m
Interest rate	133	(381)	24	(1)
	133	(381)	24	(1)

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

	The group		The bank	
	2010 £m	2009 £m	2010 £m	2009 £m
Gains/ (losses)				
– on hedging instruments	(255)	7	(231)	45
– on hedged items attributable to the hedged risk...	248	(28)	236	(57)

The gains and losses on ineffective portions of fair value hedges are recognised immediately in 'Net trading income'.

Cash flow hedges

The group's cash flow hedges consist principally of interest rate and cross-currency swaps that are used to protect against exposures to variability in future interest cash flows on non-trading assets and liabilities which bear interest at variable rates or which are expected to be re-funded or reinvested in the future. The amounts and timing of future cash flows, representing both principal and interest flows, are projected for each portfolio of financial assets and liabilities on the basis of their contractual terms and other relevant factors, including estimates of prepayments and defaults. The aggregate principal balances and interest cash flows across all portfolios over time form the basis for identifying gains and losses on the effective portions of derivatives designated as cash flow hedges of forecast transactions. Gains and losses are initially recognised in other comprehensive income, in the cash flow hedging reserve, and are transferred to the income statement when the forecast cash flows affect the income statement.

Fair value of derivatives designated as cash flow hedges

The group

	At 31 December 2010		At 31 December 2009	
	Assets £m	Liabilities £m	Assets £m	Liabilities £m
Foreign exchange	5	(19)	–	(9)
Interest rate	1,150	(628)	1,616	(950)
	1,155	(647)	1,616	(959)

The bank

	At 31 December 2010		At 31 December 2009	
	Assets £m	Liabilities £m	Assets £m	Liabilities £m
Interest rate	781	(376)	1,042	(487)

Notes on the Financial Statements (continued)

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

The group

	At 31 December 2010			
	3 months or less £m	More than 3 months but less than 1 year £m	5 years or less but more than 1 year £m	More than 5 years £m
Assets	68,844	45,548	28,345	97
Liabilities.....	(33,808)	(19,057)	(12,968)	(760)
Net cash inflow/(outflow) exposure	35,036	26,491	15,377	(663)

	At 31 December 2009			
	3 months or less £m	More than 3 months but less than 1 year £m	5 years or less but more than 1 year £m	More than 5 years £m
Assets	43,520	46,485	25,874	24
Liabilities.....	(22,353)	(26,413)	(10,906)	(1,631)
Net cash inflow/(outflow) exposure	21,167	20,072	14,968	(1,607)

The bank

	At 31 December 2010			
	3 months or less £m	More than 3 months but less than 1 year £m	5 years or less but more than 1 year £m	More than 5 years £m
Assets	42,600	35,332	21,112	–
Liabilities.....	(12,324)	(11,634)	(11,125)	(210)
Net cash inflow/(outflow) exposure	30,276	23,698	9,987	(210)

	At 31 December 2009			
	3 months or less £m	More than 3 months but less than 1 year £m	5 years or less but more than 1 year £m	More than 5 years £m
Assets	35,006	32,478	20,190	–
Liabilities.....	(12,371)	(10,790)	(7,691)	(735)
Net cash inflow/(outflow) exposure	22,635	21,688	12,499	(735)

The gains and losses on ineffective portions of such derivatives are recognised immediately in 'Net trading income'. During the year to 31 December 2010, a loss of £4 million (2009: loss of £4 million) was recognised due to hedge ineffectiveness.

Notes on the Financial Statements (continued)

18 Financial investments

	The group		The bank	
	2010 £m	2009 £m	2010 £m	2009 £m
Financial investments:				
– which may be repledged or resold by counterparties	11,266	5,718	9,930	2,852
– not subject to repledge or resale by counterparties	90,820	80,977	31,408	24,537
	102,086	86,695	41,338	27,389
	The group		The bank	
	2010 £m	2009 £m	2010 £m	2009 £m
Treasury and other eligible bills	9,354	2,349	3,296	799
– available-for-sale	9,354	2,349	3,296	799
– held-to-maturity	–	–	–	–
Debt securities	91,306	82,030	37,492	25,653
– available-for-sale	87,025	77,179	37,492	25,653
– held-to-maturity	4,281	4,851	–	–
Equity securities	1,426	2,316	550	937
– available-for-sale	1,426	2,316	550	937
Total financial investments	102,086	86,695	41,338	27,389

For the group, £10,067 million (2009: £14,998 million), and for the bank, £3,707 million (2009: £10,045 million), of the debt securities issued by banks and other financial institutions are guaranteed by various governments.

19 Repurchase agreements and securities lending agreements

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

Transfers that do not qualify for derecognition

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

The group

	2010		2009	
	Carrying amount of assets £m	Carrying amount of associated liabilities £m	Carrying amount of assets £m	Carrying amount of associated liabilities £m
Nature of transaction				
Repurchase agreements	62,101	60,774	57,124	57,388
Securities lending agreements	4,173	4,203	4,087	4,087
Total	66,274	64,977	61,211	61,475

Notes on the Financial Statements (continued)

The bank

Nature of transaction	2010		2009	
	Carrying amount of assets £m	Carrying amount of associated liabilities £m	Carrying amount of assets £m	Carrying amount of associated liabilities £m
Repurchase agreements	33,471	32,144	22,778	23,048
Securities lending agreements	4,173	4,203	4,087	4,087
Total	37,644	36,347	26,865	27,135

20 Interests in associates and joint ventures

Principal associates of the group and the bank

VocaLink Holdings Ltd (VocaLink) is a principal associate of the bank and the group. VocaLink is incorporated in England and its principal activity is that of providing electronic payments and transaction services.

At 31 December 2010 and 31 December 2009, the group had a 15.22% interest in the £133 million issued equity capital of VocaLink. The carrying amount of group's interest at 31 December 2010 was £52 million (2009: £54 million).

VocaLink is accounted for as an associate due to the group's involvement in the operational activities, policy making decisions and representation on the board of directors.

Summarised financial information on associates

The group's share of:

	2010 £m	2009 £m
Assets	115	92
Liabilities	58	65
Revenue	42	57
Profit after tax	4	(1)

Interests in significant joint ventures

Vaultex UK Limited is a significant joint venture of the bank and the group. Vaultex UK Limited is incorporated in England and its principal activity is that of cash management services. At 31 December 2010 and 31 December 2009, the group had a 50% interest in the £10 million issued equity capital.

Holmwood Termtime Credit Limited was disposed of as part of the sale of HSBC Insurance Brokers Limited. Further disclosure on this disposal is provided in Note 23.

On 12 June 2009, the bank sold its remaining 49% stake in HSBC Merchant Services LLP to Global Payments Inc, the joint venture partner. The joint venture commenced in 2008 when the bank and Global Payments Inc commenced the card processing joint venture, with the bank retaining a 49% stake in this previously wholly-owned business.

Summarised financial information on joint ventures

The group's share of:

	2010 £m	2009 £m
Current assets	91	130
Non current assets	12	13
Current liabilities	85	125
Non current liabilities	11	10
Income	46	51
Expense	(45)	(49)

Details of all associates and joint ventures, as required under S.409 Companies Act 2006, will be annexed to the next Annual Return of the bank filed with the UK Registrar of Companies.

Notes on the Financial Statements (continued)

21 Goodwill and intangible assets

	The group		The bank	
	2010	2009	2010	2009
	£m	£m	£m	£m
Goodwill	9,860	10,015	298	299
Present value of in-force long-term assurance business ('PVIIF')	710	630	–	–
Other intangible assets	573	554	388	333
	11,143	11,199	686	632

Goodwill

The group

	2010	2009
	£m	£m
Gross amount and Carrying amount		
At 1 January	10,015	10,649
Additions	–	157
Disposals	–	–
Exchange differences	(140)	(762)
Other changes	(15)	(29)
At 31 December	9,860	10,015

The bank

	2010	2009
	£m	£m
Gross amount and Carrying amount		
At 1 January	299	296
Additions	–	3
Other changes	(1)	–
At 31 December	298	299

During 2010, no goodwill impairment was recognised (2009: nil). Impairment testing in respect of goodwill is performed at least annually by comparing the recoverable amount of cash-generating units ('CGUs') determined as at 1 July 2010 based on a value-in-use calculation. That calculation uses cash flow estimates based on management's cash flow projections, extrapolated in perpetuity using a nominal long-term growth rate based on current market assessments of GDP and inflation for the countries within which the CGU operates. Cash flows are extrapolated in perpetuity due to the long-term perspective within the group of the business units making up the CGUs. The discount rate used is based on the cost of capital the group allocates to investments in the countries within which the CGU operates.

The cost of capital assigned to an individual CGU and used to discount its future cash flows can have a significant effect on its valuation. The cost of capital percentage is generally derived from an appropriate capital asset pricing model, which itself depends on inputs reflecting a number of financial and economic variables including the risk-free rate in the country concerned and a premium or discount to reflect the inherent risk of the business being evaluated. These variables are established on the basis of management judgement and current market assessments of economic variables.

The review of goodwill impairment represents management's best estimates of the factors set out in Note 3. These values are sensitive to the cash flows projected for the periods for which detailed forecasts are available, and to assumptions regarding the long-term sustainable pattern of cash flows thereafter. While the acceptable range within which underlying assumptions can be applied is governed by the requirement for resulting forecasts to be compared with actual performance and verifiable economic data in future years, the cash flow forecasts necessarily and appropriately reflect management's view of future business prospects. The process of identifying and evaluating goodwill impairment is inherently uncertain because it requires significant management judgement in making a series of estimations, the results of which are highly sensitive to the assumptions used.

Notes on the Financial Statements (continued)

The following CGUs include in their carrying value goodwill that is a significant proportion of total goodwill reported by the group. These CGUs do not carry on their balance sheet any intangible assets with indefinite useful lives, other than goodwill.

	Goodwill at 1 July 2010 £m	Discount rate %	Nominal growth rate beyond initial cash flow projections %
Global Banking and Markets	5,368	11.0	3.3
Private Banking	2,980	11.0	2.6
Total goodwill in the CGUs listed above	<u>8,348</u>		

As at 1 July 2010, aggregate goodwill of £1,175 million (1 July 2009: £1,214 million) had been allocated to CGUs that were not considered individually significant. These CGUs do not carry on their balance sheets any significant intangible assets with indefinite useful lives other than goodwill.

Nominal long-term growth rate: external data that reflects the market's assessment of GDP and inflation for the countries within which the CGU operates. The rates used for 2009 and 2010 are taken as an average of the last 10 years.

Discount rate: the discount rate used to discount the cash flows is based on the cost of capital assigned to each CGU, which is derived using a Capital Asset Pricing Model ('CAPM'). The CAPM depends on inputs reflecting a number of financial and economic variables including the risk-free rate in the country concerned and a premium to reflect the inherent risk of the business being evaluated. These variables are based on the market's assessment of the economic variables and management's judgement. In addition, for the purposes of testing goodwill for impairment, management supplements this process by comparing the discount rates derived using the internally generated CAPM with cost of capital rates produced by external sources. The group uses the externally-sourced cost of capital rates where, in management's judgement, those rates reflect more accurately the current market and economic conditions.

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

Movement on the PVIF

The group

	2010 £m	2009 £m
At 1 January	630	579
Addition from current year new business	102	104
Movement from in-force business (including investment return variances and changes in investment assumptions).....	(9)	(34)
Exchange differences and other movements	(13)	(19)
At 31 December	<u>710</u>	<u>630</u>

The group's life insurance business is accounted for using the embedded value approach which, *inter alia*, provides a comprehensive risk and valuation framework. The PVIF asset represents the present value of the shareholders' interest in the profits expected to emerge from the book of in-force policies.

PVIF-specific assumptions

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

	2010		2009	
	France	UK Life	France	UK Life
Risk free rate	3.15%	3.46%	3.46%	3.50%
Risk discount rate	8.00%	7.00%	8.00%	7.00%
Expenses inflation	2.00%	3.76%	2.00%	3.50%

The calculation of the PVIF is based upon assumptions that take into account risk and uncertainty. To project these cash flows, a variety of assumptions regarding future experience is made by each insurance operation which reflects local market conditions and management's judgement of local future trends.

Notes on the Financial Statements (continued)

The following table shows the effect on the PVIF of reasonably possible changes in the main economic assumptions, namely the risk-free and risk discount rates, across all insurance manufacturing subsidiaries.

Sensitivity of PVIF to changes in economic assumptions

	PVIF at 31 December	
	2010 £m	2009 £m
+ 100 basis points shift in risk-free rate	11	17
– 100 basis points shift in risk-free rate	(19)	(18)
+ 100 basis points shift in risk discount rate .	(29)	(22)
– 100 basis points shift in risk discount rate .	33	27

Due to certain characteristics of the contracts, the relationships may be non-linear and the results of the stress-testing disclosed above should not be extrapolated to higher levels of stress. In calculating the various scenarios, all assumptions are held stable except when testing the effect of the shift in the risk-free rate, when resultant changes to investment returns, risk discount rates and bonus rates are also incorporated. The sensitivities shown are before actions that could be taken by management to mitigate effects and before resultant changes in policyholder behaviour.

Non-economic assumptions

The policyholder liabilities and PVIF are determined by reference to non-economic assumptions which include, for non-life manufacturers, claims costs and expense rates and, for life manufacturers, mortality and/or morbidity, lapse rates and expense rates. The table below shows the sensitivity of profit for the year to, and total equity at, 31 December 2010 to reasonably possible changes in these non-economic assumptions at that date across all insurance manufacturing subsidiaries, with comparatives for 2009.

The cost of claims is a risk associated with non-life insurance business. An increase in claims costs would have a negative effect on profit.

Mortality and morbidity risk is typically associated with life insurance contracts. The effect on profit of an increase in mortality or morbidity on profit depends on the type of business being written.

Sensitivity to lapse rates is dependent on the type of contracts being written. For insurance contracts, the cost of claims is funded by premiums received and income earned on the investment portfolio supporting the liabilities. For a portfolio of term assurance, an increase in lapse rates typically has a negative effect on profit due to the loss of future premium income on the lapsed policies.

Expense rate risk is the exposure to a change in expense rates. To the extent that increased expenses cannot be passed on to policyholders, an increase in expense rates will have a negative impact on profits.

Sensitivity to changes in non-economic assumptions

	Effect on profit for the year to 31 December		Effect on total equity at 31 December	
	2010 £m	2009 £m	2010 £m	2009 £m
20% increase in claims costs.....	(48)	(69)	(48)	(69)
20% decrease in claims costs	48	69	48	69
10% increase in mortality and/or morbidity rates	(14)	(15)	(14)	(15)
10% decrease in mortality and/or morbidity rates	13	15	13	14
50% increase in lapse rates	(110)	(107)	(110)	(107)
50% decrease in lapse rates.....	173	169	173	170
10% increase in expense rates	(21)	(19)	(21)	(20)
10% decrease in expense rates	21	20	21	20

Notes on the Financial Statements (continued)

Other intangible assets

The analysis of the movement of other intangible assets was as follows:

The group

	Trade Names £m	Internally generated software £m	Purchased Software £m	Customer/ merchant relation- ships £m	Other £m	Total £m
Cost						
At 1 January 2010	15	1,071	162	207	21	1,476
Additions ¹	–	172	12	–	–	184
Disposals	–	–	(3)	–	–	(3)
Amounts written off	–	(1)	(1)	–	–	(2)
Exchange differences	–	(3)	(4)	–	–	(7)
Other changes	1	8	(5)	–	(18)	(14)
At 31 December 2010	16	1,247	161	207	3	1,634
Accumulated amortisation and impairment						
At 1 January 2010	(11)	(712)	(105)	(91)	(3)	(922)
Amortisation charge for the year ²	(2)	(121)	(17)	(23)	1	(162)
Disposals	–	(1)	2	–	–	1
Amounts written off	–	1	1	–	–	2
Exchange differences	–	4	3	–	–	7
Other changes	–	6	5	–	2	13
At 31 December 2010	(13)	(823)	(111)	(114)	–	(1,061)
Net carrying amount at 31 December 2010	3	424	50	93	3	573
Cost						
At 1 January 2009	16	949	160	209	12	1,346
Additions ¹	–	135	17	–	10	162
Amounts written off	–	(3)	(1)	–	–	(4)
Exchange differences	(1)	(10)	(12)	(1)	(1)	(25)
Other changes	–	–	(2)	(1)	–	(3)
At 31 December 2009	15	1,071	162	207	21	1,476
Accumulated amortisation and impairment						
At 1 January 2009	(8)	(624)	(90)	(71)	(1)	(794)
Amortisation charge for the year ²	(2)	(103)	(20)	(21)	(1)	(147)
Impairment charge for the year ²	–	–	(3)	–	–	(3)
Amounts written off	–	3	1	–	–	4
Exchange differences	1	10	7	–	–	18
Other changes	(2)	2	–	1	(1)	–
At 31 December 2009	(11)	(712)	(105)	(91)	(3)	(922)
Net carrying amount at 31 December 2009	4	359	57	116	18	554

1 At 31 December 2010, the group did not have any contractual commitments to acquire intangible assets (2009: nil).

2 The amortisation and impairment charges for the year are recognised within the income statement under 'Amortisation and impairment of intangible assets'.

Notes on the Financial Statements (continued)

The bank

	Internally generated software £m	Other £m	Total £m
Cost			
At 1 January 2010	902	5	907
Additions ¹	162	1	163
Other changes	(5)	–	(5)
At 31 December 2010	1,059	6	1,065
Accumulated amortisation and impairment			
At 1 January 2010	(570)	(4)	(574)
Amortisation charge for the year ²	(108)	–	(108)
Other changes	6	(1)	5
At 31 December 2010	(672)	(5)	(677)
Net carrying amount at 31 December 2010	387	1	388
Cost			
At 1 January 2009	780	–	780
Additions ¹	125	5	130
Amounts written off	(3)	–	(3)
At 31 December 2009	902	5	907
Accumulated amortisation and impairment			
At 1 January 2009	(478)	–	(478)
Amortisation charge for the year ²	(95)	–	(95)
Impairment charge for the year ²	–	(4)	(4)
Amounts written off	3	–	3
At 31 December 2009	(570)	(4)	(574)
Net carrying amount at 31 December 2009	332	1	333

1 At 31 December 2010, the bank did not have any contractual commitments to acquire intangible assets (2009: nil).

2 The amortisation and impairment charges for the year are recognised within the income statement under 'Amortisation and impairment of intangible assets'.

Notes on the Financial Statements (continued)

22 Property, plant and equipment

The group

	Freehold land and buildings ⁴ £m	Long leasehold land and buildings £m	Short leasehold land and buildings £m	Equipment, fixtures and fittings ¹ £m	Equipment on operating leases £m	Total ² £m
Cost or fair value						
At 1 January 2010	842	26	492	3,251	3,227	7,838
Additions at cost ³	69	6	30	364	42	511
Reclassified to held for sale	(32)	–	–	2	–	(30)
Fair value adjustments	4	–	–	–	–	4
Disposals ⁵	(10)	–	(15)	(56)	(3,235)	(3,316)
Exchange differences	(8)	1	(6)	(10)	1	(22)
At 31 December 2010	<u>865</u>	<u>33</u>	<u>501</u>	<u>3,551</u>	<u>35</u>	<u>4,985</u>
Accumulated depreciation and impairment						
At 1 January 2010	(119)	(11)	(237)	(2,225)	(1,156)	(3,748)
Depreciation charge for the year	(13)	(5)	(40)	(298)	(98)	(454)
Reclassified to held for sale	10	–	–	(1)	–	9
Disposals	3	–	14	53	1,237	1,307
Impairment losses recognised	(6)	–	–	–	–	(6)
Exchange differences	5	–	(1)	9	2	15
At 31 December 2010	<u>(120)</u>	<u>(16)</u>	<u>(264)</u>	<u>(2,462)</u>	<u>(15)</u>	<u>(2,877)</u>
Net carrying amount at						
31 December 2010	<u>745</u>	<u>17</u>	<u>237</u>	<u>1,089</u>	<u>20</u>	<u>2,108</u>

1 Including assets held on finance leases with a carrying amount of £21 million (2009: £151 million).

2 Including assets with a carrying amount of £20 million (2009: £160 million) pledged as security for liabilities.

3 At 31 December 2010, the group had £3 million (2009: £232 million) of contractual commitments to acquire property, plant and equipment.

4 Including the investment properties on page 161.

5 Includes assets with a carrying value of £1,992 million disposed of in the sale of Eversholt Rail Group in the year. For more information see Note 23 Investments in subsidiaries.

Notes on the Financial Statements (continued)

	Freehold land and buildings ⁴ £m	Long leasehold land and buildings £m	Short leasehold land and buildings £m	Equipment, fixtures and fittings ¹ £m	Equipment on operating leases £m	Total ² £m
Cost or fair value						
At 1 January 2009	1,044	323	453	3,323	3,117	8,260
Additions at cost ³	117	3	38	268	187	613
Reclassified to held for sale	(243)	–	–	(38)	–	(281)
Acquisition of subsidiaries						
Fair value adjustments	(5)	–	–	–	–	(5)
Disposals	(29)	(295)	(7)	(218)	(77)	(626)
Transfers						
Exchange differences	(42)	(5)	8	(84)	–	(123)
At 31 December 2009	<u>842</u>	<u>26</u>	<u>492</u>	<u>3,251</u>	<u>3,227</u>	<u>7,838</u>
Accumulated depreciation and impairment						
At 1 January 2009	(119)	(33)	(204)	(2,157)	(1,050)	(3,563)
Depreciation charge for the year	(19)	(7)	(39)	(298)	(107)	(470)
Reclassified to held for sale	17	–	–	18	–	35
Disposals	7	28	6	162	1	204
Transfers						
Impairment losses recognised	(9)	–	(1)	(2)	–	(12)
Exchange differences	4	1	1	52	–	58
At 31 December 2009	<u>(119)</u>	<u>(11)</u>	<u>(237)</u>	<u>(2,225)</u>	<u>(1,156)</u>	<u>(3,748)</u>
Net carrying amount at						
31 December 2009	<u>723</u>	<u>15</u>	<u>255</u>	<u>1,026</u>	<u>2,071</u>	<u>4,090</u>

The bank

	Freehold land and buildings £m	Long leasehold land and buildings £m	Short leasehold land and buildings £m	Equipment, fixtures and fittings £m	Total £m
Cost or fair value					
At 1 January 2010	431	29	405	2,411	3,276
Additions at cost ¹	26	6	12	272	316
Reclassified from held for sale	–	–	–	2	2
Disposals	(8)	–	(11)	(37)	(56)
Exchange differences	(4)	(1)	(4)	1	(8)
At 31 December 2010	<u>445</u>	<u>34</u>	<u>402</u>	<u>2,649</u>	<u>3,530</u>
Accumulated depreciation and impairment					
At 1 January 2010	(74)	(11)	(197)	(1,714)	(1,996)
Depreciation charge for the year	(7)	(5)	(29)	(190)	(231)
Reclassified from held for sale	–	–	–	(2)	(2)
Disposals	2	–	10	32	44
Impairment losses recognised	(4)	–	–	–	(4)
Exchange differences	2	–	–	–	2
At 31 December 2010	<u>(81)</u>	<u>(16)</u>	<u>(216)</u>	<u>(1,874)</u>	<u>(2,187)</u>
Net carrying amount at 31 December 2010	<u>364</u>	<u>18</u>	<u>186</u>	<u>775</u>	<u>1,343</u>

Notes on the Financial Statements (continued)

	Freehold land and buildings £m	Long leasehold land and buildings £m	Short leasehold land and buildings £m	Equipment, fixtures and fittings £m	Total £m
Cost or fair value					
At 1 January 2009.....	322	328	373	2,408	3,431
Additions at cost ¹	111	1	22	178	312
Reclassified from held for sale.....	1	–	–	(1)	–
Disposals.....	(7)	(295)	(5)	(173)	(480)
Transfers.....					
Exchange differences.....	4	(5)	15	(1)	13
At 31 December 2009.....	431	29	405	2,411	3,276
Accumulated depreciation and impairment					
At 1 January 2009.....	(63)	(33)	(169)	(1,651)	(1,916)
Depreciation charge for the year.....	(8)	(7)	(29)	(183)	(227)
Disposals.....	2	28	3	122	155
Impairment losses recognised.....	(5)	–	(1)	(3)	(9)
Transfers.....					
Exchange differences.....	–	1	(1)	1	1
At 31 December 2009.....	(74)	(11)	(197)	(1,714)	(1,996)
Net carrying amount at 31 December 2009	357	18	208	697	1,280

1 At 31 December 2010, the bank had £2 million (2009: £42 million) of contractual commitments to acquire property, plant and equipment.

Investment properties

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

The group

	Freehold land and buildings ¹ £m
Fair value	
At 1 January 2010.....	86
Additions at cost.....	41
Fair value adjustments.....	4
Exchange and other changes.....	9
At 31 December 2010.....	140
Fair value	
At 1 January 2009.....	105
Fair value adjustments.....	(5)
Exchange and other changes.....	(14)
At 31 December 2009.....	86

1 Included in 'Property, plant and equipment' on page 159.

Investment properties are valued on an open market value basis as at 31 December each year by independent professional valuers who have recent experience in the location and type of properties.

Included within 'Other operating income' was rental income of £1 million (2009: £3 million) earned by the group on its investment properties. Direct operating expenses of £nil (2009: nil) incurred in respect of the investment properties during the year were recognised in 'General and administrative expenses'. Direct operating expenses arising in respect of investment properties that did not generate rental income during the year amounted to £ nil million (2009: nil). Net exchange differences on translation of investment properties were £1 million (2009: £10 million).

The bank

The bank had no investment properties at 31 December 2010 or 2009.

Notes on the Financial Statements (continued)

23 Investments in subsidiaries

Principal subsidiary undertakings of HSBC Bank plc

	Country of Incorporation or registration	HSBC Bank plc's interest in equity capital %	Share class
HSBC France	France	99.99	Ordinary €5.00
HSBC Asset Finance (UK) Limited	England	100.00	Ordinary £1
HSBC Bank A.S.	Turkey	100.00	A-Common TRL1 B-Common TRL1
HSBC Bank International Limited	Jersey	100.00	Ordinary £1
HSBC Bank Malta p.l.c.	Malta	70.03	Ordinary €0.30
HSBC Invoice Finance (UK) Limited	England	100.00	Ordinary £1
HSBC Life (UK) Limited	England	100.00	Ordinary £1
HSBC Private Bank (C.I.) Limited	Guernsey	99.87	Ordinary US\$1 Preference US\$0.10
HSBC Private Bank (Suisse) S.A.	Switzerland	100.00	Ordinary CHF1,000
HSBC Private Bank (UK) Limited	England	100.00	Ordinary £10
HSBC Trinkaus & Burkhardt AG	Germany	80.40	Shares of no par value
HSBC Trust Company (UK) Limited	England	100.00	Ordinary £5
Marks and Spencer Retail Financial Services Holdings Limited ...	England	100.00	Ordinary £1

Details of all HSBC Bank plc subsidiaries will be annexed to the next Annual Return of HSBC Bank plc filed with the UK Registrar of Companies.

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

	Carrying value of total consolidated assets £bn	Nature of SPE
Barion Funding Limited	2.9	Securities investment conduit
Bryant Park Funding LLC	1.9	Conduit
Malachite Funding Limited	2.6	Securities investment conduit
Mazarin Funding Limited	6.6	Securities investment conduit
Metrix Funding plc	0.9	Securitisation vehicle
Metrix Securities plc	0.6	Securitisation vehicle
Regency Assets Limited	4.1	Conduit
Solitaire Funding Limited	8.7	Securities investment conduit

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

Details of all subsidiaries, as required under S.409 Companies Act 2006, will be annexed to the next Annual Return of the bank filed with the UK Registrar of Companies.

Acquisitions

The group made no acquisitions of subsidiary undertakings but increased its investment in existing subsidiary undertakings during 2010, where no goodwill arose (2009: £157 million).

Disposals

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

Notes on the Financial Statements (continued)

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

On 1 December 2009, the group completed the sale of HSBC Actuaries and Consultants Limited to Jardine Lloyd Thompson UK Holdings Ltd for £27 million. On 30 November 2009, the aggregate total asset attribute to HSBC Actuaries and Consultants Limited were £15 million, and the entity generated a net loss after tax of £3 million for the period to 30 November 2009. The group's pre-tax profit on sale was £12 million.

24 Other assets

	The group		The bank	
	2010 £m	2009 £m	2010 £m	2009 £m
Bullion	979	778	880	688
Assets held for sale	56	297	38	40
Reinsurers' share of liabilities under insurance contracts	432	407	–	–
Endorsements and acceptances	494	352	231	191
Other accounts	4,157	6,179	2,205	3,311
	6,118	8,013	3,354	4,230

Assets held for sale

	The group		The bank	
	2010 £m	2009 £m	2010 £m	2009 £m
Non-current assets held for sale				
Property, plant and equipment	54	294	38	40
Financial assets	–	1	–	–
Other	2	2	–	–
Total assets classified as held for sale	56	297	38	40

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

Also included within property plant and equipment classified as held for sale is repossessed property that had been pledged as collateral by customers. These repossessed assets are expected to be disposed of within 12 months of acquisition.

25 Trading Liabilities

	The group		The bank	
	2010 £m	2009 £m	2010 £m	2009 £m
Deposits by banks	26,050	29,661	29,631	36,723
Customer accounts	36,915	29,038	30,559	24,900
Other debt securities in issue	17,454	19,306	13,978	16,088
Other liabilities – net short positions	51,941	40,876	24,244	19,110
	132,360	118,881	98,412	96,821

Notes on the Financial Statements (continued)

26 Financial liabilities designated at fair value

	The group		The bank	
	2010 £m	2009 £m	2010 £m	2009 £m
Deposits by banks and customer accounts	4,040	3,911	3,859	3,749
Liabilities to customers under investment contracts ...	4,775	4,039	-	-
Debt securities in issue	15,460	6,597	10,813	3,304
Subordinated liabilities	3,381	3,363	3,662	3,622
Preference shares	279	254	-	-
	27,935	18,164	18,334	10,675

The group

The carrying amount at 31 December 2010 of financial liabilities designated at fair value was £95 million higher (2009: £194 million higher) than the contractual amount at maturity. At 31 December 2010, the accumulated amount of change in fair value attributable to changes in credit risk was a gain of £118 million (2009: £233 million gain).

The bank

The carrying amount at 31 December 2010 of financial liabilities designated at fair value was £144 million lower (2009: £48 million lower) than the contractual amount at maturity. At 31 December 2010, the accumulated amount of change in fair value attributable to changes in credit risk was a gain of £175 million (2009: £323 million gain).

27 Other liabilities

	The group		The bank	
	2010 £m	2009 £m	2010 £m	2009 £m
Amounts due to investors in funds consolidated by the group	341	491	-	-
Obligations under finance leases	171	291	-	-
Endorsements and acceptances	494	352	231	191
Share based payment liability to HSBC Holdings	344	221	197	123
Other liabilities	3,510	4,512	1,793	2,322
	4,860	5,867	2,221	2,636

28 Liabilities under insurance contracts

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

Notes on the Financial Statements (continued)

	At 31 December 2009		
	Gross £m	Reinsurers' share £m	Net £m
Non-life insurance liabilities			
Unearned premium provision	168	(9)	159
Notified claims	342	(89)	253
Claims incurred but not reported	201	(12)	189
Other	48	(2)	46
	<u>759</u>	<u>(112)</u>	<u>647</u>
Life insurance liabilities to policyholders			
Life (non-linked)	1,506	(278)	1,228
Investment contracts with discretionary participation features ¹ ..	12,930	–	12,930
Life (linked)	1,310	(17)	1,293
	<u>15,746</u>	<u>(295)</u>	<u>15,451</u>
Total liabilities under insurance contracts	<u>16,505</u>	<u>(407)</u>	<u>16,098</u>

1 Though investment contracts with discretionary participation features are financial instruments, the group continued to treat them as insurance contracts as permitted by IFRS 4.

Movement on non-life insurance liabilities

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

Notes on the Financial Statements (continued)

	2009		
	Gross £m	Reinsurers' share £m	Net £m
Unearned premium reserve ('UPR')			
At 1 January	445	(71)	374
Changes in UPR recognised as (income)/expense	(143)	10	(133)
– gross written premiums	275	(43)	232
– gross earned premiums	(418)	53	(365)
Exchange differences and other movements	(134)	52	(82)
At 31 December	168	(9)	159
Notified and incurred but not reported claims			
At 1 January	422	(128)	294
– notified claims	345	(109)	236
– claims incurred but not reported	77	(19)	58
Claims paid in current year	(358)	45	(313)
Claims incurred in respect of current year	277	(44)	233
Claims incurred in respect of prior years	240	–	240
Exchange differences and other movements	(38)	26	(12)
At 31 December	543	(101)	442
– notified claims	342	(89)	253
– claims incurred but not reported	201	(12)	189
Other	48	(2)	46
Total non-life insurance liabilities	759	(112)	647

Life insurance liabilities to policyholders

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

Notes on the Financial Statements (continued)

	2009		
	Gross £m	Reinsurers' share £m	Net £m
Life (non-linked)			
At 1 January	2,031	(411)	1,620
Benefits paid	(802)	79	(723)
Increase in liabilities to policyholders	241	(44)	197
Exchange differences and other movements	36	98	134
At 31 December	1,506	(278)	1,228
Investment contracts with discretionary participation features			
At 1 January	12,157	–	12,157
Benefits paid	(1,154)	–	(1,154)
Increase in liabilities to policyholders	2,485	–	2,485
Exchange differences and other movements ¹	(558)	–	(558)
At 31 December	12,930	–	12,930
Life (linked)			
At 1 January	1,061	(7)	1,054
Benefits paid	(134)	5	(129)
Increase in liabilities to policyholders.....	400	(15)	385
Exchange differences and other movements ²	(17)	–	(17)
At 31 December	1,310	(17)	1,293
Total liabilities to policyholders	15,746	(295)	15,451

1 Includes movement in liabilities relating to discretionary profit participation benefits due to policyholders arising from net unrealised investment gains recognised in other comprehensive income.

2 Includes amounts arising under reinsurance agreements.

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

29 Provisions

	The group		The bank	
	2010	2009	2010	2009
	£m	£m	£m	£m
At 1 January	368	428	176	158
Additional provisions/increase in provisions ¹	237	103	102	49
Provisions utilised	(174)	(94)	(43)	(19)
Amounts reversed.....	(35)	(62)	(6)	(16)
Exchange differences and other movements	29	(7)	–	4
At 31 December	425	368	229	176

1 Includes unwinding of discounts of £3 million (2009: £2 million) in relation to vacant space provisions.

Points (i) and (ii) below relate to both the group and bank and point (iii) below relates only to bank:

- (i) A provision of £44 million (2009: £35 million) for the possible cost of redress relating to the sale of certain personal pension plans and mortgage endowment policies and a provision for indemnity clawbacks. The provision is based on an actuarial calculation extrapolated from a sample of cases. The timing of the expenditure depends on settlement of individual claims.
- (ii) Provisions of £62 million (2009: £78 million) for the estimated cost of redress in relation to provision of services to a number of trusts by a subsidiary of the bank. The bank has undertaken to reimburse the subsidiary in respect

Notes on the Financial Statements (continued)

of the initial estimated cost of redress. The total provision is based on a calculation extrapolated from a sample of cases. Uncertainties arise from factors affecting the timing of notifying and reimbursing those affected.

- (iii) Included in the above are provisions for onerous property contracts of £50 million (2009: £38 million) relating to the discounted future costs associated with leasehold properties that have become vacant. The provisions cover rent voids while finding new tenants, shortfalls in expected rent receivable compared with rent payable, and the cost of refurbishing the buildings to attract tenants. Uncertainties arise from movements in market rents, delays in finding new tenants and the timing of rental reviews.

30 Subordinated liabilities

	The group		The bank	
	2010 £m	2009 £m	2010 £m	2009 £m
Subordinated liabilities:				
– At amortised cost	7,407	6,799	7,562	6,955
Subordinated liabilities	5,070	4,412	7,562	6,955
Preference shares	2,337	2,387	–	–
– Designated at fair value	3,660	3,617	3,662	3,622
Subordinated liabilities	3,381	3,363	3,662	3,622
Preference shares	279	254	–	–
	11,067	10,416	11,224	10,577

Subordinated borrowings of the group

		Carrying amount	
		2010 £m	2009 £m
US\$300m	6.95% Subordinated Notes 2011	200	198
€250m	Floating Rate Subordinated Loan 2015	215	222
€600m	4.25% Callable Subordinated Notes 2016 ¹	530	557
€800m	Callable Subordinated Floating Rate Notes 2016 ²	689	710
£350m	Callable Subordinated Variable Coupon Notes 2017 ³	362	375
€1,000m	Floating Rate Subordinated Loan 2017	862	888
£500m	4.75% Callable Subordinated Notes 2020 ⁴	499	484
€500m	Callable Subordinated Floating Rate Notes 2020	381	394
US\$1,000m	Floating Rate Subordinated Loan 2020	644	–
£350m	5% Callable Subordinated Notes 2023 ⁵	353	339
£300m	6.5% Subordinated Notes 2023	297	298
US\$300m	7.65% Subordinated Notes 2025	220	192
£350m	5.375% Callable Subordinated Step-up Notes 2030 ⁶	329	327
£500m	5.375% Subordinated Notes 2033	469	478
£390m	6.9% Subordinated Loan 2033	390	390
US\$977m	Floating Rate Subordinated Loan 2040	629	–
€900m	7.75% Non-cumulative Subordinated Notes 2040	775	799
£225m	6.25% Subordinated Notes 2041	224	224
£600m	4.75% Subordinated Notes 2046	592	592
£700m	5.844% Non-cumulative Step-up Perpetual Preferred Securities ⁷	700	700
£300m	5.862% Non-cumulative Step-up Perpetual Preferred Securities ⁸	279	254
US\$750m	Undated Floating Rate Primary Capital Notes	483	462
US\$500m	Undated Floating Rate Primary Capital Notes	322	308
US\$300m	Undated Floating Rate Primary Capital Notes (Series 3)	193	185
£350m	7.9% Perpetual Subordinated Debt	–	350
£250m	7.991% Perpetual Subordinated Debt	–	250
	Other subordinated liabilities less than £100m	430	440
		11,067	10,416

1 On 15 February 2011, the bank gave notice to holders of its 4.25% Callable Subordinated Notes 2016 that it will call and redeem the notes at par on 18 March 2011.

2 On 15 February 2011, the bank gave notice to holders of its Callable Subordinated Floating Rate Notes 2016 that it will call and redeem the notes at par on 29 March 2011.

Notes on the Financial Statements (continued)

- 3 The interest rate on the Callable Subordinated Variable Coupon Notes 2017 is fixed at 5.75% until June 2012. Thereafter, the rate per annum is the sum of the gross redemption yield of the then prevailing five year UK gilt plus 1.70%.
- 4 The interest rate on the 4.75% Callable Subordinated Notes 2020 changes in September 2015 to three month sterling LIBOR plus 0.82%.
- 5 The interest rate on the 5% Callable Subordinated Notes 2023 changes in March 2018 to become the rate per annum which is the sum of the gross redemption yield of the then prevailing five year UK gilt plus 1.80%.
- 6 The interest rate on the 5.375% Callable Subordinated Step-up Notes 2030 changes in November 2025 to three month sterling LIBOR plus 1.50%.
- 7 The distribution rate on the 5.844% Non-cumulative Step-up Perpetual Preferred Securities changes in November 2031 to six month sterling LIBOR plus 1.76%.
- 8 The distribution rate on the 5.862% Non-cumulative Step-up Perpetual Preferred Securities changes in April 2020 to six month sterling LIBOR plus 1.85%.

Footnotes 3 to 8 all relate to notes that are repayable at the option of the borrower on the date of the change of the interest rate, and at subsequent interest rate reset dates and interest payment dates in some cases, subject to prior notification to the Financial Services Authority.

31 Fair value of financial instruments

The classification of financial instruments is determined in accordance with the accounting policies set out in Note 2(i) Financial instruments designated at fair value. The use of assumption and estimation in valuing financial instrument is described in Note 3 Critical accounting policies. Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction. The following table sets out the financial instrument carried at fair value.

The group

	Of which are classified in the following valuation hierarchy			Total £m
	Level 1 Quoted market price £m	Level 2 using observable inputs £m	Level 3 with significant un- observable inputs £m	
At 31 December 2010				
Assets				
Trading assets	110,369	47,635	1,548	159,552
Financial assets designated at fair value	9,674	5,793	–	15,467
Derivatives	783	127,115	1,260	129,158
Financial investments: available-for-sale	61,199	34,796	1,810	97,805
Liabilities				
Trading liabilities	71,744	57,440	3,176	132,360
Financial liabilities at fair value	3,932	24,003	–	27,935
Derivatives	601	126,543	2,060	129,204
At 31 December 2009				
Assets				
Trading assets	107,883	55,615	1,510	165,008
Financial assets designated at fair value	10,870	5,565	–	16,435
Derivatives	795	116,121	1,600	118,516
Financial investments: available-for-sale.....	33,163	50,258	3,274	86,695
Liabilities				
Trading liabilities	60,735	55,362	2,784	118,881
Financial liabilities at fair value	6,694	11,470	–	18,164
Derivatives	714	114,963	3,012	118,689

Notes on the Financial Statements (continued)

The bank

	Of which are classified in the following valuation hierarchy			Total £m
	Level 1 Quoted market price £m	Level 2 using observable inputs £m	Level 3 with significant un- observable inputs £m	
At 31 December 2010				
Assets				
Trading assets	76,983	47,983	1,527	126,493
Financial assets designated at fair value	608	3,897	–	4,505
Derivatives	605	106,919	1,381	108,905
Financial investments: available-for-sale	34,135	3,411	3,792	41,338
Liabilities				
Trading liabilities	40,205	54,776	3,431	98,412
Financial liabilities at fair value	40	18,294	–	18,334
Derivatives	537	105,940	2,309	108,786
At 31 December 2009				
Assets				
Trading assets	57,888	63,383	2,686	123,957
Financial assets designated at fair value	2,820	3,772	–	6,592
Derivatives	246	99,030	1,524	100,800
Financial investments: available-for-sale	9,463	15,248	2,678	27,389
Liabilities				
Trading liabilities	32,093	61,944	2,784	96,821
Financial liabilities at fair value	3,298	7,377	–	10,675
Derivatives	173	97,767	3,221	101,161

Control framework

Fair values are subject to a control framework designed to ensure that they are either determined, or validated, by a function independent of the risk-taker.

For all financial instruments where fair values are determined by reference to externally quoted prices or observable pricing inputs to models, independent price determination or validation is utilised. In inactive markets, direct observation of a traded price may not be possible. In these circumstances, the group will source alternative market information to validate the financial instrument's fair value, with greater weight given to information that is considered to be more relevant and reliable. The factors that are considered in this regard are, *inter alia*:

- the extent to which prices may be expected to represent genuine traded or tradeable prices;
- the degree of similarity between financial instruments;
- the degree of consistency between different sources;
- the process followed by the pricing provider to derive the data;
- the elapsed time between the date to which the market data relates and the balance sheet date; and
- the manner in which the data was sourced.

For fair values determined using a valuation model, the control framework may include, as applicable, independent development or validation of (i) the logic within valuation models; (ii) the inputs to those models; (iii) any adjustments required outside the valuation models; and, (iv) where possible, model outputs. Valuation models are subject to a process of due diligence and calibration before becoming operational and are calibrated against external market data on an ongoing basis.

Determination of fair value

Fair values are determined according to the following hierarchy:

- Level 1 – quoted market price*: financial instruments with quoted prices for identical instruments in active markets.
- Level 2 – valuation technique using observable inputs*: financial instruments with quoted prices for similar instruments in active markets or quoted prices for identical or similar instruments in inactive markets and financial instruments valued using models where all significant inputs are observable.

Notes on the Financial Statements (continued)

- (c) *Level 3 – valuation technique with significant unobservable inputs*: financial instruments valued using models where one or more significant inputs are unobservable.

The best evidence of fair value is a quoted price in an actively traded market. The fair values of financial instruments that are quoted in active markets are based on bid prices for assets held and offer prices for liabilities issued. Where a financial instrument has a quoted price in an active market and it is part of a portfolio, the fair value of the portfolio is calculated as the product of the number of units and quoted price and no block discounts are made. In the event that the market for a financial instrument is not active, a valuation technique is used.

The judgement as to whether a market is active may include, but is not restricted to, the consideration of factors such as the magnitude and frequency of trading activity, the availability of prices and the size of bid/offer spreads. The bid/offer spread represents the difference in prices at which a market participant would be willing to buy compared with the price at which they would be willing to sell. In inactive markets, obtaining assurance that the transaction price provides evidence of fair value or determining the adjustments to transaction prices that are necessary to measure the fair value of the instrument requires additional work during the valuation process.

Valuation techniques incorporate assumptions about factors that other market participants would use in their valuations, including interest rate yield curves, exchange rates, volatilities and prepayment and default rates. During the year, as a result of evolving market practice in the pricing of certain interest rate derivatives, the group has, for single currency swaps with collateralised counterparties and in significant major currencies, adopted a discounting curve that reflects the overnight interest rate typically earned or paid in respect of the collateral posted or received. Previously, in line with market practice, discount curves did not reflect this overnight interest rate but were based on a term LIBOR rates. The financial effect of this change was not significant.

The majority of valuation techniques employ only observable market data. However, certain financial instruments are valued on the basis of valuation techniques that feature one or more significant inputs that are unobservable, and for them, the derivation of fair value is more judgemental. An instrument in its entirety is classified as valued using significant unobservable inputs if, in the opinion of management, a significant proportion of the instrument's carrying amount and/or inception profit ('day 1 gain or loss') is driven by unobservable inputs. 'Unobservable' in this context means that there is little or no current market data available from which to determine the price at which an arm's length transaction would be likely to occur. It generally does not mean that there is no market data available at all upon which to base a determination of fair value (consensus pricing data may, for example, be used).

In certain circumstances, primarily where debt is hedged with interest rate derivatives, the group records its own debt in issue at fair value, based on quoted prices in an active market for the specific instrument concerned, if available.

When quoted market prices are unavailable, the own debt in issue is valued using valuation techniques, the inputs for which are either based upon quoted prices in an inactive market for the instrument, or are estimated by comparison with quoted prices in an active market for similar instruments. In both cases, the fair value includes the effect of applying the credit spread which is appropriate to the group's liability. The change in fair value of issued debt securities attributable to the group's own credit spread is computed as follows: for each security at each reporting date, an externally verifiable price is obtained or a price is derived using credit spreads for similar securities for the same issuer. Then, using discounted cash flow, each security is valued using a LIBOR-based discount curve. The difference in the valuations is attributable to the group's own credit spread. This methodology is applied consistently across all securities.

Structured notes issued and certain other hybrid instrument liabilities are included within trading liabilities and are measured at fair value. The credit spread applied to these instruments is derived from the spreads at which the group issues structured notes. These market spreads are smaller than credit spreads observed for plain vanilla debt or in the credit default swap markets. Gains and losses arising from changes in the credit spread of liabilities issued by the group reverse over the contractual life of the debt, provided that the debt is not repaid at a premium or a discount.

Credit risk adjustment methodology

A separate credit risk adjustment is calculated for each legal entity of the group, and within each entity for each counterparty to which the entity has exposure. The calculation of the monoline credit risk adjustment and sensitivity to different assumptions is described below. The credit risk adjustment is calculated by applying the probability of default of the counterparty to the expected positive exposure to the counterparty, and multiplying the result by the loss expected in the event of default. The calculation is performed over the life of the potential exposure.

Notes on the Financial Statements (continued)

The probability of default is based on the group's internal credit rating for the counterparty, taking into account how credit ratings may deteriorate over the duration of the exposure through the use of historic rating transition matrices. For most products, to calculate the expected positive exposure to a counterparty, a simulation methodology is used to incorporate the range of potential exposures across the portfolio of transactions with the counterparty over the life of an instrument. The simulation methodology includes credit mitigants such as counterparty netting agreements and collateral agreements with the counterparty. A standard loss given default assumption of 60% is generally adopted. The group does not adjust derivative liabilities for the group's own credit risk, such an adjustment is often referred to as a 'debit valuation adjustment'.

For certain types of exotic derivatives where the products are not currently supported by the simulation, or for derivative exposures in smaller trading locations where the simulation tool is not yet available, the group adopts alternative methodologies. These may involve mapping to the results for similar products from the simulation tool or where such a mapping approach is not appropriate, a simplified methodology is used, generally following the same principles as the simulation methodology. The calculation is applied at a trade level, with more limited recognition of credit mitigants such as netting or collateral agreements than used in the simulation methodology described previously.

The methodologies do not, in general, account for 'wrong-way risk'. Wrong-way risk arises where the underlying value of the derivative prior to any credit risk adjustment is positively correlated to the probability of default of the counterparty. Where there is significant wrong-way risk, a trade specific approach is applied to reflect the wrong-way risk within the valuation.

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

During 2010, no material changes were made to the methodologies used to calculate the credit risk adjustment.

Consideration of other methodologies for calculation of credit risk adjustments

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

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

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

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

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

Notes on the Financial Statements (continued)

Financial instruments measured at fair value using a valuation technique with significant unobservable inputs – Level 3

The group

	Assets				Liabilities		
	Available for sale £m	Held for Trading £m	Designated at fair value through profit or loss £m	Derivatives £m	Held for trading £m	Designated at fair value through profit or loss £m	Derivatives £m
At 31 December 2010							
Private equity investments.....	492	51	-	-	-	-	-
Asset-backed securities	1,228	58	-	-	-	-	-
Leverage finance.....	-	-	-	-	-	-	7
Structured notes	-	-	-	-	3,147	-	-
Derivatives with monolines.....	-	-	-	144	-	-	-
Other derivatives.....	-	-	-	1,116	-	-	2,048
Other portfolio	90	1,439	-	-	29	-	5
	1,810	1,548	-	1,260	3,176	-	2,060
At 31 December 2009							
Private equity investments.....	1,115	-	-	-	-	-	-
Asset-backed securities	2,092	128	-	-	-	-	-
Leverage finance.....	-	42	-	-	-	-	15
Structured notes	-	-	-	-	2,097	-	-
Derivatives with monolines.....	-	-	-	164	-	-	-
Other derivatives.....	-	-	-	1,436	-	-	2,997
Other portfolio	67	1,340	-	-	687	-	-
	3,274	1,510	-	1,600	2,784	-	3,012

The bank

	Assets				Liabilities		
	Available for sale £m	Held for Trading £m	Designated at fair value through profit or loss £m	Derivatives £m	Held for trading £m	Designated at fair value through profit or loss £m	Derivatives £m
At 31 December 2010							
Private equity investments.....	354	51	-	-	-	-	-
Asset-backed securities	3,348	47	-	-	-	-	-
Leverage finance.....	-	-	-	-	-	-	7
Structured notes	-	-	-	-	3,147	-	-
Derivatives with monolines.....	-	-	-	144	-	-	-
Other derivatives.....	-	-	-	1,237	284	-	2,297
Other portfolio	90	1,429	-	-	-	-	5
	3,792	1,527	-	1,381	3,431	-	2,309
At 31 December 2009							
Private equity investments.....	708	-	-	-	-	-	-
Asset-backed securities	1,903	1,304	-	-	-	-	-
Leverage finance.....	-	42	-	-	-	-	15
Structured notes	-	-	-	-	2,097	-	-
Derivatives with monolines.....	-	-	-	164	-	-	-
Other derivatives.....	-	-	-	1,360	-	-	3,206
Other portfolio	67	1,340	-	-	687	-	-
	2,678	2,686	-	1,524	2,784	-	3,221

- *Private equity*

The group's private equity positions are generally classified as available-for-sale and are not traded in active markets. In financial position and results, risk profile, prospects and other factors, as well as by reference to market valuations for similar entities quoted in an active market, or the price at which similar companies have changed ownership.

Notes on the Financial Statements (continued)

- *Asset-backed securities (ABSs)*

Illiquidity and a lack of transparency in the market for ABSs have resulted in less observable data being available. While quoted market prices are generally used to determine the fair value of these securities, valuation models are used to substantiate the reliability of the limited market data available and to identify whether any adjustments to quoted market prices are required. For ABSs including residential MBSs, the valuation uses an industry standard model and the assumptions relating to prepayment speeds, default rates and loss severity based on collateral type, and performance, as appropriate. The valuations output is benchmarked for consistency against observable data for securities of a similar nature.

- *Loan including leveraged finance and loans held for securitisation*

Loans held at fair value are valued from broker quotes and/or market data consensus providers when available. In the absence of an observable market, the fair value is determined using valuation techniques. These techniques include discounted cash flow models, which incorporate assumptions regarding an appropriate credit spread for the loan, derived from other market instruments issued by the same or comparable entities.

- *Structured notes*

The fair value of structured notes valued using a valuation technique is derived from the fair value of the underlying debt security, and the fair value of the embedded derivative is determined as described in the paragraph below on derivatives.

- *Derivatives*

OTC (i.e. non-exchange traded) derivatives are valued using valuation models. Valuation models calculate the present value of expected future cash flows, based upon 'no-arbitrage' principles. For many vanilla derivative products, such as interest rate swaps and European options, the modelling approaches used are standard across the industry. For more complex derivative products, there may be some differences in market practice. Inputs to valuation models are determined from observable market data wherever possible, including prices available from exchanges, dealers, brokers or providers of consensus pricing. Certain inputs may not be observable in the market directly, but can be determined from observable prices via model calibration procedures or estimated from historical data or other sources. Examples of inputs that may be unobservable include volatility surfaces, in whole or in part, for less commonly traded option products, and correlations between market factors such as foreign exchange rates, interest rates and equity prices. The valuation of derivatives with monolines is discussed on pages 171 to 172.

Reconciliation of fair value measurements in Level 3 of the fair value hierarchy:

The group

	Assets				Liabilities			
	Available for sale £m	Held for Trading £m	Designated at fair value through profit or loss £m	Derivatives £m	Held for trading £m	Designated at fair value through profit or loss £m	Derivatives £m	
At 1 January 2010.....	3,274	1,510	–	1,600	2,784	–	3,012	
Total gains or losses recognised in profit or loss	156	112	–	110	(36)	–	455	
Total gains or losses recognised in other comprehensive income	173	–	–	5	–	–	3	
Purchases	200	16	–	–	(227)	–	–	
Issues.....	–	–	–	–	800	–	–	
Sales	(921)	(24)	–	–	–	–	–	
Settlements.....	(133)	(10)	–	(63)	(314)	–	(701)	
Transfer out.....	(2,012)	(124)	–	(153)	(381)	–	(1,078)	
Transfer in.....	973	70	–	(214)	552	–	199	
Exchange differences.....	100	(2)	–	(25)	(2)	–	170	
At 31 December 2010.....	1,810	1,548	–	1,260	3,176	–	2,060	
Total gains or losses recognised in profit or loss relating to those assets and liabilities held at the end of the reporting period.....	(4)	113	–	302	(46)	–	694	

Notes on the Financial Statements (continued)

The bank

	Assets				Liabilities		
	Available for sale	Held for Trading	Designated at fair value through profit or loss	Derivatives	Held for trading	Designated at fair value through profit or loss	Derivatives
	£m	£m	£m	£m	£m	£m	£m
At 1 January 2010.....	2,678	2,686	–	1,524	2,784	–	3,221
Total gains or losses recognised in profit or loss	563	111	–	163	(54)	–	788
Total gains or losses recognised in other comprehensive income.....	(34)	–	–	7	–	–	4
Purchases	120	16	–	–	(227)	–	–
Issues.....	–	–	–	–	800	–	–
Sales	(531)	(24)	–	–	–	–	–
Settlements.....	(35)	(11)	–	52	(314)	–	(412)
Transfer out.....	(195)	(1,306)	–	(171)	(381)	–	(1,682)
Transfer in.....	1,300	100	–	(163)	831	–	220
Exchange differences.....	(74)	(45)	–	(31)	(8)	–	170
At 31 December 2010.....	3,792	1,527	–	1,381	3,431	–	2,309
Total gains or losses recognised in profit or loss relating to those assets and liabilities held at the end of the reporting period.....	402	112	–	326	(74)	–	958

Available-for-sale securities: greater pricing certainty of valuation in the ABS market (particularly MBS) has resulted in the transfer of assets out of Level 3 during 2010.

Trading assets: greater pricing certainty of valuation of certain ABS resulted in the transfer of assets out of Level 3 during 2010. Transfers into Level 3 were driven by ABS and certain other corporate bonds for which pricing certainty decreased.

Trading liabilities: transfers out of and in to Level 3 relate primarily to increased/ decreased observability of structured notes with embedded equity derivatives. New issuances relate to structured notes particularly those with embedded equity and foreign exchange derivatives.

Derivative liabilities: the increased observability in certain OTC equity derivative markets led to transfers out of Level 3

During 2010, there were no significant transfers between Level 1 and 2.

Effects of changes in significant unobservable assumptions to reasonably possible alternatives

As discussed above, the fair value of financial instruments are, in certain circumstances, measured using valuation techniques that incorporate assumptions that are not evidenced by prices from observable current market transactions in the same instrument and are not based on observable market data. The following table shows the sensitivity of fair values to reasonably possible alternative assumptions:

The group

	Reflected in profit/(loss)		Reflected in OCI	
	Favourable changes	Unfavourable changes	Favourable changes	Unfavourable changes
	£m	£m	£m	£m
At 31 December 2010				
Derivatives/trading assets/trading liabilities ¹	232	(217)	–	–
Financial investments: available-for-sale.....	–	–	180	(166)
At 31 December 2009				
Derivatives/trading assets/trading liabilities ¹	292	(153)	–	–
Financial investments: available-for-sale.....	–	–	543	(543)

Notes on the Financial Statements (continued)

The bank

	Reflected in profit/(loss)		Reflected in OCI	
	Favourable changes £m	Unfavourable changes £m	Favourable changes £m	Unfavourable changes £m
At 31 December 2010				
Derivatives/trading assets/trading liabilities ¹	242	(231)	–	–
Financial investments: available-for-sale.....	–	–	159	(145)
At 31 December 2009				
Derivatives/trading assets/trading liabilities ¹	415	(277)	–	–
Financial investments: available-for-sale.....	–	–	465	(465)

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

Sensitivity of fair values to reasonably possible alternate assumptions by Level 3 instrument type

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

	Reflected in profit or loss		Reflected in OCI	
	Favourable changes £m	Unfavourable changes £m	Favourable changes £m	Unfavourable changes £m
At 31 December 2009				
Private equity investments.....	–	–	112	(112)
Asset-backed securities.....	15	(16)	418	(418)
Leverage finance.....	–	–	–	–
Derivatives with monolines.....	56	3	–	–
Other derivatives.....	101	(96)	–	–
Other portfolio.....	120	(44)	13	(13)

Favourable and unfavourable changes are determined on the basis of changes in the value of the instrument as a result of varying the levels of the unobservable parameters using statistical techniques. When parameters are not amenable to statistical analysis, quantification of uncertainty is judgemental.

When the fair value of a financial instrument is affected by more than one unobservable assumption, the above table reflects the most favourable or most unfavourable change from varying the assumptions individually.

In respect of private equity investments, in many of the methodologies, the principal assumption is the valuation multiple to be applied to the main financial indicators. This may be determined with reference to multiples for comparable listed companies and includes discounts for marketability.

For ABSs, the principal assumptions in the models are based on benchmark information about prepayment speeds, default rates, loss severities and the historical performance of the underlying assets.

For leveraged finance, loans held for securitisation and derivatives with monolines the principal assumption concerns the appropriate value to be attributed to the counterparty credit risk. This requires estimation of exposure at default, probability of default and recovery in the event of default. For loan transactions, assessment of exposure at default is straightforward. For derivative transactions, a future exposure profile is generated on the basis of current market data. Probabilities of default and recovery levels are estimated using market evidence, which may include financial information, historical experience, CDS spreads and consensus recovery levels.

For structured notes and other derivatives, principal assumptions concern the value to be attributed to future volatility of asset values and the future correlation between asset values. These principal assumptions include credit volatilities

Notes on the Financial Statements (continued)

and correlations used in the valuation of structured credit derivatives (including leveraged credit derivatives). For such unobservable assumptions, estimates are based on available market data, which may include the use of a proxy method to derive volatility or a correlation from comparable assets for which market data is more readily available, and/or an examination of historical levels.

32 Fair values of financial instruments not carried at fair value

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

The group

	At 31 December 2010		At 31 December 2009	
	Carrying amount £m	Fair value £m	Carrying amount £m	Fair value £m
Assets				
Loans and advances to banks	57,027	57,019	46,994	46,970
Loans and advances to customers	285,218	281,853	274,659	269,542
Financial investments: Debt securities	4,281	4,548	4,851	5,235
Liabilities				
Deposits by banks ¹	48,287	48,287	57,729	57,730
Customer accounts	344,123	344,176	332,896	333,039
Debt securities in issue	48,119	47,991	39,340	38,702
Subordinated liabilities	7,407	6,948	6,799	6,381

The bank

	At 31 December 2010		At 31 December 2009	
	Carrying amount £m	Fair value £m	Carrying amount £m	Fair value £m
Assets				
Loans and advances to banks	27,860	27,860	20,729	20,729
Loans and advances to customers	208,548	205,163	208,669	203,855
Liabilities				
Deposits by banks	38,873	38,873	39,346	39,346
Customer accounts	230,795	230,795	223,652	224,363
Debt securities in issue	29,417	29,414	14,636	14,638
Subordinated liabilities	7,562	7,075	6,955	6,516

¹ The carrying amounts of these instruments are equal to the fair value because they are short-term in nature or reprice to current market rates frequently.

(i) Loans and advances to banks and customers

The fair value of loans and advances is based on observable market transactions, where available. In the absence of observable market transactions, fair value is estimated using discounted cash flow models.

Performing loans are grouped, as far as possible, into homogeneous pools segregated by maturity and coupon rates. In general, contractual cash flows are discounted using the group's estimate of the discount rate that a market participant would use in valuing instruments with similar maturity, repricing and credit risk characteristics.

The fair value of a loan portfolio reflects both loan impairments at the balance sheet date and estimates of market participants' expectations of credit losses over the life of the loans. For impaired loans, fair value is estimated by discounting the future cash flows over the time period in which they are expected to be recovered.

(ii) Financial investments

The fair values of listed financial investments are determined using bid market prices. The fair values of unlisted financial investments are determined using valuation techniques that take into consideration the prices and future earnings streams of equivalent quoted securities.

Notes on the Financial Statements (continued)

(iii) Deposits by banks and customer accounts

For the purposes of estimating fair value, deposits by banks and customer accounts are grouped by residual maturity. Fair values are estimated using discounted cash flows, applying current rates offered for deposits of similar remaining maturities. The fair value of a deposit repayable on demand is assumed to be the amount payable on demand at the balance sheet date.

(iv) Debt securities in issue and subordinated liabilities

Fair values are determined using quoted market prices at the balance sheet date where available, or by reference to quoted market prices for similar instruments.

The fair values in this note are stated at a specific date and may be significantly different from the amounts which will actually be paid on the maturity or settlement dates of the instruments. In many cases, it would not be possible to realise immediately the estimated fair values given the size of the portfolios measured. Accordingly, these fair values do not represent the value of these financial instruments to the group as a going concern.

33 Maturity analysis of assets and liabilities

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

The group

	On demand £m	Due within 3 months £m	Due between 3 and 12 months £m	Due between 1 and 5 years £m	Due after 5 years £m	Total £m
At 31 December 2010						
Deposits by banks	13,018	39,150	4,759	3,204	658	60,789
Customer accounts	234,438	86,053	31,709	4,564	641	357,405
Trading liabilities	132,360	–	–	–	–	132,360
Financial liabilities designated at fair value	4,762	857	1,855	11,153	14,810	33,437
Derivatives	129,204	200	649	814	202	131,069
Debt securities in issue	652	22,033	15,301	10,776	411	49,173
Subordinated liabilities	22	737	68	724	7,850	9,401
Other financial liabilities	1,795	4,628	1,874	553	411	9,261
	516,251	153,658	56,215	31,788	24,983	782,895
Loan commitments	112,718	717	386	204	19	114,044
Financial guarantee contracts	571	4,092	5,263	3,146	1,559	14,631
	629,540	158,467	61,864	35,138	26,561	911,570
At 31 December 2009						
Deposits by banks	14,476	48,265	8,989	2,203	705	74,638
Customer accounts	227,086	105,528	17,347	2,631	1,000	353,592
Trading liabilities	118,881	–	–	–	–	118,881
Financial liabilities designated at fair value	4,107	161	367	8,315	10,815	23,765
Derivatives	119,345	22	347	287	10	120,011
Debt securities in issue	–	22,290	8,817	8,962	228	40,297
Subordinated liabilities	27	47	79	1,724	7,610	9,487
Other financial liabilities	1,646	5,942	1,452	571	499	10,110
	485,568	182,255	37,398	24,693	20,867	750,781
Loan commitments ¹	114,711	700	227	401	44	116,083
Financial guarantee contracts	–	6,943	5,418	3,487	2,144	17,992
	600,279	189,898	43,043	28,581	23,055	884,856

¹ 2009 comparative data have been re-presented in line with the classification used in 2010. This resulted in an increase in the 'On demand' time band of £81,248, for 'Loan commitments'. There was an equivalent reduction across the other time bands.

Notes on the Financial Statements (continued)

The bank

	On demand	Due within 3 months	Due between 3 and 12 months	Due between 1 and 5 years	Due after 5 years	Total
At 31 December 2010						
Deposits by banks	11,619	24,858	2,311	2,067	135	40,990
Customer accounts	186,133	18,386	23,088	3,252	187	231,046
Trading liabilities	98,412	–	–	–	–	98,412
Financial liabilities designated at fair value	4	857	1,730	7,398	12,432	22,421
Derivatives	108,786	199	627	461	196	110,269
Debt securities in issue	652	7,285	13,918	7,962	63	29,880
Subordinated liabilities	–	735	25	1,353	6,458	8,571
Other financial liabilities	186	2,380	739	166	156	3,627
	405,792	54,700	42,438	22,659	19,627	545,216
Loan commitments	82,267	282	225	124	18	82,916
Financial guarantee contracts	–	3,729	3,816	2,031	812	10,388
	488,059	58,711	46,479	24,814	20,457	638,520
At 31 December 2009						
Deposits by banks	12,746	24,554	1,897	138	49	39,384
Customer accounts	185,937	26,788	9,577	1,170	610	224,082
Trading liabilities	96,821	–	–	–	–	96,821
Financial liabilities designated at fair value	83	119	330	4,483	10,236	15,251
Derivatives	101,161	21	340	106	3	101,631
Debt securities in issue	–	4,667	5,733	4,361	–	14,761
Subordinated liabilities	–	46	829	2,227	4,911	8,013
Other financial liabilities	184	3,943	318	124	117	4,686
	396,932	60,138	19,024	12,609	15,926	504,629
Loan commitments ¹	83,093	188	162	86	2	83,531
Financial guarantee contracts	–	4,654	4,074	1,992	1,461	12,181
	480,025	64,980	23,260	14,687	17,389	600,341

1 2009 comparative data have been re-presented in line with the classification used in 2010. This resulted in an increase in the 'On demand' time band of, £69,482 for 'Loan commitments'. There was an equivalent reduction across the other time bands.

Trading liabilities and trading derivatives have been included in the 'On demand' time bucket, and not by contractual maturity, because trading liabilities are typically held for short periods of time. The undiscounted cash flows on hedging derivative liabilities are classified according to their contractual maturity. The undiscounted cash flows potentially payable under financial guarantee contracts are classified on the basis of the earliest date they can be drawn down.

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

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

Notes on the Financial Statements (continued)

The group

	At 31 December 2010		
	Due within one year £m	Due after more than one year £m	Total £m
Assets			
Financial assets designated at fair value.....	556	14,911	15,467
Loans and advances to banks	54,356	2,671	57,027
Loans and advances to customers	140,227	144,991	285,218
Financial investments	27,312	74,774	102,086
Other financial assets	5,070	1,360	6,430
	227,521	238,707	466,228
Liabilities			
Deposits by banks	48,686	(399)	48,287
Customer accounts.....	338,438	5,685	344,123
Financial liabilities designated at fair value.....	2,860	25,075	27,935
Debt securities in issue	37,332	10,787	48,119
Other financial liabilities	4,627	1,159	5,786
Subordinated liabilities	22	7,385	7,407
	431,965	49,692	481,657
	At 31 December 2009		
	Due within one year £m	Due after more than one year £m	Total £m
Assets			
Financial assets designated at fair value.....	774	15,661	16,435
Loans and advances to banks	45,278	1,716	46,994
Loans and advances to customers	139,453	135,206	274,659
Financial investments	15,428	71,267	86,695
Other financial assets	7,565	2,068	9,633
	208,498	225,918	434,416
Liabilities			
Deposits by banks	56,456	1,273	57,729
Customer accounts.....	329,146	3,750	332,896
Financial liabilities designated at fair value.....	642	17,522	18,164
Debt securities in issue	31,286	8,054	39,340
Other financial liabilities	5,565	1,511	7,076
Subordinated liabilities	5	6,794	6,799
	423,100	38,904	462,004

Notes on the Financial Statements (continued)

The bank

	At 31 December 2010		
	Due within one year £m	Due after more than one year £m	Total £m
Assets			
Financial assets designated at fair value	84	4,421	4,505
Loans and advances to banks	26,760	1,100	27,860
Loans and advances to customers	99,035	109,513	208,548
Financial investments	8,995	32,343	41,338
Other financial assets	2,561	1,076	3,637
	137,435	148,453	285,888
Liabilities			
Deposits by banks	38,514	359	38,873
Customer accounts	224,655	6,140	230,795
Financial liabilities designated at fair value	2,493	15,841	18,334
Debt securities in issue	21,334	8,083	29,417
Other financial liabilities	2,334	583	2,917
Subordinated liabilities	–	7,562	7,562
	289,330	38,568	327,898
At 31 December 2009			
	Due within one year £m	Due after more than one year £m	Total £m
Assets			
Financial assets designated at fair value	153	6,439	6,592
Loans and advances to banks	19,178	1,551	20,729
Loans and advances to customers	105,397	103,272	208,669
Financial investments	4,833	22,556	27,389
Other financial assets	3,914	1,588	5,502
	133,475	135,406	268,881
Liabilities			
Deposits by banks	38,455	891	39,346
Customer accounts	218,493	5,159	223,652
Financial liabilities designated at fair value	267	10,408	10,675
Debt securities in issue	10,316	4,320	14,636
Other financial liabilities	2,800	582	3,382
Subordinated liabilities	799	6,156	6,955
	271,130	27,516	298,646

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

34 Foreign exchange exposures

The group's structural foreign currency exposure is represented by the net asset value of its foreign currency equity and subordinated debt investments in subsidiary undertakings, branches, joint ventures and associates.

The group's management of structural foreign currency exposures is discussed in risk section in the Report of Directors.

Notes on the Financial Statements (continued)**Net structural currency exposures***Currency of structural exposure*

	2010 £m	2009 £m
Euro.....	12,313	12,743
US dollars	2,558	1,916
Swiss francs	2,162	1,792
Turkish lira.....	1,194	1,073
Russian rouble	166	182
Others, each less than £100 million.....	221	155
Total	18,614	17,861

35 Assets charged as security for liabilities and collateral accepted as security for assets

Financial assets pledged to secure liabilities are as follows:

	Group assets pledged at 31 December		Bank assets pledged at 31 December	
	2010 £m	2009 £m	2010 £m	2009 £m
Treasury bills and other eligible securities.....	532	–	29	–
Loans and advances to banks	6,467	3,381	6,432	3,168
Loans and advances to customers	23,077	31,901	12,439	22,688
Debt securities	110,978	108,383	61,721	54,635
Equity shares.....	4,231	4,173	4,173	4,087
Other	84	–	–	–
	145,369	147,838	84,794	84,578

These transactions are conducted under terms that are usual and customary to standard securities lending and repurchase agreements.

Collateral accepted as security for assets

The fair value of financial assets accepted as collateral that the group is permitted to sell or repledge in the absence of default is £157,462 million (2009: £175,084 million) (the bank: 2010 £83,643 million; 2009 £95,662 million). The fair value of financial assets accepted as collateral that have been sold or repledged is £93,643 million (2009: £100,631 million) (the bank: 2010 £29,208 million; 2009 £31,189 million). The group is obliged to return these assets.

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

36 Called up share capital and other equity instruments**Authorised**

The concept of authorised share capital was abolished under the UK Companies Act 2006 with effect from 1 October 2009 and amendments to the Company's Articles of Association were approved by shareholders at a General Meeting on 1 October 2009.

Issued**HSBC Bank plc ordinary shares**

	Number	£m
At 1 January 2010.....	796,969,107	797
Shares issued	–	–
At 31 December 2010.....	796,969,107	797
At 1 January 2009.....	796,969,104	797
Shares issued	3	–
At 31 December 2009.....	796,969,107	797

Notes on the Financial Statements (continued)**HSBC Bank plc non-cumulative third dollar preference shares**

	Number	£'000
At 1 January and 31 December 2010.....	<u>35,000,000</u>	<u>172</u>
At 1 January and 31 December 2009	<u>35,000,000</u>	<u>172</u>

The bank has no obligation to redeem the preference shares but may redeem them in part or in whole at any time, with prior notification to the FSA. Dividends on the preference shares in issue are paid annually at the sole and absolute discretion of the Board of Directors. The Board of Directors will not declare a dividend on the preference shares in issue if payment of the dividend would cause the bank not to meet the capital adequacy requirements of the FSA or the profit of the bank, available for distribution as dividends, is not sufficient to enable the bank to pay in full both dividends on the preference shares in issue and dividends on any other shares that are scheduled to be paid on the same date and have an equal right to dividends or if payment of the dividend is prohibited by the rights attached to any class of shares in the capital of the bank, excluding ordinary shares. The preference shares in issue carry no rights to conversion into ordinary shares of the bank. Holders of the preference shares in issue will be able to attend any general meetings of shareholders of the bank and to vote on any resolution proposed to vary or abrogate any of the rights attaching to the preference shares or any resolution proposed to reduce the paid up capital of the preference shares. If the dividend payable on the preference shares in issue has not been paid in full for the most recent dividend period or any resolution is proposed for the winding-up of the bank or the sale of its entire business then, in such circumstances, holders of preference shares will be entitled to vote on all matters put to general meetings. In the case of unpaid dividends the holders of preference shares in issue will be entitled to attend and vote at any general meetings until such time as dividends on the preference shares have been paid in full, or a sum set aside for such payment in full, in respect of one dividend period.

All shares in issue are fully paid.

HSBC Bank plc perpetual subordinated debt

	£m
At 1 January and 31 December 2010.....	<u>1,750</u>
At 1 January and 31 December 2009	<u>1,750</u>

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

Notes on the Financial Statements (continued)

37 Notes on the cash flow statement

Non-cash items included in profit before tax

	The group		The bank	
	2010 £m	2009 £m	2010 £m	2009 £m
Depreciation, amortisation and impairment	622	632	343	336
Share-based payment expense	246	191	166	107
Credit-related impairment losses gross of recoveries	1,952	3,364	1,614	2,784
Provisions raised	202	40	95	33
Impairment of investments	8	164	156	65
Credit charge for defined benefit plans	239	(79)	208	(108)
Accretion of discounts and amortisation of premiums	(432)	(88)	(367)	(91)
	2,837	4,224	2,215	3,126

Change in operating assets

	The group		The bank	
	2010 £m	2009 £m	2010 £m	2009 £m
Change in prepayments and accrued income	(214)	2,162	(294)	1,336
Change in net trading securities and net derivatives	22,388	(6,301)	(1,260)	(5,852)
Change in loans and advances to banks	1,229	8,339	(5,783)	14,389
Change in loans and advances to customers	(10,482)	22,527	(1,205)	7,049
Change in financial assets designated at fair value	951	(2,516)	2,087	(2,000)
Change in other assets	3,353	1,011	932	(518)
	17,225	25,222	(5,523)	14,404

Change in operating liabilities

	The group		The bank	
	2010 £m	2009 £m	2010 £m	2009 £m
Change in accruals and deferred income	214	(1,703)	103	(733)
Change in deposits by banks	(9,443)	(3,702)	(473)	(15,640)
Change in customer accounts	11,232	(36,984)	7,152	(16,831)
Change in debt securities in issue	8,974	(12,938)	14,781	5,966
Change in financial liabilities designated at fair value	9,770	2,982	7,659	1,246
Change in other liabilities	121	(737)	(488)	(550)
	20,868	(53,082)	28,734	(26,542)

Cash and cash equivalents

	The group		The bank	
	2010 £m	2009 £m	2010 £m	2009 £m
Cash and balances at central banks	24,495	14,274	22,357	13,130
Items in the course of collection from other banks	1,932	2,082	1,030	1,071
Loans and advances to banks of one month or less	53,557	42,076	26,086	24,802
Treasury bills, other bills and certificates of deposit less than three months	7,432	3,851	2,463	2,294
Less: items in the course of transmission to other banks	(1,411)	(1,477)	(577)	(595)
Total cash and cash equivalents¹	86,005	60,806	51,359	40,702

¹ Total cash and cash equivalents include the following amounts that are not available for use by the group: Nil held by foreign subsidiaries and subject to foreign exchange control restrictions (2009: £13 million); and £1,459 million subject to other restrictions (2009: £1,451 million).

Total interest paid by the group during the year was £4,062 million (2009: £7,626 million). Total interest received by the group during the year was £12,401 million (2009: £18,153 million). Total dividends received by the group during the year were £259 million (2009: £567 million).

Notes on the Financial Statements (continued)

38 Contingent liabilities, contractual commitments and guarantees

	The group		The bank	
	2010	2009	2010	2009
	£m	£m	£m	£m
Guarantees and other contingent liabilities				
Guarantees and irrevocable letters of credit pledged as collateral security	17,324	20,971	11,293	13,507
Other contingent liabilities	32	32	–	–
	17,356	21,003	11,293	13,507
Commitments¹				
Documentary credits and short-term trade-related transactions	1,809	1,515	725	495
Forward asset purchases and forward deposits placed.....	19	492	–	–
Undrawn formal standby facilities, credit lines and other commitments to lend ²	112,215	114,076	82,191	83,036
	114,043	116,083	82,916	83,531

1 Excluding capital commitments, which are separately disclosed below.

2 Based on original contractual maturity.

The table above discloses the nominal principal amounts of commitments, guarantees and other contingent liabilities. They are mainly credit-related instruments which include both financial and non-financial guarantees and commitments to extend credit. Nominal principal amounts represent the amounts at risk should contracts be fully drawn upon and clients default. As a significant portion of guarantees and commitments is expected to expire without being drawn upon, the total of these nominal principal amounts is not representative of future liquidity requirements.

Contingent liabilities arising from litigation against the group are disclosed in Note 40.

Financial Services Compensation Scheme

The Financial Services Compensation Scheme ('FSCS') has provided compensation to consumers following the collapse of a number of deposit takers. The compensation paid out to consumers is currently funded through loans from the Bank of England and HM Treasury. The bank could be liable to pay a proportion of the outstanding borrowings that the FSCS has borrowed from HM Treasury which at 31 March 2010 stood at approximately £20 billion. Currently, the levy paid by the bank represents its share of the interest on these borrowings.

The ultimate FSCS levy to the industry as a result of the collapses cannot currently be estimated reliably as it is dependent on various uncertain factors including the potential recoveries of assets by the FSCS and changes in the interest rate, the level of protected deposits and the population of FSCS members at the time.

Guarantees

The group provides guarantees and similar undertakings on behalf of both third party customers and other entities within the group. These guarantees are generally provided in the normal course of the group's banking business. The principal types of guarantees provided, and the maximum potential amount of future payments which the group could be required to make at 31 December, were as follows:

Notes on the Financial Statements (continued)

The group

	At 31 December 2010		At 31 December 2009	
	Guarantees in favour of third parties	Guarantees by the group in favour of other Group entities	Guarantees in favour of third parties	Guarantees by the group in favour of other Group entities
	£m	£m	£m	£m
Guarantees type				
Financial guarantee contracts ¹	7,920	1,171	10,051	927
Standby letters of credit which are financial guarantee contracts ²	456	8	1,791	1
Other direct credit substitutes ³	546	68	314	39
Performance bonds ⁴	2,018	62	2,048	51
Bid bonds ⁴	46	2	45	3
Standby letters of credit related to particular transactions ⁴	561	–	444	–
Other transaction-related guarantees ⁴	4,393	21	4,803	18
Other items	84	–	468	–
Total	16,024	1,332	19,964	1,039

The bank

	At 31 December 2010		At 31 December 2009	
	Guarantees in favour of third parties	Guarantees by the bank in favour of other Group entities	Guarantees in favour of third parties	Guarantees by the bank in favour of other Group entities
	£m	£m	£m	£m
Guarantees type				
Financial guarantee contracts ¹	5,486	2,242	7,535	2,311
Standby letters of credit which are financial guarantee contracts ²	7	–	5	–
Performance bonds ⁴	701	76	734	48
Bid bonds ⁴	16	12	12	3
Standby letters of credit related to particular transactions ⁴	128	–	107	–
Other transaction-related guarantees ⁴	2,174	451	2,290	26
Other items	–	–	436	–
Total	8,512	2,781	11,119	2,388

1 *Financial guarantees contracts are contracts that require the issuer to make specified payments to reimburse the holder for a loss incurred because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument. The amounts in the above table are nominal principal amounts.*

2 *Standby letters of credit which are financial guarantee contracts are irrevocable obligations on the part of the group and/or the bank to pay third parties when customers fail to make payments when due.*

3 *Other direct credit substitutes include reinsurance letters of credit and trade-related letters of credit issued without provision for the issuing entity to retain title to the underlying shipment.*

4 *Performance bonds, bid bonds, standby letters of credit and other transaction-related guarantees are undertakings by which the obligation on the group and/or the bank to make payment depends on the outcome of a future event.*

The amounts disclosed in the above table reflect the group's maximum exposure under a large number of individual guarantee undertakings. The risks and exposures arising from guarantees are captured and managed in accordance with the group's overall credit risk management policies and procedures. Guarantees with terms of more than one year are subject to the group's annual credit review process.

Other commitments

In addition to the commitments disclosed above, at 31 December 2010 the group had contractual commitments to purchase, within one year, land and buildings and other fixed assets from a number of suppliers for a value of £4 million (2009: £239 million).

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

Notes on the Financial Statements (continued)

39 Lease commitments

Finance lease commitments

The group leases land and buildings (including branches) and equipment from third parties under finance lease arrangements to support its operations.

	2010			2009		
	Total future minimum payments	Interest charges	Present value	Total future minimum payments	Interest charges	Present value
	£m	£m	£m	£m	£m	£m
No later than one year	12	(11)	1	22	(19)	3
Later than one year and no later than five years	53	(51)	2	103	(77)	26
Later than five years	242	(74)	168	372	(110)	262
	307	(136)	171	497	(206)	291

At 31 December 2010 future minimum sublease payments of £281 million (2009: £315 million) were expected to be received under non-cancellable subleases at the balance sheet date.

Operating lease commitments

At 31 December 2010, the group was obligated under a number of non-cancellable operating leases for properties, plant and equipment for which the future minimum lease payments extend over a number of years.

	Land and buildings	
	2010	2009
	£m	£m
Future minimum lease payments under non-cancellable operating leases expiring		
No later than one year	189	173
Later than one year and no later than five years	680	608
Later than five years	1,213	1,182
	2,082	1,963

In 2010, £162 million (2009: £113 million) was charged to 'General and administrative expenses' in respect of lease and sublease agreements, all of which related to minimum lease payments.

Finance lease receivables

HSBC leases a variety of assets to third parties under finance leases, including transport assets (such as aircraft), property and general plant and machinery. At the end of lease terms, assets may be sold to third parties or leased for further terms. Lessees may participate in any sales proceeds achieved. Lease rentals arising during the lease terms will either be fixed in quantum or be varied to reflect changes in, for example, tax or interest rates. Rentals are calculated to recover the cost of assets less their residual value, and earn finance income.

	2010			2009		
	Total future minimum payments	Interest charges	Present value	Total future minimum payments	Interest charges	Present value
	£m	£m	£m	£m	£m	£m
Lease receivables						
No later than one year	1,049	(138)	911	987	(111)	876
Later than one year and no later than five years	2,938	(438)	2,500	2,996	(486)	2,510
Later than five years	2,766	(762)	2,004	3,264	(951)	2,313
	6,753	(1,338)	5,415	7,247	(1,548)	5,699

At 31 December 2010, unguaranteed residual values of £114 million (2009: £110 million) had been accrued, and the accumulated allowance for uncollectible minimum lease payments receivable amounted to £2 million (2009: £8 million).

In 2010, £42 million (2009: £51 million) was paid as contingent rents and recognised in the income statement.

Notes on the Financial Statements (continued)

Operating lease receivables

The group leases a variety of different assets to third parties under operating lease arrangements, including property, aircraft and general plant and machinery.

	Equipment 2010	2009
	£m	£m
Future minimum lease payments under non-cancellable operating leases expiring		
No later than one year	10	267
Later than one year and no later than five years	14	565
Later than five years	1	276
	<u>25</u>	<u>1,108</u>

In 2010, nil (2009: £2 million) was received as contingent rents and recognised in 'Other operating income'.

40 Legal proceedings and regulatory matters

Bernard L. Madoff Investment Securities LLC

In December 2008, Bernard L. Madoff ('Madoff') was arrested for running a Ponzi scheme and a trustee was appointed for the liquidation of his firm, Bernard L. Madoff Investment Securities LLC ('Madoff Securities'), an SEC-registered broker-dealer and investment adviser. Since his appointment, the trustee has been recovering assets and processing claims of Madoff Securities customers. Madoff subsequently pleaded guilty to various charges and is serving a 150 year prison sentence. He has acknowledged, in essence, that while purporting to invest his customers' money in securities and, upon request, return their profits and principal, he in fact never invested in securities and used other customers' money to fulfil requests for the return of profits and principal. The relevant US authorities are continuing their investigations into his fraud, and have brought charges against others.

Various non-US HSBC companies provided custodial, administration and similar services to a number of funds incorporated outside the US whose assets were invested with Madoff Securities.

Based on information provided by Madoff Securities, as at 30 November 2008, the purported aggregate value of these funds was US\$8.4 billion, an amount that includes fictitious profits reported by Madoff. Based on information available to HSBC to date, we estimate that the funds' actual transfers to Madoff Securities minus their actual withdrawals from Madoff Securities during the time that HSBC serviced the funds totalled approximately US\$4.3 billion.

Plaintiffs (including funds, fund investors, and the Madoff Securities trustee) have commenced Madoff-related proceedings against numerous defendants in a multitude of jurisdictions. Various HSBC companies have been named as defendants in suits in the US, Ireland, Luxembourg, and other jurisdictions. The suits (which include US class actions) allege that the HSBC defendants knew or should have known of Madoff's fraud and breached various duties to the funds and fund investors. In December 2010, the Madoff Securities trustee commenced suits against various HSBC companies in the US bankruptcy court and in the English High Court. The US action (which also names certain funds, investment managers, and other entities and individuals) seeks US\$9 billion in damages and additional recoveries from HSBC and the various co-defendants. It seeks damages against HSBC for allegedly aiding and abetting Madoff's fraud and breach of fiduciary duty. It also seeks, pursuant to US bankruptcy law, recovery of unspecified amounts received by HSBC from funds invested with Madoff, including amounts that HSBC received when it redeemed units HSBC held in various funds. HSBC acquired those fund units in connection with financing transactions HSBC had entered into with various clients. The trustee's US bankruptcy law claims also seek recovery of fees earned by HSBC for providing custodial, administration and similar services to the funds. The trustee's English action seeks recovery of unspecified transfers of money from Madoff Securities to or through HSBC, on the ground that the HSBC defendants actually or constructively knew of Madoff's fraud.

Between October 2009 and July 2010, Fairfield Sentry Limited and Fairfield Sigma Limited ("Fairfield"), funds whose assets were directly or indirectly invested with Madoff Securities, commenced multiple suits in the British Virgin Islands and the US against numerous fund shareholders, including various HSBC companies that acted as nominees for clients of HSBC's private banking business and other clients who invested in the Fairfield funds. The Fairfield actions seek restitution of amounts paid to the defendants in connection with share redemptions, on the ground that such payments were made by mistake, based on inflated values resulting from Madoff's fraud.

Notes on the Financial Statements (continued)

There are many factors which may affect the range of possible outcomes, and the resulting financial impact of various Madoff-related proceedings, including but not limited to the circumstances of the fraud, the multiple jurisdictions in which the proceedings have been brought and the number of different plaintiffs and defendants in such proceedings. The cases where HSBC companies are named as a defendant are at an early stage. For these reasons, among others, it is not practicable at this time for HSBC to estimate reliably the aggregate liabilities, or ranges of liabilities that might arise as a result of all such claims but they could be significant. In any event, HSBC considers that it has good defences to these claims and will continue to defend them vigorously.

Payment Protection Insurance

Following an extensive period of consultation, on 10 August 2010 the Financial Services Authority ('FSA') published Policy Statement 10/12 ('PS 10/12') on the assessment and redress of Payment Protection Insurance ('PPI') complaints. This included (i) new handbook guidance setting out how complaints are to be handled, and 'redressed fairly' where appropriate; (ii) an explanation of when and why firms should analyse their past complaints to identify if there are serious flaws in sales practices that may have affected complainants and non-complainants; and (iii) an Open Letter setting out common sales failings to help firms identify bad practices.

After extensive consideration, the British Bankers Association ('BBA'), as the representative body of UK banks, sent a formal pre-action protocol letter to the FSA and the Financial Ombudsman Service ('FOS') setting out its concerns and what it considered to be the flaws identified in PS 10/12 and Guidance issued by FOS on the handling of PPI complaints. The letter indicated that, absent a satisfactory reply, it was the BBA's intention to apply to the High Court for a Judicial Review of both PS 10/12 and the FOS Guidance. The FSA and FOS responded on 28 September 2010 denying that they had acted unlawfully in introducing the Policy Statement or relying on the Guidance.

On 8 October 2010, an application for Judicial Review was issued by the BBA seeking an order to quash PS 10/12 and the FOS Guidance. The FSA subsequently issued a statement on 24 November 2010 seeking to clarify aspects of PS 10/12 and the Open Letter. The FSA and FOS filed defences to the Judicial Review application on 10 December 2010. The Judicial Review application was heard by the Court on 25 – 28 January 2011, and Judgement is currently awaited.

HSBC believes that the BBA has a strongly arguable case against both the FSA and the FOS. If the Court ultimately concludes, however, after any appeals of the Judgement that may follow from any of the parties, that PS 10/12 and the FOS Guidance stand, in whole or in part, then these would need to be taken into consideration when determining complaints alleging the mis-sale of PPI.

If, contrary to HSBC's current assessment, a decision is reached in the case that results in a potential liability for HSBC, a large number of different outcomes is possible, each of which would have a different financial impact. There are many factors affecting the range of possible outcomes, and the resulting financial impact, including the extent to which one or both of PS 10/12 and the FOS Guidance are upheld, and the underlying rationale for each decision; the ways in which PS 10/12 and or the FOS Guidance are found to impose additional requirements over and above the common law and the FSA Conduct of Business rules in force at the time relating to the sale of general insurance products, and in the handling of firms' PPI complaints; the effect of any decision on the nature and volume of customer complaints; and the extent to which, if at all, HSBC might be required to take action, and the nature of any such action, in relation to non-complainants. The extent of any redress that may be required as a result of a decision to uphold PS 10/12 and the FOS Guidance, in whole or in part, would also depend on the facts and circumstances of each individual customer's case. For these reasons, among others, HSBC does not at this time consider it practicable to provide a reliable estimate or range of estimates of the potential financial impact of an adverse decision.

Pending resolution of the dispute, HSBC continues to review all complaints received which allege that PPI has been mis-sold and, where possible, seeks to resolve them. Where HSBC considers it is not in a position to reach a final decision on a complaint until the conclusion of the application for Judicial Review of PS 10/12 and the FOS Guidance and any subsequent appeals, it informs the complainant that this is the case.

In December 2007, HSBC decided to cease selling PPI products in the UK and a phased withdrawal was completed across the HSBC, first direct and M&S Money brands during 2008. During the consultation process in 2009, the FSA reported that it had obtained agreement from firms representing 40 per cent of the market for face to face single premium PPI sales to review all such sales since July 2007. No HSBC subsidiary or associate was included in that group of firms.

Notes on the Financial Statements (continued)

41 Related party transactions

The ultimate parent company of the group is HSBC Holdings plc, which is incorporated in England.

Copies of the Group financial statements may be obtained from the following address:

HSBC Holdings plc
8 Canada Square
London
E14 5HQ

The group's related parties include the parent, fellow subsidiaries, associates, joint ventures, post-employment benefit plans for HSBC employees, key management personnel, close family members of Key Management Personnel and entities which are controlled, jointly controlled or significantly influenced by Key Management Personnel or their close family members.

(a) Transactions with Directors and other Key Management Personnel

Key Management Personnel are defined as those persons having authority and responsibility for planning, directing and controlling the activities of HSBC Bank plc and the group and includes members of the Board of Directors of HSBC Bank plc and HSBC Holdings plc and Group Managing Directors of HSBC Holdings plc.

Compensation of Key Management Personnel

The following represents the compensation paid to the Key Management Personnel of the bank in exchange for services rendered to the bank.

	2010	2009
	£000	£000
Short-term employee benefits	1,651	1,900
Post-employment benefits	–	–
Termination benefits	–	–
Share-based payments	1,425	1,177
	3,076	3,077

Shareholdings and options of Directors' and other Key Management Personnel

	Balance at 31 December 2010	Balance at 31 December 2009
Number of share options from equity participation plans held by Directors and other key management personnel (and their connected persons)	688,652	1,033,662
Number of shares held by Directors and other key management personnel (and their connected persons).....	14,552,607	20,094,864

Transactions, arrangements and agreements including Directors and other Key Management Personnel

The table below set out transactions which fall to be disclosed under IAS 24 'Related Party Disclosures' between the group and the Key Management Personnel of both the bank and its parent company, HSBC Holdings plc, and their connected persons or controlled companies.

	2010		2009	
	Highest balance during the year ¹	Balance at 31 December ¹	Highest balance during the year ¹	Balance at 31 December ¹
	£000	£000	£000	£000
Key Management Personnel and connected persons and companies controlled by them				
Loans	1,217,401	700,616	877,944	453,707
Credit cards	8,798	319	3,453	224
Guarantees	19,904	17,512	20,984	19,589

¹ The disclosure of the year-end balance and the highest balance during the year is considered the most meaningful information to represent transactions during the year.

The above transactions were made in the ordinary course of business and on substantially the same terms, including interest rates and security, as for comparable transactions with persons of a similar standing or, where applicable,

Notes on the Financial Statements (continued)

with other employees. The transactions did not involve more than the normal risk of repayment or present other unfavourable features.

Transactions, arrangements and agreements including Directors (Companies Act 2006)

In addition to the requirements of IAS 24, particulars of transactions, arrangements and agreements entered into by HSBC Bank plc and its subsidiaries with Directors of HSBC Bank plc are required to be disclosed pursuant to section 413 of the Companies Act 2006. Under the Companies Act there is no requirement to disclose transactions with the Key Management Personnel of the bank's parent company, HSBC Holdings plc.

The table below sets out transactions which fall to be disclosed under section 413 of Companies Act 2006.

The group

	Balance at 31 December 2010	Balance at 31 December 2009
	£000	£000
Directors		
Loans	127,868	2,242
Credit cards	101	52
Guarantees	6	–

(b) Transactions with other related parties

Associates and joint ventures

The group

	2010		2009	
	Highest balance during the year¹	Balance at 31 December¹	Highest balance during the year ¹	Balance at 31 December ¹
	£m	£m	£m	£m
Amounts due from joint ventures – unsubordinated	208	208	170	170
Amounts due from associates – unsubordinated	45	25	45	45
Amounts due to joint ventures	8	2	12	8
Amounts due to associates	–	–	–	–

¹ The disclosure of the year-end balance and the highest balance during the year is considered the most meaningful information to represent transactions during the year.

The bank

	2010		2009	
	Highest balance during the year¹	Balance at 31 December¹	Highest balance during the year ¹	Balance at 31 December ¹
	£m	£m	£m	£m
Amounts due from joint ventures – unsubordinated	208	208	170	170
Amounts due from associates – unsubordinated	45	25	45	45
Amounts due to joint ventures	–	–	10	–
Amounts due to associates	–	–	–	–

¹ The disclosure of the year-end balance and the highest balance during the year is considered the most meaningful information to represent transactions during the year.

The above outstanding balances arose from the ordinary course of business and on substantially the same terms, including interest rates and security, as for comparable transactions with third party counterparties.

Transactions of the group with HSBC Holdings plc and fellow subsidiaries of HSBC Holdings plc

Transactions detailed below include amounts due to/from HSBC Holdings plc.

	2010		2009	
	Highest balance during the year¹	Balance at 31 December¹	Highest balance during the year ¹	Balance at 31 December ¹
	£m	£m	£m	£m
Assets				
Trading assets	567	36	53	39
Financial assets designated at fair value	26	26	28	20
Loans and advances to customers	228	–	798	102

Notes on the Financial Statements (continued)

Financial investments.....	78	74	68	63
Liabilities				
Trading liabilities.....	17	16	40	15
Deposits by banks.....	35	-	-	-
Customer accounts.....	8,693	7,318	15,020	8,693
Subordinated amounts due.....	-	-	3,047	-
Guarantees.....	-	-	-	-

		For the year ended 31 December 2010	For the year ended 31 December 2009
		£m	£m
Income Statement			
Interest income.....		1	1
Interest expense.....		81	117
Fee income.....		1	-
Dividend income.....		5	13
Trading income.....		9	5
Other operating income.....		(39)	17
General and administrative expenses.....		111	114

1 The disclosure of the year-end balance and the highest balance during the year is considered the most meaningful information to represent transactions during the year.

Transactions detailed below include amounts due to/from fellow subsidiaries of HSBC Holdings plc

	2010		2009	
	Highest balance during the year ¹ £m	Balance at the year end ¹ £m	Highest balance during the year ¹ £m	Balance at the year end ¹ £m
Assets				
Trading assets.....	9,653	5,384	8,369	4,473
Derivatives.....	360,117	14,424	30,669	11,770
Financial assets designated at fair value.....	12	11	-	-
Loans and advances to banks.....	6,832	6,150	9,881	4,093
Loans and advances to customers.....	2,758	961	3,252	1,757
Financial investments.....	6,120	5,295	7,484	5,685
Liabilities				
Trading liabilities.....	17,299	12,362	29,662	10,562
Financial liabilities designated at fair value.....	35	34	34	34
Deposits by banks.....	6,061	5,599	8,632	4,176
Customer accounts.....	2,576	1,365	1,585	952
Derivatives.....	330,808	14,784	29,022	12,218
Guarantees.....	1,171	1,171	1,009	927

1 The disclosure of the year-end balance and the highest balance during the year is considered the most meaningful information to represent transactions during the year.

		For the year ended 31 December 2010	For the year ended 31 December 2009
		£m	£m
Income Statement			
Interest income.....		141	263
Interest expense.....		99	156
Fee income.....		93	175
Fee expense.....		210	197
Trading income.....		48	42
Other operating income.....		4	13
General and administrative expenses.....		201	206

Notes on the Financial Statements (continued)

The above outstanding balances arose from the ordinary course of business and on substantially the same terms, including interest rates and security, as for comparable transactions with third party counterparties.

Transactions between HSBC Bank plc and its subsidiaries, HSBC Holdings plc and fellow subsidiaries of HSBC Holdings plc

Transactions detailed below include amounts due to/from HSBC Bank plc and its subsidiaries.

	2010		2009	
	Highest balance during the year ¹ £m	Balance at the year end ¹ £m	Highest balance during the year ¹ £m	Balance at the year end ¹ £m
Assets				
Trading assets.....	23,756	16,245	34,081	16,390
Derivatives.....	25,580	14,897	32,375	20,311
Financial assets designated at fair value.....	87	77	–	–
Loans and advances to banks.....	10,157	8,287	6,595	4,046
Loans and advances to customers.....	21,307	20,425	21,106	21,106
Financial investments.....	3,309	3,309	2,670	1,680
Liabilities				
Trading liabilities.....	21,946	9,244	18,683	14,222
Deposits by banks.....	12,918	10,906	21,560	12,918
Customer accounts.....	11,243	7,085	11,849	11,243
Derivatives.....	22,495	11,597	33,368	18,255
Subordinated amounts due.....	–	–	622	–
Guarantees.....	1,896	1,273	2,139	1,474

1 The disclosure of the year-end balance and the highest balance during the year is considered the most meaningful information to represent transactions during the year.

Transactions detailed below include amounts due to/from HSBC Bank plc and HSBC Holdings plc.

	2010		2009	
	Highest balance during the year ¹ £m	Balance at the year end ¹ £m	Highest balance during the year ¹ £m	Balance at the year end ¹ £m
Assets				
Trading assets.....	567	36	53	39
Loans and advances to customers.....	228	–	798	102
Liabilities				
Trading liabilities.....	17	16	40	15
Deposits by banks.....	35	–	–	–
Customer accounts.....	8,378	7,541	15,011	8,378
Subordinated amounts due.....	–	–	3,047	–
Guarantees.....	–	–	–	–

1 The disclosure of the year-end balance and the highest balance during the year is considered the most meaningful information to represent transactions during the year.

In December 2010, the bank received two guarantees from HSBC Holdings plc in respect of monies owing to the bank by its structured investment conduits ('SICs'). The first guarantee renewed an existing contract and covers due but unpaid monies owed by the bank's principal SIC, Solitaire, up to a maximum amount of US\$16 billion, to the extent that unpaid liabilities exceed US\$1 billion. A second guarantee covers losses on unpaid monies owed by the bank's other SICs, Mazarin, Barion and Malachite, up to a maximum amount of US\$22 billion, to the extent that unpaid liabilities exceed US\$200 million.

The bank pays no fee to its parent company for the provision of these guarantees.

Notes on the Financial Statements (continued)

Transactions detailed below include amounts due to/from HSBC Bank plc and fellow subsidiaries of HSBC

	2010		2009	
	Highest balance during the year ¹ £m	Balance at the year end ¹ £m	Highest balance during the year ¹ £m	Balance at the year end ¹ £m
Assets				
Trading assets.....	9,081	5,138	7,486	4,166
Derivatives.....	17,496	14,030	24,290	11,220
Loans and advances to banks.....	5,408	4,096	8,437	2,763
Loans and advances to customers.....	2,052	864	3,085	1,640
Liabilities				
Trading liabilities.....	16,813	11,949	27,857	10,348
Deposits by banks.....	4,798	4,351	5,130	3,585
Customer accounts.....	2,198	557	1,371	819
Derivatives.....	17,327	14,577	21,599	11,435
Guarantees.....	969	969	933	837

¹ The disclosure of the year-end balance and the highest balance during the year is considered the most meaningful information to represent transactions during the year.

The above outstanding balances arose from the ordinary course of business and on substantially the same terms, including interest rates and security, as for comparable transactions with third party counterparties.

Pension funds

At 31 December 2010, fees of £6 million (2009: £5 million) were earned by group companies for management services related to the group's pension funds held under management. The group's pension funds had placed deposits of £1,163 million (2009: £531 million) with its banking subsidiaries.

The above outstanding balances arose from the ordinary course of business and on substantially the same terms, including interest rates and security, as for comparable transactions with third party counterparties.

In the first half of 2009, a gain of £322 million was recognised by the bank following a restructuring of the basis of delivery of death in service and ill health early retirement benefits to certain UK employees. These benefits were provided by the HSBC Bank (UK) Pension Scheme (the 'Scheme') but will now be provided outside of the scheme.

The Scheme entered into swap transactions with the bank to manage the inflation and interest rate sensitivity of the liabilities. At 31 December 2010, the gross notional value of the swaps was £14,686 million (2009: £14,617 million), the swaps had a negative fair value of £1,400 million to the bank (2009: negative fair value of £647 million) and the bank had delivered collateral of £2,136 million (2009: £1,729 million) to the Scheme in respect of these swaps. All swaps were executed at prevailing market rates and within standard market bid/offer spreads.

In order to satisfy diversification requirements, the Trustee has requested special collateral provisions for the swap transactions between the bank and the Scheme. The collateral agreement stipulates that the Scheme never posts collateral to the bank. Collateral is posted to the Scheme by the bank at an amount that the Trustee is highly confident would be sufficient to replace the swaps in the event of default by the bank. Under the terms of the agreement, increases in collateral when required, are posted by the bank on a daily basis and any reductions of collateral are repaid to the bank on a monthly basis.

With the exception of the special collateral arrangements detailed above, all other aspects of the swap transactions between the bank and the Scheme are on substantially the same terms as comparable transactions with third party counterparties.

Purchase of non-controlling interests

In June 2010, the group purchased the minority interest in HSBC Europe B.V. which was owned by HSBC Holdings (Luxembourg) S.A., a direct subsidiary of HSBC Overseas Holdings (UK) Limited, for a cash consideration of £176m.

In March 2009, the group purchased the minority interests in HSBC Private Bank (Suisse) SA which was owned by HSBC Investor PBRs Corporation (Delaware), a direct subsidiary of HSBC Bank USA, National Association, for a cash consideration of £247m.

Notes on the Financial Statements (continued)

42 Events after the balance sheet date

A second interim dividend for 2010 of £915 million to shareholders of the parent company was declared by the Directors after 31 December 2010.

HSBC Bank plc

Incorporated in England with limited liability. Registered in England: number 14259

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